SOUTH CENTRAL CONNECTICUT REGIONAL WATER AUTHORITY

PENSION & BENEFIT COMMITTEE

JANUARY 26, 2023

MEETING TRANSCRIPTION

[PENSION & BENEFIT COMMITTEE MEETING BEGINS AT 12:32 P.M.]

Suzanne:

Thank you. So our first item up for agenda is the approval of the minutes. So do I have a motion to approve the minutes?

Catherine:

I'll move the approval of the minutes.

Kevin:

Second.

Suzanne:

Thank you, Catherine. Second?

Kevin:

I'll second.

Suzanne:

Kevin?

All right, any discussion of changes? Okay, seeing none. All those in favor, please say aye.

I, thank you. Any nays? No. Abstentions? No.

Minutes have been approved.

All right, so we are ready. I'm sorry I can barely see this screen, but we're ready to move on to the Morgan Stanley report on performance of the two pension programs. If Steve and Joe and the team are ready, we're ready for you.

Stephen:

We are ready. Can everyone hear us okay and see okay?

David:

We can hear and see. Yes, thank you.

Stephen:

Very good. Happy New Year to you all. Hopefully it's begun with some good things happening as it actually has in the markets. So today's meeting will be a little bit more upbeat than the last meeting hopefully, because we have seen a bit of a recovery frankly from roughly September 30th until now.

So the quarter was good and the year has started out to be quite strong. Whether that continues, time will tell, but it certainly feels a lot better than when we last spoke. So let's take a look. We'll do a little brief market commentary. I have a few slides, and then we'll get into the nuts and bolts of the different pools of money, the different plans.

And as always, please, I've got Alan Kantapin is on here with us or should be, and Joe McLaughlin is here as well. Please ask us questions as we proceed and or at the end, whichever you prefer. But don't be shy obviously.

Let's take a look at the markets last year. Then we'll look at the asset allocation of each individual pool of money versus their targets, and we'll look at the results of the most recent and the longer term timeframes. Does that sound good to everyone?

We start a little differently here. We're starting by looking at the bond market, because we're reviewing the fourth quarter of last year and all of last year. And we'll look a little bit forward. But really last year, although the media primarily speaks and each of us too about the stock market, the reality is last year was led by a fed who was trying to cure inflation. To get the rate of inflation down, which it does appear that they have begun to have success on that front to a rather large degree already actually.

However, in that fight, by raising interest rates from zero to where they currently are, you see in the far right. This goes back to 1976, each gray or blackish bar is the calendar year return for the Barclays, now Bloomberg, aggregate bond index, we think of that as the S&P 500 of bonds.

And you'll note that the far right last year, it's standout in all of history. And it's even a standout if you went further history before the index existed. The bond market end of the year down 13% and the red dot below that, the 17, the bond market at one point was down as much as 17%.

So you see in history, there's always a down period during the year, but the worst year we've ever had in modern history other than last year's 13 was three and there's a couple twos. But generally speaking, the bond market does not experience this type of volatility.

So if we jump to the next slide please. That's the lead story last year as opposed to stocks, because to us our belief is that stocks, along with all other asset classes, whether it's office billings, storage units, hotels, your home, my home, et cetera, valuations, private equity, public equity, any type of bonds, global equities, the adjustment in price was a reflexive reaction to the adjustment in interest rates, the climb of interest rates.

Interest rates go higher, cost of borrowing goes higher, and thus the required return on capital has to command a higher rate if you compete with bonds. And as such, valuations dip. This was a very mechanical, I would almost call it didn't feel non-emotional, but unlike say a [inaudible 00:07:44], God forbid, or a global financial crisis, this was not a chaotic event. This was a manufactured event that I would call non-emotional relative to many market corrections in history.

I'm going to [inaudible 00:07:57] on the 10 year treasury in the upper left box here, if you can see that. Back in December of 21 it was yielding 1.52%. By December of last year it was 388, and thus if you owned just a 10 year treasury for the one calendar year last year, you were down 16.33%. Just gives you a framework for what happened.

Now, if you still own it, you own a nine year bond now, so it's one year shorter. And on January 1st it was yielding 388.

