RON GALPERIN
CONTROLLER

March 12, 2014

Honorable Eric Garcetti, Mayor
Honorable Michael Feuer, City Attorney
Honorable Members of the Los Angeles City Council

Re: RELEASE OF THREE PENSIONS FUNDS RELATED AUDITS

I. SUMMMARY

A. City Pension Costs and Liabilities:

Addressing our City government's current and future pension obligations is among the most challenging of issues for the City's fiscal well-being. This is, of course, a challenge faced by cities, counties and states nationwide – but one that will require local leadership and solutions.

While the City modified certain pension provisions for newly hired employees as of July 1, 2013, pension obligations are accounting for an increasing share of City expenditures. And, the combination of relatively flat revenues and more retirees is one that impacts security and expectations of current and former employees – and the City's ability to provide services and invest in our infrastructure.

There isn't one answer. But transparency, review and oversight of our pensions management and investments provides us with an opportunity to minimize liabilities and costs while maximizing returns, hence, the audits released by the Controller's office today.

The City of Los Angeles has three pension systems that provide pension benefits for its retirees: The Los Angeles City Employees' Retirement System (LACERS), the Los Angeles Fire and Police Pension Fund (LAFPP), and the Water and Power Employees' Retirement Plan. Today, we are releasing two management audits of LACERS and LAFPP jointly commissioned with the Mayor and Council, in accordance with Charter Provision 1112(a), and a compliance audit of annual City contributions to these funds. Future audits will further explore these two pension funds – along with Water and Power Employees' Retirement Plan as well.

The City's employer contributions to LACERS and to LAFPP were collectively $712 million in 2010, $800 million in 2011, and $869 million in 2012 -- out of the City's average annual budget of approximately $6.8 billion during the same period. The portfolio of investments supporting these retiree payments totaled $9.6 billion for LACERS and $13.3 billion for LAFPP as of June

30, 2012. Subsequent to the audit period, as of June 30, 2013, the portfolios totaled $10.9 billion and $14.7 billion, for LACERS and LAFPP respectively. From these portfolios, LACERS and LAFPP paid more than $1.4 billion in pension benefits to almost 30,000 retirees and beneficiaries in Fiscal Year (FY) 2012 and almost $1.5 billion in FY 2013.

Little things can mean a lot. While all three audits report that LACERS and LAFPP management, planning and accounting practices generally comported with other comparable public pension funds, we could have done better. LACERS portfolio underperformed its policy benchmark by just 0.6% -- but that 0.6% totaled $160 million during the five-year audit period of 2007 to 2012. Over the same five years it was estimated by the auditors that LACERS could have saved approximately $21 million in management fees, using an all passive approach.

While it is, admittedly, easier to second guess results than to achieve certain returns, the audits underscore the importance of achieving maximal efficiency and improved rates of return to grow the funds' investments. We must employ improved processes and technologies to achieve these goals. This is essential to achieving much needed long-term stability. Further, these, and future, audits are intended to help improve transparency -- as it is important for taxpayers to know: how the City's pension obligations are calculated; how the funds are invested; how much the City and employees are paying, and how much retirees are getting.

B. Three Audits:

Today, I am releasing three reports – two management audits, commissioned jointly by the Mayor, Council, and Controller, covering Fiscal Years (FY) 2008-2012 and a compliance audit which covers FY 2010-2012. These are the first of several reports that I intend to issue related to our pension systems and our mounting pension fund obligations.

1. Management Audit of the Los Angeles City Employees' Retirement System (LACERS); and

2. Management Audit of the Los Angeles Fire and Police Pensions (LAFPP).

These two Audits, conducted by two independent audit firms, conclude Interim Reports issued in 2013, and provide detailed evaluations of the two public employee funds' investments and operations. The Audits were conducted in accordance with the Los Angeles City Charter mandate that such management audits be performed at least every five years by an independent qualified management auditing firm, and jointly administered by the Mayor, Council and Controller.

3. Compliance Audit of annual City of Los Angeles contributions the Los Angeles City Employees' Retirement System (LACERS) and to the Los Angeles Fire and Police Pensions (LAFPP).

This audit evaluated whether the City and its employees are contributing the correct amounts to LACERS and LAFPP in accordance with established laws, regulations, policies, City Ordinances, and MOUs.

II. FINDINGS, RECOMMENDATIONS & GENERAL OBSERVATIONS

Overall, the three Audits reveal that LACERS and LAFPP management and accounting practices have generally comported with other comparable public pension funds and benchmarking studies reviewed by the auditors. LACERS and LAFPP also demonstrated appropriate long-term strategic and financial planning, and generally good financial and operational policies and practices.

However, all three of these audits showed that there are still opportunities for improvement, both in the management of the funds and in the investments, especially as it relates to enhancing investment strategies to understand the risks of certain asset allocations.

It is my hope and expectation that both audited pensions systems will not only embrace and implement the recommendations made in their respective audit, but that they will also each review their counterpart's audit and, where appropriate, consider recommendations that, if applicable, could also improve their own pension system.

A. Management Audits of LACERS AND LAFPP

Funding Levels -- The independent auditors reported that the funding level of LACERS was at 69% of its actuarial liability, as of June 30, 2012. The actuarial liability of a plan equals the amount of assets that the plan needs to have to satisfy all of its obligations under the assumptions of the plan. This compared to a peer project group range of 62% to 85%. The auditors determined that the funding level of LAFPP was at 84% as of June 30, 2012. This compared to a peer project group range of 67% to 96%. Subsequent to the audit period, as of June 30, 2013, the funding ratios as reported by LACERS and LAFPP were 68.7% and 83.1%, respectively. Notably, the reported funding levels of pension funds can vary significantly over time based on, among other things, portfolio values at the time.

Assumed Rates of Return -- Both LACERS and LAFPP decreased their assumed rate of return from 8.0% to 7.75% per annum in 2011 for LACERS and 2010 for LAFPP. In any given year, actual rates of return will typically exceed or fall short of the current assumed rate of 7.75%. Notwithstanding the fact that an assumed rate of 7.75% may be a somewhat optimistic measure of long-term performance, the auditors reported the assumed rates of the two funds to be at levels that were generally comparable to others in their peer groups. The assumed rate of return has a direct impact on the City's contribution, and as a result has become politicized. Given the volatility of the markets, the LAFPP audit recommends that asset/liability modeling be performed every three to five years to ensure that the assumed rates of return are based on accurate assumptions of market conditions.

Rates of Return and Funds Underperformance -- Average rates of return from 2007-2012 were 1.0% over the five year period for LACERS and 2.1% over the five year period for LAFPP. Subsequent to the audit period, both funds showed strong rates of return for FY 2013: LACERS had a 14.14% rate of return and LAFPP had a 13.75% rate of return.

> *LACERS:* Due to severe market downturns during the period audited, LACERS underperformed by $4.9 billion. While $4.6 billion of this underperformance was a result of declines in capital markets, the audit identifies $278 million of the underperformance attributed to shortcomings in LACERS' investment program.
>
> *LAFPP:* During the five year audit period, LAFPP underperformed by approximately $2.4 billion compared to what would have been gained had the assumed rate been achieved.

Active vs. passive management of investments -- The management audits examine whether active or passive management of the retirement systems' investments provides the greatest benefit to the City. Both systems have active and passive management programs.

LACERS: During the five year review period, LACERS active management underperformed by just 0.6% compared to passive policy benchmarks. However, this 0.6% totals $160 million – in addition to the added costs to the fund of active management fees. For FY 2011-12 alone, LACERS would have been better off by an estimated net amount of $21 million had it used a fully passive management approach – largely due to $20.8 million in active management fees. Had the investments been fully passive, the fees for FY 2011-12 would instead have been an estimated $3.8 million. While active management is more successful in fixed income and private equity, and less successful in US and non-US equity and real estate (over both 5 and 10 year periods), opportunistic fixed income and emerging manager programs underperformed for LACERS.

LAFPP: For FY 2011-12, LAFPP paid approximately $23.5 million in investment management fees for its public equity and fixed income portions of the portfolio. If LAFPP implemented an all-passive approach to the public equity/fixed income portfolios, its annual investment management fees would be approximately $3 million, reducing investment management fees by more than $20 million.

Investment Management Fees

LACERS: Based on the total asset base, the investment management fees associated with LACERS investment program were approximately $49 million per year on average over the five year audit period. Fees incurred with respect to LACERS' public markets portfolio were less than the average of the project peer group. Subsequent to the audit period, LACERS' actual investment management fees were $49 million for 2012-13.

LAFPP: Based on the total asset base, the investment management fees associated with LAFPP's investment program were approximately $51 million per year. Given the size, complexity and structure of the investment program, the audit found that LAFPP's investment management fees were reasonable compared to its peers. Subsequent to the audit period, LAFPP's actual investment management fees were $56 million for 2012-13.

Administrative Expenses

LACERS' administrative expenses were 17.18 basis points of average assets under management, which was above the average of the peer group. Had LACERS been able to lower expenses to the same level as the project peer group, its total administrative expenses would have been reduced by approximately $4.7 million per year, or $23.5 million over the duration of the review period. LACERS' overall cost of administration per member was also higher than the project peer group by approximately 42%. LACERS personnel costs equal approximately 72% of total administrative expenses.

LAFPP's administrative expenses were high on a cost-per-member basis when compared to peers -- but low when compared on a cost-per-assets basis at 9.37 basis points, the third-lowest ratio of costs to assets in its peer group. With these two measures, LAFPP's administrative expenses compare favorably to its peers from a cost per assets basis, however, at a cost-per-member, LAFPP was the second highest in its peer group.

As a means of reducing administrative expenses and investment management fees, the audits include discussion and a recommendation that the City should pursue a comprehensive study to determine an estimate of potential savings from some form of combination of systems and/or heightened levels of collaboration.

Portfolios and Assets Allocations -- While the portfolios of both LACERS and LAFPP were determined to be generally adequately diversified, the LACERS audit recommends examining the asset mix under specific economic scenarios to better understand risks under adverse conditions. The audits also recommend devoting more time to the review of investment assumptions at the outset of the process and to explore with investment consultants alternative methodologies, other than mean-variance optimization in determining allocation to private market assets.

Compliance -- The audits found that both systems were generally in compliance with their respective Investment policies. However, for LACERS, the actual allocation of assets has exceeded the maximum-minimum ranges on several occasions. The June 30, 2012 allocation was well outside the ranges specified in the asset mix policy approved by the Board in January 2012. The Board has established a plan to address this and to implement new policy by September 2014 -- with a net target asset mix set every quarter.

"Smoothing" -- Both LACERS and LAFPP have adopted smoothing periods of seven years, which is longer than the five year period used by most others in the peer group. The seven year smoothing period allowed for the decline in the markets to be deferred over a longer period of time, with less impact on the City's contributions. As of June 30, 2012, there remained $1.025 billion and $1.047 billion of prior investment losses still to be recognized for LACERS and LAFPP, respectively. Subsequent to the audit period, as of June 30, 2013, LACERS had an unrecognized loss of $81.6 million and LAFPP had an unrecognized gain of $77.3 million.

Investment Assumptions

LACERS -- The auditors recommended that the LACERS Board should devote more time to reviewing the investment assumptions to more fully reflect current valuations in capital markets and to better determine reasonable expectations of investment performance.

LAFPP -- The investment policies, while good, did not include a general description of the Plan's risk tolerance, and the degree of volatility the Board is willing to accept for individual mandates and for the overall portfolio.

Governance and Fiduciary Responsibilities

LACERS -- The Fund could benefit from greater autonomy from general City of Los Angeles policies. Contrary to best practices and industry standards, there are limits on the Board's authority, specifically authority to select a General Manager and legal counsel, establish staff compensation and hiring policy -- without going through the City's Personnel Department.

LAFPP -- While the Fund's written curriculum for new trustees is comprehensive and reflective of current best practices, new Board members were not actually receiving most of that training, and most of the Board members were not actually given the new trustee training on fiduciary responsibility. This lack of training is a departure from best practices. Additionally, the lack of fiduciary responsibility training for staff is inconsistent with best practices. The audit recommends implementing better training.

Review of Status of Prior Audit Recommendations

LACERS -- The prior management audit conducted by the City had 142 total recommendations. LACERS has fully implemented 68 recommendations, partially implemented 16, and has not implemented 58 recommendations, -- either because the Board determined not to implement, was not empowered to implement, or said recommendations were determined not applicable.

LAFPP -- The prior management audit conducted by the City had 169 total recommendations. LAFPP has fully implemented 91 recommendations, partially implemented 18 and has not implemented the remaining 60 recommendations -- either because the Board has determined not to implement, was not empowered to implement, or said recommendations were determined not applicable.

B. Compliance Audit of Annual City of Los Angeles Pension Contributions

The Audit of the City's Pension Contributions found that while City and employee contributions were in accordance with the City's funding policies and regulations, several matters would benefit from being addressed to increase transparency in Plan administration and of the City's contribution to the pension systems.

- **Supporting documentation --** As part of the City's annual contribution to the pension systems, the audit recommends that the City Administrative Officer (CAO) bolster its practices by maintaining supporting documentation -- to provide backup for any adjustments to the budgeted salary amounts used to calculate the City's covered payroll, upon which the pension contribution is based.

- **Annual Required Contribution --** Currently, when the CAO calculates the City's Annual Required Contribution, it applies the actuarially-determined contribution rate, as approved by the Retirement Boards, to the covered payroll which is based on budgeted amounts for salaries, as approved by the Mayor and Council. Insofar as the base did not include budgeted salaries for LACERS and LAFPP department personnel as well as part-time and as-needed employees who are LACERS members, inclusion of these employees would provide a more accurate and transparent contribution amount for the City on an annual basis.

- **True-up --** The pension contribution true-up mechanism, an adjustment made to account for the difference between an estimate and actual amount that has subsequently become available, is considered an actuarial practice improvement to promote exactness and timeliness of funding. Prior to the audit, neither of the pension systems used this practice. During the course of the audit, LACERS adopted a true-up mechanism beginning in FY 2013-14, and the CAO should work with LAFPP to implement a similar system to improve the accuracy of the contribution for all City employee pensions.

III. ACKNOWLEDGEMENTS

The Controller thanks the Mayor and City Council as joint administrators of the management audits, as well as the consultants and independent auditors retained to conduct the work of the three audits: P2E Consulting Group, LLC, Hewitt EnnisKnupp, and Bazilio and Cobb Associates – along with their staff for their diligent work in performing these audits. I look forward to working with the management and boards of LACERS, LAFPP, the City's elected officials, labor, City Administrative Officer, and other stakeholders to implement the recommendations in the three audits issued today – together with recommendations in the 2 interim reports.

Sincerely,

Ron Galperin

RON | GALPERIN
Los Angeles City Controller

Honorable Members of the Los Angeles City Council
Board of Fire and Police Pension Commissioners

As required under City Charter Section 1112, the Los Angeles City Controller, the Office of the Mayor, and the Los Angeles City Council jointly cause, once every five years, a management audit to be conducted of the pension and retirement systems by an independent qualified management auditing firm. The audit examines whether the pension or retirement system is operating in the most efficient and economical manner and evaluates the asset allocation of the system.

The Charter-mandated audits are comprehensive and require many months to complete. Representatives for the Mayor's Office, City Council and Controller's Office (Joint Administrators) identified 13 audit objectives to be addressed in the current management audits. On June 27, 2013, an Interim Report was issued that focused on five audit objectives, and an assessment of the implementation status of the prior audit recommendations.

The attached "Management Audit Final Report of the Los Angeles Fire and Police Pension Fund" represents the final report addressing the remaining audit objectives. This Final Report includes the following topics:

- The adequacy and reasonableness of the Los Angeles Fire and Police Pension's (LAFPP) asset allocation and investment diversification to minimize the risk of loss and maximize the return rate;
- Consideration of costs in investment decisions and evaluation of investment performance;
- Reasonableness of actuarial methods and validity of assumptions;
- Disability and Retirement Benefit Administration Process;

- Governance and Fiduciary Responsibilities;

- Adequacy of Long-Term Strategic and Financial Planning to enable timely decisions by the System and the City.

Attached to the Final Report is a response from LAFPP which indicates they are in general agreement with the recommendations.

If you have any questions about the report, please contact Farid Saffar, Director of Auditing, at (213) 978-7392 or at farid.saffar@lacity.org.

Sincerely,

RON GALPERIN
City Controller

ERIC GARCETTI
Mayor

HERB J. WESSON, Jr.
City Council President
10th District

Enclosure

cc: Honorable Mike Feuer, City Attorney
Ana Guerrero, Chief of Staff, Office of the Mayor
Raymond P. Ciranna, General Manager, LAFPP
Miguel A. Santana, City Administrative Officer
Holly L. Wolcott, Interim City Clerk
Gerry F. Miller, Chief Legislative Analyst
Independent City Auditors

Management Audit Final Report of the Los Angeles Fire and Police Pension Fund

December 23, 2013

Hewitt ennisknupp
An Aon Company

Hewitt ennisknupp
An Aon Company

January 8, 2014

Joint Administrators
c/o Office of the Controller
City of Los Angeles
200 N. Main Street, Suite 460
Los Angeles, CA 90012

ATTN: Mr. Farid Saffar, Director of Auditing
Cynthia Varela, Chief Internal Auditor

RE: Final Report - Management Audit Report of the Los Angeles Fire and Police Pension Fund

Dear Joint Administrators:

Hewitt EnnisKnupp is pleased to present the attached *Final Report - Management Audit Report of the Los Angeles Fire and Police Pension Fund*. This Final Report is the second of two reports -- the first, Interim Report, was issued on June 27, 2013.

We thank everyone who worked on this important project for their time and hard work. We were honored to serve the City of Los Angeles.

Sincerely,

Nancy Williams
Partner

Jeanna Cullins
Partner

Hewitt EnnisKnupp, Inc.
200 E. Randolph, Suite 1500 | Chicago, Il 60601
t 312.381.1200 | **f** 312.381.1366 | www.hewittennisknupp.com

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Table of Contents **Page**

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Executive Summary

INTRODUCTION

The City of Los Angeles (the "City") has three main employee retirement systems of which the Los Angeles Fire and Police Pension Fund ("LAFPP") is one. LAFPP was established through the Los Angeles City Charter (the "City Charter"). The City Charter grants authority to the LAFPP Board of Administration, General Manager, and staff to administer a multi-tiered defined benefit retirement plan for almost 26,000 City of Los Angeles sworn employees, including police, fire, and certain port police. Benefits are based on the member's pension tier, age, years of service, and final average salary. For the year ending June 30, 2012, LAFPP paid approximately $744,481,620 in pension benefits to approximately 12,000 retires and beneficiaries. The LAFPP portfolio of investments that provided support for these payments was valued at approximately $13.3 billion for the same period. LAFPP has 114 position authorizations, with an administrative expense budget of nearly $17 million.

