

POLICE PENSION BOARD
MINUTES
JANUARY 26, 2011

Chairman Matt Hollinger called the meeting of the Rockton Police Pension Board to order at 4:01 P. M. Present were: Sgt. Matt Hollinger, Officer Chad Ryan, Jaye Quimby, Treasurer; Bruce Lans, Dave Davison, and Steve Danekas, Investment Advisor.

At this time there were no minutes to be approved from the previous meeting.

Mr. Lans brought up the topic of fiduciary coverage and had also talked to the Village's insurance agent. He felt initially that we had appropriate coverage but found out recently they explicitly exclude fiduciary liability coverage. That is something we definitely should look at having. Mr. Lans stated that this could be written as a separate coverage from the Village. Mr. Lans volunteered to do the legwork. As Mr. Davison had noted, the statute makes the pension board members personally liable for a breach of the fiduciary duty. The big expense comes in defending an accusation of a breach of duty. The coverage provides defense cost and pay off in the event that it is necessary. Mr. Davison stated that we need someone to come in and explain the coverage, what it doesn't cover and what we need to be worried about; and also the board needs to listen to this explanation of coverage also. It would take action of this board to purchase it or the village to purchase it. The pension board is covered under the general liability policy of the village along with practices and directors and officers' liability but note that they exclude fiduciary liability coverage. Mr. Lans noted that the Illinois Municipal League probably sells this coverage; however, it is not included in the Village's coverage. This may be just a rider that you have to purchase. He explained that liability could come from violating the standards that relate to the investment of funds, funds because of our mismanagement have returned a less than market rate and we could be accused of mismanaging funds. Mr. Davison said that someone could accuse us of not giving him his appropriate benefits. He stated that on the school board you had insurance coverage for errors and omissions and if you screwed up somewhere along the line, usually unintentionally, that covered those issues.

Mr. Danekas stated that the Department of Insurance is looking at fiduciary totally differently than they did a year or two ago because of the new Arrisa Laws. Mr. Davison stated that this was discussed a lot at the conference he went to in St. Louis. This affects pension boards, private pension funds, and

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401K's. Mr. Danekas stated there are new laws changing as we speak. If you have the fiduciary coverage, the insurance company would provide the defense council. It would be nice if the Village would pay for the coverage. Mr. Lans will look into coverage with the IML and the cost for that coverage along with possible other carriers and bring that information back to the board along with someone to explain the coverage.

Updates since last meeting. Mr. Danekas explained the jelly bean chart showing the best performing sectors and the worst performing sectors going back to 2001 with equities. Focus on 2010. He pointed out that the S&P 500 returned 15.1%. You will note that the two columns above, Large Cap Growth and Large Cap Value, both performed at 15.1%. The reason why is that they use the S&P 500 for both of those indexes so they performed exactly the same as the S&P. Move up two more spots to Mid Cap and Small Cap and as you notice they outperformed the Large Cap pretty significantly last year. The reason to point this out is when we review our Large Cap Mutual Funds in the performance summary, you will see they underperformed the S&P 500 last year. This is one of the first years he can recall this happening. When you think of the S&P 500, it is the 500 best companies in America. When you break it down, 300 of those companies are Large Caps. The other 200 are Mid to Small Cap companies. If you owned a Large Cap last year, it underperformed the S&P 500 because the S&P is made up of 300 large companies and the other 200 Small to Mid Cap. The difference is an 11% return in the Small to Mid Caps. International stocks underperformed US equities pretty substantially last year. Move back to 2001 as he wanted to show how volatile international stocks can be. In 2001, it was the absolute worst place to have your money invested. For five years it was the best place to have your money invested until 2008 when it absolute worst again, then almost the best and back almost to the worst. That is why we only have a small amount of International. We still need to have a portion of them because you never know if they will be in favor or out of favor.

Bond Prices. In our review you will note that our return came in at 4.99%. In October we were up almost 7%. November and December was extremely difficult for the bond market and to be very honest about it, nobody saw it coming. Two things happened, treasury bonds went from 2.49% in November to 3.40% in December. He reminded the board that interest rates and bond prices work in adverse directions. When interest picks up, values go down. No one knew about QE2. The Fed announced in November that they were going to buy mortgage backed securities to keep mortgage rates low. So when you keep interest rates low, that should maintain bond prices; however, the market looked at it as an inflationary scare and prices went down and yields went up.

