# Ocala Investment Committee Minutes

110 SE Watula Avenue
Ocala, FL 34471
www.ocalafl.org

Emory Roberts

## Monday, February 4, 2019

## Regular Meeting

## 1. Call to Order

The Ocala Investment Committee held a meeting at the CMO Conference Room on Monday, February 4, 2019 at 9:00 AM.

| Attendee Name | Title | Status | Arrived |
|---|---|---|---|
| Tammi Haslam | Budget Director | Absent | |
| Jay A. Musleh | City Council Member | Absent | |
| Peter Brill | Assistant Director of Finance and Customer Service | Present | |
| John Zobler | City Manager | Present | |
| Emory Roberts | Director of Finance | Present | |
| Raymond Bachik | Accounting Manager | Present | |

Others present: David Siegel of Sawgrass, Steve Alexander and Jason Glidden of PFM, Kim Maichele of Seix and Jon Griffith of CapTrust

## 2. Introduction

## 3. Minutes Approval

**a. Accepted** Minutes Approval

| | |
|---|---|
| **RESULT:** | **ACCEPTED [UNANIMOUS]** |
| **MOVER:** | John Zobler, City Manager |
| **SECONDER:** | Raymond Bachik, Accounting Manager |
| **AYES:** | Brill, Zobler, Roberts, Bachik |
| **ABSENT:** | Haslam, Musleh |

## 4. Reports

### a. PFM Asset Management

**1.** PFM Asset Management

We are probably on the cusp of an economy situation that is changing. Last quarter was difficult. With the equity markets down 20%, we had more 1,000-point swings in this past quarter; we had five of them and there's only been eight recorded. We had a volatile last quarter of 2018. Bond market was moved around a little bit. We started with the first fed increase in 2015 and the fed just kept slowly methodically raising interest rates. The economy has been improving. We saw the GDP getting better over the last year or so. We saw the unemployment rate ticking down for quite some time since the great recession. We've seen inflation get to around 2%. We've seen job expansion in a lot of categories. We've been experiencing several good years of the economy moving from historical lows, but we are in a situation now that, at least from a business cycle, it may be time to start thinking about is that expansion part of the business cycle? Are we getting close to the top? Are there things we need to be concerned about changing environment as far as our economy? Small business owners are concerned that there is a slowdown and it's usually the small businesses that feel it first.

We have a lot of things to think about. Maybe the cycle we've been in is in the front now versus the rear. We need to think about portfolio structures; probably all managers are thinking about duration placement. We saw corporate spreads really widen this last quarter, to the point that treasury and agencies total return numbers were very strong because we had a flight to quality. The tremendously widened spreads in corporates made corporates underperform, which will be reflected in our portfolio.

In 2018 we saw 4 fed increases, so we're at the range or 225 to 250. We are concerned about the economic slowdown in China, which is the second largest economy in the world. If they are slowing down, it is going to have an effect across the board and that's putting pressure on the economy from that perspective. We instituted the horizon analysis in your portfolio report because of rising interest rates having a big effect on the total return of the portfolio. We saw the flipping of the returns as opposed to being capital appreciation, being a very big component or driver of total return. We saw income being a big part of the return to the City. This is better for your budgets and we said we need to put more money in your budgets for interest income. With rising interest rates, that's been happening. The fed might just be slowed down; they have a lot of things to consider. We didn't see the government shutdown coming, the largest shutdown ever, 35 days. Economists saw about a 0.4% effect on GDP numbers. There is another potential shutdown on February 15th. The fed does have a lot of things to look at and be concerned about. So, with the slowing down just put in basic supply and demand, and we will talk about what's happening to the yield curve. When there is a more demand for treasuries that's going to push yields down and prices up.

