ANNUAL REPORT – 2019

The Kent County Pension Review Committee's Annual Report to Kent County Levy Court - February 20, 2020

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

Per the revised Pension Investment Policy and Guidelines adopted by Kent County Levy Court on November 13, 2018, the portfolio is structured 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 (Global Tactical Asset Allocation), 4.00% for core real estate, 2.50% for emerging markets, and 33.5% for fixed income. Rebalancing can occur as needed, but is typically initiated when the County's partial annual contributions are made. In early 2019, the transition and transfer of assets from the three closed RCTS investment funds to Segal Marco Fixed Income Group Trust (core fixed income/bond and high yield fixed income) and AQR Capital Management LLC (international equity) was completed.

Investment Managers

The Pension Fund's investment managers include INTECH (U.S. large cap growth) effective December 1, 2003; Wedge Capital Management (large cap value) effective October 1, 2004; Invesco Balanced Risk (Global Tactical Asset Allocation) effective May 1, 2014; RCTS Emerging Markets Equities effective March 1, 2018; Principal US Property (core real estate) effective March 1, 2018, Fixed Income Group Trust/MCG Group Trust (fixed income) effective January 1, 2019; and AQR International Equity (large cap international growth) effective January 1, 2019. Segal Marco Advisors serves as pension consultant responsible for independently evaluating investment manager performance. Wells Fargo Retirement Services (acquired by Principal in mid-2019) performs pension custodian services including distribution of monthly pension checks/direct deposits.

Fund Performance

The pension fund's value increased $7.2 million by the end of 2019 to $44.9 million, up from $37.7 million the previous year. This figure includes a $3,024,582 annual contribution as recommended by pension fund actuary, The Nyhart Company, LLC., in its report dated January 1, 2018. Over the one year period the total Fund value increased +20.28% while the comparative policy index (S&P 500, Barclays U.S. Aggregate, MSCI EAFE, etc.) increased +18.41% over the same time period. For the year, INTECH lagged the Russell 1000 growth Index with a return of +34.84% vs. +36.39% in the large cap growth segment. Wedge Capital was way up +29.71% in the large cap value segment, compared to the Russell 1000 Value Index at +26.54%. Segal Marco Fixed Income Group Trust investments recorded a respectable +7.54% compared to the Bloomberg

Barclays U.S. Aggregate policy index at +8.72% for the fixed income/bond segment. AQR International Equity Fund II (International Large Cap Core Equity) was a bit behind the benchmark with a +20.57% return, compared to the MSCI EAFE (Net) index which increased +22.01% for the year. Invesco (Balanced Risk/Global Tactical Asset Allocation) underperformed with a +16.10% return compared to the MSCI World/40% Bloomberg Barclays U.S. Aggregate Index benchmark at +20.42%. RCTS Emerging Markets Equity-RBC/Wells rebounded with a +22.07% return compared to +18.44% for the MSCI EM (net) policy benchmark. Finally, the Principal US Property Account posted a modest +5.84% return compared to +6.08% 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 up with a return of +13.8% through its commingled pension fund investments compared to +19.7% for the policy benchmark for a year end market value of $19,327,040.06, up considerably from $16,837,133.93 in 2018, and included a net +$185,361.60 annual contribution ($1,366,633 less $1,181,271.14 for estimated retiree benefit costs in FY2019). At year's end, 121 retirees received County health benefits, 30 covered dependents, and 17 retirees waived coverage.

Actuarial Valuations

The annual pension valuation was completed as of January 1, 2019 by Nyhart and recommended a contribution of $3,408,084 ($3,024,100 budgeted) for Fiscal Year 2020. The figure was $383,502 higher than the previous $3,024,582 actuarial recommended contribution due largely to the final quarter percent reduction of the interest rate assumption to 7.25% 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, 2020.

The OPEB valuation was completed as of June 30, 2019 and recommended an annual contribution of $2,735,837 for FY2021. The figure was $581,388 higher than the previous $2,154,449 interim OPEB contribution recommendation, due largely to another planned interest rate assumption reduction from 7.50% to 7.25% and higher than expected health insurance expenses. 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

Per request of the Committee and Levy Court, the actuary modeled numerous scenarios aimed at reducing the annual pension and OPEB contributions. Ultimately, the Committee recommended and the Levy Court adopted an amendment to the retirement program to increase the employee contribution from 3% to 5% of base salary after the first $6,000 for new entrants effective January 1, 2020. The change is projected to reduce the annual pension contribution by $8 million over the next 30 years. On the OPEB side, while the Committee did not take a position on implementation of a graduated (sliding scale) cost share for retiree health benefits based upon years of service, the Levy Court did consider it, but requested confirmation of the estimated savings figures. Regrettably, the favored "new hires only" scenario appears to offer no significant reduction of the annual OPEB contribution over the next 20 years.

