

**TOWN OF LEESBURG**

Town Hall  
25 W. Market Street

**MINUTES**

May 21, 2021

10:00 a.m.

Lower Level Conference Room 1

Finance Board Members and Others Present:

Clark Case, Lisa Haley, Diane Starkey, Joe Mason, Nelson Bush, Mallory Sampson, Jim Link

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**1. Call to Order** by Clark Case 10:02am

**2. 3. Approval of Agenda of 03-05-2021 and 05-21-2021**

- Mr. Case: First order of business is to approve today's agenda, and the agenda from the prior meeting. We followed the agenda, but we couldn't vote on anything in that meeting. Someone wants to amend or change anything on the agenda for today?

No corrections or changes.

On a motion by Lisa Haley and seconded by Joe Mason.

**4. Approval of Minutes of 11-20-2020**

- Mr. Case: Next order to business is to approve the minutes from November 20<sup>th</sup>, 2020 Finance Board meeting. Does anybody have any corrections or changes?

No corrections or changes.

On a motion by Joe Mason and seconded by Lisa Haley.

**5. Approval of Minutes of 03-05-2021**

- Mr. Case: Next order to business is to approve the minutes from March 5<sup>th</sup>, 2021 Finance Board meeting. Does anybody have any corrections or changes?

No corrections or changes.

On a motion by Lisa Haley and seconded by Joe Mason.

Mr. Case: Next order of business is contents.

**6. Items for Discussion**

- a. Economic context and outlook
- b. Quarterly investment report
- c. Discussion of market results since quarter-end
- d. Discussion of the PFM Comparison of the TOL Portfolio's performance over the five years vs. the performance of the VML OPEB plan
- e. Investment Policy limits on Alternative Investment Managers Discussion
- f. Discussion of any other changes to investment managers since last meeting or pending changes
- g. Discussion of Benchmarking of OPEB Trust Performance

Mr. Bush's introduction:

- I'm joined today by Mallory Sampson and Jim Link. Mallory works out of our Austin, Texas office. She's been with PFM for about 3 years and she is our Multi-Asset Specialist. We got her from Vanguard where she was for a number of years. I'm going to ask her to present the economic context and outlook.
- Also, joining us is Jim Link, who is another Managing Director at PFM. Jim works out of our Philadelphia office. He heads up our multi-asset class strategies. I'm going to have him talk about the use of some of the funds we've added recently, how they fit into PFM's and into our investment strategy. Following that, there will be a specific consideration about whether they fit under the investment policy and the spirit of the investment policy. We don't want to include any sort of holding of any type in your portfolio that any member of the investment committee has a concern about, so we wanted to talk about that and Jim can help us with that conversation. I'm going to ask Mallory to give the economic outlook.

Ms. Sampson's comments:

- Let's start on page 2. We will start with the numbers and then we are going to move into a more macro approach.
- This report shows exactly one year since we started our Covid-19 lockdown, on March of 2020. This is a great comparative report.
- If you scroll down to the 1 year column, you will get an idea of the year we have had. It has been interesting for everyone.
- In the domestic equity space, the quarter-to-date and year-to-date columns are the same because this is the first quarter. The big trend is the deviation between value and growth.
- At the top of the page you will see the value of the Russell 1000. It has significantly outperformed growth. It is reversing a decade's long trend where growth outperformed, and a lot of values that performed since last quarter have to do with material, financials and the energy sector.
- It will be interesting to see how this continues, but it is something we are watching and I think the rest of the finance industry is also watching.
- Moving down to international equity and, if you compare the to-date figures with domestic equity, you will see the numbers are lagging.
- This has to do with countries starting to pull ahead or fall behind in their containment of the Covid-19 virus. If you think of some of our emerging countries that are struggling to just contain the virus, think about India. Then you think of some of our developed markets that are struggling accessing the vaccine, think about Canada. Lastly, we have developed countries that are really struggling with their roll out and variance, think of Europe. Just at the end of March, we had shut downs in Italy, Germany and France. That's a far cry from what we are seeing here in the United States, so those figures are understandably lagging.
- The fixed income space is also very interesting, if we look at the short end of the curve, it's being ranged based off of the Fed keeping rates very low, but the long end of the curve is

popping up, especially in this last quarter, and that has to do with optimism for the economic recovery, and thoughts about potential inflation.

- That difference is important because we are creating the spread that we haven't seen in a while, so if you compare the 2-year treasury to the 10-year treasury, it is about 158 basis points difference, so it is 1.58%. We haven't seen a deviation like that since 2015.
- This last quarter, the Agg struggled in the longer and intermediate term duration space. You will see the top line Barclay's US Agg down 3.38%. It had to do with those longer duration securities.
- Shorter duration securities were neutral or slightly positive. This is the worst quarter that the Barclay's Agg has had since 1981. It is a very interesting time in the fixed income market.
- We'll take a look at a more macro stand on page 3.
- 59% of Americans have had at least one shot of the vaccine against the Coronavirus.
- Hospitalizations of people with Covid-19 are down 77% since the peak.
- We've started to have conversations of herd immunity. Some believe this immunity is reached at 60%, others say at 80%. We will see.
- Our recovery has had a lot to do with the federal support that we've had.
- If we compare that support and we compare the spending from this time last year, the budget gap in March 2020 was 119 billion dollars. This last March we closed out at 660 billion dollars. The American Rescue Plan, just passed on March 11<sup>th</sup>, is giving people 5 to 6 million dollars. We are interested to hear what they have decided to do with that money and if you have talked about it.
- We also have weaker tax revenue.
- In terms of the economic recovery, another big trend is around the labor market.
- This time last year before Covid-19, we were adding somewhere around 150,000 to 170,000 jobs a month. In March of this year we added around 700,000 jobs and the expectation is that we are going to continue adding jobs each month at a very high rate until the end of 2021.
- Last April we only added 200,000 jobs. We still have around 9 million people unemployed.
- There are two schools of thought as to why we have this labor shortage and why we are not adding more jobs.
- The more optimistic thought is that people are still concerned about the virus, so they are not wanting to go back into the workforce. Or, since schools and daycares aren't completely open, the additional federal unemployment is allowing people to take their time to go back into the workforce.
- The more cynical view is, why you would go back to work for \$17 an hour when you can make \$15 an hour and stay at home.
- I lean towards the more optimistic side because the labor shortage has to do with high and low wage earners, so is not just unemployment.
- Certain states are starting to pull back that extra unemployment benefit, so we will see what the impact is in those states.
- Regarding global growth, some countries are starting to pull ahead and fall behind. Comparing India to Southeast Asia, Southeast Asia is benefiting from their export model.