For the last couple of years, we had this positive sloping yield curve, it was consistent. Short term rates were moving up, the yield curve had a nice slope to it and we are starting to see this flattening to it now. We were enjoying this constant fed increase. In December 2018 we are seeing this inversion, the beginning of an inverted yield curve potentially. When we have an inverted yield curve, it’s a precursor to a recession and that's simply because there's been more purchases of long-term bonds because of the flight to quality. People are leaving the equity market and buying more treasuries. Meanwhile, the fed is raising short term interest rates to hopefully keep price stability and unemployment low. This is maybe the signal that the economy is starting to change. There are so many unknowns with what's happening internationally.

This is where we are with this yield curve. The one year is a 260, the five year is 251 when we ended in summer of 2018. We have this situation where this is the beginning of an inverted yield curve, which normally leads to a recession. The fed is pretty much on hold in January.

Two more fed increases this year is a possibility, but we need to start thinking of the economy in different terms than last year.

Mr. Bachik - Is that the number one indicator that we could be going into a recession?

Mr. Alexander - I wouldn't say it's the number one but it's accurate.

We see how the unemployment rate has been dropping versus job openings. We have this cross here where there's more openings than before, so there are some industries where the job openings are not being filled. That's interesting when you think of that situation, an inverted yield curve, that's where the conflict is. Is the economy strong? Do we have industries booming or expanding? That is going to be helpful on the short end and keep the fed moving with fed increases potentially, but this starts to lay the foundation of potential crossroads and where we are in the economy.

Mr. Zobler - Is job expansion just limited to the service industry or it translates to the manufacturing sector also?

Mr. Alexander - Manufacturing had a pretty good year the last couple of years.

Talking about inflation as we talked about early, PC/person consumption, that's the inflation to you and I as individuals and what we are purchasing. Core CPI is above 2% which is the reason fed is pushing interest rates. The expectation for inflation over the next 5 years has been dropping. Last quarter of 2018 had a lot of challenges.

The important thing across all three portfolios is high quality grade portfolios and then having the multi-tiered strategy of one to three, one to five and long term is important. We've been enjoying the high interest rates in the short end; the longer end is more of a challenge. According to fed dot plot, their expectations, at least to get to the average, they are going to have to have a few more rate increases to get what they are thinking about.

Mr. Bachik - How many did they say last year; how many there were going to be in 2019?

Mr. Alexander - Four.

This is one of the most fluid times I've seen in a long time. It's important we maintain a high credit quality of the portfolios and we maintain lots of diversification not only on individual levels, but across the yield curve. All those segments of diversification are going to be very important with the uncertainty of everything. As the economy starts to slow down, the corporates are going to be more challenged.

Looking at yields last quarter, September to December 2018, yields went down with the exception of one to three years.

The volatility has been quite a bit this past quarter. We peaked out near the end of the third quarter and then it's been a decline as far as treasury yields. Prices of the two-year and ten year have been up, as investors have been seeking a safer place to be. In the one to three, the three-month returns are almost 130 or so. When you look at corporates, returns are quite a bit lower than the returns in treasuries. I think we will see better returns in corporates and non-treasuries this quarter as the equity market greatly improved.

Looking at fixed income returns, none were negative, it’s just to what degree the positive was.

I think in 2019, the fed will not be raising rates to any degree like 2018. I think 2019 is the beginning of that transition year that we are going to see the economy in certain areas change. The global situation will have the largest impact on us. I think we will see more flight to quality this year than in previous years. I don't think the equity markets are going to keep standing up as they did in January, as there are slowdowns in small businesses as there's not a lot of demand for credit/loans. Technology is in a revolutionary stage of constant change. Technology will be a big asset to the economy.

Jason - This is the one to three-year portfolio. The total market value at the end of December was $48.6 million. The accrued income number for the quarter was $186,000 in accrued interest. Yield at cost per yield earning was 2.09%. Effective duration was 1.75 years. We've been very defensive as interest rates have risen. The benchmark is at about a 1.8 duration, we are at about a 1.57. Average maturity 2.38 years. Very high quality, AA. Average credit quality. Very diversified on credit ratings, 5.4%. Majority of the assets are in treasuries and corporates. We had the $4 million withdrawal during the quarter. Most of those proceeds came from short maturity corporates.

