SOUTH CENTRAL CONNECTICUT
REGIONAL WATER AUTHORITY

PENSION & BENEFIT COMMITTEE

OCTOBER 27, 2022

MEETING TRANSCRIPTION

[PENSION & BENEFIT COMMITTEE MEEETING BEGINS AT 12:31 P.M.]

David:

Larry is back. Suzanne, it's all yours.

Suzanne:

Hey, David. Good afternoon everyone. Why don't we start with the minutes. So I'd like to get a motion to approve the minutes.

Catherine:

So moved.

Suzanne:

Thank you, Catherine. And second?

Tony:

Tony.

Suzanne:

Tony, thank you very much. Any changes, any amendments? Okay, very good. All those in favor say aye.

All:

Aye.

Suzanne:

May abstain. Let the record show all followed in favor of proving the minutes as presented. We'll move on to the quarterly investment performance review by Steve Keller, Joe McLaughlin and team, and everybody should have their Morgan Stanley quarterly investment performance review up on your screen. And Jennifer's also got it on the main screen here. So we're looking forward to seeing how the pensions are performing. So I will turn it over to Steve.

Steve:

Thank you, Suzanne. Good afternoon, everyone.

Suzanne:

Good afternoon.

Steve:

Nice to see you all. So we thought we'd spend a few minutes as we always do on a little market commentary, which I suspect will be of greater interest now than it has been in some prior meetings. So we want to give you our outlook and what's going on in the markets, which is a lot. We'll then look at the pensions themselves, the asset allocation and targets, where they're at versus their targets, and then the investment results for the quarter and the longer term periods. So why don't we jump, Jennifer, I think you're driving the presentation.

Tara:

I am. Tara. But that's okay.

Steve:

We're on slide 2 of 59 if that helps. Let's go to 4 of 59. So this slide you've all seen many times in the past. This is simply the S&P 500 at different points in history and the most notable at the moment is, obviously, the upper right hand side of this. We started this year at a level of 4797 on the S&P. If you see that in the upper right, we're at about 21.4 times earnings at that point. Interest rates were zero at that point. So we knew that never felt a little extended, but we obviously did not know how fast or when interest rates were going to rise. They obviously have risen quite a bit with the Fed raising rates multiple times this year, rather aggressively, actually. And that's caused the US domestic large cap equity market has dropped 25% since January 1st of this year.

That's the bad news. The good news is that that leaves us in a market that's just over 15 times earnings, if you see that in the upper right, but at lower point on September 30th. And interesting enough, if you take out those top 10 holdings that we've talked about a lot in the past, the broader market is closer to roughly 13 times earnings. And you'll note that in the COVID drop mark of 2020, just to the lower left of where we're at now, we were also at 13 times earnings, so it marked the last bottom. We're not predicting that this is the bottom yet, we really don't know. But what we do know is prices, both the bond market and the stock market, are priced much more reasonably now than they've been in quite some time, actually. The last time stock market was valued like this, it was the deepest point of COVID.

So a little perspective, if we jump forward, this slide's a little complex, but I'm going to not use the whole slide. Welcome you to review this. But what I am going to review is at the bottom left it says bear market, bull correction and correction in the blue section. You can see the average bear market, and a bear market is defined as a drop of 20% or more from the prior peak. We're obviously in a bear market now. We've been down as high as 26% this year. By the end of September it was down 20. As of today it's around 18. There has been some substantial improvement during the month of October, just like there was during the month of June, frankly.

So we've had a lot of volatility this year. Average bear market is 35%. We have not hit that in this current bear market. Average bear market to get back to the prior peak takes 26 months, and just moving left to right there, with a wide range of outcomes. If you went back to the financial crisis, you see it 10/19/07 to February of 09. That was four years, basically, to get back to the prior peaks.

The message in this slide is really how long does it take to get back to the prior peaks, and how quickly does something happen at the bottom. So you'll see that 3 months later, 6 months later, and a year later, I'll focus on 3 months and a year, on average when we do hit a bottom, again, not saying that we have yet, but when we do on average you're up 24% just 3 months later, and 45% 12 months later. So it's why you don't market time, it's why the portfolio is invested to match the duration of the liabilities is an inexact match. But we try to keep things in bonds 1 to 5 years, hybrids 6 to 10 years, and you really only own equities for liabilities that are 10 years or more out.

That being said, and we could keep jumping to the next one, please. In our minds, this is not a stock market problem that's going on right now. This is a bond market issue. Sure, the stock markets down 25% on this date, but historically, when stock markets fall, bonds give you some diversification impact and help dampen the results in a portfolio. The very unique thing that is happening this year is that although stock markets down 25%, and that's very common in history, the bond markets down 15, 16%, and that is unprecedented in history, never mind uncommon. So if you think about it, this slide here shows you kind of a generic investor. If you're a balance investor, as the portfolio [inaudible 00:08:30], you're 60% in equity and 40% in bonds. This is the worst 9 months we've had in modern history. So the bond index, the Barclays, now Bloomberg aggregate bond index, which is the S&P of bonds, if you will, began in January of 1976. So this data only goes back till January of 76, but that's a long term period.

And you look at the current year, a 60/40 portfolio through September is down 20.1%. If it's 60% in the S&P and 40% in the bond index. I'll pick 08 because I think it's fresh in a lot of our minds. 08 was a financial crisis. That year the stock market was down 37%, but the bond market was up and you were down 11.6. A number we would all like right about now. And you can see as you go down, there have been very few incidents in history where you've even been in double digits. Only 3 since 1976.

So we are in a painful market, but again, it's not the stock market. You think of a stock market, if you're half in the stock market, half of the bond market, stock's down 20%, that half contributes 10% down to your portfolio. But if bonds, which they typically would be are up 10%, that other half contributes 5% back. You could be in a 20% stock market, it's typical to have a portfolio only down 5%. Does that make sense to folks? The math this time is stocks are down 20%, bonds are down an additional, let's just use 10, you're down 15% suddenly because rather than bonds adding to the return, they're actually also subtracting. So this is why it is the worst start, well, nine months, in modern history where a portfolio that's balanced is down to this degree.