The average monthly per retiree/beneficiary benefit amount paid was $5,011. The benefits received are not directly related to the amount of the members' contributions. Members do not contribute to or earn Social Security credit. As of June 30, 2012, there were six tiers.[1]

As the plan sponsor of LAFPP, the City has a strong interest in ensuring the effective administration of LAFPP on behalf of its residents and taxpayers. The City Charter requires a management audit of LAFPP to be completed at least every five years, the broad objectives of which are to examine whether LAFPP is operating in the most efficient and economical manner and to evaluate the asset allocation of LAFPP. The management audit is one of several mechanisms designed to allow the City to monitor LAFPP.

The City and its Joint Administrators[2] retained Hewitt EnnisKnupp ("HEK") through a competitive bidding process to perform the management audit of LAFPP (the "Management Audit"), for the period covering fiscal years 2008 – 2012 (the "Review Period"). The Management Audit was divided into two reports – the Interim Report, issued June 27, 2013, and this Final Report (collectively the "Reports"). The Interim Report focused on certain priority questions identified by the Joint Administrators, including a status review of the recommendations from the prior Management Audit issued in 2007. A synopsis of the Interim Report is provided at the end of this Executive Summary. This Final Management Audit Report includes the remaining objectives outlined in the audit scope of the work provided in Appendix A. The content of the Reports supports our conclusion that overall, LAFPP is generally operating in an effective manner. Areas where we believe LAFPP would benefit from enhancements are identified and recommendations are provided.

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[1] See the LAFPP 2012 Annual Report and the Segal 2012 Actuarial Report for summary descriptions of each of the tiers. Links have been provided for ease of reference. LAFPP 2012 Financial Report   LAFPP 2012 Actuarial Valuation

[2] The Joint Administrators are composed of representatives of the City of Los Angeles' Mayor, City Council, and Controller.

This Executive Summary is an abridged version of the key topics and many of the recommendations addressed in each of the Reports. It is not intended to replace either of the Reports. We encourage readers to examine the detailed narrative contained in the body of the full Reports.

Synopsis of Final Report

I. Asset Allocation

A. *Actuarial Liabilities and Funded Level*

As of June 30, 2012, the LAFPP pension plan had an unfunded liability of $2.779 billion and was 84% funded (the funded ratio) making it better funded than most of its peers.

LAFPP's peers have funded levels ranging from 62% to 96%, with half of the peers' funded ratios ranging from 67% to 84%. According to a recent study, the estimated aggregate ratio of assets to liabilities in a sample of 109 state-administered plans and 17 locally administered plans was 73 %.[3] Compared to the plans in this study, LAFPP's funded level was 11 percentage points higher.

The funded ratio is a point-in-time measurement that relates the value of the assets of the fund to the value of its liabilities as determined by LAFPP's actuarial firm. In each year of our review, the audited financial statements reported that the City contributed the full Annual Required Contribution (ARC) to LAFPP. The ARC is an amount, calculated by LAFPP's actuary, that is designed to fund LAFPP to 100% (fully funded) over a period of time not to exceed 30 years (the amortization period). LAFPP's amortization period of 25 years,[4] a targeted funding level of 100%, and the City's full payment of the ARC are consistent with best practices for government defined benefit pension plans. It is important to remember that the length of the amortization period (25 or 30 years) is a reflection of how much smoothing of contributions is desired.

Longer amortization would lead to smoother contributions. Yet, since some amortization amounts might be negative (experience gains or changes in assumptions that lower the liability), longer amortization periods would not necessarily minimize contributions. For instance, an assumption change to lower salary increases would be a negative amount (since it lowers the liability) and, therefore, using a 30 year amortization period for this (instead of 25 years) would actually increase contributions.

During the Review Period, LAFPP's funded status declined from 99% in 2008 to 84% in 2012. The key reasons for this are the downturn in the global financial markets and an increase in the liabilities due to the benefit obligations payable under the plan design.

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[3] "Public Fund Survey" (National Association of State Retirement Administrators and National Council on Teacher Retirement, 2012).
[4] 25 years is the period used for the latest established amortization balance from the 2012 actuarial report. However, some of the amortization amounts in 2012 still have 29 years remaining in the amortization period because those amortization periods were set in 2011 at 30 years.

B. Asset Allocation Process

We concluded that LAFPP's asset allocation process and its investment strategy are generally appropriate, but could be enhanced.

The asset allocation is critical to a fund's success over the long-term. We found that LAFPP's current asset allocation is fundamentally in line with peers; however, it could be improved by conducting asset/liability modeling regularly (this was recommended in the Interim Report). An asset/liability modeling exercise would assist the Board in determining the appropriate risk posture for the Plan taking into consideration the nature of the liabilities, sensitivity of the assets and liabilities to varying market conditions, Plan demographics, need for liquidity, etc.

Although we believe that the lack of asset/liability modeling results in a process used by LAFPP to establish its asset allocation that is less comprehensive than the process used by most leading funds, we still found that the expected returns, volatility, and correlation among asset classes and sub-classes used by LAFPP in setting the asset allocation are reasonable.

The Board Governance Policies, the Board Operating Policies and Procedures, and the Board Investment Policies are the governing documents that provide Board and Staff guidance on the ongoing oversight and management of the Fund and hence it is important to ensure that these documents are current and reflect all Board-approved decisions.

The following is a summary of our recommendations to enhance the Board Investment Policies:

- Promptly update the investment policies so they accurately reflect the Board's most recent decision on asset allocation.
- Review and revise the "Current Board Allocation Within Major Asset Classes" section of the Board Investment Policies.

C. Portfolio Rebalancing

Rebalancing the portfolio is an important risk control measure that maintains the plan's target asset allocation i.e., preferred level of risk exposure. When making policy decisions regarding rebalancing, investors must weigh the potential cost of rebalancing too frequently against the potentially higher tracking error associated with rebalancing too infrequently. LAFPP's rebalancing policy addresses these issues in a concise manner. The Board's delegation of rebalancing authority to staff ensures that transactions can happen quickly, if necessary. We found LAFPP's rebalancing process to be appropriate for a sophisticated institutional investor.

Our recommendations to enhance the rebalancing process include:

- Remove the restriction on rebalancing that currently restricts it to once every three months.
- Rebalance to the target allocation, rather than the mid-point between the target allocation and the edge of the range.

D. Investment Performance and Attribution Analysis

Over a trailing five year period the LAFPP Total Fund has underperformed the return of its benchmark (-1.1% per year), at a modestly higher level of risk (volatility). Based on information available to us, we estimate that LAFPP's underperformance relative to its Total Fund Custom Benchmark translates to approximately $680 million on a cumulative basis over the five year period ending June 30, 2012. We caution that the calculation used to quantify the amount of underperformance relative to the Total Fund benchmark provides only a rough approximation. A more detailed analysis is required to arrive at a precise estimate.

LAFPP underperformed relative to its actuarial assumed rate of return on investments (ARR) for the Review Period. This underperformance relative to the ARR translates to approximately $2.4 billion less than what would have been gained had the assumed rate been achieved. The shortfall puts upward pressure on the contribution rate. The significant decline in the capital markets during late 2007 to early 2009 was a key factor in the underperformance.

LAFPP has 19% of its fixed income allocation in long duration bonds, which is not reflected in the fixed income benchmark. Accordingly, our recommendations include:

- Modify the fixed income benchmark to account for the long duration bond exposure.

After reviewing the attribution analysis provided by LAFPP's investment consultant, we concluded that it is thorough and provides important information which fosters the Board's oversight responsibilities. It is a tool used by institutional investors to analyze investment performance by visually depicting the relative drivers of performance, which assists the Board in better understanding how their investment managers' performance results were achieved. We did not have any recommendations regarding LAFPP's attribution analysis.

II. Consideration of Costs

A. Investment Management Fees

We found that LAFPP's investment management fees were in-line with peers. As would be expected, LAFPP's active management fees are significantly higher than its passive management fees; although, the active management fees are generally also in line with or favorable when compared to peers.

Moving to an all-passive management approach would reduce fees by over $20 million, but may come at the expense of additional returns in some cases. We believe that the active management decision should not be solely based on the potential reduction of investment fees over time. Because the LAFPP Board has the fiduciary responsibility to make prudent investment decisions, its use of active management should reflect its level of conviction in an active manager's ability to produce excess returns over time.

B. Net of Fees Reporting

LAFPP's investment performance reports show the gross-of-fee returns along with the expense ratio for each manager. Fees are not shown at the asset class or total fund level (i.e., aggregation of underlying manager fees). We find that it is more useful to analyze the performance of managers and the total plan on a net of fees basis for a couple of reasons. First, it is important to remember that there are costs associated with investment management. Active management is more expensive than passive management. Analyzing performance on a net of fee basis provides for a true analysis of the efficacy of active management efforts -- whether managers have added value and generated returns for the plan after their fees have been paid. Second, and more importantly, fees are an actual expense that the plan incurs. Total plan net-of-fees are ultimately what is available to meet benefit payments. Therefore, we recommend that LAFPP's investment performance reporting be modified to display net-of-fee returns.

III. Reasonableness of Actuarial Methods and Assumptions

The funded status of the Plan and, therefore, the amount of contributions needed to sustain the Plan, are a direct result of the Board's decisions on which actuarial methodology to use and the actuarial assumptions.

We found that LAFPP has been diligent in reviewing the appropriateness of its actuarial methodology and assumptions. We also found that the actuarial methodology and assumptions adopted by the Board are appropriate, and based on our review, LAFPP's actuary appears to be following the Actuarial Standards of Practice in performing the actuarial valuations and experience studies. Therefore, we had no recommendation in the Final Report related to the reasonableness of LAFPP's actuarial methods or assumptions.

IV. Retirement and Disability Benefits Administration Process

A. Plan Provisions, Administrative Rules, Policies and Procedures

Based upon the interview process and review of relevant documentation, we conclude that the plan provisions, administrative rules, policies and procedures used to process benefit payments are sufficiently thorough, comprehensive, and are in alignment with each other. The actual practice of Board and staff is reasonably consistent with the parameters set forth in the governing and operational documentation and recent updates have been made to reflect plan changes. Summary plan documentation exists for all Tiers of the Plan except for Tier 6.

A summary of our recommendations regarding documentation related to benefits payments includes:

- Develop and furnish to members, as soon as possible, a Summary Plan Description for Tier 6.
- Continue to compile in one central repository all benefit determinations received to date, including precedents set by court decisions, Board decisions, management decisions and legal opinions.

B. Processing Timeframe

The California Constitution, which applies to LAFPP, requires prompt delivery of benefits and related services to participants and their beneficiaries. We found that regular retirement application processing is being done within an appropriate timeframe. However, while the average disability application processing time has decreased somewhat since 2007, it still takes LAFPP twice as long, on average, to process a disability application as its peers.[5] LAFPP's disability application processing timeframe averages one year or longer compared to the peer group average of 5.9 to 7.5 months. Significant delays, due to the time it takes staff to process an application or the Board to determine the outcome, could strain a member's personal financial resources. While strict adherence to processing times can be difficult to achieve due to the inherent need to rely on external parties for information and

[5] The peers for purposes of this comparison were: Fire and Police Pension Association of Colorado, LA City Employees Retirement System, Ohio Police and Fire Pension Fund, Orange County Employees Retirement System, Public Employees Retirement System of Idaho, and School Employees Retirement System of Ohio. This is a subset of the peer group used in the interim report. A subset was used because only 6 of the 11 peers used in the interim report publish their average process time.

scheduling, and the complexity of some cases, we believe that improvements could be made to positively impact timeliness.

A summary of our recommendations regarding the processing timeframe for benefit payments includes:

- Add expected turnaround times for internal processing, where appropriate, to staff's Desk Manual.
- Evaluate all member-facing information and publications to ensure that disability application processing turnaround times are consistently communicated.
- Evaluate the informal practice currently used to schedule Board hearing dates and explore ways to enhance timeliness.

C. Control Environment

Our review of LAFPP's control environment in the benefits area showed that while it is generally adequate, there are some limitations to its effectiveness. For example, we found: (1) recordkeeping for paper-based files differs from the common practices of other large systems; (2) there are no automated controls for the payment approval process; (3) there is confusion among staff as to who is responsible for conducting periodic random inspections to ensure compliance with the policy for safeguarding confidential member data: and (4) there are physical security limitations to LAFPP's office environment. In addition, changes and additions to the monthly pension roll for the healthcare subsidy program are not subject to LAFPP's standard verification process, and multiple technology systems are being used to administer, calculate and pay benefits, which creates inefficiencies and potential risks.

A summary of our recommendations regarding improvements to the control environment includes:

- Subject the healthcare subsidy program to the same accounting verification process as all other monthly pension roll payments.
- Examine what additional measures could be adopted to enhance physical security in the current office space.
- Develop a comprehensive physical security plan for the new LAFPP office space.
- Continue the search process for a successor technology system which can integrate the components of the benefits administration process including calculations, automated workflow administration, controls, and the payment process.

With regard to staff training and turnover risk, we found that staff training (except regarding training for those that are fiduciaries which is discussed below) is consistent with common practices of other public retirement systems; however, LAFPP has the potential for higher than average turnover among its staff in the Disability Pension Section. Management is aware of the risk of turnover and is in the process of addressing it.

V. Fiduciary Responsibilities

We found no inconsistencies related to the fiduciary standards in the written laws reviewed. The Commissioners and staff with fiduciary responsibility generally understand the legal standards they are to follow.

LAFPP has written curriculum for new trustee orientation that is comprehensive and reflective of current best practices. Unfortunately, Board members are not actually receiving most of that training. Annual fiduciary and ethics training is being provided to the Board, and ad hoc training also occurs when specific issues arise. But, there is no specific fiduciary training program designed for staff members who are fiduciaries. The lack of any required fiduciary responsibility training for LAFPP staff members is inconsistent with best practice. The best approach is to mandate fiduciary training for new staff that have fiduciary responsibilities and annual training sessions thereafter.

The Board's deliberative and monitoring processes are effective overall. It is monitoring essential plan information as well as the performance of the duties it has delegated to staff and others, which is essential for fulfilling its fiduciary duties. However, in our review of Board deliberations it was apparent at times whether a particular Commissioner was appointed by the City or elected by the membership based on their comments. Board members may not fully understand the Board's fiduciary "duty of loyalty."

Our recommendations regarding LAFPP's fiduciaries responsibilities include:

- Require that each new Commissioner receives prompt training on all topics stated on the New Board Member Orientation table, and provide additional training on the duty of loyalty.
- Establish a fiduciary responsibility training requirement for new staff who have fiduciary responsibilities and provide ongoing training annually.
- Establish and follow a regular review schedule for the Board's policies that do not currently have formal review periods.

VI. Long-term Financial Planning

We found that LAFPP's procedures for long-term planning and monitoring of its financial condition are proper. Through Board and staff interviews and reviewing documents obtained from LAFPP, we learned that communication between LAFPP and various City departments, especially the Office of the City Administrative Officer, regarding LAFPP's financial impact on the City's budget has occurred throughout the Review Period. The communication has addressed the significant events that occurred during the Review Period, including the financial impact of the market downturn in 2008-2009, LAFPP's efforts to mitigate the impact of that downturn on the City's budget, and the creation and implementation of the new Tier 6. Consequently, we have no recommendations for this subject.

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TABLE OF FINAL REPORT RECOMMENDATIONS

Recommendations 1 through 21 are set forth in the Interim Report.

Number	Final Report Recommendations	Page Number
22	LAFPP Management should promptly update the investment policies so they accurately reflect the Board's most recent decision on asset allocation. (Obj. 1)	28
23	LAFPP Management should review and revise the "Current Board Allocations Within Major Asset Classes" section of the Board Investment Policies. (Obj. 1)	28
24	The LAFPP Board should remove the restriction on rebalancing once every three months. (Obj. 1)	30
25	The LAFPP Board should rebalance back to the target allocation for the applicable asset class, unless there is some ancillary tactical or cost reason to do otherwise. (Obj. 1)	30
26	The LAFPP Board should benchmark the Fixed Income component (Core Fixed Income and High Yield) to a weighted benchmark of 84% Barclays U.S. Universal Index and 16% Barclays U.S. Long Government/Credit Index. (Obj. 1)	35
27	LAFPP Management should require R.V. Kuhns to display net of fees returns in the performance reports. (Obj. 2)	47
28	LAFPP Management should continue to compile all benefit determinations received to date, including precedents set by court decisions, Board decisions, management decisions and legal opinions, in one central repository. (Obj. 4)	58
29	LAFPP Management should develop and furnish a Summary Plan Description for Tier 6 as soon as possible. (Obj. 4)	58
30	LAFPP Management should consolidate the paper-based member files into a centralized filing room within the new LAFPP office space. (Obj. 4)	60
31	LAFPP Management should organize paper-based member files so they include all of a member's information, correspondence, and transactions with LAFPP. (Obj. 4)	60
32	LAFPP Management should subject the healthcare subsidy program to the same accounting verification process as all other monthly pension roll payments. (Obj. 4)	65
33	LAFPP Management should examine what additional measures could be adopted to enhance physical security in the current office space. (Obj. 4)	66
34	LAFPP Management should develop a comprehensive physical security plan for the new LAFPP office space. (Obj. 4)	66
35	LAFP Management should continue the search process for a successor technology system which can integrate the components of the benefit administration process including calculations, automated workflow administration, controls, as well as the payment process. (Obj. 4)	66
36	LAFPP Management should add expected turnaround times for internal processing, where appropriate, to staff's Desk Manual. (Obj. 4)	74

Number	Final Report Recommendations	Page Number
37	LAFPP Management should evaluate all member-facing information and publications to ensure that disability application processing turnaround times are consistently communicated. (Obj. 4)	74
38	The LAFPP Board and Management should evaluate the informal practice currently used to schedule Board hearing dates and explore ways to enhance timeliness. (Obj. 4)	74
39	The LAFPP Board and Management should shift some of the burden of information submission to the member as part of the disability application process. (Obj. 4)	78
40	The LAFPP Board and Management should determine what other common practices, such as delegating specific decision-making authority or retaining a Board medical advisor, could streamline the process, and what changes to governing law, policies or procedures would be necessary to do so. (Obj. 4)	78
41	LAFPP Management should continue to develop a formalized succession plan for key Disability Pension Section staff, specifically including an individual development plan for each staff member in that Section. (Obj. 4)	80
42	LAFPP Management should ensure that each Disability Pension Section staff member receives a performance evaluation no less than annually. (Obj. 4)	82
43	LAFPP Management should expand the Disability Pension Section performance metrics and standards so that they incorporate service quality. (Obj. 4)	82
44	LAFPP Management should explore how to meaningfully tie individual performance evaluations and Section performance into the stated goals of LAFPP's strategic plan. (Obj. 4)	82
45	The LAFPP Board should require that each new Commissioner receives prompt training on all topics stated on the New Board Member Orientation table, and provide additional training on the duty of loyalty. (Obj. 5)	91
46	LAFPP Management should establish a fiduciary responsibility training requirement for new staff who have fiduciary responsibilities, and provide ongoing training annually. (Obj. 5)	91
47	The LAFPP Board should establish and follow a regular review schedule for the Board policies that do not currently have formal review periods. (Obj. 5)	91

Synopsis of Interim Report[6]

Our Interim Report addressed a number of issues, including:

- Whether the prior management audit recommendations were implemented.
- Whether LAFPP has taken appropriate steps to minimize the City contribution and properly defray expenses.
- The process for evaluating LAFPP's investment performance.
- The costs and benefits of using active and passive investment management.
- Cost-sharing and consolidation of certain services with other City retirement systems.