Quarterly performance was a very strong absolute return. Treasury agencies did very well, corporates not well. One, three, five and ten-year still very strong, outperformed against the benchmark.

Looking at accounting, we started the quarter at $51.5 million, between all the trading we did including that withdrawal, we ended up with net sales of $3.4 million. Interest on this number continues to rise, so almost $600,000 back to the City on this portfolio alone.

The stress test takes the portfolio and models it in four scenarios to show what the market value would do in the portfolio if there was an instantaneous rate change.

Mr. Alexander - One thing you don't see on this report is the change effect is getting smaller. As we are buying higher and higher coupons, that change is smaller percentage wise.

Mr. Bachik - Let's say nothing happens in 2019, so the rate increase they had in December 2018 of 25 basis points, so because of that your portfolio will go down, technically it would be down $59,000?

Mr. Alexander - Yes, it should. If everything stayed the same, then that's exactly right.

All names follow the policy.

Any questions?

**b. Seix Management Advisors**

**1.** Seix Management Advisors

The fed continued their hiking cycle, their goal being to move to a more neutral target rate. There have been discussions what is that target rate that they are looking for? We have had four increases and we're at a 2.25 to 2.5 % and the thought was they were trying to get more towards 3%. Concurrently with the hiking cycle, we had the fed continue to finish their fed balance sheet taper. We started in fall 2017 and progressed into this fourth quarter, the increase was $50 billion per month to come off the balance sheet. This is kind of like a quantitative tightening. The market didn't like that Powell commented that this balance sheet taper is on auto pilot. To give you perspective, we peaked with the fed balance sheet at $4.5 trillion. We ended 2018 at $4.1 trillion and if we continued with this 50 billion in 2019, that would total to $600 billion a year. Before the financial crisis we were at one trillion. There are estimates all over the place and they've commented that it's going to be larger than it has been in the past.

Looking at performance, it was a flight to quality. You had spread widening, there was the surge in volatility and risk assets performed poorly. With that height, you had just prior to Powell making his comment he was saying we may go past neutral, but we are a long way from neutral at this point. That suggested on October 3 a very hawkish tone. In addition, you had other global markets that were reducing their quantitative easing process and so, right in that early October time there were a lot of factors that came into play. You had high yield spreads at their tightest and from that point on they widened from a tight of 316 basis points against the treasury out to 540 basis points. Crude oil was at its highest. It plunged from $73 a barrel to $45 a barrel. Apple lost about 33% of their value, S&P lost about 13.5%. When you look at fixed income markets, bond yields were still increasing in this early October time due to the comments from Powell. They really didn't peak until November 8. A ten-year yield November 8 was 3.24% and dramatically increased over the last seven weeks to end at 2.69% since.

Looking at the investment grade sector, spreads widened about 47 basis points for investment grade corporates for the quarter and 60 basis points for the year. Corporates for the year and quarter ended up not performing well.

For the fourth quarter, the return was a 190. We have the benchmark which encompasses all of

BBB. We are required to only be in the mid BBB. This shows that against that benchmark we outperformed by about 16 basis points. For the year, we've outperformed against our benchmark by 7. Then the three, five and seven-year time periods, I think it's hopeful to see how we are going to be in between the blended benchmark, which encompasses all of BBB, because that lowest quality part of the BBB sector you're going to get paid for it in the end, and that is reflected in that benchmark. Even over the long term we've out performed. Considering our defensive strategy, it's certainly been beneficial for the fourth quarter and one-year numbers. We took a bit more defensive take starting in the fourth quarter of 2017. As we progressed into 2018, we began under-weighting in corporates. The market value is at $49.8 million and we had a $7 million distribution. We are always duration neutral because the way markets are it's hard to predict as far as with the fed. We feel like we are better positioned to focus in on sectors where there were over or under weight credit spreads, as well as positioning along the curve. We reduced our corporate exposure towards the mid to later part of October. We were at about 0.8% and if you look at the percentage distribution, you can see the corporates were underweighting here. We were at about 0.8 times the index and we are now at about 0.4. Given that we are a longer duration manager, we are more exposed to fluctuations in interest rates. We are not affected as much as the short end with the rate increases. With effects of inflation and so forth, growth in the economy, that's the area of the market that we are going to be affected by.