So let's jump to the next slide, please. So I guess my point is if it feels bad, it's because it is bad. It's a very difficult year. Let's jump right, I'm going to skip over this one. This is just where interest rates have been over time. I think that's well publicized and we all know that the Fed's been going up 75 basis points at a time.

What we may not all know is this. And this is what's really very difficult this year. This is the bond market back to the beginning of the index in 1976. And every gray bar is what the bond market has done each year. And you'll note the bar in 22 in the far right, it is an outlier event to say the least. Sure, there's been other down years in the bond market. Down 3%, down 2%, down 1%. Last year was down 2. So we are in an outlier bond event. That's the bad news. The good news is things have been repriced, commercial real estate's repricing as we speak. Private equities repricing as we speak, stocks and bonds reprice pretty much instantly.

Going forward. We could jump again, please. Give you a live example. This is not a bond you own, but this is a bond that we own in our practice in a very similar type of kind. I randomly picked one, frankly, to use for this purpose. Some of this risk is real in equities and the bond side of the risk is really more statement risk. Here's a bond issued by Citi Group, $250,000, 3.3% coupon. We purchased this bond in May of 2018 in our client base. We paid $240,185 for the bond. So we knew when we bought it would yield 3.951% from then until maturity. By January of this year, it was worth $265,000, so on the statement was showing a big gain. At that point, the yield's maturity was 1.369. By September 30th it was down to $238,000, a little bit below what we originally paid.

But bonds have facts behind them. We still know this bond matures April 27th of 25. So two and a half years from now. We still know it matures at 250 as long as Citi Group's in business and their balance sheet's quite strong. We know it pays a 3.3% coupon and we know if we hold it to maturity now, it'll yield us 5.208%. They're all facts, right? We also know that on a statement right now it's printing 10% lower than it was January 1st, but we factually know it's going to go back to 250 from the 238, and we'll get the coupon. So the nice thing about the bond side of things, although it's causing additional pain right now, is it comes with facts attached to it. They're not speculative. They're not saying, "Oh, I think the market will go up next year or the next two years." These are facts. So the bond side of things not giving us good diversification impact on a statement at the moment, but still giving us very good diversification impact in a factual, non-statement world, if you will.

So the other hidden message in this slide, maybe not so hidden, is we are also able to get much higher yields from bonds now. Much higher. And I said this at the last meeting, they're becoming quite viable. This is a two and a half year investment grade corporate bond yielding 5.2% and that was September 3rd. It's probably a little bit better today, probably a 5.3. We can buy bonds now and get anywhere 4.5% for a very short term treasury, up to 8% for preferred stock, which is considered a fixed income vehicle. So suddenly you can build out a bond portfolio that very easily has a 6% yield. Very easily. And in January I would've said that number was more like 2%.

So going forward, we will look and should look at when we look at the actuary report, what are the liabilities? That short term money, that one to five year money that in the past has been able to make 1, 2%, we'll be able to call it 5 to 6.5% moving forward. So it does allow us, for the first time, to look at it and say we think the assumed rate of returns from this point forward are likely to be higher. Exact opposite of what I was saying a year ago, right? I was a little nervous that you brought down your assumed rate of return. So it'll be interesting to look at that, as we do annually.

The next slide is, you've seen this one, but I remind you because we have an election in just a few weeks. Back to 1950, there has never been a period ever after the midterm elections, regardless of whether you're purple, blue, red, or anything in between, or your own color, where the stock market has not been up 12 months later. Doesn't mean it's going to repeat. There's also never been a global pandemic. We've never printed this much money. There's lots of factors, but it's a nice optimistic thing to look at and say it's pretty strong. I would argue that both the bond and stock markets are setting us up for this to repeat by being down a lot in advance of the election, which is not unusual in the second year of presidential cycle, frankly. It's often a down year. On average, markets have been up close to 15% 12 months later.

And finally, one more slide on this deck. I know I'm going a little deeper here than sometimes we like to, but I felt it was important today. I'd love you to leave with the message that sure, the stock market's doing its thing. Down, call it 18% right now, but the real impact on the portfolio, sure it's the stock market, but not having that buoyancy from the bond market has been a big factor this time. Our outlook, very mathematical, upper left here, bull case, base case, bear case, meaning optimistic, neutral or pessimistic. Neutral case has about a two-thirds waiting and neutrally we're saying based on what earnings should be 12 months from now, that you should get about a 9% uptick in the market over the next 12 months. And this is rolling constantly.

What I like about this case that we haven't, like sometimes when we've looked at this in the past, we think the upside to that, if the Fed's able to put in place a soft landing, and today you actually saw GDP numbers come out quite strong, I wasn't sure the market would like that because that probably means the Fed has to continue its work, but market seems to like it. And I think that market's thinking this today, Fed can put in place a soft landing, we think that could be as much as a 24% upside, as opposed to if we get a harder landing, we think the downside's about 6 or 7%. So for the first time in ages, that upside/downside capture, the 24 versus 8.8 versus 6.6 on the downside, seems like a very rational and reasonable business person's risk to take. Decent, very good upside for relatively limited downside.

We do think that it could trade below the 3350 in the meantime, if earnings were to come in poorly. But that is not happening in the current quarter. We think it could happen in one of these quarters relatively soon. Maybe it happens in the quarter we're in now when the earnings come out 90 days from now. But we do think if we hit that bottom, it's going to be very quick, very quick and lightning fast off of it. So we're not suggesting that we've hit the bottom yet. We fully expected the market to rally right around when it did, as it's doing during the month of October, and that it's doing so for lots of reasons.

But one of the reasons we thought it would rally so abruptly, it's up almost 8% just for the month, is that it was so oversold. Like no buyers, just all sellers. And that switched on a dime and we saw it switch on a dime again back in June, also. Questions, comments, concerns, make sense?

Suzanne:

Yeah, let's keep moving with the pension and the impact to the pension and then we'll come back I think with some questions. If that's okay with everybody.