The following narrative summarizes each of the key subjects addressed within the Interim Report.

I. *Implementation of Prior Recommendations*

From our review, we found that LAFPP implemented the vast majority of the prior management audit recommendations. There were, however, nine recommendations that LAFPP reported as completed that were not fully implemented which we recommend they revisit:

- The Board's Securities Litigation Policy should be amended to incorporate Claims Filing & Monitoring Procedures.
- The Board should review its investment policy statement and investment consulting contract for consistency and solidify vague requirements.
- The Board should work with the City Attorney's Office to develop and institutionalize, in advance, a process that will be invoked in the event a potential conflict of interest arises.
- The Board should consider conducting a complete asset liability study every five to ten years.
- The Board should consider working with its General Consultant to develop and implement an annual risk budget for the Total Fund and each asset class.
- The Board should insert a discussion on risk in the investment policy statement to describe and clarify the Board's risk tolerance, including a reference to LAFPPs' time horizon, liquidity needs, etc.
- The Board should acknowledge LAFPP's level of risk with some discussion of how its risk level was developed, and include specific guidelines on how to identify and measure risk.
- The Board should consider developing a detailed practical risk management policy/procedure document.

[6] The synopsis is an abridged version of the Interim Report. The reader is encouraged to read the full Interim Report. The Interim Report can be downloaded from the Controller's web site at: LAFPP Interim Report

- The Board should consider designating an Asset Allocation Index as an additional Total Fund evaluation tool and document the Policy Index and Asset Allocation Index in the Investment Policy Statement.

II. *Minimizing the City's Contribution and Defraying of Costs*

To determine whether the City's contributions are being minimized, three fundamental factors should be taken into account collectively – the cost of benefits, administrative expenses, and net investment earnings. Pension contributions are primarily driven by the cost of benefits and the investment earnings. A pension fund's administrative expenses typically have very little impact on the plan sponsors contributions. We found this to be the case for LAFPP.

We compared LAFPP's administrative expenses to its peers. For purposes of our analysis, administrative expenses did not include investment-related expenses except for the cost of the investment staff and expenses for administering a health plan or subsidy. The costs related to the investment program are evaluated in this Final Report. We used two methods for purposes of the peer comparison. Both are commonly used. The first, costs-per-assets, resulted in a conclusion that LAFPP's administrative expenses are lower than average. The second, costs-per-member showed that expenses are higher. A number of factors can contribute to the higher costs-per-member, including but not limited to, the complexity of the plans (e.g. LAFPP has multiple tiers of benefits and a Deferred Retirement Option Plan ("DROP")), the very low number of inactive members, expenses related to significant technology changes, an emphasis on customer service, and the relatively high labor costs in Los Angeles. LAFPP does not have control over a number of these factors such as the complexity of the plans or the high labor costs in Los Angeles.

Although LAFPP's administrative expenses are higher than their peers on a costs-per-member basis, we found that the higher costs have very little impact on the City's contribution or the unfunded liability. To put it into perspective, for every dollar of benefit funding in 2012, 2 cents was spent on LAFPP administration.

We separately reviewed LAFPP's travel expenses and found them to be reasonable. The policies and procedures for requesting travel and reimbursement were consistent with the City Administrative Code, and provided more consideration of the expenses and value of travel than most of the peers. We did recommend that LAFPP continue to monitor the timeliness of reimbursement requests to ensure compliance with the policy and the City Code.

In our review of whether the administration of LAFPP resulted in minimizing the City's contribution, we also examined the process used to set the actuarial investment return assumption since it can significantly affect contribution amounts. We found the process to be reasonable, but believe it would be enhanced if the Board engaged in asset/liability modeling on

a periodic basis. Such modeling will provide the Board with additional valuable information to use in setting the appropriate asset allocation.
With regard to administrative costs, we also recommended that LAFPP:

- Continue to examine ways to become more efficient in processing benefits and collaborate with peers about their cost control efforts.
- Establish administrative budgets that more tightly control spending rather than budgets that are well beyond what is needed and actually spent.

III. *Investment Performance Evaluation Process*

We found that LAFPP's process for monitoring investment performance was sound overall. The Board's Investment Policies clearly address the investment objectives, the criteria and frequency of investment manager evaluations, and the process for dealing with underperforming managers, including terminations. The Board and staff closely monitor underperforming managers and take decisive actions. The performance reports, on which the Board and staff rely to evaluate managers, are comprehensive and provide significant information. We did, however, make the following recommendations which we believe will enhance LAFPP's current investment performance evaluation process:

- Incorporate a description of liquidity needs and risk tolerance in the Board Investment Policies.
- Consider whether there is a more appropriate real estate benchmark.
- Use a total fund policy benchmark that reflects the target asset allocation approved by the Board.
- Update the watch list more frequently and expand its criteria.
- Document the due diligence process used for ongoing monitoring of managers; prepare documentation of due diligence visits.
- Establish and follow a schedule to update material portions of the Board's Investment Policies.

IV. *Cost-Benefit of Using Active and Passive Investment Management*

Twenty-two percent (22%) of LAFPP's total assets are managed passively, which is higher than a peer group survey conducted by Greenwich Associates.[7] The survey showed that, on average, peers manage 18% of their assets passively. LAFPP's use of passive investments and indexation helps to lower the cost of the investment program and provides diversification.

From a total portfolio perspective, we concluded that LAFPP's investment manager fees for fiscal year 2011-2012 were reasonable for the size, complexity, and structure of its investment

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[7] Greenwich Associates creates an annual report on institutional investor market trends.

program. The Interim Report analysis focused on fiscal year 2011-2012 because data for the prior four years was not available at the time of our analysis. Data was subsequently provided and this Final Report contains total investment management fees, by asset class, for the fiscal years 2008 – 2012 (See this Final Report Table 2-C).

We recommended that:

- LAFPP, as part of its portfolio structure review, benchmark the overall allocation between passive and active management against peers at least every five years, and
- LAFPP's investment consultant provided a report that shows whether it is receiving adequate additional returns from active equity and fixed income managers.

V. *Cost-sharing and Consolidation of Consulting and Custodial Services*

In looking at potential savings from cost sharing, we examined whether investment consulting and custodial bank fees could be reduced. We concluded that LAFPP's investment consulting fees are reasonable and that consolidation may result in a small fee reduction, but it would not be material when compared to overall expenses and LAFPP's assets under management. LAFPP already has a very competitive custodial bank fee arrangement and consolidation would not be likely to reduce fees. Where there is commonality of investment managers, the potential for investment manager fee savings have already been addressed -- LAFPP has implemented a favorable contractual provision that calls for an investment fee schedule based on the aggregate assets of all three Plans.[8]

Acknowledgements

We wish to thank the members of the LAFPP Board of Administration for their time and the insights they shared during the individual interviews. We also thank the staff for their assistance in providing materials and answering questions.

[8] LAFPP, Los Angeles City Employees' Retirement System (LACERS), and Water and Power Employees' Retirement Plan (Water & Power).

Final Report – Findings, Analysis, Conclusions, and Recommendations

INTRODUCTION

The Los Angeles Fire and Police Pension Fund (“LAFPP”) was established through the Los Angeles City Charter (the “City Charter”). The City Charter grants authority to the LAFPP Board of Administration, General Manager, and staff to administer a multi-tiered defined benefit retirement plan for almost 26,000 City of Los Angeles sworn employees, including police, fire, and certain port police. Benefits are based on the member’s pension tier, age, years of service, and final average salary. For the year ended June 30, 2012, LAFPP paid approximately $744,481,620 in pension benefits to approximately 12,000 retires and beneficiaries.

LAFPP also has a Deferred Retirement Option Plan (“DROP”), which is a voluntary program whereby a member with a minimum of 25 years of service (members of Tiers 3 and 5 must also be at least age 50) may file for a service pension but continue to work and earn salary and benefits as an active member. The DROP must be cost neutral with regard to plan funding pursuant to the Los Angeles Administrative Code. The intent of the program was to retain police officers and lengthen their careers due to significant challenges faced by the City in police retention and recruitment.

The LAFPP Board of Administration oversees a diversified investment portfolio holding assets of approximately $13.3 billion as of June 30, 2012. They have 114 position authorizations, with an administrative expense budget of nearly $17 million.

As the plan sponsor of LAFPP, the City has a strong interest in ensuring the effective administration of LAFPP on behalf of its residents and taxpayers. The Charter, Section 1112, requires a management audit to be performed on each of the City retirement systems at least every five years, the broad objectives of which are to examine whether LAFPP is operating in the most efficient and economical manner, and to evaluate the asset allocation of LAFPP. The management audit is one of several mechanisms designed to allow the City to monitor LAFPP.

Hewitt EnnisKnupp, Inc., (HEK) was selected pursuant to a request for proposals to conduct the management audit of LAFPP for fiscal years 2008 – 2012 (the “Management Audit”). HEK is a consulting firm headquartered in Lincolnshire, Illinois, with a wide array of clients including governmental bodies, non-profits, state and federal oversight entities, public retirement systems, state investment boards, corporate pension funds, endowments, and foundations. HEK is the largest firm of its type in the United States with clients having combined assets over $2 trillion. The Fiduciary Services practice within the firm, which was primarily responsible for this assignment, provides independent assessments, fiduciary and operational reviews and governance advice to its clients. The Fiduciary Services practice had resources available to it from all of the other practice areas in the firm. Based on the scope of the project, we involved traditional investment consultants (CFAs, CAIAs, and MBAs) and actuaries (FSAs)[9] to some degree.

Prior to this Final Report, an Interim Report was issued on June 27, 2013. The Interim Report focused on certain priority questions identified by the Joint Administrators as well as a review of the status of the recommendations from the prior Management Audit dated 2007. A synopsis of the Interim Report is provided at the end of the Executive Summary. This Final Report of the Management Audit of LAFPP, as of August 2013, includes the remaining objectives outlined in the Scope of Work (See Appendix A). The content of this Final Report and the Interim Report support the conclusion that overall LAFPP is generally operating in an effective manner.

This report represents the work of HEK from December 2012 to July 2013 and includes its independent findings, analyses, conclusions and recommendations. This review was limited primarily to the subject matter identified in the Scope of Work. For this reason, the review was not an all-encompassing examination or investigation of LAFPP. This Final Report provides reasonable assurance that the practices set forth in the findings are accurate. But, since the Management Audit was limited to the Scope of Work, it should not be construed as an absolute guarantee that all of LAFPP's practices fully meet applicable standards.

The practices reflected within this report are based upon information provided by third parties, including, but not limited to, the LAFPP Board members and staff, outside consultants, and others. Due to the scope and timeframe of this review, HEK relied on the information provided to it and did not independently verify all facts that were provided by those third parties, including LAFPP; however, we did request that key sources from within and outside LAFPP review the facts we relied upon for our analysis.

The opinions and recommendations expressed in this report reflect the independent, professional judgment of HEK. No one associated with the Joint Administrators or LAFPP attempted to unduly influence the scope, findings, analyses, conclusions, or recommendations expressed in this Report.

[9] CFA – Chartered Financial Analyst, CAIA – Chartered Alternative Investment Analyst, MBA – Master in Business Administration, FSA – Fellow of the Society of Actuaries.

I. Objective 1. Determine whether the asset allocation process is sound and the diversification is appropriate so that risk is minimized and returns are maximized over different market cycles.

Scope

The issues we reviewed for this objective include:

- The process used to establish LAFPP's current asset allocation, including the methodology and inputs employed and the asset liability studies performed
- The reasonableness of the estimates of expected returns, volatility (standard deviation) and assumed correlation of returns among asset classes and sub-classes
- The appropriateness and suitability of the asset allocation and the overall investment strategy, including whether investments are suitably diversified and the development of expected returns and risk ranges using HEK's capital market assumptions
- The portfolio rebalancing process, including who makes the decision, the criteria for adjustment and the frequency
- A comparison of LAFPP's investment performance for each asset class and the total fund to appropriate benchmarks and other similar plans
- R.V. Kuhns' performance attribution analysis to determine whether it is an effective tool for monitoring risk and returns and whether LAFPP is effectively using that analysis

<u>Asset Allocation</u>

Findings

The Board Investment Policies require the Board to set the asset allocation based on:

A. An analysis of the actuarial liabilities of the Fund
B. A review of all viable asset classes
C. The expected rate of return, correlation, and standard deviation of all investment asset classes included

The policies require the Board to review the asset allocation at least every five years. The asset allocation provided in the Board Investment Policies was adopted in May 2008. In December 2010 the target asset allocation was changed to include Treasury Inflation Protected Securities (TIPs) and commodities. This change has not been reflected in the Board Investment Policies as of the date of this review. Likewise, changes have not been made in the "Current Board Allocations Within Major Asset Classes" section of the Board Investment Policies.

Table 1-A below lists LAFPP's strategic asset allocation as approved by the Board in May 2008, as well as the new allocation adopted in December 2010.

Table 1-A – LAFPP Target Allocation

Asset Class	Target Allocation May 2008	Target Allocation December 2010
Domestic Large Cap Equity	29.8%	23.0%
Domestic Small Cap Equity	5.3%	6.0%
Int'l Developed Equity	15.0%	16.0%
Int'l Emerging Equity	3.0%	5.0%
Domestic Core Fixed Income	19.5%	14.0%
High Yield Fixed Income	2.5%	3.0%
TIPS	0.0%	5.0%
Private Real Estate	7.0%	7.0%
REITS	2.0%	2.0%
Absolute Return	5.0%	4.0%
Private Equity	10.0%	9.0%
Commodities	0.0%	5.0%
Cash Equivalent	1.0%	1.0%

As of December 31, 2012, LAFPP had not yet begun to implement the commodities allocation.

Table 1-B on the next page outlines the actual asset allocation as of December 31, 2012 relative to the target asset allocation.

Table 1-B – LAFPP Asset Allocation

Asset Class	Allocation as of 12/31/2012	Target Allocation	$ Amount for Each Class[10]
Domestic Large Cap Equity	27.9%	23.0%	$4,256,627,755
Domestic Small Cap Equity	6.3%	6.0%	$959,595,867
Int'l Developed Equity	15.0%	16.0%	$2,295,603,242
Int'l Emerging Equity	4.5%	5.0%	$683,052,021
Domestic Core Fixed Income	14.5%	14.0%	$2,220,747,981
High Yield Fixed Income	2.7%	3.0%	$410,591,184
TIPS	5.1%	5.0%	$784,945,160
Private Real Estate	6.5%	7.0%	$987,433,281
REITS	1.7%	2.0%	$264,934,166
Absolute Return	3.8%	4.0%	$579,667,434
Private Equity	8.1%	9.0%	$1,239,970,334
Commodities	0.0%	5.0%	$6,313,643
Cash Equivalent	3.9%	1.0%	$593,081,898

The final asset allocation adopted by the Board in 2010 was the product of a four-month project led by its investment consultant, R.V. Kuhns. The Board received asset allocation presentations from the consultant and staff during six meetings from September through December 2010. R.V. Kuhns provided the Board with analyses that showed its return assumptions, the expected volatility of those assumptions, the anticipated correlation between asset classes, a range of possible optimal allocations, the results of its asset-only Monte Carlo simulations,[11] and a final asset allocation recommendation. The Board adopted an asset allocation that was slightly different than the R.V. Kuhns recommendation. The differences are shaded in green in Table 1-C.

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[10] The asset allocation data was pulled from the 12/31/2012 LAFPP Performance Report. The table amounts exclude the "International Tax Reclaims" amount of $348,410.

[11] A Monte Carlo simulation uses a random sampling of asset class returns, all of which are based on the probability distribution inherent in the asset class assumptions, to create several thousand portfolio performance estimates.

Table 1-C – R.V. Kuhns Recommended Asset Allocation versus Board-Adopted Allocation

Asset Class	R.V. Kuhns Recommendation	Board-Adopted Allocation
Domestic Large Cap Equity	26.0%	23.0%
Domestic Small Cap Equity	6.0%	6.0%
Int'l Developed Equity	17.0%	16.0%
Int'l Emerging Equity	5.0%	5.0%
Domestic Core Fixed Income	14.0%	14.0%
High Yield Fixed Income	3.0%	3.0%
TIPS	5.0%	5.0%
Private Real Estate	7.0%	7.0%
REITS	2.0%	2.0%
Absolute Return	0.0%	4.0%
Private Equity	9.0%	9.0%
Commodities	5.0%	5.0%
Cash Equivalent	1.0%	1.0%

Analysis

The asset allocation decision is the single most important decision that has a bearing on a fund's success over the long term. Optimal decisions regarding pension plan management are made when they are based on a clear understanding of the assets and liabilities of the plan and how they interact.

The types of analyses provided to the Board for its asset allocation decision-making are reasonable and common for public pension plans. However, the analyses focused primarily on assets; it is also important that the asset allocation accurately reflect the fiduciaries' tolerance for risk. As we stated in the Interim Report, asset/liability modeling helps define the appropriate risk level for a fund by taking into consideration the nature of the liabilities, the sensitivity of the liabilities and assets to varying market and economic conditions, plan demographics, the need for liquidity, etc. Best practice is that asset/liability modeling be conducted every three to five years unless changes in plan circumstances (for instance, closing the plan to a portion of the population) or market environment warrant conducting a study within a shorter period of time. Asset/liability modeling would significantly improve the asset allocation process.

