



**RETIREE HEALTH CARE BENEFIT TRUST**

**ANNUAL REPORT**

FOR THE YEAR ENDED  
SEPTEMBER 30, 2011

PREPARED BY  
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ORANGE COUNTY COMPTROLLER

## EXECUTIVE SUMMARY

**The portfolio had a total rate of return of -3.6% in fiscal year 2011 compared with 9.1% in 2010, and an average annual total return of 1.14% since inception in 2007.** Annual returns are reported on a time weighted basis to minimize the impact of cash flows, which is a standard practice in the money management industry and allows for comparison across funds. The portfolio balance increased by approximately 6% on March 22, 2011 with a \$1,844,671 contribution by the County.

Compared to established benchmarks, the Trust portfolio was outperformed by the Fidelity Balanced Fund (2.34% total return) and the Principal SAM Balanced Fund A (-0.56% total return) in fiscal year 2011. The target asset allocation of the Trust was changed in February 2011 to 80% equities from 60% equities. The Fidelity and Principal benchmark funds had asset allocations similar to the Trust's former allocation of 60% equities and 40% fixed income. Thus, the Trust had a higher exposure to equities when global stock markets dropped in the second half of the fiscal year, and this was the primary cause of the Trust's underperformance. Subsequent to fiscal year end, global stock markets rallied sufficiently to recover from the downturn experienced. New funds with asset mixes similar to the Trust's new target allocation will be chosen for comparison purposes in fiscal year 2012. The returns of the funds in the Trust were as follows: Vanguard Total Bond Market Index Fund, 5.15%; Vanguard Total Stock Market Index Fund, 1.44%; and Vanguard Total International Stock Index Fund, -11.73%. The return on the Vanguard Prime Money Market Fund was only 0.06% due to low short-term market interest rates.

The unfunded actuarial accrued liability amounted to \$51.2 million at the end of fiscal year 2011. The total benefits paid for participants amounted to \$3,177,662, including a charge of \$2,072,040 for the annual implicit rate subsidy obligation. This subsidy arises from a statutory requirement to offer retirees health care coverage at the same total premium as for active employees. The actual cost of retiree health care claims in excess of premiums paid by retirees is the implicit rate subsidy.

Table of Portfolio Balance and Variation from Targets

<b>Portfolio Balance and Variation from Targets</b>				
September 30, 2011				
<b><u>Current Allocations</u></b>	<b><u>Balance</u></b>	<b><u>Actual</u></b>	<b><u>Target</u></b>	<b><u>Variance</u></b>
Prime MMKT and DDA	\$732,431	2.62%	2.5%	0.12%
Total Bond	5,150,286	18.44%	17.5%	0.94%
Total International Stock	6,684,586	23.92%	24.0%	-0.08%
Total Stock	15,370,083	55.02%	56.0%	-0.98%
<b>Total Balance</b>	<b><u><u>\$27,937,386</u></u></b>			

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**RETIREE HEALTH CARE BENEFIT TRUST  
ANNUAL REPORT**

for the year ended September 30, 2011  
ORANGE COUNTY, FLORIDA

I. INVESTMENT POLICY

It is the policy of the Orange County Comptroller (Comptroller) to manage the investments of this Trust for the benefit of the beneficiaries participating in the Trust in a manner that will preserve the assets of the Trust, provide adequate liquidity to meet cash flow needs, and optimize returns while conforming to all federal, state, and local laws governing the investment of public funds. The Trust was established in September 2007 to fund the County's Other Postemployment Benefit Plan (OPEB).

II. INVESTMENT COMMITTEE

The Committee was established by the Comptroller to formulate investment strategies, provide short-range direction, and monitor the performance and structure of the County's portfolio. The Committee consists of Comptroller staff and two other qualified individuals with financial or investment expertise who are independent of employment and business relationships with Orange County. The two outside members of the Committee are John M. Cheney, D.B.A., retired Associate Professor of Finance, University of Central Florida, a member since 1997; and Edward J. Manning, retired managing partner of Ernst & Young, Certified Public Accountants, a member since 2001.