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Mortgages are now 4.5 to 4.75%. Bernake announced today that he is going to continue buying the 600 million dollars worth of mortgage backs. The Edward Jones people feel that this will work itself out.

The other thing that happened was the tax cut extension which is good for us but bad for the bond market because of inflationary scares. When you have inflation, interest rates go up. When interest rates go up, bond values, go down. Municipal bonds got hit the hardest in November and December because of the old supply and demand. The Build America bonds are municipal bonds to build highways, bridges, and schools. Any type of municipality could apply for these bonds. The government would pay 35% of the cost of that interest which was a pretty good deal for the municipalities. This program was to end December 31, 2010. All the analysts expected the program to be extended, but it was stopped December 31, 2011. So when it was stopped, we had a flood of muni bonds come to the market so we had a huge supply. Supply and demand generates what will happen with bond prices. Muni bond prices fell substantially in the month of December. Mr. Davison stated that as interest rates go up, bond values drop which is a concern since we have to invest 90% in bonds.

Fixed Income Outlook. Mr. Danekas stated that at some point inflation will creep into the picture and rates will have to go up to start fighting off inflation along with fighting off this deficit. Remember when rates go up, values go down so what we own will drop in value but will still pay interest on the full face amount. We still get the full face amount if they call it in or it matures, but on the flip side with new dollars to be invested, we should be able to get a higher interest rate. This report basically is what we think the outlook will be for 2011 with fixed income. It will be a challenging market with opportunities to invest money with higher interest rates. Rates haven't moved on the short end but on the long end – we bought a Build America taxable muni on Monday for 7.7%. That was not available two months ago. We did not see the QE2 and the Build America program ending. That caught the whole bond market off. In 2008 when the stock market took its fall, a lot of investors went into the bond market. People's risk tolerance changed dramatically when that happened and as soon as bond prices started going down in November and December, the selling started moving out of bond funds back into equities or cash and that helped fuel the fire to bring the values down.

Mr. Lans, on the taxable muni side, which are the only muni's that make sense for this organization, what do you see out there for 2011. The Build America bonds were pretty good yielding instruments. Mr. Danekas stated that we just bought the Chicago bond which is a taxable muni. He stated that he feels it will be come very hit and miss. Some issues will come out taxable and

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others will go tax free. The thing that will help taxable muni's is that they left interest rates low. If tax brackets had gone up this last year, it would have incentivized municipalities to offer things that were tax free because it would be better deal for the investor. We are subject to what comes to market.

Mr. Danekas shared a report about the fixed income department in regards to the State of Illinois. If you listen to the media, the media will scare you to death that the State of Illinois is going bankrupt, the bondholders will lose all their money and the pension plans are going broke. We have three State of Illinois General Obligation Bonds. We consider General Obligation Bonds of the State of Illinois appropriate holdings for investors seeking income from a diverse portfolio. The State of Illinois has faced several issues that have been well publicized. There are several factors supporting this recommendation: Large diversified economy with above US median wealth indicators by the third largest metropolitan area in the US. Illinois does have a budget in place for fiscal 2011. Through it, it relies on several one time sources of revenue and continued accounts payable. The State's aggregated pension system annual requirement contribution is expected to be funded this year from an upcoming debt issue. Finally under the general obligation bond act, the state has the irrevocable and continuing appropriation of funds for debt service payments on general obligation bonds to provide bond holders as a propriety claim on state revenue. In other words, any revenue that comes into the state, the GEO bonds are the first in line to get payments. On January 25, both Moody's and S&P have affirmed their respectable ratings of A+ and A1 on State of Illinois bonds. The highest rating is AAA. The only way you can be triple A rate is if you are insured. The S&P has removed the State of Illinois from credit watch and negative and assigned a negative outlook. Moody says retain their negative outlook on the state GEO bonds. This may be a response to the substantial tax increase that was discussed on January 12. Mr. Davison stated that the five pensions got greatly dinged and greatly lowered in a one day session last spring. They were trying to show that they were being fiscally responsible by lowering the costs of their pension plans. In spite of doing that they still got dinged but maybe not as bad as they might have. What they are saying is that it is OK to invest in State of Illinois bonds as long as you have a diversified portfolio.