All the different countries' methods of dealing with the virus consider that the economy is still going to grow in 2021 and continue to grow in 2022, so we are feeling positive.

- We will continue with the asset classes on page 9.
- The way to read this heat map is, the white circle represents what we thought last quarter, and the black circle represents what we think this quarter. Also, you will see an arrow that represents how we moved.
- There is a lot of green in the equity space. One thing to know in the domestic equity, the large cap is neutral. We are concerned that large corporations may face regulatory headwinds under the Biden administration and, that there is more potential in the small-cap and mid-cap.
- In the international space, as these countries are beginning to recover more robustly, we expect them to bounce back, similar to the strong returns that we've seen in the US, especially the emerging markets.
- Fixed income is going to continue to be interesting, we are not as optimistic about that space.
- Real Estate has moved from neutral to slightly positive. The valuations in the Real Estate market are very attractive. They absolutely took a hit last year.
- In addition to that, we are at the space in a cycle where businesses are reopening, people are going out, people are shopping and we are removing half the point of defaulting and evictions in that space, so we think there is potential there.
- We will take a look at our macro view on what is happening on page 10.
- What everyone is watching is the US recovery.
- I heard a really great analogy the other day. We are like a car trying to get onto the highway, some people think we are on the frontage road and we haven't even merged and we need to put the pedal to the metal and keep going; some people think we are on the ramp and we are merging and we are in a start and stop phase and it is awkward; and some people think we are on the highway and if we continue putting our foot on the gas, the engine is going to blow. It is going to be really difficult to tell where we are until it is over.
- We do know that our supply and demand space is different than it should be. We have extremely pent-up demand, so people who haven't moved are wanting to move now, people are wanting to go on trips where they didn't last year, and everyone on the planet wants to go out.
- We have all this pent-up demand and our supply chain is still struggling to keep up. Car manufactures can't get access to chips, lumber prices are outrageous, it is hard to get people back into work, and we know that when demand is up and supply is down, it increases prices.
- Used cars are up 20% over last year. If you bought a car in the last few years and you purchased it from a dealership, they will be trying to buy it back from you for more than what you bought it for.
- With the labor market, there is upward pressure with wages.
- Once demand abates, once people go on that vacation, get tired of going out, build the house, move, or buy the car, how is that going to impact the prices increasing?
- If you take a look at inflation on the right side of this page, yes inflation is here. The question is how long will it be here and how will the Fed react to it?

- The Fed has said that they want inflation to go above average 2%, until they start making a change with their bond buying program and from the Fed's fund rate. The Fed is also saying that they are going to make changes based on results not on forecast, so we will see how long that lasts. We don't expect this to last an extended period of time, but it is here.
- The valuations moved down from neutral to orange. This is addressing the question of the stock market being so high, how can it continue?
- Valuations aren't as great as they have been in the past, but if you had 1 million dollars you are not going to put it in your checking account, you won't put it cash in the bank because you won't make any money, you probably won't put it in a fixed income market because returns are so low; that leads you to the stock market. We still feel that equities in the next quarter or so are going to outperform, there is still room for growth there.
- That wraps up my market update. Any thoughts or questions?

No questions were asked.

Mr. Bush's comments:

- I will summarize some of the focuses for PFM, we are thinking about portfolio strategy here.
- Inflation is one of the things that we are watching. We want to be sure that we are focused on that. Is it temporary or is it longer term? Does it signal that the market is running away with itself, or does it just suggest there has been a reversion? Is it all based on the prices of underlying materials, which has resulted in production prices going up, and producers are surely passing those costs on the consumers right now? Is it a temporary supply and demand or is it a longer term structural issue? That is the inflation issue.
- We are focused on valuations, particularly in the domestic equity range. Will consumer behavior continue? Is there some change in the market that will result in less interest? Can companies continue to grow both, top line revenues and profits in the equity side? We know we are in the middle of a very significant streak of companies announcing stock buybacks right now.
- Many corporations have vast amounts of cash, they are trying to decide what to do with this cash.
- There have been many announcements of stock buybacks that pay greater than when the tax plan under Trump cut taxes at the corporate levels, and corporations suddenly had cash and executed a lot of stock buybacks. The pace is even stronger right now. How does that affect valuations?
- We've seen the combination of monetary policy and fiscal policy that made it very inexpensive to borrow, and lots of cash have been put from the federal government out to consumers, out to state and local government and small businesses to a certain extent, to get folks back to spending money and going and doing things. How is this all going to shake out? Will it continue? Is the tap going to continue from the federal government? What is the transportation package? Is it a transportation package or is it an infrastructure package? Who defines what infrastructure means? Is infrastructure bridges, roads, and water and sewer systems? To us of course it is, but to some, infrastructure is also free community college, waiving student loans, money for early childhood education and a number of other things. Who gets to define it? Whose bill will pass congress and get signed by the

president? What is the implementation time of that? Who pays for it? Those are the things we are watching from an economic stand point. We are happy to try to answer any questions.

