CITY OF PHILADELPHIA

SINKING FUND COMMISSION

In Re: November Meeting

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Wednesday, November 8, 2017

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This Meeting of the Sinking Fund Commission, held pursuant to notice in the above mentioned cause, before Angela M. King, RPR, Court Reporter - Notary Public there being present, held at Two Penn Center, 16th Floor Conference Room on the above date, commencing at approximately 10:00 a.m., pursuant to the State of Pennsylvania General Court Rules

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A P P E A R A N C E S

COMMISSION MEMBERS:
Donn Scott, Chairman
Rasheia Johnson, Treasurer

ALSO PRESENT:
Christopher R. DiFusco, CIO, PGW
Bill Rubin, First Deputy City Controller
Alex Goldsmith, PFM Asset Management
Marc Ammaturo, PFM Asset Management
City Solicitor Representatives
PGW Representatives

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CHAIRMAN SCOTT: Good morning, everyone. Welcome. It's my plan to call this meeting to order. The first order of business is the Approval of the Minutes from September 13, 2017.

Is there a motion?

MS. JOHNSON: I make a motion.

MR. RUBIN: Second.

CHAIRMAN SCOTT: Motion is made an properly seconded.

All those in favor?

(Ayes.)

CHAIRMAN SCOTT: Ayes have it. The motion is approved.

All right. Next order of business is the September 2017 Investment Performance Review.

Chris, I will turn that over to you.

MR. DIFUSCO: Thanks. I will let Alex and Marc cover just the numbers.

Just by way of quick update, the markets continues to rise in October. So as of this morning, the market value of assets is a little over 400 -- $542 million, and that's before benefit payments. So after those go out tonight,

we will have about 540 million in the account in total.

I think I had sent email out last week. The transition from Fred Alger and O'Shaughnessy is complete, so about $50 million is now with PineBridge, as you will recall, is a lower fee manager that you folks had approved. Another 11 million in change went to index fund with RhumbLine. We held back a couple million in benefits to go out tonight.

We also are in the process of posting RFPs for international equity managers to get us out of the mutual funds and separately managed accounts. First one went up this morning. I sent an email about that. The international index is up as of this morning. I would say in the next week or so, we will get the active one up, as well.

With that, I will let Alex and Marc cover the numbers.

CHAIRMAN SCOTT: Thank you.

MR. GOLDSMITH: Thanks, Chris.

I think we handed out the September performance, you know, back in September I

believe or actually at the last brief meeting in October. We didn't cover it. In the interim, we now have the full report books. That is what I handed out. And I think I will walk through that since usually we only just have the flash.

But I will begin briefly with review of the markets. And for reference, you can open to Tab 1, page 1.1, market index performance and some economic data. Story here is not new. Equities continue to deliver strong returns. The S&P 500 up almost 4 and a half percent for the quarter, the third quarter.

I will address a few trends. Small caps actually outperformed large caps in the third quarter, a reversal of the trend from the first half of the year. That's also reversal of the trend if you remember back in 2016, small caps pretty significantly beat large caps. You can look and see over the one-year column in the Russell 2000, in about 20 percent range versus 18 and a half or so for large cap. So this year to start the year, small caps which had done well lag the large cap counterparts until really in the third quarter.

Another interesting trend, growth stocks in sectors -- tech, healthcare, IT, et cetera -- continue to outperform. They outperformed each quarter in 2017. After flip-flopping back and forth with value over the prior eight or nine quarters. And so again, I think that's important to note that I think it's evidence of a strong growing economy and also the fact that I think investors are expecting pro-growth policies to come through. You know, those sorts of expectation benefits small cap stocks and growth sectors, you know, more advantageously than large caps in value sectors like financials.

You know, one possible explanation -- I will address large cap one final time. Why it's until this quarter has pretty significantly outperformed. Large cap stocks are generally tied more to the health of the global economy rather than just, you know, the U.S. economy or the economy where they are domiciled. And as you are probably aware, international markets, international economies from market standpoint, economic standpoint have seen a very positive trends upward in 2017. So, U.S. small caps are

benefitting from that.