So what's happened, the crux of this slide, and this slide's a little too complex, is the right-hand side of it. It says what would happen now, let's pick that same 10 years, the fourth one from the top in the right half of the page. What would happen to that 10-year treasury now if rates went up or down 1%?

So if the rate on the 10 year now fell 1% from 388, which it's begun to do, to 288, which is a possibility between now and year end, that bond would make 11.8%. But if rates went up an additional percent, so from 388 to 488, it would actually only fall 4.1. Because the bonds have higher yield now and thus their duration is shorter, and a better way of saying that is their sensitivity to moves in interest rates is less than it was a year ago because we are starting at a higher point now.

So I think that's important, that we would not expect or anticipate the bond market to have a repeat of anything like it had last year. Doesn't mean it can't have negative years, but it would be unlikely to have two back to back. That would actually be three back to back. And even if it was a negative year, it would be highly unlikely it would ever be in the caliber that it was in last year.

So jumping ahead please. One of my new favorite slides, this takes every stock market year back to 1929, every down year, and in light blue you see what the equity market did in that particular the year. So last year you see the S&P including dividends dropping 18.1%, the right most bar.

In dark blue, that's the bond market last year. You've already seen that down 13. The idea here is we look at history of every other down stock market year, you see very few incidences where the stock market was down and the bond market was not up. So it's this lack of diversification impact I call it that really hurt last year. Pick at 01 for example. 01, you had equities down 11 nine, and if you're half in equities, let's call that 12, that would cause your portfolio to be down six.

But if you had the other half in bonds, those were up eight, you'd gain four of those points back. So thus in a 12% down market, your portfolio was only down 2%, a balanced portfolio.

So we did not have the seesaw impact last year. Instead we had both asset classes down for one of the few times in history. I think I'm counting exactly two, 1931 and 1966.

So that's how unusual last year was. And we could jump ahead. Does that make sense to folks? I think it's pretty simple.

Now valuations. So this is very important, because watching the market day-to-day is not a great game necessary for anyone. But the upper right, we know certain things about valuation. We know that we started last year at 21.4 times earnings. We knew it was bit high at 21.4 times earnings, but we also knew as long as inflation stayed low, as interest rates stayed zero, it was likely to remain high.

That obviously changed pretty quickly last year. The market came down, according to this 20% because this does not include dividends.

But you were then at 16.7 times earnings by year end. Let me give you some relatively for that number on the next slide.

The left side here. So that line graph on the left side, you can see that line coming down as we were in last year. And if you could draw a straight line from where we ended that 16.7 to the far left, you'd see that we are a little bit below the average valuation on the market since 1990. We're not super low, but I would say we're in effect back to average.

So unlike last year, we knew 21 times going into the year was high, but we also knew rates were zero. We would argue that you could almost flip a coin this year, is it going to be up or down? I think we're back to normal on the bond market and we're back to relatively... It may not feel it, but I would consider us from a valuation perspective back to a relatively normal situation in the stock market.

Stock market's becoming, and you can see it happening day to day, a lot less worried about what the Fed says, and we think this is the theme for the current year, not so worried about the Federal Reserve, much more worried about earnings. So we believe that focus will turn to earnings and it has indeed already turned to earnings.

And then one more I believe, what does Morgan think? Morgan still thinks we're in for a pretty flat calendar year for equities. So Morgan's base case, now we're looking at 2024 earnings because the market tends to adjust quickly. If you take the base case of 241 and we put a two-thirds weighting on this, simple multiple of 16.1 times earnings, you'd be at 3,900.

Low and behold, as we sit here, the market is, I'll give you the exact number while we're talking. The market is at 4,037. It's up a little bit today. So we're close to that.

So we think that as a base case, a volatile but flattish year with probably a hockey stick up at the end of the year. We think the [inaudible 00:13:58] case you're up about 8%, and the worst case we're down about 10%. Fairly tight range of possible outcomes in our mind.

We hope we're wrong, but that's the simple math of earnings forecasts with a practical multiple. That assumes no major change in interest rates. If interest rates start to drop, I was with the head of fixed income research for a major money manager last night and they're talking about a 10 year treasury of two and a half percent by year end. I think they're a little aggressive on that, but if that was indeed the case, this 16 multiple would probably be back to 17 or 18 even.

Make sense?