Steve:

Okay, let's roll right to the next section then, which I'm going to go to the pie chart. So the pie chart, this first pie chart is the salary and union plans. And what you see here as of September 30th in the upper center there was $60,078,000 in those two pensions. Their weightings were per the pie chart, or as most of you know, I like using this little box on the right, just between 54.57% in equity at that time. And I'll show you where that stands versus target. About three quarters of that equity's still domestic and a little less than a quarter in international. We do think the dollar being so strong creates better opportunities for having exposure internationally, because you'd rather be bringing in dollars if you're European than bringing in euros if you're dollar based, if that makes sense. Just as an example.

And your tilt at the bottom of that box, almost even between value and growth. So that's a lot more value oriented than the underlying indices are. And that helped the results. The results are difficult at this time, but they're quite a bit better than the benchmarks, as you'll see.

Let's jump to the matrix on the next page, please. So where you invested versus benchmark. Close to target on Russell 3000 Broad US stock market, almost at target 0.21% below. Internationally, we're about 2.63% below. We are overweight in bonds right now because we're underweight in global bonds, underweight in alternatives, underweight in real estate and a little underweight in cash. So that it looks like a big overweight, but the reality is we've been able to buy some short term treasuries getting 4, 4.5%. So why leave it sitting in any cash at the moment when we can get very good return from cash equivalents, if you will.

If we look at the VEBA on the next pie chart, relatively similar. 55% in equity, 55, 44 with all of those other underlying ratios looking quite similar. Value, 7,909,000 at the end of the quarter, upper center.

And we look at the VEBA matrix, if you will. You're seeing slight overweight to US equities, same underweight to foreign equities, and same overweight to bonds, and underweights to the other asset classes that you've seen in the two pensions.

So if we jump two more in and get right to where the pain is in the funds, so this is the third quarter. So when we spoke 90 days ago, I'm going to the upper left here on the spreadsheet, top half of the page, there was $72,144,228 in the different pools of money. During the quarter, you had net withdrawals of

$97,530. Transfers are just funding matrix trust, basically. So that gives you a starting value, if you will, from 90 days ago, $72,016,000 down to $68,618,000 at the September 30th number. $3,397,000 down for the quarter. 4.78% net and 4.69% gross.

Obviously, in years like this, there's no way we're making the actuary rate of return, but we are rather substantially beating the benchmarks, especially the strategic benchmark is down 526 and I always like looking at the equal weighted equity benchmark, and that's down 540. So about not quite a hundred basis points of improvement over that for the quarter. But regardless, there's pain.

One thing I should state is the actuaries, the rising interest rates can help the funding of pensions, too. So this would be Jeff Bauer after the year is over. But you remember this is a seesaw. Rates go up, pension liabilities go down. So it's an odd year. Markets are down substantially. The funded status of the plan will be down less substantially, if that makes sense. Because when rates go up, the actuaries are able to use a higher rate and thus, if a participant was eligible to take a lump sum, the lump sum actually becomes smaller when rates rise. So your funded status goes up because rates rise, goes down when the equity market's down. We don't know the math yet on this, but it's going to be interesting because a pretty substantial down year for the asset values, but a very substantial up year for interest rates. And it will dampen the impact of what you see here.

Let's jump to next slide please. Did you have a question, David? Year to date, again, math left to right, starting in the upper left on the top half of the page. January 1st, there was $84,006,000 in the plan. Net withdrawals just $69,000, so very slight net withdrawals. So thus your net invested 83,937,000. Ending value, same as you've seen 68,618,000. So it's a big number this year, down 15.3 million. Could be since we just added the quarter on top of that. 1839 net of costs, and 1817 before. Percentage wise, again, no way making the actuary rate of return this year, but again, rather substantially beating the benchmark itself. The investment benchmark is down 2035 for the strategic. Equally weighted a bit better, and we have equal weighting so that helped us, down 1869. But from a benchmarking perspective, it looks quite strong.

We go up further, fiscal year I think is next. Yep, fiscal year. I won't read you all the numbers if you want to, but let's go to the percentages on the right and the dollar amount. Since the fiscal year started down almost 7.4 million, 7.394, 982 net, 971 gross. Again, not going to beat the actuary rate of returns without a complete miracle this year, but nicely meeting the benchmarks which are down 10.5 And 1104 for the midpoints. We're much closer to the least equity risk one, which we're not positioned in, it's just because we have more value and that is doing better.

If we jump ahead and go out a little longer now. And here's what happens. We've seen this before. We went through this in, I think it was 18, we went through this. When we start to be down substantially in one year, it hurts the longer term numbers. This is trailing 12 months. So this runs last September until this September, October 1st until September 30th. Again, I'll go to the right in the interest of time. Ending value, $68,618,000. You've seen $11,745,000 down in the last 12 months. That equates to 1476 net, 14 gross. Same story. There's real strategic benchmarks down 1710. So actually the improvement there gets even more substantial over the benchmark. Still very painful because it's not making its primary benchmark, which is the actuary rate of return right now.

So we start to go out a little longer on the next slide. Over the last three years, these returns were looking wonderful before this year started. There's still a gain over three years. $3,636,000 in the upper half of the page on third column from the right. It only nets at 174% a year now, or 210 gross. Again, that benchmarks well, the midpoints at 191 and 190, but it's obviously not as robust as it needs to be to meet those actuary returns.

So we go out five years now on the next slide and it improves a bit, but obviously when you take off 18% in one year, it's taking off, think about that, that takes 6% off the three year returns, and I can't do the math that quickly over the five years, but it brings the numbers down. Last five years, the plans have now earned $10,290,000. 326 net, 364 gross. Again, same message is in place. Beating the investment benchmarks, not quite at the actuary benchmarks. It starts to look a lot better when we go out further.

