ANNUAL REPORT – 2018

The Kent County Pension Review Committee's Annual Report to Kent County Levy Court - February 21, 2019

Purpose and Structure

The Kent County Pension Review Committee was established in 1993 by Kent County Levy Court "to regularly review the investment performance of the Kent County Employee's Pension Fund, the Retiree Benefits Trust Fund, and other such funds as directed by Levy Court. The Committee oversees fund valuation processes, ensures compliance with applicable pension, OPEB, or other such funds rules and regulations, directs studies and fund manager searches, as necessary, and as a result makes prudent recommendations and reports to the Levy Court of Kent County regarding plan amendments, investment policies, investment strategies, professional fund manager(s) or trustee(s), investment advisor(s), etc."

The Committee includes four (4) citizens from the community with pension, investment, legal, or financial experience, the Kent County Administrator (by virtue of position), the Kent County Director of Finance (by virtue of position), and one Kent County employee representative nominated by the Kent County Employee Council or similar successor group. The current membership includes citizen member and Chairman David Craik, citizen member Timothy R. Horne, citizen member Christopher S. Smith, and citizen member Ronald D. Smith, Kent County Administrator Michael J. Petit de Mange, Kent County Finance Director and Vice-Chair Susan Durham, and Kent County Employee Council representative Kristopher Connelly. The Committee meets regularly on a quarterly basis to review the pension fund and OPEB performance reports and more often as needed to conduct additional business such as new fund manager interviews.

Kent County Levy Court serves as the Board of Trustees and is the fiduciary for both plans.

Investment Strategy

Due to dynamic (+17.15%) pension fund growth the previous year and a compelling interest to reduce portfolio volatility with more consistent returns, Kent County Levy Court approved a Committee recommendation on January 30, 2018 to add Emerging Markets Equities (2.50% target), High Yield Core Fixed Income (3.50% target), and US based Real Estate (4.00% target) exposures to the allocation.

As a result, at the same January meeting Levy Court adopted revised Pension Investment Policy and Guidelines to restructure the portfolio to maintain an average balance of 20% for large capitalized US growth stocks, 20% for large capitalized US value stocks, 10% for international (developed) non-US growth stocks, 10% for balanced risk (GTAA), 30% for fixed income, and new allocations of 2.50% for emerging markets equities with Rogers Casey Target Solutions, 4.00% for the core real estate sector with Principal Real Estate Investors, and 3.50% for high yield fixed income with RCTS. Rebalancing can occur as needed, but is typically initiated when the County's annual contributions are made. In early 2018, the annual contribution ($2,743,160) was directed by the Committee into the new Principal Real Estate ($1,750,000) fund and existing RCTS Core Fixed Income ($993,160) fund, and the portfolio was rebalanced with $1,500,000 from Wedge (large cap value equities) and $1,400,000 from INTECH (large cap growth equities) distributed to the new RCTS High Yield Fixed Income ($1,550,000), the new RCTS Emerging Markets Equities ($1,100,000), and RCTS Core Fixed Income ($250,000 more) funds.

Later Segal Marco Advisors announced plans to close the RCTS funds by the end of the calendar year. The Committee recommended and Levy Court approved on October 9, 2018 selection of Segal Marco Fixed Income Group Trust (FIGT) as fund manager for the fixed income and high yield allocations, underlying manager AQR, LLC as fund manager for the International Equities allocation, and a new co-mingled Segal Marco Advisors fund with the same underlining managers for the Emerging Markets Equities allocation. The Pension Investment Policy and Guidelines were further amended on November 27, 2018 to combine the Fixed Income and High Yield allocations and designate the new managers.