Quarterly Review. Mr. Danekas stated that the return for 2010 was 4.99% up a little bit from what we looked at the end of third quarter. Two things happened. Our equities went up but that is only 10% of our holdings. Ninety percent of our holdings went down. We are down a little over a quarter of a percent for this year. Mr. Danekas stated that he can bring additional detail from this report if desired. Mr. Davison noted that your pension benefits are based on the pension earning 7-7.5%. That should be a concern. With

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investing so much in bonds to achieve 7.5%. He related that this could be part of the fiduciary responsibility. Mr. Lans stated that you don't have to accept the calculations of the Department of Insurance. The Village could hire an actuary. It might be something to discuss whether we want to keep using that number which is high. We don't actually have to use them if we don't agree with it. They would come up with a rate of return and then come back with a levy which is commensurate with the rate of return they are using. Mrs. Quimby explained the problem with the levy. The levy has to be done in December so in December of 2010 we levy for money that we are going to collect 2011 which is our next fiscal year. The state does their levy projections based on the prior year audit which typically does not get submitted to them until the end of November. In December when she is setting the levy, she does not have their numbers because they don't turn them around immediately. She is guessing what the levy should be based on the prior year numbers and what she expects the officers' payroll to increase. So in other words, it is a guess. Jaye and Mr. Davison stated that the levy is set high enough to get all that you can get. The Village does not have a separate levy for pension, but it is part of our overall tax limitation rate. Mr. Lans stated as a board are we not required to insure that the village is contributing an appropriate amount to fund pension obligations to the future which she confirmed. When the state does their report, they look at what we have, they look at all the data and they come up with a projection. They factor in what the village has put it. They will increase it as necessary if it is too low. They are still using the artificially high percentage. Mr. Davison stated there are consulting firms that will come to you about various issues that being one of them, but those consulting firms are only interested in larger funds than ours. The cost of seeking our own actuarial firm may make it so you are not actually ahead. Those people hiring their own are running very large pension funds. Mr. Lans feels you need to ask the questions even if you cannot afford to hire your own actuary.

Mr. Danekas stated that the fund has grown by almost a hundred thousand in the first couple of weeks since we have had a couple things happen. At the end of the year 2010, we have a little over 1.7 million. A year ago we were at 1.4, a month before that at 1.6 million.

On the next page, you will note that this plan returned \$47,636.50 in interest even though the bond values went down. Interest is still paid on the face amount of the bonds. At the bottom of the page it shows each individual issue, when it pays and how much it pays each year going forward for a total of three pages.

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On page 4, we have a CD that is due next week for \$15,000. We bought a bond on Monday which will use the \$15,000. The next page continues with the certificates of deposit and we do not have any other CD's coming due this year. We do have some coming due mid year 2012. We do have a muni 0 coupon being called in on December 1, of 2012. A zero coupon is bought at discount and when it matures it will mature at \$25,000.

On the next page, 2nd one down, is a State of Illinois General Obligation Bond we just talked about paying 4.35% which pays out interest twice a year. The next page is just a summary but you can see the credit ratings on everything we own, with the exception of Sallie Mae, is A rated or higher. Because of all the issues with Sallie Mae in the past 2-3 years, their credit rating has been dropped pretty significantly, triple B rated. The price reflects it. As the bond is downgraded, the price will go down also as they are not so credit worthy. Even though they are down they are still paying 6.3, 6.1 and 5.8% in interest every year. Two are callable this year, but if called they get called at full face value. If this was a normal A rated company, they would probably call those bonds in and finance them at a lower rate, but because of their credit rating, that lower rate is probably not available for them. They have to decide if it is beneficial to retire this debt and issue out at a lower rate. If they had an influx of cash, they might want to pay off the debt. Once you hit your call date, you are callable every thirty days after that until the bond matures.

On Page 11 we get into the Mutual Funds that are at \$191,289.62 at the end of the year. We have since had a nice 3-3.5 week run in the market so they are up higher than that.