As for compliance, we were within the policy. Our strategy, as it relates to corporates, we continue to have an underweight in corporate bonds. We focus in on fundamentals, technicals and valuations, and since September 30th's report, we have gone from a mild negative in fundamentals to a negative positioning. We are in a deterioration phase of the credit cycle. Leverage is elevated. We feel that the benefits that we've seen from the tax cuts and so forth have been share holder related. As it relates to earnings, many are questioning the earnings as it relates to the political environment. In addition, we are rolling on tougher earnings comparisons. You've had this uptick in earnings because of those tax cuts and deregulation and that was from the beginning of 2018. It is certainly going to make it tougher for earnings going forward. The technicals haven't changed and as it relates to valuations. Looking at those spreads on the corporate side, we've gone from a negative to a mild negative. So that's improved at the margin, but that improvement has been more so when you look at a rolling one-year basis over the last year, to compare for the spreads over the last five years. We still feel that those spreads are still leaning a little rich, so we have not added to our corporate exposure at this time. We were expecting continued volatility.

When you look at the global bank balance sheet, we are projecting that to contract. In addition, China isn't in that position to implement large scale stimulus like they used to do. They don't have the finance flexibility as they did in the past. This could put pressure on China to come up with a deal with the U.S., but that deal will probably be from an optic standpoint, helpful for both parties, but won't address what's really at the matter of that being technology.

As it relates to U.S., we've had the tax cuts and the stimulus, we feel that as we progress into 2019 that growth is going to diminish or wean a little bit. We may get more to trend line growth, it was typical during this entire recovery, then there is that risk that we could decline further. In the short term, we may see a boost in rates, typically on the long end, and that would be derived from a pause from the fed. We are anticipating that the fed may be on hold for the first half of the year. Secondly, if we do see a trade deal, it would be a short-term boost.

We have a lower for longer stance and we feel that we are going to be in that 2.5 - 3% range and if we exceed that, that it may be more temporarily.

Any questions?

**c. Sawgrass Asset Management**

**1. Accepted** Sawgrass Asset Management

The magnitude of the moves we saw, in the equity markets and treasury market and corporate bonds, it was stupefying and surprising. We did underperform for the quarter. Treasury rates moved down and corporate bonds spreads widening out is what hurt the portfolio. We did have an overweight to high quality assets, which did numb some of that pain. It was the magnitude of the moves that really hurt the portfolio. We had somewhat seen this coming, we had prepared for a move in bond spreads and we had increased duration, expecting either a fed pauses or just the movement in rates to not continue to increase, certainly at the pace that it was. We did not expect it to happen this quickly or to this extreme.

Wages are moving up but not to the extent where people expected. Same as with inflation. You do still have strong economic numbers, the so called hard economic numbers, your GDP, unemployment rate, your retail sales, hasn't necessarily slowed down. If you look at a snapshot of the economy, especially as it pertains relative to the global economy, the U.S. economy looks relatively strong. As it stands we have strong economic numbers, strong labor numbers and wages are increasing. We see some concern in the soft data side - the investor sentiment, consumer sentiment, consumer confidence, a lot of these so-called soft numbers which tell more of a story of what the sentiment is. It's concerning because as sentiment, the feeling of what the investors is, will trickle down to the economy. The consumer confident number that came out last week was lower than it has been and lower than expected.

Mr. Zobler - Where do you factor in debt in all of this? The national debt. Where does it show in the presentation how it will impact?