It is common to review and adjust the asset allocation targets every three to five years. LAFPP's policy of reviewing the asset allocation "at least" every five years is consistent with best practices, so long as it is actually completed on a regular basis.

Table 1-D compares LAFPP's target asset allocation to peer Public Funds greater than $5 billion (Greenwich Associates-Market Trends-U.S. Institutional Investors 2012).

Table 1-D – Peer Asset Allocation

	Greenwich Public Funds > $5 Billion (%)	LAFPP Current Target Allocation (%)	Difference
U.S. Equity – Active	16.9	16.6	-0.3
U.S. Equity – Passive	10.4	12.4	2.0
Total U.S. Equity	**27.3**	**29.0**	**1.7**
International Equity	14.4	16.0	1.6
Global Equity – Active	3.6	0.0	-3.6
Emerging Market Equity – Active	3.7	5.0	1.3
Total International Equity	**21.6**	**21.0**	**-0.6**
U.S. Fixed Income – Active	22.2	22.0	-0.2
U.S. Fixed Income – Passive	3.5	0.0	-3.5
Global Fixed Income	1.6	0.0	-1.6
Total Fixed Income	**27.3**	**22.0**	**-5.3**
Equity Real Estate	5.8	7.0	1.2
REITs	1.2	2.0	0.8
Private Equity	7.1	9.0	1.9
Hedge Fund	3.6	4.0	0.4
Commodities	0.8	5.0	4.2
Money Market	1.4	1.0	-0.4
Other	3.8	0.0	-3.8
Total	**100.0**	**100.0**	**-----**

Primarily, the asset allocation should reflect the circumstances of LAFPP and its governing Board's tolerance for risk; however, the comparison above of LAFPP's asset allocations to that of other funds is useful for purposes of assessing its degree of reasonableness.

Table 1-D shows that LAFPP holds a lower target allocation to fixed income with an offsetting higher target allocation to commodities relative to peers. However, we do not find these

differences to be material, and believe that LAFPP's current allocation is generally in line with peer portfolios.

Capital market expectations are a critical input to the process of setting the asset allocation. There is not a single, established methodology to develop capital market expectations. Different firms may use different approaches to derive their expectations – all of which may be sound based on capital market theory and practice. Given the importance of capital market assumptions in setting the asset allocation, it is useful to review the assumptions used and compare them to those of others to ensure a degree of reasonableness.

Table 1-E compares HEK's and R.V. Kuhns' 10-year capital market assumptions as of December 31, 2012. You will note that HEK's capital market assumptions are slightly different than R.V. Kuhns' assumptions.

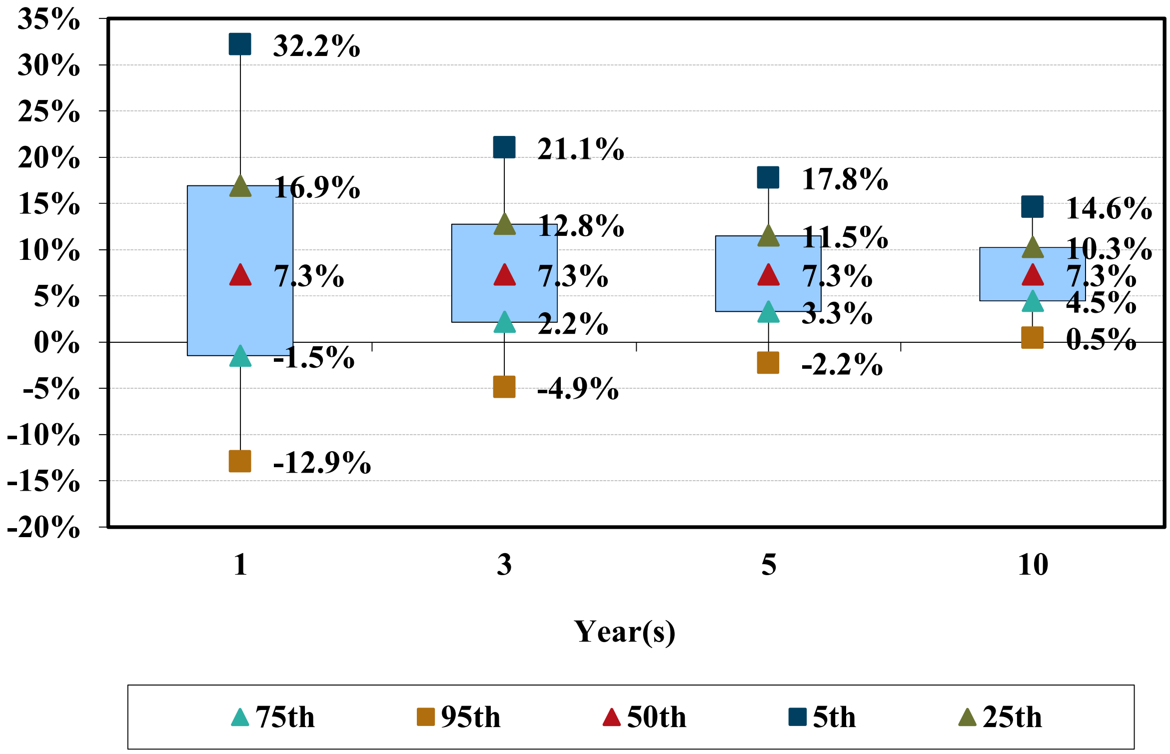
Table 1-E – Capital Market Assumptions

	HEK		R.V. Kuhns		Difference	
	Return	Risk (Standard Deviation)	Return	Risk (Standard Deviation)	Return	Risk (Standard Deviation)
U.S. Large Cap	7.5%	19.0%	7.8%	17.8%	0.3%	-1.3%
U.S. Small Cap	7.9%	25.0%	8.5%	21.3%	0.6%	-3.8%
Non-U.S. Developed Equity	8.5%	21.0%	8.7%	20.8%	0.2%	-0.2%
Emerging Market Equity	10.1%	30.0%	10.5%	29.0%	0.4%	-1.0%
U.S. Fixed Income	3.3%	5.0%	4.3%	5.8%	1.0%	0.8%
U.S. High Yield	4.9%	14.5%	7.3%	15.0%	2.4%	0.5%
Cash (Govt)	2.6%	2.0%	2.3%	3.0%	-0.4%	1.0%
TIPS	2.9%	5.0%	4.0%	5.8%	1.1%	0.8%
Real Estate (Core)	6.4%	12.5%	7.3%	12.5%	0.9%	0.0%
Hedge Funds	6.1%	8.5%	7.0%	9.5%	0.9%	1.0%
Commodities	5.4%	21.5%	7.0%	19.8%	1.6%	-1.8%
Private Equity	9.7%	27.0%	11.8%	30.3%	2.1%	3.3%

The differences between R.V. Kuhns' and HEK's capital market assumptions are not material, and we believe that the assumptions used by R.V. Kuhns are reasonable. Accordingly, we believe that the expected returns, volatility, and correlation among asset classes and sub-classes used to establish LAFPP's asset allocation are reasonable.

Based on HEK's capital market assumptions, there is a 50% chance that LAFPP's target asset allocation will result in a 7.3% return, with an estimated range of 0.5% to 14.6% over a ten-year timeframe.[12] Chart 1-F illustrates LAFPP's expected 1-, 3-, 5-, and 10-year returns and ranges, utilizing HEK's capital market assumptions.

Chart 1-F – LAFPP's Expected Returns Using HEK's Assumptions



The bar to the far right represents the distribution of expected returns for 90% of market scenarios over 10 years. The top value of 14.6% represents the 5th percentile. This means that there is a 95% chance that the 10-year annualized return will be less than 14.6%. Conversely, the bottom value represents the 95th percentile value. There is a 95% chance that the 10-year annualized return will be greater than 0.5%. The median expected return of 7.3% is represented by the center value.

[12] This data is different than reported in the Interim Report because of updated capital market assumptions.

The Board Investment Policies include a “Current Board Allocations Within Major Asset Classes” section containing guidelines and target weightings within various asset classes. A few of these guidelines are not currently being met. Additionally, some guidelines include targets, but do not outline acceptable ranges. This section of the investment policies is outdated and does not accurately capture the Board’s latest decisions. As a result, the Board’s intent is not appropriately recorded for the staff to follow or for the Board’s use in monitoring compliance with its directives.

Conclusions

The process used to establish LAFPP’s asset allocation is less comprehensive than the process used by other leading funds. It can be improved by conducting asset/liability modeling now, and every three to five years going forward. Asset/liability modeling is better than the process LAFPP used because it more clearly defines the pension plan’s appropriate risk level by taking into consideration factors such as demographics and need for liquidity.

Although the Plan holds a lower target allocation to fixed income with an offsetting higher target allocation to commodities relative to peers, we do not find these differences to be material, and the current allocation of the Plan is in line with peer portfolios.

We believe that the expected returns, volatility, and correlation among asset classes and sub-classes used to establish the asset allocation of the Plan are reasonable.

The Board Investment Policies “Current Board Allocations Within Major Asset Classes” section is outdated and does not provide clear ranges within the asset classes, which LAFPP should review and revise.

Recommendations

22.[13] Promptly update the investment policies so they accurately reflect the Board’s most recent decision on asset allocation (LAFPP Management)

23. Review and revise the “Current Board Allocations Within Major Asset Classes” section of the Board Investment Policies (LAFPP Management)

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[13] Recommendations 1-21 are in the Interim Report, issued on June 27, 2013.

Portfolio Rebalancing

Findings

The Board Investment Policies provide the guidelines for portfolio rebalancing. Staff is to monitor the portfolio's asset allocation relative to the target allocations. If actual allocations to an asset class fall outside of the established range, staff must rebalance "back to the mid-point between the end of the range that was exceeded and the target allocation." We understand this to mean that if the target is 5% and the upper end of the range is 10%, if the actual allocation goes over 10% then staff is to rebalance back to 7.5%, or half-way between the target and upper range.

The only restriction on this rebalancing is that it cannot occur more frequently than every three months. Staff also has the authority to leave an asset class outside of its range in certain situations where it is "impractical to rebalance", such as when staff knows of pending asset shifts or there is an upcoming asset allocation review.

The process provides a prioritization for rebalancing that takes into account transaction costs, requiring staff to first invest contributions into asset classes that are below their ranges. Next, staff is to draw on cash flowing out of the portfolio from asset classes that are above their ranges to invest in asset classes that are below their ranges. Only then is staff to sell over-weighted assets or purchase under-weighted assets.

Staff is to report all rebalancing activities to the Board on a quarterly basis, but must seek approval from the Board if staff recommends leaving some portion of the portfolio outside of its range for an extended period of time.

Analysis

Movements within the capital markets can cause an investor's actual asset allocation to move from its target allocation. When the actual asset allocation moves too far away from the target allocation, the return and risk characteristics of the portfolio can be meaningfully different than that of the target asset allocation. Rebalancing brings the actual allocation back within the range established by the Board, and is an important risk control mechanism.

Rebalancing too often can result in significant and unnecessary transaction costs. When making policy decisions regarding rebalancing, investors must weigh the potential cost of rebalancing too frequently against the potentially higher tracking error associated with rebalancing too infrequently.

LAFPP's rebalancing policy addresses these issues in a concise manner. Board delegation of the authority to rebalance to staff ensures that transactions can happen quickly, if necessary. The policy also delegates to staff the authority to maintain an allocation outside the established range when it is determined to be “impractical to rebalance”, which allows for informed decision-making and sound judgment.

However, restricting the rebalancing to every three months is not optimal. A significant change in the market that results in a rebalancing may be the beginning of an extended economic adjustment. In the course of another three months, such an economic event could take LAFPP’s allocation substantially out of its range and result in significant tracking error. Allowing staff to rebalance whenever the actual allocation moves outside the range is a best practice. Establishing ranges that balance the costs and risks of rebalancing is a more appropriate mechanism to manage the costs and tracking error of the investment program than restricting rebalancing to once every three months.

Also, the policy to rebalance to the mid-point between the target allocation and the end of the range is reasonable, but not best practice. Unless there is a tactical or cost reason to maintain that requirement, rebalancing to the target allocation is more appropriate in order to maintain the risk profile set by the investment policy.

Conclusions

LAFPP’s rebalancing process is appropriate for a sophisticated institutional investor. Setting the policy at the Board level and delegating the actual rebalancing responsibility to staff is common and best practice for public funds. The policy is generally consistent with best practices.

However, restricting rebalancing to every three months is not an optimal way to control costs and risks. Further, rebalancing to the mid-point between the target allocation and the end of the range that was exceeded is also not ideal in all circumstances.

Recommendations

24. Remove the restriction on rebalancing once every three months (LAFPP Board)

25. Rebalance back to the target allocation for the applicable asset class, unless there is some ancillary tactical or cost reason to do otherwise. (LAFPP Board)

<u>Investment Performance (Net of Investment Fees)</u>

Findings

LAFPP’s Total Fund returns and peer rankings as of December 31, 2012, for the 1-, 3-, and 5-year trailing periods are provided in table 1-G. The peer rankings[14] are based on a universe of

[14] A rank of 25 for a given manager indicates that manager outperformed 75% of other funds in that universe. "1" indicates the highest ranking, "99" the lowest.

67 public pension funds that have over $1 billion in assets compiled by BNY Mellon Performance & Risk Analytics as of 12/31/2012.[15]

Table 1-G – LAFPP Investment Returns – Total Fund (Net of Investment Fees)

	1 Yr (%)	Rank (%)	3 Yrs (%)	Rank (%)	5 Yrs (%)	Rank (%)
Total Fund	**13.0**	**50**	**8.7**	**51**	**2.1**	**66**
Total Fund Custom Benchmark	*13.0*	*51*	*8.7*	*50*	*3.2*	*31*

LAFPP's returns and peer rankings for each asset class as of December 31, 2012, for the 1- 3- and 5-year trailing periods compared to its benchmarks is provided in table 1-H. The benchmarks against which LAFPP measures its returns are provided in the Board Investment Policies. The Total Fund Benchmark is currently a weighting of the sub-asset classes held within the portfolio.

Table 1-H – LAFPP Investment Returns – Asset Class (Net of Investment Fees)

	1 Yr (%)	Rank (%)	3 Yrs (%)	Rank (%)	5 Yrs (%)	Rank (%)
Total Domestic Equity	**16.2**	**33**	**11.0**	**37**	**2.6**	**48**
Russell 3000 Index	*16.4*	*31*	*11.2*	*35*	*2.0*	*52*
Total International Equity	**16.1**	**73**	**3.3**	**86**	**-4.4**	**87**
MSCI ACW ex US Index	*16.8*	*67*	*3.9*	*81*	*-2.9*	*77*
Total Fixed Income	**8.5**	**38**	**9.8**	**25**	**8.4**	**23**
Barclays US Universal Index	*5.5*	*58*	*6.7*	*54*	*6.2*	*49*
Total Real Estate	**13.3**	**--**	**8.0**	**--**	**-2.3**	**--**
Real Estate Custom Index	*10.8*	--	*12.7*	--	*2.2*	--

[15] HEK receives peer information gross of fees and converts it to an estimate of net of fees returns.

	1 Yr (%)	Rank (%)	3 Yrs (%)	Rank (%)	5 Yrs (%)	Rank (%)
Absolute Return	**5.3**	**--**	**1.8**	**--**	**-0.9**	**--**
BofA ML 91 Day T-Bill + 4%	*4.1*	--	*4.1*	--	*4.5*	--
Total Private Equity	**14.2**	**--**	**12.4**	**--**	**4.1**	**--**
CPI + 15%	*17.0*	--	*17.3*	--	*17.0*	--
S&P 500 + 4%	*20.6*	--	*15.3*	--	*5.7*	--

The Total Fixed Income component includes approximately 19% long duration bonds.[16] However, it is benchmarked to the Barclays U.S. Universal Index, which is an intermediate duration benchmark.

Analysis

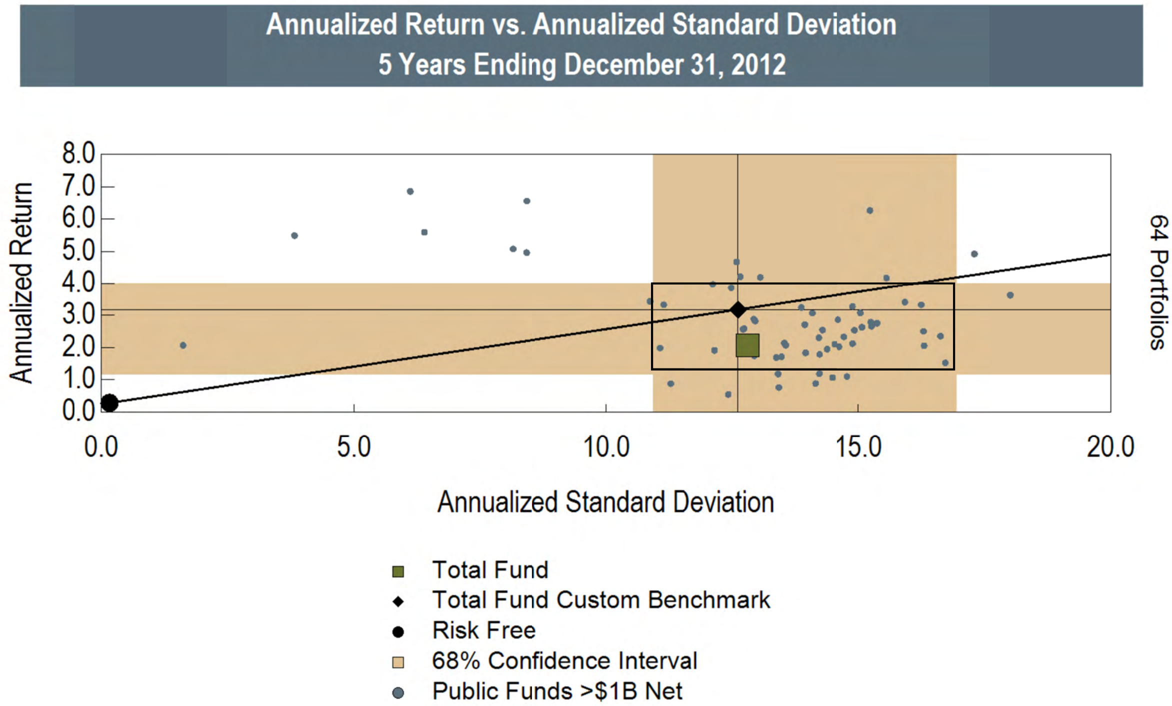
Table 1-G shows that, over the trailing 1-year and 3-year periods, the Total Fund return net of fees has matched the benchmark and has performed in line with peers. Over the trailing 5-year period, however, the Total Fund return is below its benchmark and below 66% of its peers.