I mentioned international. Again, story there continues that international equities are outpacing U.S. You know, going back to the election, which was, gosh, well, a year ago yesterday or today, I guess. Hard to believe. U.S. markets went on a tear in the fourth quarter of 2016. International markets were off significantly. Starting this year, there was a big valuation discrepancy. And so, we saw a lot more fund flows into the relatively undervalued international markets.

Along the way, there were a couple of elections that presented possible headwinds. We have seen those risks fall to the side. And we're now at the point where we are at the end of the third quarter. The global economy is sort of in a synchronized positive trend, which is something we really haven't seen going back really to the financial crisis. If you recall in the U.S., the U.S. recovery was early. And we led international markets, you know, had starts and stops along the way. China, which had been doing very well for a long time, experienced some

bumps in the road in 2015. And Japan, which is sort of been a really underdog going back beyond ten-plus years, is experiencing some positive job growth and GDP growth there.

We have all major areas of the world synchronized in what's a positive economic move upwards. So, I think that's positive. And you know, stories like that along with, you know, we had GDP growth in the U.S. come in at 3 percent for the third quarter. I know last week I think unemployment ticked down either further to 4.1 percent. I don't recall what peak employment was in 2007. But if it wasn't 4.1, I think we were right on top of where that was.

Consumer confidence came in last week. And I apologize, I don't know the exact -- getting my numbers mixed up. It's either the highest in seven years or the highest in 15 years so going into, you know, the fourth quarter of this year which is historically a good quarter for consumption, et cetera, consumers are healthy. Corporate fundamentals are healthy. Global economy continues to move in the right direction. And so, I think that despite high

valuations, equity prices can be sustained as long as the growth continues to be there.

Risks are -- remain primarily geopolitical and political. We did see a new tax plan floated last week. You know, I think a lot of the last seven days in runups the market again, hitting record highs along the way is partially owing to expectations, you know, corporate tax rate proposed. And I think that was 20 percent down from 35. Would be very, very significant.

You know, I think that to get past, you know, that agenda, we will need both sides of the aisle. Probably not in its final form, but it's something that we are going to follow very closely because we think it will have a significant impact on the markets. And then certainly, after I listen to the interesting speech last night late by the President in South Korea, geopolitical risks between U.S. and Korea, U.S. and Russia, Russia and Isis, Syria, et cetera, there are a lot of entanglements. You know, I think every time we get up to a brink, people tend to step back from that. Again, we

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want to look for any change in those patterns.
So, the last thing I will address on this page once again is relatively muted low returns of fixed income down at the bottom. You can see the, you know, obvious absolute returns much lower than equities. You know, high yield and credit sectors continue to deliver outperformance. This plan obviously benefitted from that. We have the recent corporate credit RFP and high yield, which we will bet in October about. Fund in short order.
The spreads between, you know, those sectors and government securities have come down, but they are still delivering a premium in this type of market where corporate fundamentals are generally strong. And we expect default rates to remain low. So, we are comfortable with -- you know, you are not getting paid much for being in those areas, but it's still delivering returns in excess of flat Barclays aggregate.
You know, I think as the new Fed Chair proposed out there. He, Powell, doesn't look like there will be any different change to the current policies they have, which is measured

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small rate hikes as economic conditions, you know, point to that which the Fed looks at job. They look at inflation. Job growth has been robust. Inflation remain slightly low, but we can expect it positively to tick up here in the new year. We expect a rate hike in December. Then we look to the new Fed Chair to lay out policy of similar small rate hikes throughout 2018.
But we continue to benefit from a improving economic, improving markets. I don't know if there are any questions broadly on markets or economy.
(No questions posed.)
If not, we can move on to discussion of the plan. Tab 2, page 2.1. And again, you can see the market value as of 9/30, 528 million. You know, it's -- the last month and a half, it's grown pretty significantly. It's up to 542 now. But pretty strong absolute performance. Pretty good relative performance as well for the quarter net of investment management fees, up 3.7 percent. Beating the benchmark by, you know, ten-plus basis points or so.