Let's do some work on the plan on the next few slides, I believe. We start with the salary and union plans combined. So it's 1231. The salary and union plans combined had 63,769 million of them upper center. They were allocated per the pie chart, which the box in the right helps us dissect that pie chart.

Just over 56%, call it 56.5% in equity. The remainder in the pie chart itself in the grayish brown, about 40% in fixed income, very light in alternatives, very light in cash and equivalents because that's really not paying much these days. Any cash and equivalents we're keeping in shorter term treasury type vehicles.

Bottom right of that box, let me go up a little bit, sorry. International, about 24% that's been performing extraordinarily strong for the last four months now. That's a huge sea change, as the dollar has come down that's performed strongly. 76% of the equity domestic, and then pretty even balance in the bottom between value and growth.

A little point or so higher in growth as that's come back a bit, but mostly in core domestic equities. We jump to the next page which will give us what we call the matrix. So if we dissect the benchmark for the salary and union plans into its components, it's the leftmost column of numbers equaling 100. How it's actually invested, we're about 1% overweight US equities after the quarter because we had a very strong quarter there, we're still a little bit underweight international equities. That would help us if we were actually fully weight there now.

We're at 179, we are very overweight fixed income. That's been very helpful at the moment. 873, that's domestic fixed income. That comes at the expense of the next several categories.

We have nothing in global bonds. We've been like that for a while. We have very little in alternatives. We've been like that for a while. We have a half weighting in global real estate, that's been very additive to the results.

Real estate's readjusted its values quite steeply, and we're underweight in cash. So the real overweight here is to fixed income instead of those four categories.

If you look at the next page please, we look at the [inaudible 00:16:53], it's somewhat similar. Slightly different targets, slightly different mix. For instance, not a lot different here, but we don't have the individual bonds. But overall the weightings, similarly you've got almost 57% in equity. We've got closer to 39 instead of 40% in fixed income. But a similar weighting in alternatives in cash and equivalents and a similar value core growth look at the equities.

If you look at its matrix, which would be on the next page again, you'll see it's a very similar story. A little overweight US equities, underweight international, very overweight domestic fixed income with an underweight to the other categories of global bonds at zero, hedge fund type vehicles at reduced weighting, global real estate at less than a half weighting, and cash, obviously a light weighting because we can do better than cash.

So very similar theme, and then we roll forward and we can look at the results. So here's the fourth quarter last year. So this finishes out the calendar year. This was the bottom frankly at the moment, not predicting the future, but at the moment it was the bottom.

So when we last spoke, there was 68,618,823 in the combination of salaried union and [inaudible 00:18:15] plus their cash accounts at Matrix Trust. They were withdrawals during the quarter. So benefit payments of 361,429, those are net benefit payments. The transfers equal zero. They're intra account transfers, meaning either in or out of Matrix Trust in order to pay a benefit.

So that simple math, your net invest was 68,257,394. It ended December 31st. The combination of the vehicles 72,859,355. So we didn't get to say this last year I don't think at all. But the dollar gain for the fourth quarter was 4,601,961. 6.78% net of all costs, 6.89% gross.

It obviously out earned the actual rate of return for the quarter. Again, this is only a quarter. It also out earned very nicely the benchmarks, the primary benchmark. The primary benchmark is the 612, the strategic benchmark for the portfolio and the others are if you were equal weighted last quarter, you continue to do better than if you're market cap weighted. And if you took on less risk, you did less well than if you took on more risk.

So the main benchmark is the 612, and it had a nice return versus that. Due to those, I don't want to call them extreme, but due to our allocation, that's not exactly on that benchmark. So that was good.

I'm just going to give you a quick update because we usually do this when it's this late in the month. This trend continues into January. The three plans are up another almost 4%, 3.94% in January alone, 2 million 839. So when you look at the two timeframes, we're now up north of 10% from the bottom.

The trailing 12 months now, interest enough is down, I shouldn't say only, but in the world we've lived in I'll say only, 6.03% net for the trailing 12 months. Or a dollar degradation in value over 12 months of 4 million 868. So things have improved rather substantially between the fourth quarter and currently.

This timeframe, could you scroll up just a little please? I just can't see the top of it.