- *Mr. Case: It is really the result of year over year comparisons against a period where prices were falling very rapidly? So oil, gas, building materials during the down turn were dropping when a lot of commercial construction stopped. Prices fell pretty dramatically in the second quarter of last year, now as we are running over that quarter, a lot of these price increases are really prices returning to normal. To understand how much of the pricing is due to supply shortages and things like that, it has to be normalized against 2019 price levels. We can't get too shook up about the fact that inflation is very significant for this quarter. As we get passed this quarter, it is going to be a lot more interesting to see what really transpires from there. What we are seeing now has a certain amount of distortion in the headlines that get made a lot of by the media. Many people are going to be pushing for the Fed to move. The Fed is smart to recognize that it has to adjust for that.*
- *Mr. Bush: Inflation has run at around 1.5% for a bunch of years. The fact that inflation, last quarter, was over 4%; it is a short period of time. What matters is what we see going forward.*
- *Mr. Case: In addition to that, we come off of a 30-year or 40-year secular bull bond market. Fixed incomes have been dropping very steadily overall, both inflation and interest rates. There were quarters where they kicked up and down, but the overall long term trend was that interest rate and inflation were declining, and that made it very easy to make money in the fixed income space. We are not in that situation right now, it is almost going back the other way. I wonder if we are going into a secular bear market in fixed incomes, where all you have to do to outperform the indexes is be short. Are we going to have a very rapid kick up in interest rates and have some losses in our portfolio? The tradeoff for that is that we just start getting interest income again, and right now the fixed income portfolio is taking losses and generating no interest income, as well. From my prospective, I'm almost in favor of the short term loss, to get back to having investment income for a number of different reasons, some of them are operational. I'd rather not see a long term secular bear market in fixed income. I'd rather see a short term realignment, because we probably will not unwind our overall strategy and maintain our fixed income allocation. It is our buffer in a market downturn with such high valuations. I lived through 40%-50% declines in the stock market and was very thankful for having my fixed income allocations there. You can never predict the timing on that. You never can change your portfolio fast enough to avoid those losses. Our overall strategy is what it is for a number of reasons, and it is primarily that we are trying to avoid significant losses more than we are trying to capture all the gains. The valuations are always hard to assess and people have always been trying to figure out where the stock market is overvalued, relative to what's happened in the Town the last few years. It is the old proverb that the market is not the economy and the economy is not the stock market. It's true. Business is driven by the business, the economy mainly is 70% driven by the consumers. It depends on who is in the winning or losing position this day. Those are my observations, I don't think the portfolio is badly positioned, fixed income has always dragged on the way up and they always protect on the way down. The way down is always a bigger concern to me than the way up.*

Ms. Sampson's comments:

- You said a couple of things that were really important for the semantic stand point. Your first comment was, we need to look at the long term, I think that is really important and I think that most investors get really distracted.
- The second comment that you made was talking about the short term pain in the fixed income market for the longer term return to income, and I also think a lot of investors forget that. There have been all these studies that said people are more sensitive to a down turn in the fixed income market, than they are to the stock market, but you are correct, in the long run a bad year in a bond market is nothing compared to a bad year in the stock market. So yes, fixed income is not returning how it should be, but it is still a very important part of that portfolio.
- *Mr. Case: I have been at this for a long time, I managed a 420 million dollar equity portfolio, the pension plans and the OPEB, since 1989 in Winston-Salem before I came here. So I've been through many downturns and many booms.*
- *Mr. Mason: On page 10, I see one little note on the bottom left hand corner related to increasing the corporate tax rate, and we talked about monetary policy, we talked about fiscal stimulus. The flip side of the fiscal stimulus coin is paying for it. How do you handle the tax policy, particularly the corporate tax rate and capital gains if they come for hand in hand, how does that shake out?*
- *Mr. Bush: Capital gains is an interesting discussion. If we think that capital gain tax is going to go from where it is at now up to 33%, or wherever a person's marginal tax rate is, then that might cause the investor, who is about to deal with those capital gains, to do something different. Is it a long-term issue? There is surely going to be some period of hyper-activity, resets and focus looking for ways on how to avoid these taxes. Is the muni market going to fill the space? I am sure muni market participants will like to fill this space, more demand and lower yield. Where else is the tax advantage? Does that impact growth stocks in the future? Does that impact value stocks and their dividends? Those are good questions.*
- *Mr. Case: Don't forget the private equity and hedge funds. They get very rich off of low tax rates. They are big players in the markets now and drive a lot of the volatility. If they have a higher tax rate, that may eat into capital flows from them to other places, as well. Those players would be very heavily impacted and that can change the dynamic in the market; certainly valuations.*
- *Mr. Bush: Other personal tax rates, maybe. On the corporate tax rates, it depends on how high they go. If they reset back to where they were before 2017, there will be a period of adjustment. I think it is one of the reasons corporations are buying back equity now, so that they can bulk their stock price ahead of that. Will the corporations have to pay? That's the big question. The combination of Republican Senators, and perhaps the Senator from West Virginia, prevents that from happening. So far, he is saying he is not on board. There is a division within the Democratic Party on the kind of corporate tax increase other Senate Democrats seem to want. The Party participation from the large states have very high state and local taxes (New York, California, etc.) who want the state and local government tax,*