Table 1-H shows that LAFPP's Total Domestic Equity and Fixed Income asset classes have performed well versus peers over all three time periods. On the other hand, LAFPP's Total International Equity asset class has lagged both its benchmark and its peers for all three time periods. LAFPP's alternatives asset classes have had mixed results versus their benchmarks.

Table 1-I represents the risk/return profile of the Total Fund (green square) relative to its benchmark (black dot with crosshairs) and public funds (small blue dots). Peer Plans include the 64 public pension plans from the BNY Mellon universe with 5 years of performance history.

[16] The Board Investment Policies require 16% allocated to long duration bonds.

Table 1-I – LAFPP Risk/Return



The bottom left corner of the graph represents low risk and low return. The top right corner represents high risk and high return. Therefore, the top left corner is preferred because it represents higher return with lower risk. The shaded square in the center represents where 68% of peer portfolios fall in terms of risk and return. The diagonal line represents the risk/return tradeoff offered in the market, or the level of return an investor should expect for varying levels of risk. If the Total Plan dot falls to the left of the diagonal line, the portfolio is considered to be achieving superior risk adjusted returns.

As shown in the graph, however, the Total Fund has achieved a lower return at a slightly higher risk than its benchmark. Likewise, many of the public funds in the chart above also had lower returns at higher risk than the Total Fund Custom Benchmark.

In the Interim Report we determined that LAFPP's benchmarks were appropriate for the specific asset classes, with the minor exception of the real estate benchmark. From our further review of the Board Investment Policies we understand that there is a 16% allocation to long duration bonds. However, the asset class is benchmarked to the Barclays U.S. Universal Index, which is an intermediate duration fixed income benchmark. A more appropriate benchmark would be a weighted benchmark of 84% Barclays U.S. Universal Index and 16% Barclays U.S. Long Government/Credit Index.

Conclusions

Over a trailing five year period the LAFPP Total Fund has underperformed the return of the Total Fund Custom Benchmark (-1.1% per year), at a modestly higher level of risk (volatility). During the period, manager underperformance has been a significant detractor. However, the Total Fund's out of benchmark exposure to long duration bonds (appreciating 10.2% per year over the period as compared to 6.2% for the Barclays Universal) has offset a meaningful amount of manager underperformance.

We were requested to quantify the impact in dollar terms of LAFFP's underperformance relative to the Total Fund Custom Benchmark. Based on information available to us, we estimate that LAFPP's underperformance relative to the Total Fund Custom Benchmark translates to approximately $680 million on a cumulative basis over the five year period ending June 30, 2012. We caution that this is a rough approximation. A more detailed calculation and analysis would need to be conducted in order to arrive at a precise estimate.

The dollar underperformance noted above was calculated as the aggregate of the estimated outperformance/underperformance during each year of the five year Review Period.[17] It is important to note that this calculation does not factor possible rebalancing, cash flows that occurred during the year, or compensate for manager underperformance that has been underreported due to the benchmarking issues that we discussed in our review.

In the Interim Report, we indicated that LAFPP's had an investment loss of $802 million relative to the actuarial assumed rate of return on investments ("ARR") fiscal year 2011-2012. For the five-year Review Period (2007 – 2012) the underperformance relative to the ARR was approximately $2.4 billion.[18] The shortfall puts upward pressure on the contribution rate. The average asset return based on the actuarial value of the assets for the Review Period was 4.4% while the underperformance relative to the Total Fund Custom Benchmark was (-1.1%). The average return based on the market value of the assets is less than the average based on the actuarial value because the negative returns attributable to the significant market declines from late 2007 to early 2009 are not immediately recognized in the actuarial value of assets.

The risk profile of the current fixed income benchmark, the Barclays U.S. Universal Index, does not reflect the risk profile of the long duration bond exposure.

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[17] Derived by multiplying the fund's assets at the beginning of each year by the outperformance/underperformance achieved in that year.
[18] The 2012 LAFPP Actuarial Valuation Report (page 9) provides a table showing the historical asset returns for each year. LAFPP 2012 Actuarial Valuation

Recommendations

26. Benchmark the Fixed Income component (Core Fixed Income and High Yield) to a weighted benchmark of 84% Barclays U.S. Universal Index and 16% Barclays U.S. Long Government/Credit Index (LAFPP Board)

Attribution Analysis

Findings

Every quarterly investment performance report that LAFPP receives from R.V. Kuhns contains an attribution analysis on the Total Fund, each asset class, and each manager.[19] The Total Fund attribution analysis summarizes outperformance and underperformance of the Plan resulting from several factors, such as outperformance/underperformance of the underlying asset classes, the effect of the asset allocation differing from the investment policy, and the effect of cash flows on the investment performance of the Plan. At the asset class/manager level, the holdings-based attribution analysis summarizes outperformance and underperformance of the manager by GICS[20] sector. The analysis also outlines the effects caused by stock selection within each sector, as well as the effect of manager overweighting/underweighting each sector.

R.V. Kuhns' consultants present each of the quarterly performance reports to the Board. The consultants point out notable issues from the attribution analyses in the reports, and provide explanations to the Board regarding possible reasons for the outperformance or underperformance. The Board has the opportunity to discuss that information with the consultants during the Board meeting.

Analysis

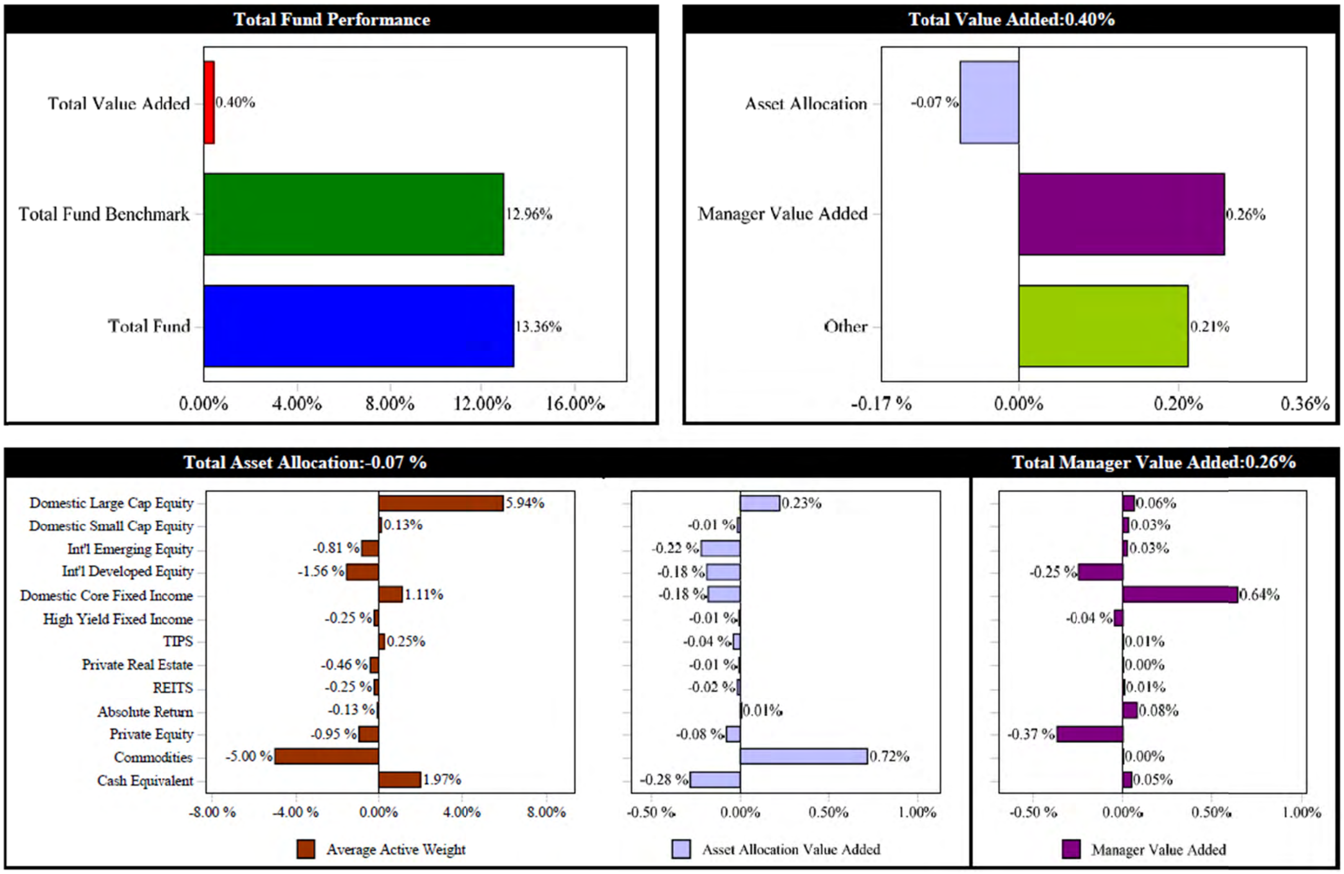
Total Fund Attribution

Total Fund attribution can be an extremely valuable tool in analyzing the relative performance of an investment program. R.V. Kuhns' 1-year Total Fund attribution analysis as of December 31, 2012 is shown in Table 1-J.

[19] An "attribution analysis" is a tool that institutional investors use to analyze investment performance by depicting the relative drivers of performance visually.

[20] The Global Industry Classification Standard (GICS) provides consistent classifications of stocks available in the market for research and asset allocation purposes.

Table 1-J – LAFPP Total Fund Attribution



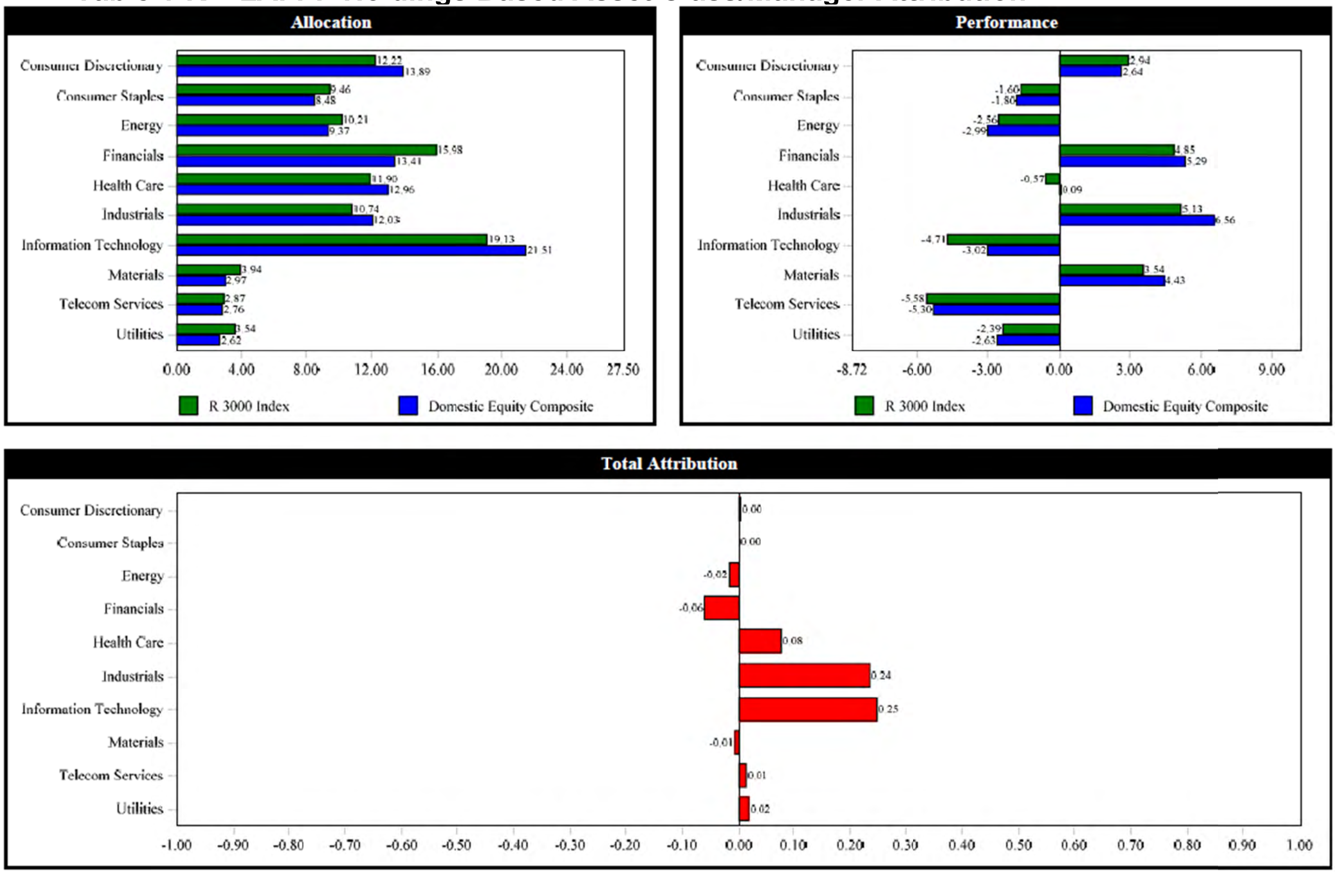
The Total Fund attribution analysis that R.V. Kuhns provides in its quarterly investment performance reports is thorough and provides the Board with important information for its use in monitoring relative investment performance. For instance, in the "Total Value Added" box in the upper right-hand corner, we can see that R.V. Kuhns calculated that LAFPP's deviation from its target asset allocation was responsible for a reduction in its investment returns of .07%, but that its managers added .26% to the return. The bottom right-hand box breaks out the value added by the managers in each separate asset class.

This analysis and these charts give the LAFPP Board an effective tool for identifying the sources of outperformance or underperformance of the Total Fund.

<u>Holdings Based Asset Class/Manager Attribution</u>

Holdings based asset class/manager attribution can be a valuable source of information when monitoring the investment performance of the underlying managers. The fourth quarter 2012 Domestic Equity Composite attribution analysis is shown in Table 1-K.

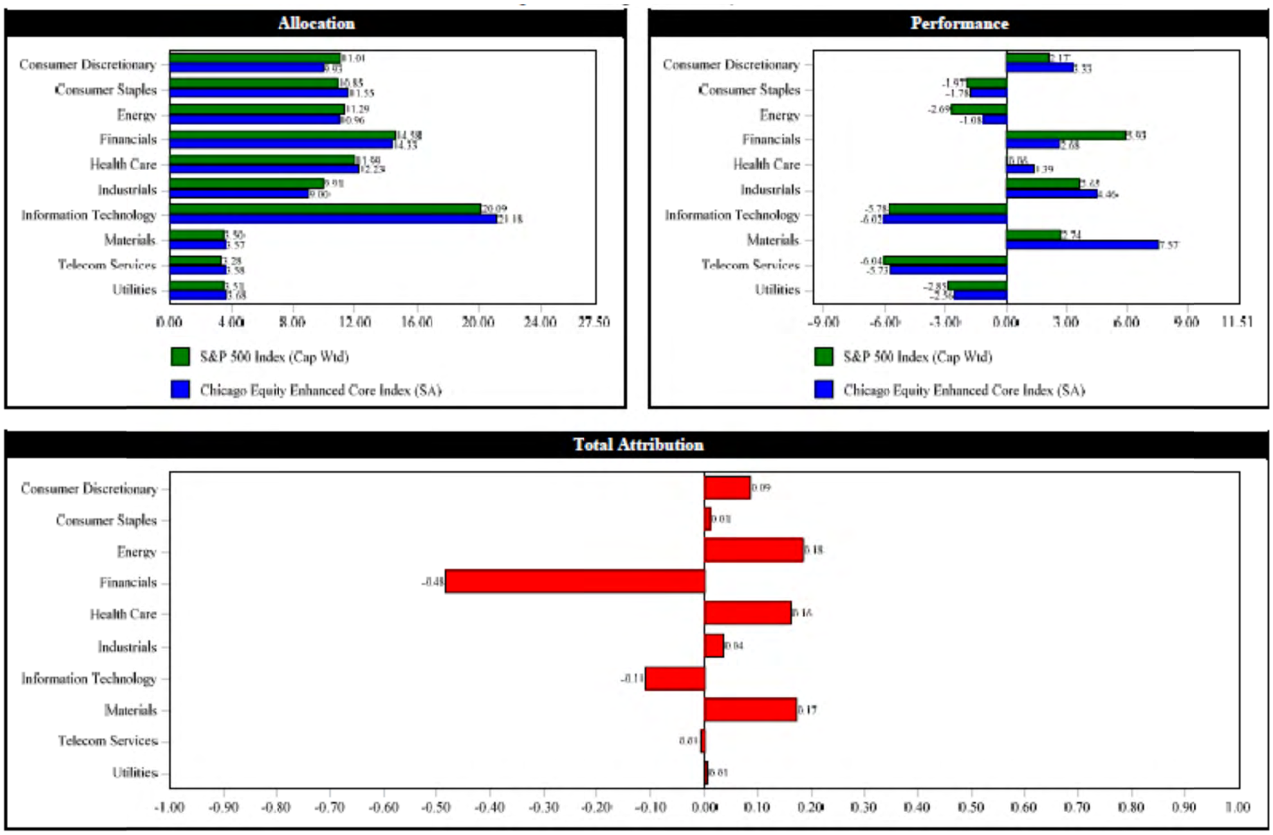
Table 1-K – LAFPP Holdings Based Asset Class/Manager Attribution



The analysis in the charts shows the LAFPP Board the outperformance and underperformance of the asset class (or manager) by GICS sector. It also outlines the effects caused by stock selection within each sector, as well as the effect of overweighting/underweighting each sector. From the data presented, LAFPP can quickly see the effects of being over or underweighted in each sector compared to the Russell 3000 index. The analysis also outlines the managers' ability to select individual securities within each sector.

The attribution analysis for each of the managers contains similar information, as shown in Table 1-L.