Plan Amendments

Levy Court approved two amendments to the retirement program in 2019. The first adopted on November 12, 2019 increased the employee contribution from 3% to 5% of base salary after the first $6,000 for new entrants effective January 1, 2020, and the second increased the "allowable interruptions" time period from one year to two years effective upon adoption on December 10, 2019.

OPEB Assumptions

Late in the year, the Committee considered a recommendation from the actuary to revise the OPEB assumptions to reflect those adopted for the retirement program following an Experience Study in 2017. The matter is pending before Levy Court, but the Committee did recommend update of the mortality table, termination rate table, and employer funding policy with a total estimated +$236,000 contribution impact. Revisions to the annual rate of salary increases assumption and retirement rate table with an estimated +$190,000 impact were not favored.

Fund Expenses

Pension and fee payments are drawn from the fixed income (bond) segment and transferred to Wells Fargo, on a monthly basis. For 2019, pension payments totaled $3,015,301.65 with a total of 233 recipients at year's end. The annual fee for pension consultant Segal Marco Advisors was $38,000. The fund custodian fee paid to Wells Fargo Retirement Services was $23,480.54 for processing checks, reports, and trades. Actuary expenses totaling $36,892.50 were paid to Nyhart for the valuation, pension statements, pension modeling reports, and pension benefit calculations. In 2019, fund manager fees were $50,267.49 (INTECH-52bps), $43,220.51 (Wedge-55bps), $15,436.56 (Invesco-38bps), and no direct fees for the AQR (60bps), RCTS (91bps), FIGT (26bps), or Principal (110bps) funds. Except for Wedge, which is paid directly, such fees are assessed from investment proceeds. Retiree benefits fund (OPEB) net fees drawn from investment proceeds totaled $32,677.22, and $18,500 was paid to Nyhart for the valuation and OPEB modeling study in 2019.

Segal Marco Advisors performs pension consulting services for an annual fixed fee of $38,000, and The Nyhart Company performs actuarial services as follows: 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

2019 closed the decade and provided strong returns across financial markets. U.S. equities, as measured by large cap S&P 500 stocks returned 31.5% and Non U.S. stocks as measured by the ACWI x US returned 22.1%. This is the second strongest return of the decade for U.S. equities (the S&P's 2013 return was 32%). The Barclays Aggregate Bond Index provided a return of 8.7%, thanks to the easing by the Federal Reserve throughout the year. Even commodities, which have been largely negative in recent years, returned 7.7%.

Within U.S. equity markets, many of the trends we have discussed in recent years held in 2019, in particular growth (led by technology), outperforming value by nearly 10%. U.S. Fixed income markets were driven by the Federal Reserve lowering benchmark rates three times to the 1.5%-1.7% range. High yield bonds returned 14%. Non US stocks were led by a rebound in Developed Europe, with the EAFE index returning 22% and the Emerging Markets index 18.4%. Non U.S. fixed income markets were the weakest, with worldwide bonds returning 5.3% (unhedged). Negative interest rates outside the U.S. remain an area of concern with $17 billion of negative yielding debt curtailing the ECB and other Central Banks.

Looking ahead to 2020, it is difficult to envision a year with the strength in markets we saw in 2019. Forecasts are for the Federal Reserve to hold rates steady at least for the first half of year, although economic data will determine the course. Valuation of equity markets are elevated, but not exceedingly so. Profit margins remain under pressure due to rising materials and labor costs. However, the indications on tariffs have improved and their potential negative impact on earnings in U.S companies, and also Europe and emerging markets, could be mitigated in 2020. The improved tariff outlook could contribute to a rebound in earnings, after a 2019 earnings decline and help equity valuations this year. Overall the economy remains positive and inflation is low. The County's pension fund gained 20% for the year.

For the longer term, the Committee recommends Levy Court refrain from awarding regular COLAs to retirees, pensioners, & beneficiaries, revise the OPEB assumptions, and restructure the retiree benefits cost share.

Finally, David Craik was recognized by Levy Court at a public meeting on July 23, 2019 for his 25 years of service – almost all as Committee Chairman. In addition, Mr. Craik retired at the end of the year from his position as State of Delaware Pension Administrator after more than 30 years in the pension office, but he has agreed to continue to serve on the Committee. His dedication, commitment, and wealth of knowledge are greatly appreciated by his fellow members and staff.