Six years, your return is almost $16,000,000. 460 net, 499 gross. Same story, still not at the actuary return, but getting a lot closer even with the current damage. And for the first time, I believe this is the first time, if we go one more page, we have a seven year return now. So over seven years, the funds have made almost $20,000,000, $19,833,000. This is obviously at a very bottom on September 30th. So the net return becomes 527 net, 567 gross. Again, the benchmarking is 544 and 519, so that narrowed. We had a lot of out performance in this down market. We had a little under performance in the upmarket. That's somewhat of our hallmark. But as you have time, you come in closer to it with less, believe it or not, this is less volatile in the benchmarks, what we're going through right now.

So still a little more than, like it's a point and a half net below the 675 that we need to be earning. And that is at the dead bottom, so that's not shocking to me. And you can see what happens. The three year numbers are very impacted, the five year numbers are less so. You get to seven years, it's even less so. And on the upside, it will be the same thing though. The short numbers will move faster up, the long numbers will move slower up. But we're confident that, especially with a market selling at 13 times earnings now, with interest rates having gone up as much as they've gone up, I'm more confident than I was in January that you could actually earn the 675 rate of return on a forward looking basis now. But it's always very difficult to look at it at the dead bottom.

We could jump to the next slide and maybe pause for one minute. One question we're getting a lot is how does this bear market compared to others that we've seen in history and others that we've been through? I'll give you a few thoughts on that. And I was asked the question, what's the worst bear market you've been through? And I said, "Well, the obviously answer to that in our lifetimes was 9/11." You had absolute chaos, you had so many unknowns. Were we going to war? How long was this going to last? Who caused it? Stock market literally closed, obviously we're all sitting at home with no access to anything. The trading was shut down, and that's a definition of chaos.

And you could think to the financial crisis of 08 and 09, where the market fell 37% in 08, and it topped out at, I think it was a 57% loss by the time you hit March of 09. That was also utter chaos. Banking system collapsing, on Fridays, wondering if the financial industry is going to still be intact, and our own firm still be intact on Monday.

We saw Lehman fail, we saw AIG fail, we saw lots of failures. We saw Bear Stearns get eaten up by JP Morgan, et cetera. It was a crazy period. All we worried about then was having money safe from Friday until Monday. That was chaos and the 29s, chaos. But this is not chaos. This is helping me sleep at night during this one. The dollar amounts certainly aren't, those are keeping me up. Equity market keeps me up a little bit, but the bond market doesn't know.

But when you look at it, go, this is not chaos. This is a mechanical, orchestrated, deliberate act by the Fed to slow down this economy, being forced by the fact that we've printed so much money during COVID, and we had to print a lot of it. That Fed was at 0% interest rates. Congress and the White House were doing bills regularly from all the way back to March of 2020.

So this is a purposeful reduction of all that stimulus. So it does have an end, and the end is known. So the end of this, and when will this market actually rally, is probably the moment we begin to see inflation numbers. And you're seeing them, they're heading in the right direction. It's the moment you begin to see them get closer to their destination. Like not 0.4% a month, which we've been running, it was 8 and 9%. Those numbers are behind us. If you look at the current numbers and multiply it by 12, you'd say, well, we're still running maybe at 5. We are seeing them come down.

And when the Fed even says something that, look it, we're going to go another 75 basis points, which we really believe they will at this next meeting, maybe they do it a few times. Ultimately, you see it. I see it. There's damage being done in the economy. And that's the goal. It's kind of an interesting goal. But the goal is to increase the unemployment rate. The goal is to decrease the inflation rate. The goal is to slow down things like stock market housing, et cetera. The minute the Fed hints they're going to take a breather, obviously, I can't predict the markets, but it's high likelihood at that point is that marks the bottom of this market.

So unlike other bear markets, it has an end. The end is likely within the next, I'm going to go with six months as educated guess. Maybe sooner. But when the end comes, I think we'll be back to normal and the returns will get back, they'll slowly lift back to where they need to be. What's happened in the bond market is absolutely a tailwind to funds like this because we can earn 5, 6, even 7, 8% from preferred's going forward. I'll take a breather there. You've probably said, "Okay, Steve, that's a lot of information in 31 minutes."

Suzanne:

Well, thank you for all that. Clearly, you're having a lot of disappointing conversations with people and it's got to be very taxing. We appreciate your honesty, we appreciate all the smarts you have about the market commentary and the impact of the fixed income market, as well. Are there any questions from the group?

David:

I actually-

Catherine:

Go ahead, David.

David:

Catherine, you go first. Ladies first.

Catherine:

Well, thank you. Such a gentleman. Actually, you sort of answered my primary question, which was how does this effect the funded ratio, or funded status of the pension funds? And kind of answered that. And I know we've got to wait for those numbers, but you gave me a little bit of comfort.

Steve:

Well, and don't forget the actuaries also do something, Catherine, that's called smoothing. So the actuaries don't look at any one. Remember last year was really good and I don't remember exactly, I think they go three years. In my side of the street, we have to live in the world where you make 20%, you're down 20%. The actuaries don't live in that world. So in addition to the higher rates that help the funded status, they smooth the returns.

Speaker 2:

We're going to get into that a little bit when we do the model later on in the day.

Suzanne:

Okay, great. And so Rochelle, when will we know-

Suzanne:

Okay, so Rochelle, when will we know from both the actuary and what's going on, how this is impacting funding status?

Rochelle:

We do know, I was going to get into it with a model, but the change in our level contribution will be, and we're also working on some additional analysis.

Suzanne:

Okay, okay. All right, thank you for that. All right any other questions? David?

David:

Just a question and a thought. We were fairly close to a hundred percent funded, we were in very good shape, especially compared to most other governmental entities that have pension funds. What difference does that make with us? Should we be more worried because we were closer to a hundred percent and we lost so much more? Should we be less worried because we aren't going to run short on money? What's your thoughts with regard to how we should react to this versus what some of the other governmental entities are having when they're in 50% and 60% funded?

Steve:

You are in better shape when this started, you will be in better shape when it's over, that that hasn't changed. It may not be close to a hundred, let's call it 90. I don't know what the number is obviously because that's actuary's job. But if somebody was at 50, they're probably going to be at 40. It's going to be a relative number, if a hundred went to 90 50, probably went to 40, maybe worse because I will say this, when someone's highly underfunded, they often go more to equities to try and make up the difference.