Mr. Siegel - We've talked about the deficit before, but it wasn't being discussed because there was growth. Really when the tax cuts were announced, I think we focused more on it and what kind of impact it can have. The counter to that was if we are positively growing, and things are good then deficits don't matter. Well deficits do matter, and they certainly do have an impact on the strength of the economy. It will be interesting to see how that comes up now, not that the shutdown is necessarily related to the deficit, as it has been ironically in the past. That's always been a concern about raising budget caps and what that means. Ironically, that has not been the issue around this government shutdown. I think that will be a concern going forward. It's an issue and one that's probably not being discussed enough. Touching on the sheer quickness of the change in sentiment, we saw how quickly they changed from a couple rate hikes to having just two. The market is pricing at 0. The statements that came out recently from the January fed meeting were quite dubbish. It's not even a matter of a quarter, it's a matter of about 6 weeks. From early November when the ten year was well above 3% to how it ended the year, and then the 180 that you essentially saw from the fed was surprising.

The goal of the fed essentially is to stabilize the economy, to make it a more normalized growth environment. Factors that they look at, financial conditions which consider volatility, stock prices, corporate bond spreads, is really just a variety of different facts they look at. At the time when I showed this last quarter, the stock market was going up, it had since 2015 when they started raising rates, corporate bond spreads were at all time tights, volatility was relatively low, essentially the fed had not accomplished what it set out to do based on those factors alone. Since that point, things have shifted drastically. They are tightening, if you look at where they were in 2015, stock market is still up, corporate bond spreads are still tight, however compared to where they were just a few months ago, it's not what it was and now you see the fed is essentially putting their foot on the brake based on these conditions they are seeing.

The ten year went down about 40 basis points, and that doesn't take into account how from the month of September to November it was up to about 3.25 on the ten-year and plummeted down to a 2.68 number.

Corporate bond spreads for the quarter was over 40 basis points of widening on the one to five year, which is very short duration. We stress high quality names in the portfolio and in this quarter, while you did some divergence between the BBB's and the higher single A, double A securities, it was not as much as you would expect in that type of move. There are a lot of reasons for that. A lot of it is liquidity, as you see typically in a sell of that magnitude, becomes somewhat of a liquidity punch and the easiest thing to sell are those single A, double A, high quality type names that people need to pump out of their portfolios. It's more of a technical short-term move, where those names would underperform relative to the lower quality names and that will bounce back over time. It's good to see that what you believe in, and what historically has been the case, will eventually revert to historical norms.

Since 2013 and consistently we have been lowering your overall risk of credit. We saw credit spreads were tight and we liked the name we were in. However, we did believe there was somewhat of a correction probably coming and because of that, we continued to lower your credit risk exposure. Unfortunately, still with the magnitude of the move that we saw, we underperformed because of that overweight.

In prior credit bare markets, not to say this is necessarily a bare market but there are signs that we could have movement in credit spreads underperforming for the foreseeable future. Even in those scenarios, if you go back to prior bare markets, the late 90's into early 2000's, the 2014 to 2016 range, even if you have credit bond spreads widening, it doesn't have to necessarily in a linear fashion. You're going to have ups and downs; the key is to find those opportunities within those overall movements to try to add where you can. We have gone ahead and done that. Names that we thought even though were lower in credit risk, if there were names that we thought were going to widen out way too much than they should have, we are going to rotate into those names. Maybe add other names that we don't think would protect the portfolio as much. It's all about finding opportunities, relative value. Even in times of stress, that's the time you want to take advantage of it. You see misplaced opportunities and misplaced sell offs and you want to take advantage of it.

For your overall performance for the quarter, we did under perform. On a one-year we out performed, and then looking a the two, three, five and ten-year we out performed as well. This month we bounced back and outperformed the benchmark. We have adjusted the portfolio based on where we were historically. We have always been high quality. I'd say we are higher quality at this point than we have been in the past. We have increased duration a little bit because of the fed path. They are still pricing in two hikes. As always, it's a little bit more hawkish than the market is pricing in. There's a lot of positives in the economy that we are seeing, especially on a relative basis to the world.