Investment Managers

The Pension Fund's investment managers include INTECH (large cap growth) effective December 1, 2003;

Wedge Capital Management (large cap value) effective October 1, 2004; Rogerscasey Target Solutions (large cap international growth) effective June 1, 2013; Invesco (balanced risk/Global Tactical Asset Allocation) effective May 1, 2014; RCTS Core Fixed Income (fixed income) effective January 1, 2015; RCTS Emerging Markets Equities effective March 1, 2018; RCTS High Yield Fixed Income effective March 1, 2018; and Principal US Property (real estate) effective March 1, 2018. Segal Marco Advisors serves as pension consultant responsible for independently evaluating investment manager performance. Wells Fargo Retirement Services performs pension custodian services including distribution of monthly pension checks/direct deposits. Effective December 31, the RCTS investment funds were closed and transitioned to new fund managers.

Fund Performance

The pension fund's value decreased $2.5 million by the end of 2018 to $37.7 million, down from $42.2 million the previous year. This figure includes a $2,743,160 annual contribution as recommended by pension fund actuary, The Nyhart Company, LLC., in its report dated January 1, 2017. Over the one year period the total Fund value decreased -5.81% while the comparative policy index (S&P 500, Barclays U.S. Aggregate, MSCI EAFE, etc.) declined -2.97% over the same time period. For the year, INTECH was behind the Russell 1000 growth Index (-1.51%) with a return of -3.65% in the large cap growth segment. Wedge Capital declined -11.90% in the large cap value segment, compared to the Russell 1000 Value Index (-8.27%). RCTS Core Fixed Income investments recorded a modest -0.27% retreat compared to the Bloomberg Barclays U.S. Aggregate policy index (+0.01%) for the fixed income/bond segment. RCTS Target Solutions LLC (International Large Cap Core Equity) was well behind the benchmark with a -18.95% return, compared to the MSCI EAFE (Net) index which declined (-13.79%) for the year. Invesco (Balanced Risk/Global Tactical Asset Allocation) lagged with a -5.48% return which underperformed the MSCI World/40% Bloomberg Barclays U.S. Aggregate Index (-4.76%). For the second half of the year, the three new fund managers achieved mixed results including: RCTS Emerging Markets Equity, which declined -7.25% compared to -8.49% for the MSCI EM (net) policy benchmark; RCTS High Yield Fixed Income, which returned -2.21% compared to -2.34% for the ICE BofA/Merrill Lynch High Yield Master II benchmark; and Principal US Property Account, which earned +3.70% compared to +3.74% for the NCREIF ODCE Equal Weighted benchmark for the real estate allocation.

The retiree benefits fund managed by the State of Delaware Pension Office was down with a -4.0% return through its commingled investments compared to -4.6% for the policy benchmark for a year end market value of $16,837,133.93, up slightly from $16,831,331.07 in 2017, and included a net +$492,834.13 annual contribution ($1,366,633 less $873,798.87 for estimated retiree benefit costs in FY2018). Effective December 1, 2018, the State Pension Office merged and comingled OPEB Trust assets with Pension assets for investment purposes. At year's end, 114 retirees received County health benefits, 26 covered dependents, and 16 retirees waived coverage.

Actuarial Valuations

The annual pension valuation was completed as of January 1, 2018 by Nyhart and recommended a contribution of $3,024,582 for Fiscal Year 2019. The figure was $281,422 higher than the previous $2,743,160 actuarial recommended contribution due largely to another quarter percent reduction of the interest rate assumption to 7.50% as approved by Levy Court in early CY2017. Kent County typically makes a partial contribution at the mid-point and near the end of the ensuing fiscal year. The next pension plan actuarial valuation is underway as of January 1, 2019, and will include the third and final interest rate assumption reduction to 7.25%.

The OPEB valuation was completed as of June 30, 2018 and recommended an annual contribution of $2,154,449 for FY2020 & FY2021. The figure was $847,195 higher than the previous $1,307,254 due largely to another planned interest rate assumption reduction from 7.75% to 7.50% and higher than expected health insurance expenses. Based upon a preliminary contribution figure from early CY2016, Levy Court actually budgeted and made higher OPEB contributions of $1,366,633 for FY2018 and FY2019, so the annual contribution difference is $787,816. The gradual 0.25% discount rate assumption reductions are programmed to continue for each biennial valuation until achieving 7.00% for FY2024.

