



**RETIREE HEALTH CARE BENEFIT TRUST**

**ANNUAL REPORT**

FOR THE YEAR ENDED  
SEPTEMBER 30, 2010

PREPARED BY  
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ORANGE COUNTY COMPTROLLER

## EXECUTIVE SUMMARY

The portfolio had a total rate of return of 9.1% in fiscal year 2010 compared with 5.5% in 2009, and an average annual total return of 1.62% since inception. Annual returns are reported on a time weighted basis to minimize the impact of cash flows on reported returns, which is a standard practice in the money management industry and allows for comparison across funds. The portfolio balance increased by approximately 39% on March 2, 2010 with an \$8,536,557 contribution by the County. The Retiree Health Care Benefit Trust (the Trust) generated modest returns from this date to the end of the year.

The Trust portfolio was outperformed by the Fidelity Balanced Fund (10.43% total return) and the Principal SAM Balanced Fund A (11.25%) in fiscal year 2010 due primarily to successful active management strategies. The Trust was led by a 10.76% return on the Vanguard Total Stock Market Index Fund; 8.07%, Vanguard Total Bond Market Index Fund; and 6.68%, Vanguard Total International Stock Index Fund. The return on the Vanguard Prime Money Market Fund was only 0.08% due to low short-term market interest rates.

The unfunded actuarial accrued liability amounted to \$53.9 million at the end of fiscal year 2010. The total benefits paid to participants amounted to \$3,904,218. This total included a \$2,948,526 accrued liability for benefit payments made to retirees, which was transferred out of the Trust after the end of the fiscal year. Excluding this accrued liability, the monthly benefit payment to participants was \$79,641.

Table of Portfolio Balance and Variation from Targets

<b>Portfolio Balance and Variation from Targets</b>				
September 30, 2010				
<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	\$1,417,674	4.55%	5%	-0.45%
Total Bond	10,552,651	33.90%	35%	-1.10%
Total Stock	15,955,281	51.25%	50%	1.25%
Total Int'l Stock	3,205,931	10.30%	10%	0.30%
<b>Total Balance</b>	<b><u><u>\$31,131,537</u></u></b>			

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ANNUAL REPORT**

for the year ended September 30, 2010  
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 with the primary objective of preserving the long-term principal value of the assets in the Trust. Assets shall be invested to achieve a return that will provide a sufficient level of funds to meet future disbursements on an inflation-adjusted basis, and maximize returns for the level of risk taken. The horizon for the portfolio is long term, and significant deviations from the total return objective may occur over short-term time periods.

The Trust has a long-term total return objective of 7.5% annually.

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 9.1% in fiscal year 2010 compared with a return of 5.5% in 2009, and an average annual return of 1.62% since inception.**

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 target asset allocation in March 2008 based on the Trust's objectives. The asset allocation is as follows:

<u>Investment Type</u>	<u>Composition Limit</u>
Vanguard Total Stock Market Index Fund	50%
Vanguard Total Bond Market Index Fund	35%
Vanguard Total International Stock Index Fund	10%
Vanguard Prime Money Market Fund	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 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.

On September 30, 2010, 44% of the fund was invested in U.S. Treasury and agency securities and 27% was invested in government mortgage-backed securities.

C. 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 EAFE and Emerging Markets Index, formerly known as the Total International Composite Index. The benchmark index is a weighted blend of the MSCI Europe Index, MSCI Pacific Index and the MSCI Emerging Market Index. 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.

D. Vanguard Prime Money Market Fund

This fund invests in high-quality, short-term money market instruments, including 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. The maximum weighted average maturity was lowered to 60 days from 90 days in accordance with new SEC rules for money market funds that went into effect in May 2010.

VII. LIQUIDITY REQUIREMENTS

The Trust must maintain sufficient liquidity to meet required benefit payments on a monthly basis and annual administrative costs of the Trustee. The total benefits paid to participants amounted to \$3,904,218. This total included a \$2,948,526 accrued liability for benefit payments made to retirees, which was transferred out of the Trust after the end of the fiscal year. Excluding this accrued liability, the monthly benefit payment to participants was \$79,641.