III. INVESTMENT OBJECTIVES

Assets shall be invested to achieve a long-term return of 7.5% annually, provide a sufficient level of funds to meet future disbursements on an inflation-adjusted basis, and maximize returns for the level of risk taken. As the horizon for the portfolio is long term, significant deviations from the total return objective may occur over short-term time periods.

IV. PORTFOLIO PERFORMANCE

Acceptable portfolio performance is the result of balancing the rewards of investing, or the income earned, with the risks associated with those investments. Factors influencing the portfolio's performance include the types of authorized investments, the economic environment, liquidity requirements, sensitivity of asset values to changes in interest rates and market conditions, and the investment operation.

**The portfolio had a total rate of return of -3.6% in fiscal year 2011 compared with a return of 9.1% in 2010, and an average annual return of 1.14% since inception in 2007.**

This report discusses in detail each of the factors influencing portfolio performance. The report also discusses the County's depository banking relationship.

V. AUTHORIZED INSTRUMENTS

- A. Securities and Exchange Commission (SEC) qualified constant net asset value money market mutual funds.
- B. SEC registered, U.S. dollar-denominated mutual funds comprised of the following assets:
  - 1. Equity ownership in companies located anywhere around the globe.
  - 2. Debt obligations in investment grade securities with an S&P credit rating of BBB- or above, or a Moody's credit rating of Baa3 or above.
  - 3. Real estate investment trusts (REITs).
  - 4. Funds comprised of commodity index futures contracts.

VI. ASSET ALLOCATION

The Comptroller established a new target asset allocation in February 2011 based on the Trust's objectives. The asset allocation is as follows:

<u>Investment Type</u>	<u>Composition Limit</u>
a. Vanguard Total Stock Market Index Fund	56.0%
b. Vanguard Total International Stock Index Fund	24.0%
c. Vanguard Total Bond Market Index Fund	17.5%
d. Vanguard Prime Money Market Fund	2.5%

The Trust is allowed to drift from its target allocations but will be rebalanced on a semi-annual basis. Contributions to the Trust are invested with the intent to restore target allocations, or come as close as reasonably possible.

A. Vanguard Total Stock Market Index Fund

This fund employs a passive management strategy known as indexing to track the performance of the Morgan Stanley Capital International (MSCI) US Broad Market Index, which represents 99.5% or more of the total market capitalization of all the U.S. common stock regularly traded on the New York Stock Exchange, American Stock Exchange and the Nasdaq over-the-counter market.

B. Vanguard Total International Stock Index Fund

This international stock fund employs a passive management, or indexing, investment approach. The fund seeks to track the performance of the MSCI ACWI ex USA IMI Index, which is designed to measure equity market performance in developed and emerging markets, excluding the United States. The index includes more than 6,000 stocks of companies located in over 43 countries. The fund holds a broadly diversified collection of securities designed to match the key characteristics of the full index. These characteristics include industry and country weightings, market capitalization, and financial measures such as price/earnings ratio and dividend yield.

### C. Vanguard Total Bond Market Index Fund

The fund employs a passive management strategy known as indexing to track the performance of the Barclays Capital U.S. Aggregate Bond Index. The index measures a wide spectrum of public, investment-grade, taxable, fixed income securities in the United States – including government, corporate, and international dollar-denominated bonds, as well as mortgage-backed securities, all with maturities of one year or more. The fund uses a sampling technique to closely match key benchmark characteristics: sector weight, coupon, maturity, duration, and credit quality. Full replication of the index is prohibitively expensive and impractical.

### D. Vanguard Prime Money Market Fund

This fund invests in high-quality, short-term money market instruments, including U.S. government securities, certificates of deposit, bankers' acceptances and commercial paper. The fund seeks to provide current income and a stable net asset value. This money market fund maintains a dollar-weighted average maturity of 60 days or less, and a dollar-weighted average life of 120 days or less.