Table 1-L – Attribution Analysis Slide for Chicago Equity Enhanced Core Index Fund



In total, the attribution analyses provide useful information for the Board and staff to use in evaluating each manager against their benchmarks in a number of important ways. During the Board meetings, R.V. Kuhns addresses notable information from the attribution analysis, and the Board has the opportunity to discuss that information and ask questions.

Conclusions

The attribution analysis information that R.V. Kuhns includes in its quarterly investment performance reports is thorough and provides the Board with the type of information it should have for monitoring investment performance by asset class and manager. R.V. Kuhns' presentation during the Board meetings enables the Board to evaluate the most pertinent information and make sure they understand it.

Recommendations

No recommendations

III. Objective 2: Determine whether LAFPP adequately considers costs when making investment decisions and when it evaluates investment performance.

Scope

The issues we reviewed for this objective include:

- Whether investment returns are reported net of fees and expenses
- An expansion on Objective 9 from Interim Report to include an analysis of returns net of fees for active versus passive investments
- A comparison of LAFPP's returns and fees to relevant benchmarks and peers
- Whether consolidation of LACERS and LAFPPS would result in investment expense cost savings compared to comparable sized public funds

Findings

R.V. Kuhns reports gross of fees return information to LAFPP, but not net of fee return information.[21] Table 2-A, on the next page, highlights the differences between the gross and net returns of LAFPP's asset classes and sub-classes.

[21] HEK calculated net returns from gross returns provided by R.V. Kuhns. The calculation of net returns included gathering each underlying manager's annual fee, aggregating the managers' annual fees on a monthly basis, and deducting the monthly fees from the monthly gross returns. The managers' fee information was provided by LAFPP.

Table 2-A – LAFPP Asset Class (Gross vs. Net) Returns

	Year Ending December 31, 2012		
	1 Yr (%)	3 Yrs (%)	5 Yrs (%)
Total Domestic Equity (Gross)	**16.4**	**11.2**	**2.8**
Total Domestic Equity (Net)	**16.2**	**11.0**	**2.6**
Difference	*0.2*	*0.2*	*0.2*
Domestic Large Cap Equity (Gross)	**16.2**	**11.0**	**2.2**
Domestic Large Cap Equity (Net)	**16.1**	**10.9**	**2.1**
Difference	*0.1*	*0.1*	*0.1*
Domestic Small Cap Equity (Gross)	**17.0**	**12.2**	**5.4**
Domestic Small Cap Equity (Net)	**16.5**	**11.6**	**4.8**
Difference	*0.5*	*0.6*	*0.6*
Total International Equity (Gross)	**16.6**	**3.8**	**-4.0**
Total International Equity (Net)	**16.1**	**3.3**	**-4.4**
Difference	*0.5*	*0.5*	*0.4*
Int'l Developed Equity (Gross)	**15.6**	**3.4**	**-4.2**
Int'l Developed Equity (Net)	**15.2**	**3.0**	**-4.5**
Difference	*0.4*	*0.4*	*0.3*
Int'l Emerging Equity (Gross)	**18.3**	**4.5**	**-3.9**
Int'l Emerging Equity (Net)	**17.8**	**4.0**	**-4.3**
Difference	*0.5*	*0.5*	*0.4*
Total Fixed Income (Gross)	**8.6**	**10.0**	**8.6**
Total Fixed Income (Net)	**8.5**	**9.8**	**8.4**
Difference	*0.1*	*0.2*	*0.2*
Domestic Core Fixed Income (Gross)	**8.2**	**9.7**	**8.4**
Domestic Core Fixed Income (Net)	**8.1**	**9.6**	**8.3**
Difference	*0.1*	*0.1*	*0.1*
High Yield Fixed Income (Gross)	**13.9**	**11.3**	**9.3**
High Yield Fixed Income (Net)	**13.6**	**10.9**	**9.0**
Difference	*0.3*	*0.4*	*0.3*
Total Real Estate (Gross)	**14.2**	**9.1**	**-1.3**
Total Real Estate (Net)	**13.3**	**8.0**	**-2.3**
Difference	*0.9*	*1.1*	*1.0*
REITS (Gross)	**17.8**	**18.3**	**5.5**
REITS (Net)	**17.3**	**17.4**	**4.7**
Difference	*0.5*	*0.9*	*0.8*

Table 2-B shows the passive and active management fees for the five fiscal years ending June 30, 2012. The fees are shown in dollar amounts and basis points (e.g., 1.00% equals 100 basis points or bps).

Table 2-B – Active and Passive Investment Management Fees[22]

2012	Domestic Equity		International Equity		Fixed Income	
Passive	$ 238,377	*1 bps*	$ 30,262	*14 bps*	$ 228,709	*4 bps*
Active	$ 7,807,324	*28 bps*	$10,058,241	*46 bps*	$5,112,626	*18 bps*
2011	Domestic Equity		International Equity		Fixed Income	
Passive	$ 252,817	*1 bps*	$ -	*0 bps*	$ -	*0 bps*
Active	$ 9,848,675	*33 bps*	$11,236,930	*40 bps*	$5,260,493	*20 bps*
2010	Domestic Equity		International Equity		Fixed Income	
Passive	$ 188,799	*1 bps*	$ -	*0 bps*	$ -	*0 bps*
Active	$ 8,327,925	*37 bps*	$10,052,400	*46 bps*	$4,553,596	*18 bps*
2009	Domestic Equity		International Equity		Fixed Income	
Passive	$ 130,667	*1 bps*	$ -	*0 bps*	$ 950	*0 bps*
Active	$ 7,466,739	*34 bps*	$ 9,092,618	*42 bps*	$3,875,300	*17 bps*
2008	Domestic Equity		International Equity		Fixed Income	
Passive	$ 211,986	*1 bps*	$ -	*0 bps*	$ 140,156	*2 bps*
Active	$ 12,980,862	*48 bps*	$14,152,486	*41 bps*	$5,784,687	*23 bps*

Table 2-C shows the total investment management fees paid by LAFPP for the five fiscal years ending June 30, 2012.

Table 2-C – Total Investment Management Fees

	FY 2008	**FY 2009**	**FY 2010**	**FY 2011**	**FY 2012**
Domestic Equity	$13,192,849	$7,597,406	$8,516,725	$10,101,492	$8,045,702
International Equity	$14,152,486	$9,092,618	$10,052,400	$11,236,930	$10,088,504
Fixed Income	$5,924,843	$3,876,250	$4,553,596	$5,260,493	$5,341,335
Total	**$33,270,178**	**$20,566,274**	**$23,122,721**	**$26,598,915**	**$23,475,541**
REITs	$1,181,647	$1,043,808	$1,936,911	$1,264,772	$1,163,442
Hedge Funds	$2,344,438	$3,935,790	$5,377,927	$5,655,688	$5,697,658
Private Equity	$9,752,846	$17,875,726	$12,345,390	$13,100,355	$12,987,897
Private Real Estate	$11,781,056	$10,203,677	$11,328,269	$8,161,992	$7,865,333
Other Management Fees	$109,674	$35,187	$18,841	$14,266	$--------------
TOTAL	**$58,439,839**	**$53,660,462**	**$54,130,059**	**$54,795,988**	**$51,189,871**

[22] Active management is an investment approach that seeks to exceed the average returns of the financial markets. Active managers rely on research, market forecasts, and their own judgment and experience in selecting securities to buy and sell. As a result, active management is more expensive than passive management. Passive management, also known as “indexing”, is a low-cost investment strategy in which a manager attempts to match, rather than outperform, a particular stock or bond market index.

Analysis

R.V. Kuhns reports gross of fees returns. The practice tends to overstate actual returns, specifically on an annualized basis. Net of fees returns show what an investor actually earned in a given period, which is a more useful way to analyze performance against benchmarks and peers.

As we would expect, LAFPP's passive investment management fees are significantly lower than for its active investments. LAFPP's active management fees for international equity and fixed income are comparable to its peers, and in the case of domestic equity investments the management fees are more favorable than those of peers. Table 2-D outlines LAFPP's active management fees relative to its peers.[23]

Table 2-D – Active Management Fees Relative to Peers (Year Ending December 31, 2012)

	LAFPP (bps)	Public Funds >$5 Billion (bps)
Domestic Equity	28	38
International Equity	46	44
Fixed Income	18	20

For the fiscal year 2011-2012, LAFPP paid approximately $23.5 million in investment management fees for its public equity and fixed income portions of the portfolio, including $23 million in active management fees. At fiscal year-end (June 30, 2012), approximately 72% of LAFPP's public equity/fixed income portfolio was invested in actively managed strategies, with the remaining 28% invested in passively managed (index) strategies. If LAFPP implemented an all-passive approach to the public equity/fixed income portfolios, its annual investment management fees would be approximately $3 million. An all-passive approach would therefore reduce the investment management fees by over $20 million. Doing so would also eliminate "soft costs" associated with active management, such as staff and consultant time spent on manager due diligence.

We believe, however, that the active management decision should not be solely based on the potential reduction of investment fees over time. Because the LAFPP Board has the fiduciary responsibility to make prudent investment decisions, its use of active management should reflect its level of conviction in an active manager's ability to produce excess returns over time.[24]

[23] The peer universe includes public funds (greater than $5 billion) that participated in the Greenwich Associates survey. Please note that the peer group fees shown represent an average for the group.
[24] Notably, our research has determined that, while a meaningful percentage of active equity managers earn enough excess return on average to cover their costs, less than 2% of all active managers have demonstrated that their excess returns were due to skill.

A comparison of active manager returns to their benchmarks can indicate whether the active managers are adding value even with their higher fees. Table 2-E outlines the net returns of LAFPP's traditional active managers relative to their respective benchmarks and peers. Outperformance is highlighted in green, and underperformance is highlighted in red. Rankings lower than 50 are better than the median in the peer universe and are highlighted in green and rankings higher than 50 are highlighted in red. A list of the peer universes is available in Appendix B.

Table 2-E – LAFPP Traditional Active Managers (Net) Returns

	Ending December 31, 2012					
	1 Yr (%)	Rank	3 Yrs (%)	Rank	5 Yrs (%)	Rank
Total Domestic Equity	**16.2**	**33**	**11.0**	**37**	**2.6**	**48**
Russell 3000 Index	***16.4***	***31***	***11.2***	***35***	***2.0***	***52***
FIS Group Emerging Managers	**12.7**	**60**	**9.1**	**60**	**0.6**	**66**
Russell 3000 Index	*16.4*	*31*	*11.2*	*35*	*2.0*	*52*
Robeco Large Cap Value Equity	**21.2**	**7**	**11.6**	**19**	**3.3**	**20**
Russell 1000 Value Index	*17.5*	*25*	*10.9*	*34*	*0.6*	*65*
Chicago Equity Enhanced Core Index	**15.1**	**46**	**11.7**	**14**	**---**	**---**
S&P 500 Index	*16.0*	*30*	*10.9*	*23*	*---*	*---*
Research Affiliates Enhanced Core Index	**16.4**	**26**	**12.1**	**11**	**---**	**---**
S&P 500 Index	*16.0*	*30*	*10.9*	*23*	*---*	*---*
LA Capital Enhanced Growth Index	**15.2**	**59**	**11.5**	**24**	**---**	**---**
Russell 1000 Growth Index	*15.3*	*58*	*11.4*	*29*	*---*	*---*
Daruma Asset Small Cap Equity	**19.3**	**18**	**12.0**	**54**	**5.0**	**34**
Russell 2000 Index	*16.3*	*38*	*12.2*	*50*	*3.6*	*58*
Attucks Group Emerging Managers	**14.3**	**55**	**11.7**	**60**	**2.5**	**72**
Russell 2000 Index	*16.3*	*38*	*12.2*	*50*	*3.6*	*58*
Frontier Capital Small Cap Growth	**14.1**	**41**	**11.2**	**78**	**4.7**	**29**
Russell 2000 Growth Index	*14.6*	*39*	*12.8*	*58*	*3.5*	*49*
Total International Equity	**16.1**	**73**	**3.3**	**86**	**-4.4**	**87**
MSCI ACW ex US Index	***16.8***	***67***	***3.9***	***81***	***-2.9***	***77***
Brandes International Large Cap Equity	**11.6**	**99**	**2.0**	**88**	**-4.2**	**81**
International Equity Custom Index[25]	*16.8*	*66*	*3.9*	*68*	*-3.5*	*77*
Fisher Asset International Equity	**16.1**	**74**	**6.0**	**61**	**-1.3**	**51**
International Equity Custom Index[1]	*16.8*	*67*	*3.9*	*81*	*-3.5*	*80*

[25] International Equity Custom Index consists of the MSCI EAFE Index through 12/31/2009 and the MSCI ACW ex US Index thereafter.

	Ending December 31, 2012					
	1 Yr (%)	Rank	3 Yrs (%)	Rank	5 Yrs (%)	Rank
Principal Global Investors Emerging Equity	**20.6**	**38**	**6.1**	**46**	**-1.1**	**57**
MSCI Emerging Markets Index	*18.2*	*66*	*4.7*	*60*	*-0.9*	*56*
Total Fixed Income	**8.5**	**38**	**9.8**	**25**	**8.4**	**23**
Barclays US Universal Bond Index	***5.5***	***58***	***6.7***	***54***	***6.2***	***49***
Reams Asset Management Fixed Income	**9.5**	**6**	**9.1**	**5**	**9.1**	**1**
Barclays US Aggregate Bond Index + 0.75%	*5.0*	*71*	*7.0*	*42*	*6.7*	*38*
LM Capital Group Fixed Income	**7.1**	**24**	**7.5**	**20**	**7.0**	**27**
Barclays US Aggregate Bond Index + 0.75%	*5.0*	*71*	*7.0*	*42*	*6.7*	*38*
Loomis Sayles Long Duration Fixed Income	**10.4**	**66**	**15.0**	**32**	**12.1**	**47**
Barclays Long Govt/Credit Index	*4.8*	*99*	*6.7*	*99*	*6.1*	*99*
MacKay Shields High Yield Fixed Income	**13.4**	**82**	**10.8**	**61**	**8.8**	**51**
High Yield Custom Index[26]	*15.6*	*34*	*11.7*	*28*	*9.7*	*36*
Bridgewater Portable Alpha US TIPS	**7.2**	**49**	**11.3**	**16**	**8.4**	**12**
Barclays Inflation Index	*7.0*	*62*	*8.9*	*66*	*7.0*	*69*
Western Asset US TIPS	**7.0**	**60**	**8.7**	**70**	**7.1**	**67**
Barclays Inflation Index	*7.0*	*62*	*8.9*	*66*	*7.0*	*69*

Overall, the performance of LAFPP's active managers has been mixed over the long term. Over the trailing 5-year period, the domestic equity asset class outperformed its benchmark by 0.6% net of fees. In other words, after taking the increased management fees into account, LAFPP's actively-managed domestic equity investments resulted in a return 0.6% higher than if it had obtained the benchmark returns through a passive investment in the index.[27] Similarly, LAFPP's actively-managed fixed income investments also outperformed the benchmark, returning 2.2% more, net of fees than the benchmark over the trailing 5-year period.[28] In contrast, LAFPP's actively-managed international equity asset class underperformed the benchmark by 1.5% net of fees.

[26] High Yield Custom Index consists of the CS High Yield Index through 12/31/2011 and the BofA ML US High Yield Master II Constrained Index thereafter.
[27] Disregarding any passive investment manager fees, the amount of which would be speculative.
[28] However, if LAFPP utilized a style-specific benchmark more suited to its fixed income exposure, as recommended in Objective 1, which returned 6.9%, its fixed income asset class excess return over the trailing 5-year period would be 1.5%.

Table 2-F compares the gross and net returns of LAFPP's total fund relative to its peer group (Public Funds > $1 Billion) for the 1, 3 and 5-year periods.

Table 2-F – LAFPP Total Fund (Gross vs. Net) Returns and Rankings

	Year Ending December 31, 2012					
	1 Yr (%)	Rank[29]	3 Yrs (%)	Rank	5 Yrs (%)	Rank
Total Fund (Gross)	**13.4**	**38**	**9.1**	**31**	**2.5**	**54**
Total Fund (Net)	**13.0**	**50**	**8.7**	**51**	**2.1**	**66**
Difference	*0.4*	---	*0.4*	---	*0.4*	---
Total Fund Custom Benchmark	***13.0***	***51***	***8.7***	***50***	***3.2***	***31***

LAFPP's total returns, when compared to the peers in the Greenwich Associates survey, all of whom report net of fees returns, are at the mid-point or slightly lower than the peer group average, depending on the time frame.

In the Interim Report we examined the feasibility of consolidating investment consultants and custodian services with the Los Angeles City Employees Retirement System (LACERS). We concluded that the cost savings that might be realized by sharing investment consultants or negotiating a new a joint custodian agreement would be relatively small, particularly given the current favorable custodian fee arrangement LAFPP already has. As part of this Final Report, we were asked to also consider whether the consolidation of LACERS and LAFPPS would result in investment fee cost savings compared to comparable sized public funds.

In order to comply with this request, we compared the hypothetical consolidation of LAFPP and LACERS assets under management and their total investment management fees incurred for the fiscal year ending June 30, 2012 to the investment expenses of funds over $20 billion that participated in the State Association of County Retirement Systems ("SACRS") Public Fund Universe Analysis conducted by R.V. Kuhns, the investment consultant to LAFPP. A list of the 78 public funds that comprise the SACRS survey universe is provided in Appendix C. A large universe of public funds affords a more robust analysis.

Using the 2012 SACRS survey information, we created a theoretical estimate of the potential annual savings in management fees that might be achievable through combination of LACERS and LAFPP. Our limited analysis, admittedly simplistic and speculative in nature, showed that the savings do not seem significant. Our analysis presumes that the total investment management fees resulting from a hypothetical combination of LAFPP and LACERS would be the sum total of the current investment management fee of each fund. In reality, if the funds

[29] "1" indicates the highest ranking and "99" indicates the lowest ranking.

were combined the investment management mandates would also be combined; consequently, the actual savings could be greater or less than the estimate depending on a number of factors, including, but not limited to, the market value of portfolios, asset allocation, level and structure of fees, and the investment strategies utilized, the size of the mandates, and the active/passive mix. As noted in the Interim Report, LAFPP currently requires investment managers, by contract, to give it a price break if LACERS and/or Water and Power Employees' Retirement Plan (WPERP) invest with the same manager within the same mandate. When this is the case, fees are based on the combined asset amount, rather than LAFPP's individual amount.