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For the year, a year-to-date, excuse me, very strong absolute performance, 12.1 percent, beating the benchmark by well over half of percentage points. Maybe 60 to 75 basis points of relative outperformance year-to-date. You know, that -- still outperformance over the trailing one-year period and then, you know, strong absolute returns certainly over three years. You know, basically right on top of the actuarial target which is 7.35. You know 5 and 7 in excess of actuarial target. Booking actuarial gains annually over those periods is a positive trend.
Look through the managers. Again, very briefly, the two index funds within large cap. Vast majority of the assets in that component of the plan, you will see as the rebound. But as part of the termination of O'Shaughnessy and Fred Alger, part of those assets were moved to the index fund. So, we have relatively more index now in domestic large cap than we did back at the end of September. Again, that's historically been a space where, you know, active management has been challenged. But you know, we feel that,

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you know, RhumbLine or, excuse me, not RhumbLine but PineBridge benefits from that extreme relatively very low cost fee which is 18 basis points. And you know, a program that's designed to sort of minimize tracking error and generate steady, you know, measured outperformance over a full year, full market cycle. So, they were just put in the plan. They don't show up on this page.
Within the small cap managers, you know I think slight underperformance again this quarter. Those managers have lagged, you know, over various periods in the past. Last, you know, call it, you know, one year or so. Certainly, Vaughan Nelson more so than Eagle. You know mostly, I would say it's -- it's selection-based misses. You know, they are not adding significant overweights or underweights relative to their benchmark. The small cap index, significantly more securities to choose from. So selection tends to weigh, you know, more on performance, either the positive and negative than say overweight or underweighting wholesale industries.

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You know, healthcare, for example, I think was a detractor selection within healthcare for both Vaughan Nelson and Eagle. You know, but I would be remiss if I didn't point out that despite this quarter, Eagle is still leading for the year. So, I think pretty positive there.

Within -- I will move onto international equity. Again, this is an asset class where the structure of the space will look very different in the next, you know, several months as we attempt to -- we won't attempt. We will get rid of the mutual funds, which you might know are not -- even if they are not in violation of the Sandy Hook and MacBride principles, there is no way to guarantee that will always be the case because it's a mutual fund. We can't direct, you know, the portfolio.

We will move to sort of a two manager situation. That's what's been proposed, an index fund and then an active all cap global manager or global ex-US. But for the time being, you have a -- the active funds here Monterey and Harding. Again, in this instance, I think a little bit of their performance was tide more to certain

overweights and underweights.

For example, Monterey had overweight of energy, which detracted during the quarter. Harding Loevner was overweight to healthcare, which most significant detractors for each of those.

You know, but over the longer periods, I think both of them tend to have matched their benchmark pretty closely. I think we would like to see stronger outperformance. But I think by moving to this dual structure, we can lower fees by moving significant assets to an index fund. And we can select from the broad universe of separate account managers, top quality active as a counterpoint there.

You know, lastly again, you have the DFA, or dedicated emerging markets fund. You know, not quite an index. Sort of an enhanced index so you can generally, you know, fluctuations quarter to quarter but over longer periods close in performance to its benchmark.

Move on to fixed income. You know, again, if you look at the fixed income sector, the blue line, right on top of the benchmark for

the quarter, 85 basis points versus 85 basis points for the Barclays aggregate. Logan Circle investment grade credit, the middle manager right there was added, you know, back in the third quarter. I don't think they have the full experience -- expect the full quarter of performance. Nice to see slight outperformance. But again, we think that allocation will start to contribute, you know, handily to the overall fixed income performance of this plan. Same thing with SKY Harbor, the high yield manager gets funded. Those will represent overweights to credit, overweights to high yield, which we think can help beat the Barclays aggregate.