*which has been kept from deductibility on your federal taxes (the \$10,000). They want that to go away, they want to reset it to what it was before, but people like Senator Sanders from Vermont says that it is best to go in the other direction, which is to abolish all deductions for state and local government taxes from the federal tax return. That is an interesting dynamic. What happens when the same Party can't agree with itself? We issue more treasury bonds and we run a larger federal deficit.*

- *Mr. Case: Just from a pure management point of view, the corporate execs doing the buy backs, they are just driving up their options for their own compensation.*
- *Mr. Bush: It surely helps them.*
- *Mr. Case: They are buying stock at high prices rather than buying them at low prices. I wonder how the management practices are, if you are investing in stocks. They are driving up the rates, but who is that benefiting? It is really benefiting the management at the expense of the stockholders, because then the stock goes back down, and yet they still have that overpaid for priced stocks on the books.*
- *Mr. Bush: If the managers, who you think are going to be there for 20 or 25 years, have a different view, maybe. But if it's the typical CEO for a large organization right now, who is going to be there for 3 or 5 years and they get rewarded in bonus based on stock price appreciation, there is a very different view on the short term and the long term on the benefit of that.*
- *Mr. Case: It makes me always have questions about that particular corporate stock. You are propping up the valuation under the short term management strategy for returns. It also means that, you are not managing the corporation well enough to put that cash back into investing the business to improve long term the prospect of business.*
- *Mr. Bush: It is the decision any corporation is making who is buying back equity. They are choosing to put the money toward buying back equities, support the stock price and other financial metrics, rather than necessarily deploying that cash in some other way. How else do you deploy cash as a corporation?*
- *Mr. Case: You buy your competition, your market share, or do more R&D.*
- *Mr. Bush: Or, you hire more people, you do more buildings, or you do things to stimulate.*
- *Mr. Case: The time for expanding capacity is when the market is expanding. So, the question is, if you are buying back your stock, what is the message you are sending about you as a long term investment? From my prospective it is a sell sign.*
- *Mr. Mason: Where are we at in the two secondary and tertiary proposals after the ARPA? Is that 4 trillion on top of the first 2 trillion passes with or without the tax increases? Where does that put us in terms of debt to GDP and, at what point the rating agencies wake up and strip the US of AAA ratings?*
- *Mr. Bush: You can only do those programs, particularly at least in the short term, with a view that US national government debt doesn't matter. That the GDP doesn't matter.*
- *Mr. Mason: At some point, I feel we are testing it.*
- *Mr. Bush: We sure have been testing it. When the Treasury markets issue 50 billion on a Thursday, they've had some days where demands have been less than they want it to be; some of that may be reflected in the uptick in rates that we saw in March. I think it was maybe more of just a reset. At some point in time, there has to be a true economic cost to lending somebody money for 30 years. At some point in time, you can't lend money for 30*



*years below the rate of inflation, but if we add another 3 or 4 trillion next year and the year after, it doesn't make any sense that there hasn't been a problem yet.*

- *Mr. Case: There is one reason, and that is because interest rates everywhere else in the world are either negative or lower, so our low interest rates are sucking capital from elsewhere, simply because the other people are worse than we are, and their interest rates are either negative or neutral at best, so even though our rates are low, they are still relatively attractive on an international capital basis. However, that can quickly reverse if the world economy picture changes. These low rates, this secular bear market, has been going on for a long time. There doesn't seem to be a lot of prospect of Europe providing that incentive for higher rates, nor Japan.*
- *Mr. Bush: It is not the developed markets that are going to provide it, perhaps if you have a China that grows enough, long enough and fast enough. Or, if India gets on the course, that is a huge country from a population stand point in a comparison to China from a per capita basis, still a very poor country. We thought for many years about manufacturing jobs going to China, well manufacturing jobs aren't going to China anymore, in fact they are leaving China, they are going to Vietnam, Malaysia, Indonesia, they are going to other countries. They are not coming back to United States, but they are leaving China because they are becoming more of a middle class and more service oriented, rather than production oriented. When do they eclipse the United States and does that have an impact? It's a big question. It feels that it has got to give at some point, but there are members of Congress, and members in the current and past administration, who simply think that US debt doesn't matter.*
- *Mr. Link: The one thing that wasn't touched on specifically, but would be a full blown sea change is reserved currency status. As China grows, the US treasury's securities holdings for nationals declined again this last year down from 50% to low 40's or high 30's. Reserved currency status imparts upon us, as an economy and the US as a market, great benefits. Almost unlimited flow of capital and the ability to export inflation and not import inflation. According to Stanley Drukenmiller, the reserved currency status is concerning. That would be the major thing that would impact us and in some of this fiscal policy, could have negative effects on that front, as well.*
- *Mr. Case: Those are longer term considerations, but right now we are living off the relative rates. The question is at what point you reach the inflection point? Nobody has a good feel on that front.*
- *Mr. Mason: I feel it is coming.*
- *Mr. Bush invited Ms. Sampson to take us through the investment returns.*

Ms. Sampson's comments:

- On page 12, we are looking at our return figures compared to our blended benchmark and how that has done from this quarter, and in the 1, 2, 3, 4 or 5 years. You are paying us to add value to the portfolio, all these returns are netted fees and added managers' fees.
- In the last quarter we did what you paid us to do as we hit the benchmark.
- That is not going to happen every single quarter, it is not going to happen with every manager, but in the long run, we've done that. And that is something to be proud of.