Plan Benefit Review

While a recommendation for a Pension & OPEB Benchmarking & Cost Containment Study ($30,000) was not supported by Levy Court, the Committee did initiate an OPEB Expense Reduction Strategy Review ($2,400) by

Nyhart. The study evaluated the impact of a sliding scale cost share for retiree benefits similar to the State of Delaware, which imposes a 100% cost share for eligible retirees with less than 10 years of service; 50% cost share for 10-14 years, 25% cost share for 15-19 years, and 0% for 20+ years of service. As of July 1, Kent County retirees over age 65 pay no cost share and retirees under age 65 pay 7% cost share for individual coverage. Retirees pay a 20% cost share for eligible dependents. The Nyhart report estimated the annual OPEB contribution could be reduced by $300,000 +/- if the sliding scale formula was initiated immediately. After comparing peer group retiree health insurance benefit designs, Committee members expressed reservations about cost share increases for existing County retirees, but also recognized that a “new hire only” scenario delayed any contribution expense reduction for the near term. Further analysis was directed by the Committee and is expected to be completed in early 2019.

Fund Expenses

Pension and fee payments are drawn from the fixed income (bond) segment and transferred to Wells Fargo, on a monthly basis. For 2018, pension payments totaled $2,780,919.20 with a total of 224 recipients at year’s end. The annual fee for pension consultant Segal Marco Advisors was $35,000. The fund custodian fee paid to Wells Fargo Retirement Services was $14,650.28 for processing checks, reports, and trades. Actuary expenses totaling $19,360 were paid to Nyhart for the valuation, pension statements, and pension benefit calculations. In 2018, fund manager fees were $49,901.61 (INTECH-52bps), $46,426.69 (Wedge-55bps), $14,723.96 (Invesco-45bps), and no direct fees for the RCTS or Principal funds. Except for Wedge, which is paid directly, such fees are assessed from investment proceeds. Retiree benefits fund (OPEB) custodian fee and investment manager/advisory fee expenses drawn from investment proceeds totaled $6,522.56 and $5,600 was paid to Nyhart for the interim valuation and modeling study fees in 2018.

During the year, Levy Court approved Committee recommendations to extend the pension consulting services agreement with Segal Marco Advisors for an annual fixed fee of $38,000, and the actuarial services agreement with The Nyhart Company for the following: Annual pension valuation - $13,750; Biennial OPEB valuation - $7,000; Pension certificates - $275 each; Biennial pension statements - $2,750; Interim GASB 75 reports - $3,000; and Misc. services - $415/hour.

Comments and Recommendations

2018 was a difficult year for all financial assets. In the US, the S&P 500 was down 4.4%, the NASDAQ and Russell 2000 down 11% each. Markets outside the U.S. fared far worse with average declines for Europe and the MSCI Emerging Market index down 13.8% and 14.6% respectively. Fixed income markets, which were largely negative throughout the year as the Federal Reserve raised interest rates four times in 2018 ended up with the Barclay’s Aggregate Index returning 0.01% for the year. Other assets such as commodities also declined in 2018, led by oil which fell 25%. Although 2018 was a difficult year, 2017 was an above average return year bringing the two-year S&P 500 return to 7.9% and the MSCI All Country World index up 5.97%. Furthermore, since the 2008 great financial crisis, stock markets globally are up over 240%, while bonds are up almost 40%. Global GDP has been positive, inflation has remained low, and earnings growth has compounded at double digit rates. In the U.S. historically low unemployment, strong retail sales numbers for the holiday season, strong consumer balance sheets and increasing wage growth (albeit from low levels) provide further evidence of positive fundamentals. Overall, the County’s Pension fund lost 5.8% for the year.

The Committee recognizes recent market volatility and higher OPEB expense may cause consternation among many, but remains confident that portfolio diversification and ongoing interest rate assumption reductions offer moderating advantages under most market conditions in the future. For the longer term, the Committee recommends Levy Court revisit the plan assumptions and achieve consensus on funding COLAs and modifying the retiree benefits cost share.