## VII. LIQUIDITY REQUIREMENTS

The Trust must maintain sufficient liquidity to meet required benefit payments and annual administrative costs of the Trustee. The total benefits for participants in fiscal year 2011 amounted to \$3,177,662, consisting of \$1,105,622 in health insurance subsidies payable on a monthly basis and the implicit rate subsidy of \$2,072,040 payable annually to the County self-insurance plan. For the health insurance subsidies, the average aggregate payment to retirees was \$92,135 per month. The implicit rate subsidy is the actual cost of retiree health care claims in excess of premiums paid by retirees, arising from a statutory requirement to offer retiree health care coverage at the same total premium as for active employees.

## VIII. CONTRIBUTIONS AND UNFUNDED LIABILITY

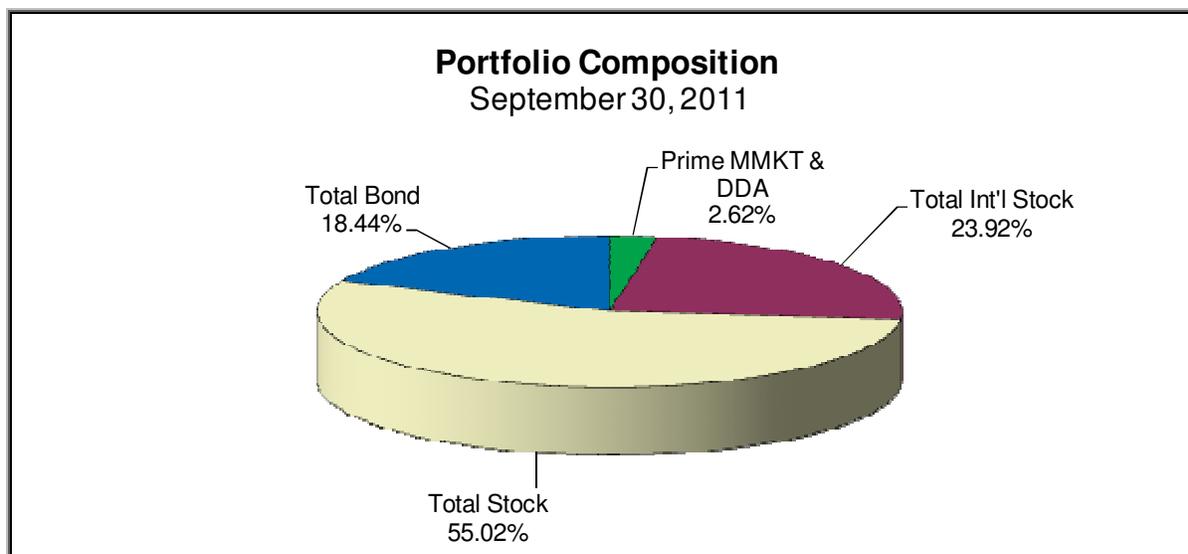
Orange County contributed \$1,844,671 to the Trust during fiscal year 2011. The OPEB unfunded actuarial accrued liability decreased from \$53.9 million at the end of fiscal year 2010 to \$51.2 million at the end of fiscal year 2011.

## IX. INVESTMENT OPERATIONS

Qualified professionals in the Comptroller's Office conduct investing activities in accordance with written policies and procedures. Quarterly reports of investment activity and positions are prepared and distributed to management of the Comptroller's Office, management of the County and the Investment Committee. Regular meetings of the Committee are held to monitor the portfolio, evaluate investment performance and discuss investment strategies.

The Comptroller's Office uses sophisticated techniques in carrying out its investment activities including the use of electronic bank account systems, real-time monitoring of U.S. securities markets and electronic trading. Bank account balances, cash requirements and investment positions are monitored daily.

## PORTFOLIO COMPOSITION



### **Portfolio Balance and Variation from Targets**

September 30, 2011

<u>Current Allocations</u>	<u>Balance</u>	<u>Actual</u>	<u>Target</u>	<u>Variance</u>
Prime MMKT and DDA	\$732,431	2.62%	2.5%	0.12%
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Comparison to investment alternatives is often useful to gauge investment performance. The following table includes a comparison of the total return on the Trust with returns on the Fidelity Balanced Fund and the Principal SAM Balanced Fund A. The Fidelity Balanced Fund typically maintains a 60% equity and 40% debt asset mix. The Principal SAM Balanced Fund A will vary the holdings of equity and debt securities between 70% and 30% of the fund's total assets. The higher returns on the Fidelity and Principal funds were primarily due to the decline in equity values after the Trust increased its equity allocations in March to 80% of the portfolio. New funds with asset mixes similar to the Trust's new target allocation will be chosen for comparison purposes in fiscal year 2012.