It should be noted that LAFPP investment management fees during the Review Period have been trending downward. We understand this has also been the case for LACERS.

We were informed that LAFPP requested an opinion from outside fiduciary counsel advising that consolidation could not take place without a change to the California constitution and the City's Charter. In order to judge the feasibility and cost-benefit of consolidation more accurately, an in-depth study of the matter should be performed by the City.[30]

Conclusions

LAFPP's performance reports now show the gross of fees returns which is useful for some peer comparisons, but the reports could be enhanced by also including net of fees returns. Reporting net of fees returns is the most useful way to analyze performance against benchmarks because net returns show what investors actually earned in a given period. Net of fees returns are also useful for some other peer comparisons, like those mentioned in this report.

As expected, LAFPP's fees and expenses for passive management are significantly lower than for active management. LAFPP's active management fees are generally in line with peers, as compared to participants in the Greenwich Associates survey. In the Domestic Equity asset class, LAFPP's active management fees are favorable relative to its peers.

If LAFPP had used an all-passive approach for public equities and fixed income it would have saved fees and eliminated "soft costs" such as time spent on manager due diligence. However, LAFPP's actively-managed Domestic Equity and Fixed Income asset classes have outperformed their benchmarks even after taking into account the higher management fees. LAFPP's actively-managed International Equity asset class underperformed its benchmark and therefore it would have been better to use a passive (index) approach for these investments. However, if LAFPP would have taken an all-passive approach for all three asset classes, it would not have benefitted from the additional returns generated by the active management in the Domestic Equity and Fixed Income asset classes.

[30] It was not within the Scope of Work for the Management Audit to perform a more detailed study of the subject.

In order to judge more accurately whether consolidation of the City's pension systems would result in material investment costs savings, a full in-depth feasibility study of the matter should be performed by the City.

Recommendations

27. Require R.V. Kuhns to display net of fees returns in the performance reports (LAFPP Management)

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IV. Objective 3: Assess the adequacy of actuarial methods in order to assure the validity of actuarial assumptions.

Scope

The issues we reviewed for this objective include:

- The reasonableness of LAFPP's actuarial method and assumptions
- The frequency of and rationale for changes to LAFPP's actuarial methods
- Whether LAFPP's actuary followed the actuarial standards of practice

Please note that actuarial matters were also addressed in Objective 2 of the Interim Report and additional analysis can be found there.

Findings

Reasonableness of Actuarial Method and Assumptions

The funded status of the Plan and, therefore, the amount of contributions needed to sustain the Plan, are a direct result of the Board's decisions on which actuarial methodology to use and the actuarial assumptions. LAFPP uses the Entry Age Normal actuarial method to value the assets and liabilities of the fund. This method allocates costs over a member's working career as a level percentage of their pay and, therefore, results in less volatile costs for the governmental sponsors of the Plan.

The actuarial assumptions impacting the costs of the Plan include both economic and demographic assumptions. The current economic assumptions are: the investment return assumption of 7.75%, the inflation assumption of 3.5%, and the salary increase assumption of 5.25% to 12.25%, which depends on each participant's years of service.

The key demographic assumptions relate to mortality and retirement rates. Mortality is based upon the "RP-2000 Combined Healthy Mortality Table"[31] (separate for males and females) set back four years for healthy members and set back two years for disability retirees and all beneficiaries. The retirement rate assumptions range from 1% to 30% from ages 41 to 64 for Tiers 2 & 4 (Fire); from 5% to 40% from ages 50 to 64 for Tiers 3 & 5 (Fire); from 8% to 40% from ages 41 to 64 for Tiers 2 & 4 (Police); and from 10% to 30% from ages 50 to 64 for Tiers 3 & 5 (Police). The retirement rate assumption is 100% at age 65.

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[31] RP-2000 mortality tables are developed by the Society of Actuaries (Retirement Plans Experience Committee).

Frequency and Rationale for Actuarial Method Changes

The Los Angeles City Charter requires LAFPP to use the Entry Age Normal Cost Method to determine the contribution amounts it reports in the annual budget that it presents to the City. LAFPP also uses the Entry Age Normal method in its actuarial valuations. Actuarial valuations and experience studies performed by Segal during the past five years show no reason or recommendation to change from the Entry Age Normal method.

In 2009, LAFPP changed its "smoothing period"[32] and "corridor"[33]. Currently, LAFPP uses a five-year smoothing period for unrecognized asset returns (either gains or losses) prior to July 1, 2008, and a seven-year smoothing period for unrecognized returns after that date. LAFPP now uses a 40% corridor rather than the 20% corridor it previously used on the actuarial value of assets. LAFPP increased the smoothing period and widened the corridor range to reduce the impact of volatile financial markets on the City's contribution level.

Economic actuarial assumptions, specifically the investment return rate, and inflation rate, were reconsidered in 2010. As a result, the investment return rate was lowered from 8.00% to 7.75%, and the inflation rate was lowered from 3.75% to 3.5%. These changes were recommended by the actuary based upon recent experience and expected future economic conditions.

The demographic assumptions were reconsidered in 2011 based upon Segal's experience study issued June 24, 2011. This study analyzed the period July 1, 2007 through June 30, 2010. As a result, LAFPP adjusted the setback period for the RP 2000 Mortality Tables to become more in line with the reality of longer lifespans of its membership. The reconsideration of the demographic assumptions also resulted in the salary increase assumption being changed from an age-based rate of 4.9% to 10.1% to a service-based rate of 5.25% to 12.25%. Other demographic assumptions were also adjusted, such as retirement termination rates to reflect more recent experience.

The economic and demographic assumption changes reflected the findings and recommendations of the actuary but also resulted in an increase in the stated liabilities.

Compliance with Actuarial Standards of Practice

The actuaries for LAFPP, being a Fellow and an Associate of the Society of Actuaries, are required to follow the Actuarial Standards of Practice. In the November 8, 2012 cover letter to the actuarial valuation, the actuaries from Segal state "This report was prepared in accordance

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[32] "Smoothing" recognizes only a portion of the actual gains or losses each year. For example, if a system has a five-year smoothing period, only one-fifth of the system's actuarial gains or losses are recognized each year.

[33] A "corridor" is used in conjunction with smoothing in order to keep the actuarial value of assets within a certain percentage of the market value of assets. For example, if a system has a 40% corridor, the actuarial value of assets must be between 60% and 140% of the market value of assets. If the actuarial value falls below 60% or rises above 140%, the system must recognize the excess returns or losses in that year without smoothing.

with generally accepted actuarial standards and practices…." The letter further states that "We are Members of the American Academy of Actuaries and we meet the Qualification Standards of the American Academy of Actuaries to render the actuarial opinion herein".

Analysis

The Entry Age Normal actuarial method is not only common among public retirement systems but also appropriate for them because it is based upon a predictable and level percentage of pay for members, and it dampens volatility for the governmental plan sponsors. It is a sound method to use for an ongoing public plan. This method is used by about 80% of the public retirement systems in the United States.[34]

Smoothing is a legitimate actuarial practice and is used by a majority of large public funds. The rationale for smoothing is that unusually high or low investment returns should be viewed in the context of a plan that is intended to be in place for infinity. Without smoothing, other generations of public employees may either be paying too much or too little for the benefits they receive.

The primary economic assumptions are the investment return, inflation and salary increases. These should not change very often. They are intended to be long term assumptions and the best estimate of what the rates will be for the next 30+ years. When economic conditions change significantly, it is wise to revisit and perhaps revise the assumptions. The majority of the larger public retirement systems reviewed their economic assumptions in the past few years and many of them modified them to reflect the economic downturn.

It is important to analyze each economic assumption separately and also in relation to each other since there must be some consistency and the spreads among them are as relevant as the rates themselves. In particular, the spread between investment return and inflation represents the expected real return assumption. The salary increase assumption, which is composed of inflation, across the board salary increases, and merit/longevity increases based on service, must be reasonable.

With regard to the demographic assumptions, it is best practice to review these every three to five years. In the case of LAFPP, the actuary performed experience studies in 2007 and 2010 during which they reviewed and reported on demographic assumptions. The recommended changes in mortality assumptions were to use the RP-2000 Combined Healthy Mortality Table (separate for males and females) set back four years for members and set back two years for beneficiaries. This was reasonable because it reflects the recent experience of LAFPP in terms of comparing actual versus the expected number of deaths.

[34] "Public Fund Survey" (National Association of State Retirement Administrators and National Council on Teacher Retirement, 2012).

The frequency of and rationale for changes to the smoothing of assets and the actuarial assumptions are reasonable.

In analyzing whether the actuary followed Actuarial Standards of Practice, we considered the following which are relevant to this audit:

1. Actuarial Standard of Practice No. 4: Measuring Pension Plan Costs or Contributions
2. Actuarial Standard of Practice No. 27: Selection of Economic Assumptions for Measuring Pension Obligations
3. Actuarial Standard of Practice No. 35: Selection of Demographic and Other Noneconomic Assumptions for Measuring Pension Obligations
4. Actuarial Standard of Practice No. 44: Selection and Use of Asset Valuation Methods for Pension Valuations

All of the Actuarial Standards of Practice listed above were developed by the Pension Committee of the Actuarial Standards Board and available from the American Academy of Actuaries. From our review of the last five annual actuarial valuation reports and the triennial actuarial experience studies issued by Segal for LAFPP, we believe they comply with these standards.

The 2011 actuarial experience study of Segal for LAFPP has the following elements of best practices:

1. The study was done to compare actual experience for 2007 to 2010 period versus the expected experience under the current assumptions
2. Based on the study's results and expected near term experience, the actuary made recommendations to change the current assumptions
3. The study used three years of recent experience in order to obtain more data points that can increase the statistical reliability of results and to smooth out fluctuations that may occur from one year to the next
4. The actuary also calculated the year-to-year changes in experience to check for any trend that may be developing in the later years
5. The recommended changes in mortality assumptions were recommended based on a comparison of the actual number of deaths versus the expected number of deaths while providing some margin for future mortality improvements
6. The review of the retirement rate assumptions incorporated the following relevant factors that are specific to LAFPP: deferred vested members entitled to future pensions, percentage of married retirees, age differences of retiree spouses, DROP utilization of retirees, and expected periods of participation in DROP
7. Based on recent experience of termination/withdrawal rates, the actuary recommended a reduction in the withdrawal rate assumptions
8. For the merit and promotional salary increase assumption, the actuary recommended that it be a function of years of service instead of age

Conclusions

LAFPP has been diligent in reviewing the appropriateness of its actuarial methodology and assumptions. They appear to be sound and reasonable.

Based on our review we believe that Segal is complying with the Actuarial Standards of Practice.

Recommendations

No recommendations

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V. Objective 4: Ensure that benefits have been provided to LAFPP members as required by the applicable City Charter provisions and in a timely manner.

Scope

The issues we reviewed for this objective include:

- The plan provisions, administrative rules, policies and procedures used to process service and disability retirement payments
- For both disability and regular retirement files:
    - Eligibility, benefit calculations and timeliness, and assess the effectiveness of quality controls
    - Whether LAFPP has the proper controls over the signatory process for payments and disbursements
    - Whether LAFPP has adequate controls to ensure invoices and payments for members' health benefit premiums are based on accurate calculations

- For disability retirement files only:
    - A comparison of LAFPP's disability review procedures to best practices and market norms
    - How errors and disputes are resolved
    - Disability staff training and how supervisors evaluate disability staff and the performance measures used

Findings

<u>The plan provisions, administrative rules, policies and procedures used to process payments</u>

The authority, structure and format of LAFPP's retirement, disability, survivor, and health benefits are set forth in the following governing documents:

- California Constitution, Article 16, Section 17
- City Charter, Article 11, Sections 500 – 503, Section 506
- City Administrative Code, Chapters 1, 20, 21 and 22

In addition, LAFPP has a Summary Plan Description (SPD) pertaining to each Tier of its Plan, with the exception of Tier 6[35] which was adopted in 2011. Each SPD explains rights, benefits and responsibilities with respect to each Plan Tier, and provides self-service instruction for members on how to create a retirement benefit estimate. In addition to being available to the membership, staff uses the SPDs for reference during processing when needed.

[35] Tier 6 of the Plan was contained in Charter Amendment G, approved by voters in March 2011. All new LAFPP members hired on or after July 1, 2011 are subject to Tier 6 of the Plan.

LAFPP has a Policy Manual consisting of Board Governance Policies and Board Operating Policies and Procedures[36] which set forth the benefits administration duties and responsibilities of the Board as vested by its applicable governing documents, along with its Committees, and the General Manager. Through written delegation from the Board, the General Manager has primary responsibility for supporting the Board and its committees in developing and recommending policies where appropriate.

Four (4) major sections within the Board's Operating Policies and Procedures document the Board's direction with respect to benefits payment processing:

- *Section 3.0 Pension Processing.* Addresses applications and documentation, Deferred Retirement Option Program (DROP), authority of the Board and the General Manager, topics relating to the disability process, survivor benefit applications, post retirement survivor benefit purchase program, reinstatement of service pensioners, and correction of erroneous payments

- *Section 4.0 Hearings.* Addresses representation, release of files, witnesses, evidence, assignment of cases, conduct of hearings, deliberations by the Board, approval and review by the Board, official notice of Board action, rehearing, and active death hearings, among others

- *Section 5.0 Member Accounts.* Addresses crediting of interest, refund of contributions, contributions owed to the system, contributions collected in error, purchase of service credit, and acceptance of electronic signatures, among others

- *Section 8.0 Health and Dental Subsidies and Reimbursements.* Addresses the health insurance premium reimbursement program

Documented staff procedures relating to calculating benefits and processing payments reside within the Desk Manuals of the sections dedicated to serving various transactions and member types. A separate discussion and evaluation of the Disability Pension Section's written policies, procedures, checklists and practices in administering the disability application process appears later in this report.

LAFPP's Internal Audit Section (IAS) reviewed the member benefit payment process as part of its work plan in 2011. Some of the resulting findings involved the need to enhance process-related policies and procedures.

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[36] The Board Governance Principles and Board Operating Policies and Procedures were last updated on November 1, 2012 and May 2, 2013, respectively.

Analysis

Based upon our review of applicable documentation, LAFPP's governing documents are consistent with the Board's Policy Manual and staff's procedural manuals. LAFPP recently updated its documentation pertaining to benefits processing when the new Tier 6 was adopted, including its Board Policy Manual, and staff's procedural Desk Manuals.

The Board's Policy Manual is thorough and contains information that is appropriate for the policy level. We observed best practice in several areas:

- The history of revisions is evident on each policy along with the next Board required review date
- Applicable sections of City Charter and Administrative Code are referenced where appropriate, aligning the administration with the Board's vested authority
- Delegations between the Board and the General Manager are specific and well-documented, with linkages to the Benefits Committee where appropriate

Each Section's Desk Manual, available in both electronic and hard copy format, is comprehensive, thorough and generally up-to-date. They include written procedures, as well as cross-references to the applicable City Charter, the Administrative Code, checklists, relevant Board decisions, court decisions, management decisions, legal opinions and links to correspondence templates. Screen prints with redacted member information are incorporated where appropriate to serve as a visual reference. Recommendations made in 2011 by the LAFPP IAS relating to the need to enhance policies and procedures have been implemented by staff.

Staff noted that the Desk Manuals were designed to provide sufficient instruction for a lay person to use in case of an emergency or disaster. This degree of documentation reflects best practice.

Staff also reported that if ambiguities in governing documentation are identified in the course of processing benefits, the City Attorney's Office is contacted for guidance. The resulting written determinations are retained, but not within a centralized repository where they can be easily accessed and referenced by all staff in the future. Staff reported than an effort is underway and would be completed in 2014 to archive all benefits determinations in one central location.

SPDs for each Tier align with the governing documents, are written in plain language, with the exception of the Tier 6[37] SPD which is not yet available. Many public employee retirement systems provide their participants with SPDs, either voluntarily or as a requirement of state law.

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[37] A limited summary of some Tier 6 plan provisions, which was approved by voters in March 2011 and effective July 1, 2011, are listed on LAFPP's website.

The Government Finance Officers Association (GFOA) recommends that all state and local government pension plans provide documentation that completely, accurately, and clearly describes the significant components of the pension plan for participants.
Although SPDs are not required by City Charter, and LAFPP has its SPD documentation available for download from its website, its failure to provide a SPD for Tier 6 and distribute it to new members enrolling in the Plan represents an inconsistency with the GFOA's recommended practice for distribution.

Conclusions

Based upon the interview process and review of relevant documentation, we conclude that the plan provisions, administrative rules, policies and procedures used to process benefit payments are sufficiently thorough, comprehensive, and are in alignment with each other. The actual practice of Board and staff is reasonably consistent with the parameters set forth in the governing and operational documentation, and recent updates have been made to reflect plan changes. Summary plan documentation exists for all Tiers of the Plan except for Tier 6.

The documentation itself is not presenting any issues with respect to processing that hinder LAFPP's ability to process benefits in a timely manner. Although staff cites delays in developing the Tier 6 Summary Plan Description due to ongoing work with the actuary, lacking such documentation for a period of over two years is excessive, and presents a risk in terms of furnishing adequate governing and processing documentation as prescribed by the GFOA.

Recommendations

28. Continue to compile all benefits determinations received to date, including precedents set by court decisions, Board decisions, management decisions and legal opinions, in one central repository (LAFPP Management)

29. Develop and furnish a Summary Plan Description for Tier 6 as soon as possible (LAFPP Management)

Findings

<u>For service and disability retirement files:</u>

- <u>Eligibility, benefit calculations and timeliness</u>

In order to determine that LAFPP is accurately processing benefits in compliance with requirements for eligibility and timeliness, we reviewed a sample of fifty (50) random files which reflected benefit payments commencing between January 2007 and June 2012. The sample population represented Tiers 2, 3, 4 and 5, over a variety of payment types including normal service retirements and disability retirements, among others.

We performed several assessments with respect to the files, including testing the calculations to confirm validity in terms of eligibility and gross distributions paid. In addition, we reviewed audit reports of the LAFPP Internal Audit Section (IAS) pertaining to the member benefit payment process and health care subsidy program.

In 2011, IAS formally questioned the methodology that LAFPP used to calculate interest on Deferred Retirement Option Plan (DROP) payments. The original methodology resulted in LAFPP paying interest before it would have ordinarily become due. Based on the IAS report[38], LAFPP subsequently changed its interest crediting methodology. This change was characterized by LAFPP as a management decision rather than a correction of an error. The latter may have required the collection of overpayments. The change, even if it is a change to a better method, has created an inconsistency in the way interest has been credited during the period of this review.