- When we are putting together our portfolio, our investment methodology is to keep cost as low as possible, and recognize that there are areas of the market that are highly efficient and it is really difficult to add value to.
- There are areas of the market where it is not worth it.
- The majority of your domestic equity space is in equities.
- In international equity, other growth and fixed income space, there is potential to add value and you will see more actively managed funds there. You will also see that, in the last quarter, they have done well.
- If you look on the report, in the last year we are looking at the Harding Loevner International Equity that has outperformed, also Artisan and Hartford.
- When we are looking at these active managers, we are not looking at quarter to quarter, we are looking at the long run, at the trend.
- Let's look at the fixed income space, again this is where you can add value and, as we all know, the quarter was down.
- The Bloomberg Barclays Agg was down 3.38%, for the quarter and we were down 3.42%; we will take it.
- Again, a down quarter in a fixed income market is harder to stomach than a down quarter in the equity market. We haven't had a down equity market in a long time.
- Are there specific managers that you want to touch on here?
- *Mr. Case: I was looking at the 1-year, 2-year and 3-year, and yes it was a bad quarter, but the whole market had a bad quarter. It was not far off of it. It looked to me that overall, over the long term, we are pretty well outperforming over the benchmarks in the fixed income space, so we don't need to spend out a lot of time on it, I don't see somebody whose numbers jump off the page as being very far off the bench mark.*
- *Mr. Bush: In fixed income, Prudential (PGIM) underperformed this quarter, which is entirely because the duration of their portfolio is about a year longer than the duration of the benchmark. The other things that they do in their portfolio helped performance, but being longer than the benchmark hurt performance. Looking at the longer term, they've been a good manager and they've added value.*
- *Mr. Case: Yes, they've beaten their benchmark by more than the other managers have on the 1, 2 and 3 year space. It is not a red flag for me yet.*

Mr. Link's comments:

- Baird, PGIM and Voya, even though they are all similar in the aggregate strategy, core, core plus strategy, each of them executes in a somewhat different way. Baird is a much more plain vanilla kind of structure, much more stick to the benchmark and the duration. Whereas, Voya is going to be a little more structured often times. There is a little bit of method to the madness, even of mixing 3 managers that have the same benchmark, but they have somewhat different styles the way they get at that benchmark.
- We will talk about the comparison. We will start by talking about the recent investments in real estate and commodities in the context of policy and I'm going to describe our rationale for what we did and why we did it, but I will say if at the end of the day, if that is not what you

want we are happy to clarify the policy and our understanding of the policy and adjust our management on that front.

- When we think about the policy, the first thing we think about is investment vehicles and the overarching authority for the investments.
- In this policy we are allowed to hold things like neutral funds in ETFs and all those kinds of pooled type vehicles.
- We can never take possession of the securities, they must be maintained at the custodian, so that there is never an opportunity for any fraud malfeasance or other issues related to the holding of securities.
- We think about our objective, which is to enhance the value of the trust in real terms over the long term through asset appreciation, income generation protecting on the downside. We are much better off protecting on the downside, than blowing it up on the top side because we all know it takes twice as much to make up the one time's down.
- In terms of the guidelines, we have 3 broad groupings of assets, either growth assets which are equity style assets, income style asset which are primarily fixed income, real return assets which include some kinds of inflation hedging assets, some kinds of real estate. Those are the broad categories of investment that we can make.
- In terms of portfolio risk hedging, we have a fairly straight forward strategic allocation in the way we think about the portfolio. As Mallory indicated, we are going to be very straight forward in terms of the allocation to equities being 60-65%, the fixed income being 35% and that is going to be the primary focus of the portfolio.
- What we do look at are situations, where we believe the market has produced some need for a tactical allocation change in order to preserve capital, or help the overall return and risk characteristics of the portfolio. In some cases that could be simply acquiring or utilizing an active manager versus a passive index, that's just one way you could do it.
- Another way you can do that is by tactically allocating to other asset classes that may have different risk and return characteristics. What we have done of late, giving our view that fixed income is going to be under stress for some period of time, right now as a general matter we've discussed here, in the negative returns low rates, as rates rise that would create the capital losses that we referred to earlier while we reset it at new coupons and the like.
- As Mallory mentioned, we started out first, the valuations in real estate and in certain parts of the real estate market, were very attractive. So, we made a decision to invest in some real estate investment trusts, about 4% of the portfolio. That money came almost exclusively from fixed income. It was designed to be an income producer, we thought that there is opportunity for capital appreciation.
- The second thing that we have done recently is that we added 2 mutual funds in an ETF that have exposure to commodities through commodities' contracts, with the idea being, if inflation is going to kick up, in particular, if we are going to get that spiky inflation where we get dramatic changes or material changes over a short period of time, that would show up in the commodities market and will help produce returns. That was entirely sourced from fixed income and that was about 3% of the portfolio.
- About 7% of the total portfolio was invested in real estate and commodities. I understand there are questions about how we got there either in spirit or in actuality. We think the way

the policy is written today, that we have the ability to invest in mutual funds, ETFs and alike. We have the ability through the portfolio risk hedging sections.

