

**PENSION REVIEW COMMITTEE
RECOMMENDATIONS
ADDITIONAL INVESTMENT CATEGORIES
HIGH YIELD BOND, PASSIVE BOND INDEX, EXTENDED MARKET EQUITY INDEX,
AND PASSIVE INTERNATIONAL EQUITY
May 3, 2018**

INTRODUCTION

The Pension Review Committee met April 10, 2018 to discuss augmenting the investment arrays for the 401(a) Lancaster County Employees Retirement Plan and 457(b) Deferred Compensation Program to include the following categories: (1) high yield bond; (2) passive bond index; (3) extended market equity; and (4) passive international equity. During the meeting a conference call was conducted involving the following representatives from Prudential and Segal Marcos Advisors: Robb Craddock, Prudential Vice President of Investment Strategy; Leah Kostuck, Prudential Client Service Manager; Frank Picarelli, Segal Marcos Senior Vice President; and Christopher Hill-Junke, Segal Marcos Research Associate. The following reports, updated through the first quarter of 2018, were prepared by Segal Marcos Advisors and presented to the Committee for consideration: (1) High Yield Bond Fund Search; (2) Passive Bond Index Search; (3) Extended Market Equity Search; and (4) International Equity Search.

DISCUSSION

High Yield Bond

The inclusion of a high yield bond fund was considered as part of a strategic look at the entire investment lineup for the Lancaster County retirement and deferred compensation plans. Segal Marcos identified three funds for consideration: Hotchkis & Wiley High Yield; MainStay High Yield Corporate Bond; and Loomis Sayles High Income.

While it was noted that the high yield bond asset class typically does well in a rising interest rate environment, the Committee noted the following concerns with adding this investment category to the County's investment lineup. The high yield bond category is not included with most pension plans. This asset class is more expensive because it is active managed, and more risk is taken to produce yield. High yield bonds behave more like an equity component than a bond component, and they are often referred to as junk bonds. The Committee was concerned that inclusion of this asset in the bond category may mislead participants into believing it has lower risk than it actually does.

Given these concerns the Committee advises against adding the high yield bond asset class to the County's investment lineup.

Passive Bond Index

Segal Marcos identified three funds for consideration: iShares US Aggregate Bond Index K; Principal Bond Market Index Instl; and Vanguard Total Bond Market Index Adm.

The Committee noted that one of the advantages to adding a passive bond index to the investment array is the low expensive ratio. Both iShares and Vanguard have expense ratios of .05, while Principal has an expense ratio of .17. The County's lineup presently includes the actively managed Core Bond Plus/PGIM Fund, which has an expense ratio of .40.

However, the Committee noted the County's existing bond fund is performing very well. In fact, Core Bond Plus/PGIM has been consistently ranked in the top quartile, and the manager for this fund was recently named as the fixed income manager of the year by Morningstar. Additionally, actively managed bond funds traditionally out-perform passively managed bond funds. This is also true in a rising interest rate environment.

After weighing the advantages and disadvantages, the Committee concluded that a passive bond fund should not be added to the investment lineup at this time.

Extended Market Equity Index

The only fund identified by Segal Marcos under this category is the Vanguard Extended Market Index Admiral Fund. This Vanguard fund is a combination of small cap and mid cap equities, commonly referred to as a SMID. However, most of the holdings are in the small cap category. The expense ratio is .08.

The investment array presently includes both small cap and a mid cap index funds: the Vanguard Small Cap Index Admiral Fund; and the Vanguard Mid Cap Index Admiral Fund. Both of these funds have an expense ratio of .06.

If the extended market index fund is added to the investment array it will be necessary to eliminate the existing small and mid cap index funds and map their proceeds to the new extended equity fund.

Several concerns were raised by the Committee regarding the addition of the extended equity index fund. It was noted the expense ratios for the existing index funds are lower. Also, participants would LOSE some tactical ability to allocate between small and mid cap index funds because the SMID fund is more heavily weighted towards small caps. Given these concerns, the Committee believes it is better to stay with the existing index funds.

Passive International Equity

The investment lineup already has two strong actively managed funds in the international equity category. Both Segal Marcos and Prudential advised the Committee that adding a low cost passively managed fund in this category makes sense from a fiduciary point of view.

Segal Marcos identified three funds for the Committee to consider: TIAA-CREF International Eq Idx Instl; Fidelity® Global ex US Index Premium; and Vanguard Developed Markets Index Admiral. TIAA-CREF is a classic index fund and has the lowest expense ratio at .07. Vanguard includes small cap stocks and has an expense ratio .08. Fidelity includes emerging markets, and has the highest expense ratio at .10. Fidelity also takes the most risk of the three options.

Based on the information presented, the Committee determined Vanguard is the best choice. The lineup already includes other Vanguard index funds, and over the last 15 years the Vanguard option has produced the best returns of the three choices. Although the inclusion of small cap stocks slightly increases the risk, and the expense ratio of .08 is slightly higher than TIAA-CREF's expense ratio of .07, the Committee believes that our familiarity with Vanguard and the demonstrated higher returns outweigh these factors.


RECOMMENDATIONS

Based on the foregoing information and discussion the following recommendations are hereby tendered to the Lancaster County Board of Commissioners:

1. **NEW FUNDS SHOULD NOT BE ADDED TO THE 401(a) LANCASTER COUNTY EMPLOYEES RETIREMENT PLAN AND 457(b) DEFERRED COMPENSATION PROGRAM INVESTMENT LINEUPS IN THE FOLLOWING CATEGORIES:**
 - A. **HIGH YIELD BOND;**
 - B. **PASSIVE BOND INDEX; and**
 - C. **EXTENDED MARKET EQUITY INDEX.**

2. **THE VANGUARD DEVELOPED MARKETS INDEX ADMIRAL FUND SHOULD BE ADDED TO THE 401(a) LANCASTER COUNTY EMPLOYEES RETIREMENT PLAN AND 457(b) DEFERRED COMPENSATION PROGRAM INVESTMENT LINEUPS UNDER THE CATEGORY OF PASSIVE INTERNATIONAL EQUITY.**

Respectfully submitted May 3, 2018 on behalf of the Pension Review Committee.


Kerry P. Eagan
Chief Administrative Officer