When somebody gets closer to fully funded, like you, they often go to more fixed income. We've taken an approach here that's neither of those and is somewhat agnostic to the fund of status. Meaning we've taken the approach of what are the liabilities in the next five years, what are the liabilities in the second five years? What are the liabilities beyond 10 years, and thus have the equity exposure in your accounts is all for liabilities that are 10 years or greater. That gives me great comfort on the equity side. And the bonds are for liabilities in the shorter term and it's those shorter term liabilities that when they're paid out that they do have a... There's a beneficial impact to higher rates, if that just made sense.

David:

Well it did and the fact that we're 40% and 40% means that we're not as aggressive as some of the ones that are behind. So it may be soften the blow a little bit.

Steve:

Correct, you're going to look it, when the numbers come out this year, they're going to be... meaning when you read the database of numbers of pension results, they're going to be all over the place, right? They're going to be some pensions, so frozen pensions, if you weren't still accruing a benefit, pensions often go to an LDI, a full LDI like Liability Driven Investment. So those assets go heavily to bonds because there's no future liabilities accruing. So you've freezed the plan if you will. You won't earn 6.75% doing that. So it's a very expensive thing to do, right, because at the time you probably would've earned 3% or 4% if you were doing that a year ago. But when you're fully funded in frozen, that's a typical approach. So those funds will look much better when you see the results from this year and I'm going to suggest that in our likelihood, the more underfunded plans are actually going to look worse. You're in the middle somewhere.

You have a balanced approach with some equities, some fixed, I think you'll probably be close to the mean of all yet since we're not all indexed and we do own some individual bonds here. Your returns, although they're very painful, if anything keeps me up at night... Thank you Susan. It is a client emotions reactions our own. We try to keep in check, right? Look at the facts, but if anything, I think you're probably on the better side of that median because we weren't down as much as the benchmarks are and that helps a little bit at least.

But I would not change your strategy one bit. It's not naive optimism. I'm not saying we're right at bottom, but we're certainly 25% lower than we were and bonds we've never in history seen bonds down 16%. So that's pretty unique opportunity in my mind that boy, we can buy... I will tell you this, we are in many cases moving, we're not doing it yet, but we're planning on taking a bit more fixed income exposure if this rally in the equity market continues because we can knowingly get, let's call it 6% from a little bit longer corporate bond portfolio, that gets us a long way to your 6,75%, right? And so the luxury here forward, not back... There's no luxury looking backwards for the last nine months, but the luxury looking forward is Equities don't need to do as much heavy lifting. When we run those forward looking, that we do once a year, the forward looking return expectations, they will be higher than they were a year ago.

David:

Well and that ties in and I know Suzanne, I'm sorry to keep going on, but Rochelle, you are going to talk about whether there should be a consideration of a larger investment into this fund over and above whatever the actuarial will tell us to keep in the two year or maybe expand however many years, we had left to get to the hundred percent. Maybe that's part of the conversation we could have now because I don't think that's something that I'd like to hear Steve's take on that, if you would.

Steve:

I would love you to put more money in while things are down. That's logic, A and B, I would strongly consider putting more money into fixed while things are down. Because look at Equities have been down 25% many times in history, Fixed has never been down 15 or 16. It's pretty interesting opportunity set and it has facts tied to it. We can go buy an investment grade corporate, easily get a 5.5%, get a 6% return. So it's guaranteed by the issuer obviously like My City group example, but they're strong issuers. So look, I love that because you give us a goal of getting to 6,75. We structure the portfolio and not so much around that but around your liability stream. Before we do that, David, I would suggest we once again look at the liability stream, like the data that we get from Angel to say what will be paid out in each year.

They give us the whole series of years, we group it into 0 to 5, 5 to 10, 10 and above. But I think we look at that and then have a stronger inclination to fund up to 10 years even, in fixed income. These breaks may not stay this high for long, right? History says they'll go really high and then the federal will overshoot and they'll come back down pretty quickly but we could lock them in

David:

Lots of ways to put our money.

Steve:

So you probably can tell this... When there's a chaos and randomness, we're all humans, you can't know the end. This is a little different. Doesn't make the returns better, but it makes the opportunity set more known I would call it.

Suzanne:

What are the questions does everybody have? So I have a couple of questions for you Steve. So first off, let's see, one of my observations in listening to the conversation is that the whole issue of non-correlated assets are not performing the way they normally would, right? Your stock market goes down, your fixed income's not going up.

Steve:

Yep.

Suzanne:

So did you think it would or did Morgan Stanley think it would?

Steve:

It has in all of history, so I would say to some degree, yes. However, to some degree we knew not... To some degree, we knew rates were very low. So part of the out-performance, if we kept the bond side shorter than we would otherwise keep it. So the out-performance benchmarking is heavily because of that, right? It's because we have a little less tilt to growth than the index and shorter bond maturity is on average if that's making sense. So we expected rates to go higher, not at the speed they have gone. And if they went just as high as they've gone, but it happened over two years, the impact will be vastly less than having it in such a condensed period of time. So we were positioned for rates to go up, no question, not at the speed. If you knew rates were going to go up to speed, you'd put all your bonds in cash, but virtually you would never do that because they're really set up to defeat the liabilities, is that make sense?

Suzanne:

Yeah, it makes sense and it feels like we're just on the tail of the dog going for the ride in terms of very unexpected interest rate climb, et cetera. But it feels also like we're using, and I'm not just saying you and we or WA, it feels like the whole world is using old investment tools to solve common and unexpected investment climate. And so I don't really know what else to say about that except that it just feels like we have very little in our toolbox to deal with what's going on.