## PORTFOLIO PERFORMANCE

### **Total Return vs. Comparable Funds** Fiscal Year Ended September 30, 2011

	<u><b>Total Return</b></u>
Trust Portfolio Return	-3.62%
Fidelity Balanced Fund	2.34%
Principal SAM Balanced Fund A	-0.56%

## VANGUARD FUNDS ANALYSIS

### **Vanguard Funds Return Analysis** Fiscal Year Ended September 30, 2011

	<u><b>Total Return</b></u>
Actual: Prime Money Market Fund	0.06%
Reported: Prime Money Market Fund	0.07%
Benchmark: Lipper Average Money Market Fund	0.00%
Actual: Total Bond Market Index Fund	5.15%
Reported: Total Bond Market Index Fund	5.28%
Benchmark: Barclays Capital Aggregate Bond Index	5.23%
Actual: Total International Stock Index Fund	-11.73%
Reported: Total International Stock Index Fund	-12.14%
Benchmark: MSCI ACWI Index	-11.20%
Actual: Total Stock Market Index Fund	1.44%
Reported: Total Stock Market Index Fund	0.72%
Benchmark: MSCI US Broad Market Index	0.70%

Actual returns represent the returns earned by the Trust. Reported returns are the returns published by Vanguard on each respective mutual fund and the Benchmark returns represent the index utilized by Vanguard to evaluate the performance of each respective fund.

The Vanguard Prime Money Market Fund outperformed the Lipper Average Money Market Fund. The minimal return on this fund reflected exceptionally low market interest rates on short-term securities. The Federal Reserve maintained a target range for federal funds of 0% to 0.25% throughout the fiscal year. On September 30<sup>th</sup>, the Prime Fund's largest holdings were U.S. government and agency securities (51.5%) and Yankee/foreign (30.1%). Yankee/foreign securities are dollar-denominated instruments issued in the U.S. by foreign banks, as well as dollar-denominated assets issued in foreign markets. The credit quality of all investments in the Prime Fund was first tier.

The Vanguard Total Bond Market Index Fund tracked closely to the Barclays Capital Aggregate Bond Index. Since bond markets cannot be fully replicated, Vanguard manages this fund to replicate the same risk and return characteristics as the index. Therefore, deviations from the benchmark are expected. The Trust's investment in the Total Bond Market Index Fund underperformed relative to Vanguard due to the semi-annual rebalancing of portfolio investments to target allocations. The Trust is not actively managed, and any gains or losses from the timing of contributions or rebalancing are unintended.

The Trust's loss on the Vanguard Total International Stock Index Fund was less than the loss reported by the Vanguard Fund in fiscal year 2011, but greater than the MSCI ACWI Index. The outperformance of the Trust relative to the Vanguard Fund was primarily due to the timing of the annual contribution to the Trust at the end of business on March 22<sup>nd</sup>. International equities rallied after the investment in this fund was increased. The deviation between the Vanguard Fund and its benchmark is expected since the index cannot be fully replicated. On September 30<sup>th</sup>, this fund was invested in European stocks (42.6%), Pacific stocks (25.6%), and emerging markets (22.7%).

The Trust's return on the Vanguard Total Stock Market Index Fund was greater than the return reported by Vanguard and its benchmark MSCI US Broad Market Index in fiscal year 2011. The Trust's higher gain compared with the Vanguard Fund and its benchmark was primarily due to the timing of the County's annual contribution to the Trust and the semi-annual rebalancing back to target weights in March. The stock market rallied after the investment in this fund was increased at the end of business on March 2<sup>nd</sup> and March 22<sup>nd</sup>, respectively.