Thank you, I just don't want to give you the wrong timeframe. This is the calendar year. So for the calendar year, maybe I won't read all the numbers, I don't know if you want me to. But you started the calendar year with 84 million, you net paid out 431,000 in benefits. At end of the year it's 72 million 859. So it was a $10.7 million loss for the year, which is 12.85% net, 12.53 gross.

Pretty big numbers, obviously didn't make the actual rate of return for that timeframe, but did do quite well. The strategic benchmark was actually down 15.74%. So a very healthy amount of out performance versus the benchmark, which at least helps as we begin to recover. We're recovering from a better place than had we been down with the benchmark.

If we scroll forward, please, fiscal year, could you scroll up again please? Sorry, just got to keep my dates in mind.

So this is really your June one until December. So it's a seven month timeframe for your fiscal year through December, and this would obviously look quite a bit better now too. Hopefully that continues through May. It's usually the opposite. We have good calendar years and then the fiscal year ends up being the tougher one historically.

But fiscal year, you're currently down 2 million 792 since the fiscal year started, ending value the same obviously 72,859. It's 370 net, it's 349 gross. We're obviously not up at the actual rates of return right now, which would currently be the 3.94 number. But there's some optimism that we could get there, the way things are running. It also benchmarks really well, the main strategic benchmark is the negative 528. So not even close to that.

We'll go longer timeframes. So we get the last three years, so a one year down 12% does a lot of damage to the three year returns obviously, but they're still positive.

If you go January 1st of 20, so think about January 1st of 20, COVID was about to hit these shores in 60 days. So that 69 million 887 is before we really knew about COVID. You've had net withdrawals of deposits over that timeframe of 2 million 189. You're ending value same number, 782,859. Your net invest is 67,697.

So a dollar gain of 5 million 162, relatively modest for the size, but 2.43%, 279 gross. Obviously below the actual rates of return right now. But again, the primary benchmark's 208, so it's good against that. Primary investment benchmark.

If we go out further in time, we're going out to five years. It improves. Again, five years ago the funds combined had 59 million 123. Started to get some perspective with some distance. You've actually had net deposits when you get to five years of a million and 43,536.

So your total invested, if you will, from five years ago is the 60 million 167, same ending value, the 72,859.

Dollar gain for five years, 12 million 692, starts to get a little better.

Obviously we're getting time on our side. 382 net, 420 gross, still benchmarks. Now net, you're not above the midpoint benchmark, but gross, you still are here.

We go to six years, so the next slide. A lot of accounting, I know, but important. Six years ago the combination of the plans had 48 million, 754 in them. You have made net of any benefit payment, you've made deposits of 3 million 750. When you look at six years, thus your net invested six years ago plus deposits is 52,504. Same ending value, the 72.8. 20 million 350 for a gain over six years. Starting to get up in the territory we need to be in, 5.7% net, 609 gross. Again, a bit below the actuaries still, but still above the primary benchmark, which is 567, just there.

For the first time, happy anniversary, we have a seven year number on the next page, or we should.

Yep, so seven years. It's about the same, gets a little better, but the dollars get a lot better. There was 41,761,987 when we first began working with you. There have been deposits net of withdrawals since that time of a much bigger number now, a lot more deposits came in.

Some of that might have been the conversion back then, so it may not all be new deposits. Because deposits, these are deposits to Morgan Stanley, 7, 964, 573. Transfers again net zero. So your net invested from seven years ago, 49,726. Same ending value of 72.8. 23 million 132 gain. 578 net, which is the number that matters to the actuaries. 617 gross, which is for benchmarking purposes.

And again, the actuaries during that time, we went from seven to 675 at one point more recently. So we're still not quite back to meeting the long term actuarial target, but made a lot of progress just from three months ago at our last meeting.

Benchmarks did change over this timeframe, but the current benchmarks, the strategic one from the investment point gross is 587. So me talking a lot, but definitely more optimistic than the last meeting. Definitely getting closer to the long term targets again, but definitely still behind them by a little bit based on the market activity of last year.

I have a lot more detail if we wanted to go into it on the holdings, but I think we typically stop right here and at least pause. And do we have any questions, comments, concerns?

Suzanne:

Yeah, I don't think we need to cover the holdings this time around. Unless you have something radically new and different that's going on. My guess is you've been shifting around on the edges, but not necessarily major.