Steve:

The only thing in the toolbox to really deal with it, and this has also helped a little bit and it's also been a wide range of outcomes right now, but is a lower risk alternative space. Like Hedge Funds, not so much private equity because that's devaluing also, it just has a delayed reaction. The only space that we're in right now that has added actual positive returns this year is the Hedge Fund space. Again, lower risk Hedge Fund alternatives. Some of them, like Millennium has been running, I don't know what it's up here today, but it's a good number but it's been running in the 10% a year range, very difficult to get into. It's currently close to new investors again but it opens periodically. We own a fund called Shaun Feld. It's up fractionally this year, but up fractionally this year is a home run, right? Those are illiquid, we've talked about it before. They have unknown risks, they're contemporary. There's also the range of outcomes this year is, some of them are down 70%, right? All those are-

Suzanne:

They use... I'm sorry to interrupt you, but are they using some investment philosophy or tools that are different or are they lucky?

Steve:

Oh no, I think the ones that are down 70% are unlucky and they probably were lucky the year before. But the ones that are steady, the ones that earn... You're looking for returns and the 7% to 9% range over time would work for you guys for your fund. Excuse me, and those are using trading tools for the most part. So they're very tax inefficient, which does not matter here. They're expensive, which I know does matter to some of the committee but those returns are net and there's a few, the ones I gave you as an example, that and there's more obviously, but that have low volatility, low correlation stocks, low correlation to bonds and very respectable returns. They're not guaranteed, obviously like nothing is in this world, but they have proven their correlation coefficients are low, multiple times and particularly right now. They are expensive relative to the rest of the world, there's no question.

Suzanne:

And so, one of the other things you mentioned in the stock portfolio is the value driven equities have softened the blow if you were in fact invested in the values. So share with the group what those kind of stocks look like.

Steve:

So I'm going to give you a super basic example, I think. Your portfolio owns VTI. So that's the Vanguard Total Stock Market Index, right? Extraordinarily inexpensive market cap weighted, so it owns the biggest companies to the larger prices and the smaller companies are smaller. By doing that, you entered the year knowingly, and this is actually partly why we offset it, so we did offsets in bonds, in offsets and stocks knowing valuations were high, but you never know when they're going to change. That index is currently selling and we're selling at 21.6 times earnings. It's now selling at 15. We sell that number. We also own an equal weighted version of the S and P. So if I had $500 to invest, we put a dollar in each of those 500 stocks that by definition becomes more value oriented.

That by definition is 13 times earnings and was about 18 and not, it never hit 21. So it's more value oriented by definition. We own both of them and we have them in a ratio that over time reduces the risk and it's happening this year, whether you a Columbia dividend that owns pure dividend yielding stocks. So the only thing that's working this year from a sector perspective is energy. And it's traditional. and so it's not ESG friendly because it's the Exxon Mobils and Chevrons or the pipelines of the world. Those stocks are through the roof. But most tech stocks are... Tech stocks you're talking down 35, 40% this year. But those deep value stocks like the Exxons and Chevrons of the world have been what's working and that's what would be owned more heavily in the equal weighted index. More heavily in a Columbia dividend for example and very light in a standard index.

Suzanne:

And are the big dividend payers benefiting also or because they've lost so much value, the dividend is offsetting it.

Steve:

No, the big dividend payers are doing better than the underlying market, but they're still down double digits, on average. So you're not avoiding it, you're mitigating. Kind of like we on a vanguard value index, it's mitigated it, but it is not eliminated it. But the mitigation is good. The reason you get the little performance are all these little tweaks, all these little tweaks we're talking about, like having a little more value, having shorter term bonds, all those little tweaks are helping on the edges, but they would be big vets to make in mass. So we have a good size mission in Vanguard dividend value, I'm just looking at it right now.

It's a big mitigating factor as to why we're down less. As a matter of fact, we have virtually the same amount in that as we do in the broad index. So makes a substantial difference. And we have about half that amount in the equal weighted index. So by moving away from those tech stocks, which is what we're trying to do in this current positioning, its helped but if we ever did it to... Here's the hard part of what we do for a living and what you're doing here, but if we move completely away from it, the risk is that like last year, we'd miss a big chunk of the upside

Suzanne:

Right, and hindsight's an exact science, right?

Steve:

Yeah, so when you see things like you started at the beginning of the year, you own more value and that's how we enter the year. You own shorter term bonds and that's how we enter the year and it gains a percentage or two over the benchmark, but it's not nirvana where you're all of a sudden at 0 when everyone else is down 20.

Suzanne:

Understood, but as you know, the climb back up, every point that we don't have to climb back up can be advantage. So even though we may be optimistic about what's to come in the market or interest rates or whatever, to make up the loss is significant. It's a very significant climb.

Steve:

Yeah, it's likely to be a couple year climb.

Suzanne:

Yeah, yeah. So last question is treasuries. You said you were taking advantage of some treasuries. How do we pay for treasuries? Do we pay for them inside of fund? Are you buying them and they're transactional?

Steve:

We don't charge any transactional fees. So we buy them like we buy a corporate, right? So our fee is our fee when we're buying a treasury, which is we're buying it outright. And here we own more governments like Federal Farm credit, Federal Home Loan Bank. There's been a little bit of edge on yield there, Tennessee Valley Authority but we also own outright US treasuries.

But we don't charge any transaction fees, everything's just done as an agent, not a principal. And that's the base Morgan Stanley fee. So they're stripped in net. They are the yields. We can buy a treasury. If I look right now, I'll give you a number, just live example might be good. If we were to go and buy... Give me one second here. Let's say we went right now and bought a one year US treasury, just for example, that one year US treasury, right the second's paying 4.514. I would expect if we would go buy it right now, we would get 4.514 or a basis point above or below, is that precise and there's no cost to do it other than what you pay us.

Suzanne:

Right, okay, thank you. Any other questions from anybody? Anything else Steve, from you or your team?

Steve:

I guess I'd ask the question, we've done this in the past, we've never made a big move in that direction. I don't want to say there was resistance to it, there wasn't but it might be worth looking at again, I'm seeing if there's an [inaudible 00:51:27] Would you want us in a future meeting to spend a little time talking about those non correlated Hedge Fund type assets? Again,

Suzanne:

I would like the group to comment. I mean, I don't know is the answer. If you think it's worth our time, my experience with hedge funds and private equity is it varies, right? And this might be impossible. But what I'm hoping for is to find some strategies that can deal with what's going on today, and locking into something that hedge fund where we're locked in and that may or may not be as adaptable and nimble as we need it to be. I don't know. The answer is, I don't know.