- There is a section in prohibited transactions that I do want to talk about, and talk about our thinking as it relates to the prohibition part of the policy. It starts out by saying “except for purchase within authorized investments, securities having the following characteristics are not authorized and shall not be purchased”. We think that is pretty important because the point there is that the reason the types of portfolios structures are available, mutual funds and ETFs in particular, is they don’t impart leverage on the plan, they are transparent, they have daily liquidity, and they have experts managing them, people who have demonstrable track records of managing those kinds of assets.
- Those are the elements that we tried to get to with the prohibitions. Prohibitions for letter stock, commodities contracts, direct commodities, other derivatives and things like that.
- Our view and our read on that is that the reason those are there is because those kinds of securities and those kinds of investments either, lack transparency, they have a lack of liquidity, they have a lack of expertise to manage the assets, or they have or require the plan to take leverage in an unnecessary way. Kiddingly, if you buy commodities directly you have to store it somehow, right? We don’t want to have to find a place to store the gold bricks. So, our read of that is it is those things as opposed to a prohibition against the asset class. We may be reading the same words and just applying them differently, and if that is the case, we will adjust from there.
- That is kind of the rationale for how we read the policy and why we will take probably not a long term, probably a relatively shorter term, maybe a year, maybe a 24 month, depending on how the Fed acts or how the economy acts. That is why we made those kinds of decisions to hedge the portfolio, in particular the fixed income side of the portfolio, and how we interpret the policy.
- *Mr. Bush: If there is any discomfort, if the feeling is that this is not within the guidelines of the policy, we’ll change it and we won’t do it. We want to align with your risk tolerances, and we want to align with your concerns.*
- *Mr. Case: I wrote the policy specifically to try to make sure that we did not get into things like CDOs, where you got a policy that says that you can only invest in investment grade funds, but when you look underneath the hood, what you got are tranches of things that wind up being significantly less than AAA put in, to kick up the return and you wind up owning things that you never intended to own. The goal of the policy is for us not to be owning things that we don’t really want to own, and that the policy, otherwise, wouldn’t allow us to own upfront directly. It is intended to avoid us being where a lot of people found themselves in the fixed income space in 2007/2008. My concern is, do we know what’s really embedded in these securities? Yes, it is a market traded security, but what is underlying are the things that are going to go bust, and the market traded security is only as good as the underlying investment is. The policy was written to prevent us buying into new innovative investment instruments that allow you to combine much more risky things, regardless if that is in the equity space, in the fixed income space or any space. Wall Street has got a lot of really bright innovative people who are perfectly willing to sell you something worthless. The policy was written to prevent us from getting into those investments in the first place.*

*The other thing we wanted to avoid is leverage. We don't want underlying leveraged investments. There is a whole breadth of them, but in the CDO space in particular, and commodities options are often leveraged, but it is two layers down from the fund that holds them. We don't want to be in leveraged loss positions. However, if you notice the way the language was written, it was also written to allow enough flexibility that if the decision is made, even if we don't really like active managers, when the market gets to the point of seeing fixed income losing 3%, it can be shifted over to high dividend yield bond or switch it over to a convertible bond fund. Convertible funds are not really mentioned in the policy, I wanted to leave enough flexibility so it can move to things that are in the spirit of the policy, but I don't want leverage or underlying assets to be a lot riskier than what we ordinarily allow in the portfolio. What I am trying to avoid is the typical Wall Street subterfuge that looks like an AAA investment, ETF, or an index fund, but really is something else underneath the hood. What is the confidence level here? I remember when I sat at a presentation by a guy who was pitching a hedge fund of hedge funds and talking about what a great deal this thing was. I was sitting there seriously thinking that maybe I needed to bite the investment consultants' work, because this guy had me sitting listening to this presentation by a man named Bernie Madoff; before this all became public. A lot of it depends on the transparency. Can you tell me exactly what the underlying investments are? Are they leveraged? And, is there actual evidence with the custodian that we own something? The red flag for me with the previous story was that no one had any clue what Bernie Madoff was owning. It was that "hedge fund of hedge funds", but no one had any idea what the growing assets were, and the answer was there weren't any. That's what we are trying to avoid here.*

*Transparency is really important to me. What are the underlying investments in the commodities fund? Are there options on commodities? Are those options leveraged?*

- I can answer them a little bit now, I'll get you more definition shortly.
- About 95-97% of the assets are in treasuries TIPS and other as collateral for the overall portfolio.
- The balance of each of the portfolios is primarily in futures contracts, these are contracts that rollover periodically on quarterly and monthly basis.
- About 75% of the piece of the portfolio that is oriented to commodities are futures contract, the others are exchange traded notes. I can get you the specific details.
- In both cases, because these are registered investment companies, they have very stringent leverage and reporting requirements, as promulgated by the ACC, so we can get you all of that detail.
- We have the same situation with the real estate investment trust, because they are registered investment companies, there are very specific rules and regulations around transparency.
- Typically, it's got to be quarterly reporting at a minimum, some of them report monthly.
- On the real estate side is more common to be quarterly, just because valuation in real estate doesn't change as frequently. The buildings that they own and/or manage are less volatile in terms of the valuations as your typical annual kind of valuations on the underlined securities, but we can certainly get you that.
- That is the reason why we got comfortable, because of transparency, liquidity and those kind of things, as it relates to the vehicles that they were in. These are not private investments,

these are not LPs or other kinds of hedge vehicles. These are registered investment companies promulgated under the Investment Company Act, and that's where we gained a lot of our comfort in this.