If things continue to falter in the stock market especially, you'll see some pressure on to get something done. It may be somewhat watered down but like what we saw with the Nafda deal, the overall deal if it gets passed, wasn't a huge change than what we have in the past. It was the uncertainty hovering over the market overall. It may be short term, but I think you'll see relief there.

A lot of things went bad at the same time in a span of just a few weeks. I think you will some of that sorted out. We will get back to the fundamentals while were still in a strong economy. I think we will see rates creep up a little bit.

For the overall portfolio, we comply within your parameters.

Any questions?

| | |
|---|---|
| **RESULT:** | **ACCEPTED [UNANIMOUS]** |
| **MOVER:** | Raymond Bachik, Accounting Manager |
| **SECONDER:** | Peter Brill, Assistant Director of Finance and Customer Service |
| **AYES:** | Brill, Zobler, Roberts, Bachik |
| **ABSENT:** | Haslam, Musleh |

## d. CapTrust Asset Management

**1. Accepted** CapTrust Asset Management

This is a summary of the flows in portfolio that occurred. You can see for the 3-month period and the 2019 fiscal year to date, you see the drop down of about $20 million in favor of the pension fund.

This is the history of fees that have been paid by the portfolio. The total has declined by about $3,000 per quarter. That is again due to the drop down.

Looking at the allocation of funds of active managers as opposed to the internal accounts. There's approximately a total of $202 million, with $166 million being managed by outside managers. The internal accounts are approximately $36 million, divided between Florida Prime, Florida Fixed Income Trust and Sun Trust checking. That remains as it has been essentially.

This is a detail of the asset allocation of dollars. Again, the numbers are very close to our policy requirements with 29.23% at PFM, 40.84% at Sawgrass and 29.93% at SEIX.

This is the actual summary of the investment returns for the total portfolio. Again, I remind everyone that these numbers are netted fees, not just manager fees but also custody fees and so forth. The total portfolio for the three-month period was 1.28%, which trailed the total portfolio benchmark by approximately 20 basis points. For the year to date, 2018, again that performance number is the same, but the benchmark is slightly different because it is on calendar basis; it was 1.28% against the benchmark of 1.48%. For fiscal 2018, we have a total return of negative 1.15% against the benchmark negative 0.37%. One thing was you look at that data, you can see that the blue bar is essentially riding positive for most periods. The 2015 period was the only period where the portfolio hasn't beaten the benchmark, and that is on a total net all fees basis.

The total portfolio resides relative to all other assets, including your fixed income assets. The portfolio is quite conservative, taking a very small amount of risk, which of course is what was intended.

Any questions?

| | |
|---|---|
| **RESULT:** | **ACCEPTED [UNANIMOUS]** |
| **MOVER:** | Raymond Bachik, Accounting Manager |
| **SECONDER:** | Peter Brill, Assistant Director of Finance and Customer Service |
| **AYES:** | Brill, Zobler, Roberts, Bachik |
| **ABSENT:** | Haslam, Musleh |

## 5. Overview - Internal Investment Report

Investment CPE Requirement

**1.** Internal Investment Report

We want to note that in the fourth quarter, we have moved $14 million back to our money market account, which we had taken that out in the previous quarter, end of September, to pay some other items for that month. Total value for the quarter was down $6.5 million. We have recovered some but some of that is attributed to our tax revenue that comes in the fourth quarter. We are still behind some, but we have recovered some with the interest income. The contracts were all renewed.

Council has approved renewal of all the contracts for our managers our advisors. They are one-year contracts. We will revisit that again at end of the year.

## 6. Other Matters

**1.** Investment Managers Agreement

## 7. Adjournment

### Minutes

A motion to approve the minutes as printed on this __________ day of ___________; ________ was made by _____________________, seconded by _______________________,

votes for __________, votes against _______________.

________________________________ ______________________________________

Secretary Chairman