But moving through the actives Weaver Barksdale generally right very close to the agg itself. Outperformance for the year, longer periods. Logan Circle, the core fund is typically delivered higher outperformance than Weaver Barksdale. They take more, as you can imagine, from the Logan Circle. They have overweights to corporate credit at that portfolio which benefitted them. And then, obviously, the investment grade credit, benchmarked against a

credit index. That is evidence of, you know, not just overweighting credit, but they have positive selection of issuances. That is why they have outperformed there. So, positive to see.

Lazard, again, right on top of its intermediate benchmark. Lazard is actually relatively underweight to corporate. I mean, you have sort of Logan circle overweights, Lazard underweight. Managers take counteractive positions at times, but that's I think caused them to, you know, not outperform by as much as they have in the prior quarters.

And then the lone significant miss, Garcia Hamilton. That's an instance of they're also underweight to corporates. And they don't hold any BBB related rating securities. So higher quality, you know, I would say more risk averse strategies but in low coupon, rising great environment. The managers outperform by more, are those that take on that marginal unit of risk, I think.

MR. AMMATURO: Point I wanted to make on total fund performance. Alex mentioned as much to be clear, strong on absolute basis but it's also strong on a relative basis. If you look at the year-to-date columns, 12.15 verse 11.4. Part of that, just so you understand, is because you are overweight equities. Total fund benchmark is 11.43. That's if you just used index funds and just stay on top of those target allocations. But you are overweight the equity markets. That's obviously been a tailwind to your performance on a relative basis. That is why you see some of that outperformance.

Again, Alex will get to this. If you look at your asset allocation as it stands, you have about 3 to 4 percent equity markets, again relative to your targets in your investment policy statement. And again, that benchmark, that total fund TMI row, that is based upon the targets in your investment policy statement, if I am making sense. That row is based upon 65 equity. But you don't have 65 equity in reality. But let's call 68/69 percent equity.

Again, being not rebalancing back to target has been beneficial as you remain equity overweight. Just so we fully understand that.

MR. GOLDSMITH: Thank you, Marc.

Actually, we can probably flip ahead if there are no other questions on the managers or the performance specifically. We can flip to pages 2.5, and I will focus on 2.6 first. But this is what Marc spoke to just now. This is where it is made visible here. You can see, you know, the 3.7 percent underweight to fixed income is allocated between, you know, domestic and international. Slight overweight to domestic equity relative to international.

Again, if you are thinking, if you look through the manager performance year-to-date, it's relatively tight to their benchmarks or even some net underperformance. But you know, given how equities have performed relative to fixed income, you know, that -- this overweight of, you know, 3.7 percent, you know, has been the most significant, you know, driver of that outperformance.

MR. AMMATURO: This is where we spend majority of our time as investment committees, is determining where we want to be exposed in asset classes and where do we want to be underweight and overweight. When I look at this portfolio,

it's very, very consistent with where we have discretion on other accounts. It's overweight equities by the same magnitude. Again, this is how PFM views the world in terms of where to invest and how much to invest. Even more so than is this active manager adding value relative to the benchmark. It's more at macro the level.

You can have the best active manager, but it could be the worst asset class. So, 2.6 is very, very important in terms of keeping an eye on where you are exposed and where you are not exposed relative to your targets obviously.

MR. GOLDSMITH: You know, we are not take it to 5 percent equity. I think we are concerned about valuations. And times in the past our investment committee and other discretionary accounts have had overweights to equity. But we think a measured slight approach has benefitted pretty nicely. We are not going to recommend stepping on the gas. We are not recommending pumping the brakes a little bit either.

So, 2.5 is the cash flow for the plan. Again, we don't typically focus on these things.

They are more in the quarterly book. But it's nice to see moving in the right direction here. You know, I think the net outflows tend to be -- looks like they are relatively consistent. And I know they are on a month-to-month basis. That makes sense. That is just any contributions into the plan by participants and then money taken out to pay those benefit payments. That is offset by investment return, which has been very strong in percentage terms translated to dollars. It's, you know, more than, you know, doubling the net outflows.