VIII. CONTRIBUTIONS AND UNFUNDED LIABILITY

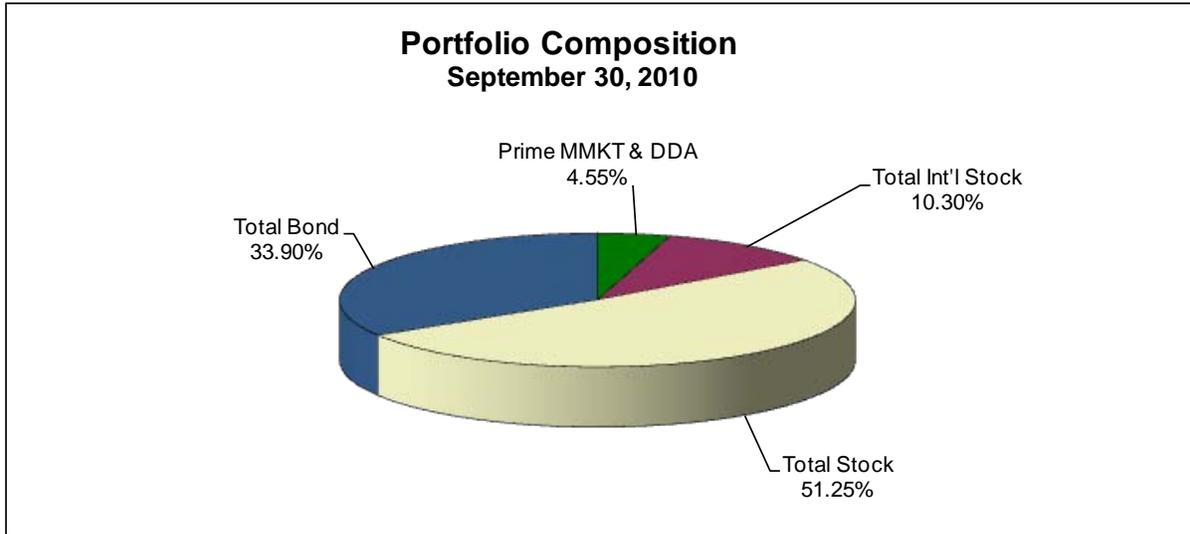
Orange County contributed \$8,536,557 to the Trust during fiscal year 2010. The OPEB unfunded actuarial accrued liability amounted to \$53.9 million at the end of fiscal year 2010.

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, 2010

<u>Current Allocations</u>	<u>Balance</u>	<u>Actual</u>	<u>Target</u>	<u>Variance</u>
Prime MMKT and DDA	\$ 1,417,674	4.55%	5%	-0.45%
Total Bond	10,552,651	33.90%	35%	-1.10%
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<b>Total Balance</b>	<b>\$ 31,131,537</b>			

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% bonds 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 successful active management strategies.

## PORTFOLIO PERFORMANCE

<b>Total Return vs. Comparable Funds</b>	
Fiscal Year Ended September 30, 2010	
	<u><b>Total Return</b></u>
Trust Portfolio Return	9.10%
Fidelity Balanced Fund	10.43%
Principal SAM Balanced Fund A	11.25%

## VANGUARD FUNDS ANALYSIS

<b>Vanguard Funds Return Analysis</b>	
Fiscal Year Ended September 30, 2010	
	<u><b>Total Return</b></u>
Actual: Prime Money Market Fund	0.08%
Reported: Prime Money Market Fund	0.08%
Benchmark: Lipper Average Money Market Fund	0.00%
Actual: Total Bond Market Index Fund	8.07%
Reported: Total Bond Market Index Fund	8.12%
Benchmark: Barclays Capital Aggregate Bond Index	8.28%
Actual: Total Stock Market Index Fund	10.76%
Reported: Total Stock Market Index Fund	11.13%
Benchmark: MSCI US Broad Market Index	11.15%
Actual: Total International Stock Index Fund	6.68%
Reported: Total International Stock Index Fund	7.03%
Benchmark: MSCI EAFE & Emerging Markets Index	7.16%

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 yankee/foreign (42.3%) and U.S. government and agency securities (41.1%). 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 primarily to the timing of new contributions from the County and the rebalancing of portfolio investments that occurs every six months. The Trust is not actively managed, and any gains or losses from the timing of contributions or rebalancing are unintended.

The Trust's return on the Vanguard Total Stock Market Index Fund was lower than the return reported by Vanguard and its benchmark MSCI US Broad Market Index in fiscal year 2010. The Trust's smaller gain compared with the Vanguard Fund and its benchmark was primarily due to the timing of the County's annual contribution to the Trust on March 2, 2010. Rebalancing the portfolio to target weights twice during the year also contributed to the difference in the Trust's return on this fund and Vanguard's reported return. The strong return on this fund was driven by an equity market rally in the fourth quarter.

The Trust's actual return on the Vanguard Total International Stock Index Fund was lower than the return reported by the Vanguard Fund in fiscal year 2010, as well as the MSCI EAFE and Emerging Markets Index. The underperformance of the Trust relative to the Vanguard Fund was primarily due to the timing of the County's annual contribution to the Trust. 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 (48.3%), Pacific stocks (25.6%), and emerging markets (26.1%).

#### X. DEPOSITORY BANKING

The Trust's general banking and cash management services are provided by an Agreement for Banking Services with Wachovia Bank, for the period July 1, 2007 through June 30, 2010. Wachovia Bank was selected as the County's banking institution in a competitive selection process. The contract provides for three one-year extensions upon mutual agreement of the parties. In February 2010, the County and Wachovia extended the contract through June 30, 2011. If the remaining two one-year options are exercised, the contract would run through June 30, 2013.

The Trust utilizes a NOW account, or a full-service demand deposit account that generates interest income on excess funds. Contractually, available cash balances earn interest at the intended federal funds rate minus 7.5 basis points. Monthly interest is first utilized to offset service charges; earnings in excess of service fees are distributed to the County. After the Fed reduced the overnight target rate to a 0% to 0.25% range, Wachovia reset rates temporarily to 75 basis points on balances offsetting service fees and 40 basis points for balances in excess of those necessary to offset fees. The rates were gradually reduced through the year. In September 2010, Wachovia paid 35 basis points on balances offsetting service fees and 20 basis points for balances in excess of those necessary to offset fees. The accounts are covered by the Federal Deposit Insurance Corporation up to a total of \$250,000 and collateralized by the Florida Security for Public Deposits Act.