Steve:

So let me add one more. Do we have another minute? I'm going to add one more thing because there's something that you own that we are using to do this and we've done this a few times this calendar year. So JP Morgan has a series of hedged equity funds, not hedge funds, they are equity mutual funds, institutional that are hedged and a new version comes out every 30 days, once a month. And the way they work, and I just looked one of the accounts has a million dollars in one right now that we just purchased as recently as, when did we buy this... This month, October 4th, we purchased a version. So when they come out, we don't necessarily own these strategically. This is very tactical for us at the moment and this has been helping a bit too because we've done this a few times this year.

Where they're issued, So let's say it's issued October 1st, that would be series one I believe. So they're issued October 1st. You know a few facts, you know that over the next 90 days, you're maximum downside is 5%, the S and P falls 20%, you fall five, I'm oversimplifying it. It's really collared. So if the S and P then starts falls 15% or more you participate, once it's down 5, now it goes down 15% more, you participate, so the 21st percent on you're participating fully. So you're collared out, you can only follow 5% and then between 5 and 20 you don't fall at all. What's happened that's unique year, I don't ever remember it happening, has happened a few times. We did this, I want to say in May and we just did it again in October. They're priced for the quarter. There's an opportunity set in here and because you're not taxable and this pool isn't taxable, it's actually very interesting.

Markets down 5%, funds down 5% and it's only October, whatever I just said, fourth or fifth, we can buy that with no further downside unless the market falls on additional 15. But almost all of the upside on the first 10, 12%. Pretty interesting opportunity set which only happens if the market falls a lot in a short time. So twice this year and this has helped, these are all edges. You pick up basis points as you said, it's hard. That's how you picked up, I want to say 200 basis points in the last 12 months over the index because we're doing these things tactically, you don't talk about them a lot, but because this is a new one, but we're putting a million or two in these things. We say yeah, there's a little downside. The downside's fractional, like less than a percent and the upside let's say is 10%.This is a good opportunity set, right? So we're in that. Your fund is partially in that right now. So that's a tactical non-hedge fund vehicle that hedges within a mutual fund structure that really, I don't normally buy it, but when we're down 5% already for the quarter, it's why not. So we are doing things like that. We just haven't done them in a huge enough scale.

This is the problem with these tough markets and this is the problem with hedge funds. You're going in a hedge fund, you're nervous, you can't look inside of it very easily. We all know periodically something blows up in one of them. The visibility is bad. The nice thing with the JP Morgan fund is it is a publicly traded mutual fund. The visibility is high but again, am I going to start January 1st with all your equities in that? No, by no means, but I think again, it's picking up basis points all around the edges add up. And it's same thing on the upside, hopefully, right? Because we're still position... What that does to me, it limited downside, but it leaves us very well positioned for the upside. Look at the first, let's say 10% and after that we'll get half. So it's pretty interesting.

Suzanne:

And really for me, that's where you can add the most value, is you're on the ground able to see that, take advantage of those opportunities. You understand what our liabilities are. So you don't want to go crazy, but I do believe that those edges make a difference over time so.

Steve:

Oh no doubt, right? Yeah, I agree with you a hundred percent. And look it, do I wish the edges were a little bigger right now? Of course. I'm looking at the 12 months again, you're down 1445, your benchmarks down, the mid one's down 1710, that's two and a half, 250 basis points of edge in 12 months. It's big in the world I live in, it's still a relative game but that's big. So you say we're outperforming our benchmark by 250 basis points is a lot. Because I know we worry about fees and we worry about them too, but suddenly, I don't know what the fee is 30 something basis points, we just earn almost like eight years worth of fee in 12 months over if it was indexed. It's pretty powerful. It's going to be hard to do that on the downside and the upside, but that's the goal. That's why I'm using JP Morgan a bit where we have that in there where we can get the upside without more downside on that slice of asset.

Suzanne:

Right, right.

Steve:

But I'll leave you with this again, it feels bad because it is bad. This is the worst year for a diversified investor. Basically, I was looking at a study, it looks like it's since World War I that the bond market was [inaudible 00:57:38] bad, World War I, right? So we're in an outlier event here. You saw it on the bond slide. Yeah, I'll leave you with that. It feels bad because it is and sure-

Suzanne:

It is but we've also think the diversified investor has been giving up performance for years now, right? Because of the low end on the fixed income and the very unexpected way that it's been performing and now it's just clobbered us so.

Steve:

Oh, I would argue though, I'd go with this though. Remember the bond market's down 15, this dog marks down 25. So there wasn't no diversification in effect and we're on the short end of the bond market for a lot of it. So that's more like down 10. So it's still [inaudible 00:58:21] impact, not it's not reversing the return. We all have a 20% down stock market and we're only down five, beautiful. That's what should happen. That's what I think will happen from here out because the one thing I left out, because bonds have a higher yield now, they have a shorter duration, right? Because you're starting what's to say, a 6% coupon. You're like great, Walmart market is down 6%, I end up even. So if Fed do the same thing from this moment forward, bonds will go down less, a lot less.

But I agree with you then. But if we're not diversified, we'd be down. If we were all equities, we'd be down 25% right now if not worse. If you had tech exposure, you're down worse. If you're all fixed and you were in the fixed index, you're down, call it 16. And most people get... Look at oh 809, if you're non diversified in all equities, you down 57%. Most entities just can't hang on.

Suzanne:

Yeah, I'm not arguing for non diversification, it's just saying that old investment theory seems to be really having a hard time making a difference in this.

Steve:

I agree with you, although I'm going to go with this that I believe old investment theory with rates this high is going to be back in vogue because when's the last time we could get 6% safely? Pretty interesting.

Suzanne:

Yeah, yeah.