Stephen:

More than usual. Yes, more than usual, but correct.

Suzanne:

Okay. I guess the only thing I would ask if you could share with the board, Steve, is your take on after seven years, still not getting the portfolio to the benchmark necessary from an actuarial point of view, sometimes exceeding the benchmark of the investment perspective. What does that mean to the RWA in terms of impact?

Stephen:

Well, I'll try to answer it, but it would really be an Angel pension question. It's an actuarial question. It would mean, and it's interesting. At this moment in time that is accurate. One year ago, we were nicely above it. It's interesting how one year changed that. And one year from now we could be back at it.

So here's a challenge. When you have a pension that's a live pension, meaning providing benefits, accruing benefits, if you did not have that, you would typically move a lot more of the fund to fixed income, lower the actual rate of return, and in effect [inaudible 00:28:02] your risks. Meaning the ups and downs that we're experiencing over time.

At a moment in time like this, the actuaries would look at it and say, "Well, we're underperformed our expectation. But there's another side to this equation too."

However, the discount rate has also gone up a lot. So what Angel is finding and what all of our actuaries are seeing right now, is it a plan that lost as much as even 16, 17% last year and we were down 12? It actually has improved or not lost any standing from its funded status. Because the backdrop, you need the backdrop to understand this. It's counterintuitive, but when a liability, which it sounds like a bad thing, but the actuaries consider the liability.

So liability equals a pension benefit to a person. When a pension benefit is paid out, the calculation is done on the current underlying rate of interest. The current underlying rate of interest went up. And when a current underlying rate of interest goes up, your liabilities actually go down.

So I am optimistic that your liabilities may have gone down more last year than your assets. That would be what we're seeing typically. And especially when you're down in a 12 range, not the 16 range, which is more typical. It's very possible you're funded status actually improves, Suzanne.

Rochelle:

Yeah, I think the way our plan works though, when we saw this at the end of May, our liabilities absolutely went up because of how governmental is calculated.

Stephen:

Right, I knew that was coming. That's where it's typical. In a governmental plan, the actuaries do a different calculation. So yes.

Okay, I'll stop on that one because you're right on that. I don't understand the mechanics that the actuaries go through on that front, but more typically a liability would go down when rates go up to this degree.

So your question, we're meeting the strategic benchmark from an investment perspective but not from an actuary perspective. I would say that that's a moment in time, and the same moment in time a year ago we're in effect patting ourselves on the back saying, wow, we're actually at the actual rates of return. It's great.

As you can see, the longer term numbers move a lot less sensitively than the shorter term numbers. You get to seven years, you're at 580, call it. Net, net, net, we need to be at 675.

And so Rochelle and I have been talking behind the scenes the last week or so on some emails, and with Alan involved, we think it's time to do again the asset liability study.

And Rochelle, I read your email from the other day, but we don't have the data to do that with yet currently. But when we have that, if you recall what we like running is on a periodic basis, annually is nice, but every couple of years is fine too. What are the dated liabilities, meaning what is owed out in the next year, the next two years, the next five, the next 10, the next 20, and so on.

Angel runs that number for us. We then match the assets to that and say for instance, all liabilities or pension payments due in the next 10 years, for example, should be in fixed income.

And that's how you ultimately fix and match the assets and liabilities. And thus the mix of say 55% equity, there's no randomness to it at all if you recall. It was based on those liabilities are 10 years and longer. And the shorter liabilities, especially the one to five year, are absolutely in fixed income.

We, as you know, even like the 10 year liabilities in fixed income. And the more you have in fixed income, with the exception of last year really, you typically dampen the misses to the actuary rate of return. But at the same token, the more you have in fixed income, this has been our push and pull for a while, the more you have in fixed income, the lower your assumed actuary rate of return needs to be.

So it all interplays. If we say we're going to put a whole portfolio in fixed income just to be extreme, and we think we can get four and a half percent a year out of fixed income, then the actuary rate of return can't be more than four and a half percent. If that just made sense.

But when we add equities in and we say equities will make 8% a year, just as an example, and we have half of it in equities, well, now we can actually get to a rate. So to get to a rate even 675 that I know we went through a lot of analysis to lower, and I don't think it needs to be lowered again, we'll run that for the next meeting too.