- *Mr. Case: One of the reasons why I wrote the language the way I did is that there are a lot of things like, even in your conventional fixed income bonds funds, they will use some options and things of that sort to aid in their liquidity as they move things in and out the market. I didn't want to eliminate what I regard as mainstream investment funds just because they were using some of those tools. I am trying to be reasonable about it, but at the same time, I don't want to find out that an investment was made in something that was leveraged up five times.*
- How about even two times?
- *Mr. Case: Yes, even two times. The spirit of it is to avoid the leverage, to avoid non-transparency and to avoid owning something that was not what we thought it was. If you could convince me that you are comfortable on those aspects, and if you limit the investment to 2% or 3% of the portfolio, then I could probably be ok with this. The spirit of this was to allow us to do asset allocation management. As Nelson is probably tired of hearing me say, I am not a big believer in active managers, and I think they are a distraction. You end up hiring them and firing them, spend a lot of time on that process. They tend over the three year period not to perform as they did in the prior three years, and they are distraction to asset management. On the other hand, what's being said here is maybe moving some money more into commodity space, because there is a short-term opportunity to generate some revenue and pricing is going to pop. They are going to get valued up, it will get cashed out performing the asset allocation management, which is what the Town pays to be done. And what was done with the convertible bonds, which is exactly what I expect to be done, too. The asset allocations are being managed, a manager was hired, and was let go. When I get asked the question of why did they get rid of the manager so quickly? The answer is, once it ran his course, we moved into another asset class, great answer. Hiring and firing active managers in the same space doing the same thing, not so much, because philosophically I don't think that is something that is generating any value. Having the right amount of fixed incomes, turning them in at the right times, adding it back at the right times, those are the things you have done, and done well. I am pleased with the overall returns against the benchmark, but I think you've gotten there from your asset allocations not from your active manager selection.*
- I appreciate the commentary because much of what you were describing are, in fact, the way we are trying to think about things working in the public sector, as a general matter. We also understand the fishbowl effect. It's better to make a small gain than a big gain if it comes with a big loss.
- *Mr. Case: There's always the public scrutiny aspect of it, which can cause you to have to take actions you don't want to have to do. I remember being in an investment conference in North Carolina, and having all the guys from the Town of Cary get up and walk out because there has been a letter in the editor from a Duke University professor saying that the Town had investments in Freddie and Fannie, and it was all going to go belly up. These were appropriate investments from local government securities, and they all had to get up and leave the conference to go home to sell off those things. We owned them too, but my*

*assessment was that the federal government could not afford let those fail, so I wasn't worried about it. But, the Town of Cary people had to jump up and leave because their Council Members were having to respond to a letter to the editor of the local paper. I don't want to be in a position where we are suddenly having to sell a bunch of assets at a loss because somebody's public scrutiny of our portfolio finds something that they can make waves about. Any equity portfolio is going to have ups and downs, have some losses and big gains too. I am a long-term investor and one of the reasons the board is composed the way it is, is because we want informed people with expertise sitting on this board. At the end of the day, we still have to account back to the public.*

- I will continue to work with Nelson and Mallory, they will make sure that they have the policy exactly where you want it, both, in work and in spirit, and I'll make sure that we will manage it appropriately.
- *Mr. Case: Do any of the other board members have comments about this particular topic?*
- *Mr. Mason: No, Jim said it well. I am more comfortable with real estate than he is with commodities, though.*
- *Mr. Case: I am too, but as a short term play, I am ok with it.*
- *Mr. Mason: It makes sense.*
- *Mr. Bush: We need to get to the bottom and provide you with the information that was requested. Assuming that it is appropriate, they are not strategic allocations. Looking at the blended benchmark and the asset allocation plan, we don't put 5% of the allocation to commodities, we just don't believe that. We think they are tactical asset allocations that might last two years or might last six months.*
- *Mr. Case: It was very much like the convertible bond, and as long as that's what it is, the base level approach, from my perspective, is that he still wants to make sure they all are doing their due diligence to know what underlies those assets.*
- *Mr. Bush: Yes.*
- *Mr. Case: I am not going to ask them to divest it at this time pending getting that information.*
- *Mr. Link thanked everyone and left the meeting.*

Mr. Bush comments:

- I emailed Mallory the presentation to show your historical performance to the VML/VACO portfolio performance.
- Mallory is going to put it up on the screen for us. Let me tell you what this is and let me tell you what this isn't.
- Before the town created its own OPEB Trust and engaged in investment advisor, you invested your OPEB Trust access that the Town had set aside through the VML/VACO OPEB Trust.
- The VML/VACO OPEB Trust run by the Virginia Local Government Finance Corporation is a pooled OPEB Trust, it elects trustees and they are the decision makers for the individual managers, funds or allocations.
- They have an investment consultant that currently manage two portfolios.
- One portfolio, called Portfolio 1, is designed to provide a greater return in the range of 7%