Steve:

That helps it. Doesn't help it looking backwards, but it helps it a lot looking forward.

Suzanne:

Yes, it makes it very simple.

Steve:

I mean we could get to a world... It's possible if The Fed keeps doing this, it would be a bad situation because it means inflation's running away. It's not out of the realm of possibilities that we could go buy solid bonds and get 6.75%.

Suzanne:

Right.

Steve:

Right? Think about this, mortgages being issued today for the average American hit seven last week. We go buy those mortgages in your portfolio, I'll give you these double line to do that. That means on their new paper they're getting seven in some tranches.

Suzanne:

So it would be good for pension investment and bad for everything else.

Steve:

Pretty much, that's actually very true actually.

Suzanne:

Okay, so any other questions? All right, listen, thank you very much. We always appreciate the hard work that you put into helping us, give it a perspective and a context so that we do not cry in our suit for the rest of the meeting. But we'll look forward to more conversation with Rochelle about funding status and what we need to do to contribute and we hear that you would like to have some money to put it to work in a market that there's opportunity.

Steve:

No doubt and please keep you in the loop on that. I appreciate you very much. We go through good times together. We go through difficult times together, this is the most difficult time I think we've been together so far and it is but it will pass.

Suzanne:

Yeah, thank you.

Steve:

Thank you so much, enjoy the rest of your day everybody.

Suzanne:

Thank you Joe.

David:

[inaudible 01:01:32] Steve [inaudible 01:01:33]

Speaker 3:

Suzanne, thank you for leading that discussion. It helped me to go from place to place. I appreciate it.

Suzanne:

Sure, sure. Just talking sort of with these guys gone, the real challenge really is, I said it sort of as plainly as I could, is that these guys are all set up to do very classic approaches in a very disrupted set of investment parameters right now. And so the most disheartening part of this message was to look at six year and seven year returns and that we're not making our actuarial returns over that time. That's just because you can make up a lot of different things, but when over the long term, we've invested in excess a $100 000 a year to pay for services, we've put all our money in, we've put all our excess contributions in and we still aren't making the benchmark at the end of the day. That's really disheartening.

I don't have any quick answers for us about that. One of the things I did say to David, and this is not because I blame these guys, but I do think that every five years the Pension and Benefit Committee should go out to the world and do a RFP about utilizing different folks for investing because people don't all do it the same, don't have all the same cost structures, et cetera, et cetera.

I have no complaints about these guys, it's just that they're definitely using what everybody uses and everybody is just suffering at this point and so are there money managers out there who are able to anticipate or work in a slightly different way that still manages our risk management profile? Unsure, don't know. Anyway, any other comments or questions from anybody? Okay-

Catherine:

The only thing I would say, I'm just going to jump in. I completely agree with you on it. It does make sense to do an RFP periodically for these types of services. You probably are going to find that everybody's doing the same thing, but it's still makes sense to ask the question.

Suzanne:

Thank you Catherine, it does. When I was on my undergraduate pension, not pension foundation board and we went ahead and did that, we brought in seven different groups and I would say there were really four fundamentally very different approaches to the way they did it. And it ranged widely in expense and widely in how they would manage the money. And what it did is it confirmed that we were with the right group, we stayed with the group that we wanted once we had all that information. But it was quite educational and informative in a way to feel good about, even though we're not doing as well as we'd like to, this is really the right place to be doing it. So that too can be beneficial, right? It's not that you actually end up making a change.

Catherine:

I agree.

Suzanne:

All right, so that is all that's on our committee agenda. Is there anything else from anybody else related to this topic? Okay, very good. Then I guess I will get a motion to adjourn as-

David:

Before you do it. I just had a thought after you spoke as chairman and Catherine Echo that, could agree by consensus as a committee then that Suzanne, we'd want you to work with management, which I assume would be with Rochelle or maybe even with Larry, to begin the process of seeing what it would be and where what the process is. Go and get an RFP and get something ready.

Suzanne:

You know what, I would actually take a step before that. I would take... So it doesn't feel like we're reacting to poor performance is that I would say that you'd want to think about and or implement as a part of our guidelines or makeup of the committee that every so often we automatically do this so that it puts us in a-

Suzanne:

Every so often we automatically do this, so that it puts us in a process and so we could be up 40% and we're still going through the process because it's our discipline to do that. So, rather than feeling like... Because if you go back to Steve, because Steve will absolutely need to be able to compete. So, when you go back to him and tell him this is what you're doing, he's going to feel like, for sure this is because we have all this bad news. And that's not the message. The message is really about what is out there on a consistent basis. So, it's just like my Board of Education. Every five years we're supposed to do an RFP for legal services. It just that, don't get into bed with one person forever and not see what's out there for services for the board. So, it's the same thing. So, I would say, I guess we have, I don't know what they're called the- [inaudible 01:06:55]

David:

Well, the charters that we review in the spring.

Suzanne:

The charters. Yes.

David:

Yeah. That we review in the spring. So, next spring when we review your charter, this committee's charter, we will consider approving a plan to have a five year review.

Suzanne:

That's how I would approach it, but I'm very open to whatever the committee feels.

David:

Okay. All right. Because I know the RPB has a five year review of the auditors and it's standard in certain aspects of professional business and...

Suzanne:

Yeah, and ethics. Because again, if me and Steve were like this, you want to just have that process turn over all the time.

David:

Yeah. I don't think we think that, but anyway.

Suzanne:

No, I don't think Steve thinks that either, but that's okay. He's doing his job. He's doing his job.

David:

Good. All right.

Suzanne:

Then I'll adjourn as the Pension and Benefit Committee. I'll take a motion to adjourn.

Tony:

So moved.

Suzanne:

Thank you, Tony.

Catherine:

Second.

Suzanne:

Second. Thank you, Catherine. All those in favor?

Group:

Aye.

Suzanne:

Any opposed or abstain? Okay. The record shows we have just adjourned as the Pension and Benefits Committee. I'll turn it back to you, David.

[PENSION & BENEFIT COMMITTEE MEETING ADJOURS AT 1:38 P.M.]