The next pages show the summary of investment activity and notes interest ACH'd to First American Credit Union. We are currently reinvesting all of the dividends in the mutual funds. Interest we pay out, dividends we reinvest. On the Diversification Bar Chart, the current value as of last night is \$1,762,342.40, including outside assets. At 2.5 million or less, you can invest 10% in equities and 2.5 million or higher, you can have 45% in equities. After 5 million, you can have 45% and actually buy 10% in stocks.

The next page is the maturity bar chart and we have done a nice job of laddering. This will really benefit the board as we move forward and rates start going up as you will always have money coming due to investing at higher rates.

The next page shows that we have \$35,000 at First American CU, \$11,000 in Illinois Funds, \$5,800 in cash not available, which is one fund that money has to be left in for a certain period of time, and \$500 at Sauk Valley. Cash notes a

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negative \$51,000 which is the bond we just bought. The pension board has \$2,700 in cash right now. He had told the board we had \$68,000 and invested \$50,000 in the Chicago Bond that he called around about last week. We have the \$15,000 CD coming due next week which is the difference. This was a syndicate offering, the Chicago bond. The SEC limits what he can hand out. The interest rate on the bond 7.78. Because you paid the extra \$1,000 in premium, to buy a higher rate. Net to the board 7.59%. 2.5% was Jones's take on that.

On the next page under Aggressive Income, on the far right hand side, the first bond we bought \$50,000, worth \$38,739 right now so we are down roughly \$11,261 in principle; however, we have owned that bond for four years and it has paid interest for four years and we have made money on that bond if you factor in that interest. At this point we are actually in the money, slightly. That total return factors in the principle amount, up or down, and how much interest it has paid out over the lifetime of the bond.

With the mutual funds, we need to focus on the two right hand columns. For example with Capital World Growth and Income, total return 34.04% averaging 4.2% a year. The next two we bought in 2008, and they have averaged 10 and 13% per year. The bottom two 6.3 and 5.4% American Funds Capital World G/I, and international fund with total return for 2010 of 7.7%. International funds underperformed US. None of these gave a ranking or number of funds in the category. Europacific came in at 9.4%, slightly beat Eafe and underperformed the World Index. All of these funds underperformed the S&P last year because they are strictly large cap companies that cannot buy mid caps or small caps. American Funds Fundamental had a return last year of 14.05%. We underperformed the S&P by 1%. American Growth Funds had return of 12.2 underperforming the S&P by 2.7%. If that continues going forward, you may want to look at bringing some small or mid caps into the portfolio. The last mutual fund, Lord Abbett, returned 14.30%. That one had been on our radar screen, but it had a pretty nice year for a large cap value. The four top holdings in this fund are banks. We actually think some of these banks that have paid back their TARP money could possibly start paying dividends again in the near future.

Mr. Danekas noted that when you hit 5 million, you are still at 45% but you can have 10% in individual stocks and/or managed money. We are above 10% right now, we do not have to reduce, but we can't add.

The Feds by not raising interest rates today which nobody expected, but also by continuing the QE2, it is telling us the economy is still very soft.

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Mrs. Quimby will reimburse Mr. Lans \$1,000 for the cost of the Certified Pension Trustee IPPFA Seminar, 4 sessions for 32 hours. Mr. Davison stated that he was uncomfortable going to the seminar in St. Louis without the board's approval. That was a considerable amount of money and we need some kind of policy for approving these things. There are some classes on the internet. He felt that the board needed to talk about this. Mrs. Quimby stated we covered, the class, hotel room and travel and meals. Part of the issue she stated was that we were under the gun to get that done. Moving forward, we will have some flexibility to get it done. The existing board members were supposed to have 16 hours by the end of August, 2009. They wanted it done, but did not give us classes to attend. The IPPFA is more geared to police and fire and Mr. Lans stated we should think about joining. Membership gives you a discount on some of the classes offered. The 32 hours of training covers all the issues we have been discussing. Everyone has to do the 16 hours every year along with continuing education. A lot of it is geared to whatever a trustee would need to proficiently do his job. The 32 hours could be four days in a row or spread out over several months.

Mrs. Quimby stated that she had been notified that an audit has been requested by the Department of Insurance and she would be contacting some of the members for information.

The next meeting was set for April 20, 2011, at 4:00 P.M.

Respectfully submitted,

Judy Rossi
Recording Secretary.