And so, we -- that's pretty nice gain in the last year, 493 million to, you know, 528 now 540 million.

So that's, you know, really is the end of my remarks in this section. I guess, you know you can -- just another interesting thing to know, if we flip ahead to page 2.14, this is your allocate or your performance relative to peer group all public plans that we have in our data base. And over the year-to-date figure, 21st percentile, that universe of 439 plans, pretty squarely over the last one year, even three years

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five years, you know, top quartile plan performance and excess relative to the benchmark, which is the yellow dot.

MR. AMMATURO: Just so everyone understands what this is. Again, this is your pension plans performance relative to other public pension funds. So again, just to -- and the number in parenthesis is your peer ranking. Obviously, the lower the number, the better. What Alex is amplifying is year to date. You are ranked 21st percentile, which means your plan is outperforming 79 percent of the public plans.

MR. RUBIN: For the record, again, look at this from the viewpoint of why does it matter? Why are we putting it on the record? And I get that it looks great for Chris as the CIO to be able to say he's doing really well and getting up in the numbers and our staff and our consultants. But is it strictly so that the people on the outside will have a view and see, yes, we are in the top grouping? Or is there another meaning to this.

Because what I see is, that doesn't matter to me one bit because our objectives, our

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goals, our numbers are based on us paying our liabilities to our people.

MR. GOLDSMITH: Right.

MR. RUBIN: Everybody else's goals, objectives and numbers are based on their liabilities that they have to pay to their people. So, they are going to take more or less risks based on their percentage of funding. We are going to take more or less risk based on our percentage of funding. And where we stand next to the company next to us, generally doesn't mean anything to me.

So, I haven't heard an answer from anybody. We have been asking this for a long time. Why does that matter? And is there something that I missed when we look at those peer rankings?

MR. AMMATURO: It's data point. Not a be all and end all. Just a data point. We totally appreciate the fact that your asset allocation is going to be significantly different than some of these other plans because of the reason you just cited. Some plans may be taking on a lot less equity because they don't need to

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achieve 7 percent, let's se. Maybe they need to achieve 6 and a half because they are less well funded.

So yeah, this is not meant to be a be all, end all, everything is perfect. Everything is relative to your current situation. Again, this is just there relative for reference. It's not meant to say everything is perfect. We are trying to say, take a step back. It's always healthy to look at it verse the benchmark. It's also, I think, relevant to look at it relevant to peers.

This does not take into account your allocation relative to the other plans, which I think is kind of what Bill is getting at indirectly. A lot of these plans may not have 65 equity. They may have 55 or 50 equity. That's why it's not a perfect science. It's more of an art than a science. You are saying, here is your ranking.

Again, it's a data point. It's not meant to drive decision making by any stretch.

MR. RUBIN: The point that I wanted to bring out for that, I love the work you guys are

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doing. I think you are really on top of a lot of what is there. The input we are getting from you on the main fund, I think our consultants have really helped. Chris' leadership have been great on both of those points, as well. I want to protect the record so when we are not in that group and they come back to us and say, well, look at all of these other plans. They are doing great and look at you, why are you not where they are? I don't want to take credit now and duck and dive later.

Let's be on the same plan. We've always --

MS. JOHNSON: That's fair.

MR. RUBIN: We've always said, we managed our liability, not everybody else. So, I appreciate the work you are doing. I don't want you to take that as a negative or Chris and the staff. I just want to be on record when we are no longer here, and then it comes back that we always felt the same way. We managed the liabilities.

MR. GOLDSMITH: That's the point.

MR. AMMATURO: Point taken.

MR. GOLDSMITH: One thing I think actually where this would be even more relevant would be in an instance where you fall out of the top tier, or fall into below median. It can be used in tandem with the chart up above, which this shows your allocation relative to peers. And maybe the big takeaway for me is, certainly your equity, U.S. equity, international equity is high, but your fixed income allocation is also high. Where you're significantly underweight your peers is these alternative sectors.