But to get to that rate requires some volatility. It requires some equity like returns. You can't get there with fixed income, only returns. And then to your balance sheet question, if you went to all fixed, I know you're not suggesting that, but just to be extreme, if you went to all fixed and we said it can only make four and a half percent. Well, if we drop that to four and a half percent, Rochelle can comment on this, but I think Angel's going to tell you that you need to put a lot more money in the plan.

So it's very much a delicate balancing act. There's no question. And we firmly believe the most important part of that balancing act is to have those 10 year liabilities or pension payments funded with fixed income.

Suzanne:

Okay, thank you.

Stephen:

Long answer, huh? But it is delicate. It's a one part moves, something pops out elsewhere. It's how these work. But I think given that we just went through a dire historical poor bond market and a lousy stock market, not historical, frankly, seven year returns are reasonably close to that.

But it really ends up when Angel does the calculations, and in a way it helps average into bad markets, they're likely to say that you need to put a little bit more money in the plan.

Suzanne:

I'm sure that's what they're going to say.

Stephen:

They're saying you need to make 675 and we actually just lost money. And even if you look long term, we're below six. So the two questions we want to ask in the near term formally, one is let's do the asset liability study, which we're working on that behind the scenes, but as soon as we have the data, we'll do that and present it to you. Two is is the 675 still realistic? We think it is, but we haven't come out with our forward looking forecast yet. We do that once a year, I believe, Alan, it's in March usually.

I think Alan's out there somewhere, but it's hasn't come out yet.

Alan:

Sorry, I was on mute. But yeah, that's true. Morgan Stanley releases their forecasts on March 31st of every year.

Stephen:

So once we do those two things, Suzanne and the whole committee, I think we'll have a better grasp on, and Angel, at that point, Rochelle, they will have given you actuarial numbers based on last year.

Suzanne:

Correct.

Rochelle:

So can we do that? Can we discuss that at the next meeting?

Stephen:

We can if we have the data, when do we expect the data from them?

Rochelle:

Yeah, well, I believe the next meeting is April, and we will have the information.

Stephen:

So as long as we have the information, I actually would suggest that that will likely take up a good percentage of the next meeting. Because that's more important than just reporting the results. It's more forward looking.

Suzanne:

All right. Are there any other questions for our Morgan Stanley team?

Okay, well we're grateful for better news. Thank you very much. And we look forward to continuing to improve. Appreciate it. So thanks guys for being here. Here, Alan, Joe, and Steven.

David:

Madam chairman, would you like a motion to adjourn your committee?

Suzanne:

Not actually, actually I'd like a point of information just for a second. I know that at our last meeting for the Pension & Benefit Committee, we discussed altering the charter or adding to the charter, some consideration of some sequence of time, years. We would RFP our services for this particular aspect. And I just want to check, is that for April or is that for July?

David:

Good question.

Suzanne:

Which meeting would be the right meeting, Rochelle, for the charter to come up? I don't have my work plan in front of me. I don't know if anybody else does.

Rochelle:

We could do it at any time, but I believe the work plan for pension would actually be at the April meeting for the upcoming year.

Suzanne:

Okay, so if the charter is in the work plan for April, let's stick with what the work plan says. I don't feel any need to do anything out of cycle. But what I would do, you and I can talk offline about what to communicate to Morgan Stanley, I don't want them to show up and be surprised at that part of the [inaudible 00:37:41].

Not that they have to be a part of that conversation, but just in any way, shape, or form, they deserve to be given a heads up about the whole thing.

So anyway, does anybody else have anything else on their minds about this? Not so much technical investment stuff, but I kept it pretty short today because I don't think there's a whole lot new to say, both forward looking and backward looking.

So it is what it is at this point, given this is our mode of investing, this is our return, this is our target, and we're still struggling to get there over time.

Okay, great. Then I will take a motion to adjourn the meeting, the subcommittee for Pension & Benefit.

Kevin:

So moved.

Suzanne:

Thanks, Kevin. The second?

Catherine:

Second.

Suzanne:

Thank you. If no discussion, all those in favor please say aye.

Aye, thank you. Any opposed?

[PENSION & BENEFIT COMMITTEE ADJOURNS AT 1:07 P.M.]