- Portfolio 2, which is a portfolio with a different asset allocation, is designed to provide earnings in the range of 5%.
- We are able to access their data on the website when they publish annual reports. They publish annual reports sometime after each June 30<sup>th</sup>. We have asked, but they haven't answered if we are able to receive their other quarterly reports.
- We were able to go back and look at 3 years' time. These are the 3 years where we were able to get their reports and we have been managing assets for you, and compared the performance of the trust to their Portfolio 1. Portfolio 1 is where the assets came from. The asset allocations are extremely different, they have 15% to 20% between True Blue alternatives, the kind that are unquestionably not permitted through your investment policy.
- *Mr. Case: It is the reason why the board withdrew from them.*
- They have a propensity to use all active managers. They have an investment approach that is a little less active than they have a goal of achieving. However, a common rate of return, they target 7%.
- Starting on page 4, you can see their performance.
- There are several pages of footnotes and disclosures then there is a summary.
- As of June 30, 2020, 1 year returns, 2 year returns, 3 year returns of your investment portfolio net of all the fees we understand. The performance we report to you is net of all the underline manager fees, is net of all PFM's fees.
- This comparison also nets out PFM's fee.
- If you can see the comparison of your portfolio's return for this period to your blended benchmark, we use your blended benchmark as the standard, so 1 year outperformance of 110 basis points to the 2 year average, underperformance of the benchmark of 8 basis points; 3 year average 12 basis points.
- When you look at this from quarter to quarter, it varies, longer term views are better views.
- *Mr. Case: It is exactly our target. Our target is that we have a lot of passive investments, we perform what the market performs. Whether PFM hits that or exceeds it, that's gravy, but our expectation is that we would perform like the market and that's really our goal. We are not trying to outperform the market, but if PFM can add value that way, great. The goal is to do at least, as well as the market.*
- On page 5 you can see that the 2 year and 3 year performance netted PFM's fee roughly in line with the blended benchmark.
- We compared the performance that they reported in their annual report. I can't tell you whether it is gross of fees or net of fees, I'm not able to tell from the foot notes. Let's assume that they are net.
- Their asset allocation is more like a 75%-25%, as well. They always have 75% or so to equity.
- If you compare your performance to your blended benchmark, that is the performance analysis.
- Why is the performance that way? Well, I'll say it is different periods, I think some of it is their alternative allocations haven't worked super well for them, some of their allocations that we might think are tactical like a commodity, they think are strategic and over the long term, you are not going to find a commodity funded on a strategic basis.



- That's the best performance comparison that we think kind of cobble together. It's not an apples to apples comparison, we have no ability to go in and somehow look at their performance and say this is the performance of each manager. We couldn't say if the asset allocation was more like a 60%-40% instead of a 75%-25%.
- *Mr. Case: The point of the exercise is to see how we have done relatively versus had we stayed there. It doesn't matter if the asset allocations are different, other than the outcome is different. I am not looking to see at your performance and their performance on a comparable portfolio, I am looking to say the Town made the right decision to move its assets out of that portfolio and to manage it under the program we are using. Did we add value by doing that?*
- *Your selection of the blended benchmark, which aligns with your risk tolerances at the asset allocation level, has outperformed the VML/VACO OPEB Trust by a respectable measure.*
- *Mr. Mason: By 110 points.*
- On slide 7 you can look at all public plans that are tracked in a database called eVestment Alliance
- It only tracks the plans that are reported to it.
- There is something in the range of 140 or 160 basis points, depending on the time frame of public plans that have fixed income allocations between 30% and 50%, you have a strategic fixed income allocation of 40%.
- The prior slide just looked at all public plans
- This one looks at some that are more in line with your asset allocation.
- I can't say that these other plans don't have alternatives or a 50%-50%, some of them do. They are all a little bit different.
- You can see the performance by quartier.
- The yellows, for these time periods, 1 year, 2 year, 3 year, as of June 30, 2020, is your blended benchmark's performance.
- The blue dot is your portfolio's performance.
- They are all public plans which had broader asset allocations, on the prior page it looked pretty similar.
- If VML/VACO is your peer, your blended benchmark strategy has been successful, if looking at some other group of public plans that can be cobbled together through an independent database. This is not PFM's database, this is a database that we pay for and we can access.
- We can put these slides in your quarterly performance report, if you have any interest. Some clients do some clients don't. This just shows the performance, your strategic asset allocation has been pretty successful.
- That's the materials that I think you might find valuable, as you consider the decisions that you've made on leaving the VML/VACO, on creating your own Finance Board, on adopting the asset allocation strategy that you have adopted.
- *Mr. Mason: What is the name of that report?*
- The name is eVestment Alliance, or they could've changed it to Investment Metrics. Chesapeake and Prince William like to look at these couple of slides.

- *Mr. Case: We would certainly like to see documentation where we can see how we compare to other governmental plans. I think it is affirming that you are doing better than your peers, but I am not sure that's who I want to compare ourselves to.*
- *Mr. Mason: Thank you for putting that presentation together.*
- *Mr. Case did the same.*
- *Ms. Sampson: Do you have add-ons to my to-do list, other than the full looks at the commodity span?*
- *Mr. Mason: The same on Cohen & Steers, the Real Estate fund.*
- *Mr. Case: We have one more thing on the agenda and that was any discussion of other changes and potential changes since the report. Just a brief report on it, if any. And an overall performance since March 31<sup>st</sup>.*
- There is nothing else to report, we talked about the commodity's change, which is the only change that has impacted the portfolio since the March 31<sup>st</sup> date and there is follow up to do there.
- As of May 14<sup>th</sup>, the portfolio was up just about 2.5%.
- As of yesterday, I have our standard 60%-40% composite returns.
- The difference between this portfolio and your portfolio is the use of a high yield fund which its performance has been a little bit better.
- I think your performance right now is likely in the range of 2.4% to the positive quarter-to-date, and that is right on top of the benchmark.
- *Mr. Case: Very well. We need to discuss the renewal of PFM's contract, and that necessarily has to happen in close session. Thank you Nelson and I appreciate you bringing in Mallory and Jim into the meeting. It doesn't happen at every meeting and it was certainly a nice enhancement to this one.*
- *Mr. Case proceeded to dismiss the meeting with PFM at 11:34 am.*

## **7. Additions to Future Board Meetings**

- a. None

## **8. Information Memorandums**

- a. None

## **9. Members Statements/Comments**

- a. None

## **10. Closed Session – Discussion of the Proposed Contract Renewal for PFM**

A decision was made to renew the PFM Contract.

## **11. Adjournment**

Mr. Case made a motion to adjourn at 11:50 am.

Approval was unanimous.