You know, and I know that that in times, you know, large public plans can have significant amounts. And I think in the past, that has caused some plans that have significant private equity allocations or hedge fund allocations to underperform. So by looking at what your allocation is, looking at how you perform, peer allocation and peer performance, you might be able to pick up on some of those strategies that have caused that relative under or outperformance. So, it's great to know now and you might help identifying issues if things were to change.

So, that really brings me to the end of my prepared remarks on the plan. Next several sections include, you know, indexed statistics on each manager. I know this does get sent out on a quarterly basis. We typically don't discuss at this meeting. If there are questions, happy to answer them. But I know that a lot of these managers, some of them are already out of the portfolio. There will be others that will be out shortly as new managers are added.

MR. AMMATURO: Can I make two brief comments at the firm level?

You may have seen a press release, you may have not. There was an acquisition of PFM. I think it hit P&I. PFM acquired fixed income, small fixed income asset management shop in Connecticut. It's about $2 billion shop. Again, you may have seen a press release. They specialize in fixed income money management especially within the stable value sectors. Stable value is more akin to 401K plans.

So, we did make that small acquisition. And another press release you may see coming in the December/January time frame, is we are in the

works to develop PFM mutual funds, PFM multi-manager domestic equity, PFM multi-manager international equity, and PFM multi-manager fixed income. This really doesn't pertain to PGW, but I just want to give you a heads up. This pertains more to the clients where we have discretion.

Our -- we are still going to hire managers, active managers index funds, but they are going to roll up into PFM multi-manager mutual funds. We are not going to get any fees from those mutual fund. The fees are not going to change. But it's a way where we can get access to a lot of managers we don't have access today by aggregating our clients' assets. So, we have about 5, 6 billion across our discretionary business that we want to aggregate and go to managers.

This enables us to do that by rolling out these products. Again, I just didn't want you to see the press release and say, what is going on here. I want to be transparent.

CHAIRMAN SCOTT: Thank you. Thank you for the presentation.

MR. GOLDSMITH: Yeah, it's no problem.

CHAIRMAN SCOTT: Next item of business is New Business. And I think there is one matter Chris wants to cover.

MR. DIFUSCO: This should be fairly brief. This is a page 5 of the investment policy statement that was approved late last year. Alex and I were reviewing it the other day related to an RFP. And noticed that if you look at the first sentence under D, it only makes reference to MacBride and doesn't make reference to Sandy Hook. And so while we do enforce the Sandy Hook principles, we should explicitly make reference to the investment policy statement.

Apologies for that oversight. We have been -- it's implemented. It's part of the program. You know, funds aren't allowed to invest in those stocks. But I would just ask for a motion to add that, you know, sentence in and to post that corrected version to the IPS on the website.

MR. RUBIN: Chris, does that -- are they the only two that have been implemented here as opposed to what we have implemented on the Board?

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MR. DIFUSCO: Correct.
MR. RUBIN: Okay.
MR. DIFUSCO: That's right.
MR. RUBIN: Is there --
CHAIRMAN SCOTT: Go ahead. I'm sorry.
Well, a motion has been put on the table to make certain adjustments to this document.
Is there a second?
MR. RUBIN: Second.
CHAIRMAN SCOTT: Motion has been made and properly second.
All those in favor?
(Ayes.).
CHAIRMAN SCOTT: Ayes have it. Motion is passed. Thank you.
MR. DIFUSCO: Thank you.
CHAIRMAN SCOTT: I guess the final order of business based on this agenda is adjournment.
Is there a motion?
MS. JOHNSON: Motion.
CHAIRMAN SCOTT: So moved.
Thank you guys.
(Meeting adjourned at 10:38 a.m.)

C E R T I F I C A T I O N

I, hereby certify that the proceedings and evidence noted are contained fully and accurately in the stenographic notes taken by me in the foregoing matter, and that this is a correct transcript of the same.

ANGELA M. KING, RPR
Court Reporter - Notary Public

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