LAFPP consulted with the City Attorney's Office regarding this matter, which concurred with the recommendations outlined in the IAS report. The Audit Committee and the Board approved the IAS recommendations in July 2011.

During the file review process, we observed that LAFPP houses paper-based member records in several different locations around its office according to the type of transaction in which that member has engaged. For example, if a member is involved with multiple transactions such as a domestic relations order due to divorce and a disability application, separate paper files would be retained for that member in different Sections' cabinets. This method for housing paper-based records is used for working files as well as for those that have been recently completed.

LAFPP is in the process of migrating paper records to digital records by electronically scanning member files in accordance with Board policy.[39] This creates an environment where, in the near term, the staff must continue to rely on paper-based records for processing.

Analysis

When we recalculated the benefit amounts for all of the sample population files, we came within $0.03 of the amount LAFPP calculated for every one of the files. That is an immaterial difference and shows LAFPP accurately calculated those benefits. We found that files were generally processed in a manner that complied with applicable plan provisions, including eligibility, as set forth by the governing documents and prescribed by staff's procedural Desk Manuals.

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[38] LAFPP Internal Audit Section Report to the Audit Committee dated June 2011.
[39] The Board approved the Electronic Content Management System Document Management and Paper Records Destruction Policy in 2011.

In addition, we found that the files were processed in a manner that generally complied with the timeframes that LAFPP publicizes in its stated communications. For example, normal service retirements were processed so that the member's payments generally began in the month following retirement. We observed that community property divisions were performed and subsequently implemented at the appropriate time, and that service credit purchases were made in a manner that complied with the governing documents. Only one case file took longer to process than the timeframe communicated to members; however, it was due to the member not being timely in submitting required information to LAFPP.[40]

While LAFPP's method for housing its paper-based member files is consistent with the way that it organizes its member services (i.e., predominantly by transaction type), it is not consistent with common practice or best practice. In addition, it may present challenges in terms of the ability to efficiently process member transactions, perform supervisory review, and cross-reference important documentation which would impact a benefit amount, therefore increasing the risk for error. In addition, the dispersed nature of the files increases the difficulty of monitoring the physical security of sensitive member paperwork.

Conclusions

Based upon our review of the sample file population of benefits payments, we conclude that LAFPP is generally processing benefits payments in a manner consistent with plan provisions and stated timeframes. The findings of the 2011 IAS report regarding DROP interest payments were observed as implemented.

The manner in which LAFPP houses and retains its physical records exposes the organization to greater risk due to the inability to see a member's complete file history with LAFPP in one central location. Due to the potential longevity of any one member's relationship with LAFPP, it is imperative that the method used for record maintenance and retention be efficient, reliable and practical. While the effort to migrate paper-based files to digital records is in line with common and best practice, LAFPP should exercise caution during this time of transition to minimize its risk associated with its paper-based records retention practices.

Recommendations

30. Consolidate the paper-based member files into a centralized filing room within the new LAFPP office space (LAFPP Management)

31. Organize paper-based member files so they include all of a member's information, correspondence and transactions with LAFPP (LAFPP Management)

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[40] A separate discussion and evaluation on the timeliness of disability application processing can be found later in this report.

Findings

<u>Assess the effectiveness of quality controls of the following:</u>

- The benefits calculation process including the disability pension application process and its corresponding internal audits
- the signatory process for payments and disbursements
- the process for invoices and payments for members' health benefit premiums

Public pension systems like LAFPP face many risks in benefits administration. LAFPP has specific controls in place with respect to service and disability benefit calculations, the signatory process for payments and disbursements, and the accuracy of invoices and payments for members' health benefit premiums.

In addition, LAFPP has broad controls – those which are not related to any particular process, but impact the entire business operation – in place to address segregation of duties, technology supporting the administration, physical security, and confidential member data.

- *Segregation of duties*

LAFPP segregates its duties through organizational structure with different departments serving different member transactional needs. Within this structure, organizational hierarchy is used to subject each file being processed to supervisory review, including calculation documentation as well as official board direction, member correspondence, and intra-office correspondence, when necessary. Workflow and workflow tracking, including supervisory review and approval, are not automated, but are incorporated through a system of hard copy file sign off. No automated controls exist to reduce the risk of payment entries that differ from such hard copy sign off.

- *Benefits administration and payment technology*

Staff uses multiple technology systems to administer and pay benefits, including:

  - *Onpoint*, a web-based technology platform, serves as the means to electronically record member data and calculate benefits.
  - *Benefit Payment Passport (BPP),* another web-based technology system, is used to electronically record member tax-related and voluntary deduction data, as well as pay benefits.
  - *Microsoft Access and Microsoft Excel* templates are used to perform supervisory review and approval, and calculations which are not programmed into Onpoint, respectively.

Staff stated that access to the technology systems along with role-specific (i.e., edit, change/delete, approve) and data-specific (i.e., a Section does not have access to member data which is not necessary to perform its functions) permission levels within them are determined and authorized by the relevant Section Supervisor and implemented by the Administrative Operations Division.

In June 2011, LAFPP's IAS issued a report of its audit of the member benefit payment process, which was subsequently presented by the General Manager to the Audit Committee and the Board. Within that report, IAS cited "inefficiencies, redundancies, and control weaknesses associated with LAFPP's use of three systems to manage and administer pension benefits." In addition, the report noted:

- Although pension benefit calculations were manually approved by supervisors, supervisory approval should be automated and integrated into the system to better prevent unauthorized payments.
- The monthly pension roll reconciliation is not reconciled to the final disbursement roll, which undermines LAFPP's ability to detect errors, discrepancies, and irregularities creating potential opportunities for unauthorized payments.

Upon inquiry, LAFPP IAS noted that all of the stated recommendations from the report have been implemented, but may be at different stages of completion due to the resources that are required. For example, LAFPP has retained a technology consultant to help it identify and evaluate successor technology systems, which is anticipated to require a multi-year effort.[41]

- *Physical Security*

With respect to LAFPP's physical security, we observed unlocked secondary doors during business hours. Employees are not required to wear identification or use badges to enter specific areas of the office. Visitors are required to sign in and out in a log book kept in the office lobby. LAFPP staff acknowledged that management is aware of the limitations presented by the current office space, and intends to address physical security when LAFPP moves to a new office location in 2014 or 2015.

- *Confidential Member Data*

Protection of confidential member data is governed by LAFPP's Administrative Policies and Procedures[42], which require that staff safeguard working files on desktops and lock cabinets holding paper-based member files when not in use, among other measures. By Policy, Section Supervisors are to conduct periodic inspections of filing cabinets and employee workstations to ensure compliance with the policy. Upon interview, staff was aware and articulate regarding the policy; however, there appeared to be some confusion as to who was responsible for conducting routine inspections for compliance – a Section's Supervisor or the Internal Audit

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[41] The Member System Conversion and Lifecycle Review Project is assigned a very high priority on LAFPP's three-year strategic plan adopted by the Board on April 18, 2013.
[42] LAFPP Administrative Policies and Procedures, Section 1.14, Security Policy and Procedures.

Section. The majority of senior management with whom we spoke had not conducted inspections on a regular basis. LAFPP's Internal Audit Section reported conducting such inspections on a random, unannounced basis.

Analysis

Process Specific Controls

Certain aspects of LAFPP's control environment with respect to processing are automated, including payroll data integration and system access, but primary controls related to benefits calculation and processing, supervisory review and approval, and reconciliation are manual. While many of LAFPP's process specific controls align with common practices at other similar organizations the predominantly manual nature in which the controls are implemented is inconsistent with best practice.

Through our review of files and applicable documentation, adequate controls around the review and signatory process for payments are being implemented. All payments, including those which are exceptionally large, such as one-time lump sum payments from a member's deferred retirement option plan (DROP) account, require double signoff. In addition, we found the monthly pension reconciliation process as reported to us by the Accounting Section to be reasonable.

Beyond its involvement in the reconciliation process, the Accounting Section is performing at least two additional reviews to validate new member payments commencing in the next month's pension roll. An accountant level position verifies system data, including member salary, service credit, gender, and Social Security number, and duplicates the calculation rather than relying on the initial Section's calculations. Once the verification is complete, a senior accountant signs off.

The exception to this control is that new additions to the health care subsidy program are not subjected to the same process. While the Medical and Dental Group does have its own set of controls in place to ensure accuracy of calculations, including its own levels of supervisory review and signoff, the Accounting Section does not perform the same verification and signoff activities as it does with all other member related pension roll payments. Upon interview, staff stated that management is aware of the inconsistency and are working to develop a solution.

We did observe that LAFPP has implemented certain process-specific controls which go beyond common practice. For example:

- LAFPP's control of using three system-selected physicians to conduct disability medical examinations, as required by the City Charter, is more comprehensive than the common control of two physicians performing an examination of the applicant, one of which is system-selected.[43]

- LAFPP case processing documentation is generally subject to multiple intra- and inter-departmental reviews, to ensure accuracy and compliance with legal requirements and procedure
- Staff reported frequent manual checking of benefits calculations and payments to ensure the technology system was calculating benefits correctly

Broad Controls

Beyond process specific controls, broad controls pertaining to physical security, supervisory review and approval, and the use of multiple technology systems differ from the common practices of large systems like LAFPP, and are notable:

- *LAFPP's physical security.* With the office serving as the primary location to perform counseling sessions, there is a constant flow of visitors. Manual methods, such as keeping all doors closed except for the main lobby entrance, requiring all visitors to sign in and out in a visitor log book, locking cabinets where paper-based member files are stored, and storing working files when employees are not at their workstations, are used to prevent access by unauthorized persons and protect member confidential data. Physical security fundamentals such as locked doors (i.e., with the exception of the main entry) and a badge system, among other measures, would serve to better align LAFPP with common practice, and better protect confidential member data
- *Supervisory Review and Approval.* Staff and LAFPP IAS reported the use of manual methods to conduct supervisory review and approval, as well as to track information and important deadlines regarding cases. Manual tracking, rather than automated tracking, introduces weakness and subjectivity into the control environment because of the inability to prevent unauthorized payments, inherent nature of human error, and the complexity of the benefits which LAFPP is processing. Automated workflow administration was reported by staff to be one of the components that LAFPP is seeking through its member system conversion assessment project
- *Multiple Use of Technology Systems*. LAFPP's use of multiple technology systems to calculate benefits and pay benefits is not consistent with best practices or even common practices of similar large public pension funds and reflects a weakness to its control environment. Although prepared data and reconciled data can be fed from Onpoint, the benefits management and administration system into BPP, the benefit payment system, new member records, withholdings and deductions, and payments commencing must be manually entered by staff, introducing redundancy, inefficiency, and the inability to prevent unauthorized payments. As previously mentioned, LAFPP is presently in the process of researching successor technology systems that might be better able to meet its needs, with

[43] "Public Pension Systems: Operational Risks of Defined Benefit and Related Plans and Controls to Mitigate those Risks." The Association of Public Pension Fund Auditors (APPFA), July 2003.

a specific focus on seeking a system that has both processing and payment capabilities, along with corresponding controls

It is important to note that LAFPP's environment of predominantly manual controls requires experienced staff for implementation. Any turnover of key staff could create a special risk, which could be mitigated through proper planning and training.

Conclusions

Based upon information gathered through the interview process, along with our review of applicable documentation, we conclude that LAFPP has an adequate structure of controls relating to benefits processing, including the disability application process, the signatory process for payments, and the accuracy of its healthcare subsidies; however, there are some limitations to its effectiveness.

Improvements could be made in the following areas:

- The Accounting Section's verification and signoff of all new additions and changes to the monthly pension roll is a key control to which the health care subsidy program is not subject
- LAFPP's physical security is not consistent with common practice and presents risk in terms of potential exposure to sensitive member confidential information. Staff acknowledges the issue and represents that a plan will be developed to address the issue when it moves its new headquarters location in 2014/2015
- Staff's manual tracking of workflow to monitor key deadlines subjects the process to potential error and subjectivity
- Staff's use of multiple technology systems to calculate, administer and pay benefits, and manual supervisory review and approval introduces redundancy and inefficiency into the process, and greater risk in terms of preventing unauthorized payments

Lastly, we were asked within the scope of this audit to comment on the effectiveness of internal audits of the Disability Program. LAFPP has not yet had a formal internal audit of its Disability Program Section; therefore, we are unable to draw conclusions with respect to the effectiveness of such an audit. The ad hoc, unannounced inspections performed by the LAFPP IAS to ensure employee compliance with LAFPP's confidential member information policy is appropriate in terms of its value in identifying exposure given the constraints to physical security that presently exist.

Recommendations

32. Subject the healthcare subsidy program to the same accounting verification process as all other monthly pension roll payments (LAFPP Management)

33. Examine what additional measures could be adopted to enhance physical security in the current office space (LAFPP Management)

34. Develop a comprehensive physical security plan for the new LAFPP office space (LAFPP Management)

35. Continue the search process for a successor technology system which can integrate the components of benefits administration process including calculations, automated workflow administration, controls, as well as the payment process (LAFPP Management)

Findings

How LAFPP resolves errors and disputes

The LAFPP Board Operating Policies and Procedures set forth a number of provisions relating to the proper resolution of errors and disputes, including recovery of payments made in error, contributions owed to the system, contributions collected in error[44] and official Board hearings. Through them, the Department is responsible for recovering overpayments in excess of $100, with interest, as well as remedy underpayments, with interest. In addition, the General Manager is authorized to refund mandatory and non-mandatory contributions collected in error. The Board itself is responsible for conducting hearings to provide members a forum to challenge staff's recommendations regarding benefits determinations.

The collection of overpayments provision requires notification to the recipient, along with the opportunity to pay the total amount due in a lump sum. The member or beneficiary may also elect to have the amount collected from future payments, of which the payment period cannot exceed twenty (20) years. Regardless of whether the erroneous payment was an over-or underpayment, interest at a rate equivalent to that credited to member contribution accounts is calculated as a component of the amount due.

The possible actions that can be taken to collect contributions owed, with interest, are detailed in the policy and are based on the amount owed by the member. Criteria by which LAFPP must provide member notification prior to initiating salary deduction or benefit reduction is set forth, along with the payment period options and terms to be extended to the member.

The section of the policy which pertains to hearings defines the process by which members can dispute staff's recommendations to the Board. Topics covered include the admission of evidence, the Board's power to subpoena, assignment of cases, hearing conduct, and

[44] Board Operating Policies and Procedures Sections 3.1, 5.3, and 5.4.

deliberation, approval and review by the Board, among others. Deadlines for the member and Board are established for certain steps in the process.

The City Attorney's Office supports the LAFPP Board and staff with respect to errors and disputes, providing Board policy and rule review, legal opinions regarding specific cases or errors, and assisting the Board during the hearing process. LAFPP also uses outside tax counsel for policy review and guidance regarding compliance with IRS requirements regarding errors and overpayments.

Analysis

From our review of applicable documentation, LAFPP's policies with respect to errors and disputes are comprehensive and sufficiently thorough; however, they exist only through LAFPP's Board Policy Manual, and are not specifically expressed in any applicable sections of City Charter or the Administrative Code. While this aligns with common practice for other California city and county pension funds, it does not reflect the common practice of other large public pension funds, many of whom have statutory provisions regarding errors and corrections upon which they can rely.

Other aspects of the Board's Operating Policies and Procedures pertaining to errors and disputes align with common practice and IRS requirements, where appropriate, including the notification procedures required with respect to resolving errors, providing payment term options to the member with respect to collecting monies due, and providing a forum vis-à-vis hearings where the member can dispute the recommendation of staff.

Through the interview process, we observed the staff to be cognizant of the process and procedures in place to drive error resolution, regardless of whether the error was discovered by a member, or by other staff through the supervisory review process while processing benefits. In addition, staff was sufficiently articulate regarding the Board hearing process, its timeframes, requirements and procedures. Their description of actual practice matched the corresponding policy requirements.

Conclusions

Based upon the interview process and review of applicable documentation, we conclude that LAFPP has thorough policies and procedures in place with respect to resolving errors and disputes. They are based on IRS requirements, where applicable, and generally align with actual practice.

While it is common practice for large public pension funds to be granted with the authority to remedy errors and disputes through their governing statutory sections, in California, it is common practice for city and county pension plans to address errors and corrections through board policy. LAFPP's practice is consistent with the latter peer group, but its legal position may be enhanced by aligning with the common practice of other large public pension funds.

Recommendation

No recommendations

Findings

An evaluation of LAFPP's disability pension program administration

- LAFPP's written policies, procedures, checklists and practices in administering the disability application process

The LAFPP Board, through its Board Governance Principles and Operating Policies and Procedures[45], has established written policies governing the administration of multiple aspects of its disability program, including the application process, hearings, suspension of disability payments, restoration of disability pensioners to active duty, and workers compensation award recapture and suspension. The Board acknowledges its duties and responsibilities in determining the merits of applications for disability benefits, and making necessary determinations with respect to disability, service connection, and permanence of injury.

The policies also document the responsibilities that the Board has delegated to the General Manager with respect to administering the disability program, such as the duty to adopt procedures for the submission, verification, and withdrawal of applications, selecting physicians to examine disability applicants; and making the determination of whether the applicant has met the qualifications set forth in the applicable sections of the City Charter and Administrative Code[46].

LAFPP's formal practices related to administering the disability program are summarized and made available to members through its website, including publications available by Tier.[47]

The Disability Pension Section staff, under direction from the General Manager, has written documentation pertaining to the disability pension application review process. Referred to as the "Disability Pension Section Desk Manual," it contains procedures, checklists, correspondence templates and other reference information relating to each step in the disability pension application and ongoing review process.

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[45] The Board Governance Principles and Board Operating Policies and Procedures were last updated November 1, 2012 and May 2, 2013, respectively.
[46] LAFPP Board Operating Policies and Procedures, Section 3.3.
[47] Disability Pension Information Booklet and Forms is a publication download available for Tiers 2 through 5 at http://www.lafpp.com/LAFPP/plan_dis_pension.html.

The Desk Manual references applicable sections of the City Charter and Administrative Code, applicable sections of the Board Operating Policies and Procedures, legal opinions, and relevant case law, where appropriate. In addition, it documents procedural steps, evidence to be collected, forms, checklists, correspondence templates, and logs to be used, along with instructions for the special handling of sensitive information, and the roles of individuals within LAFPP responsible for performing the various functions, among others.

Staff reported that the Desk Manual, which is available both electronically and in hard copy, is issued to each Disability Pension Section staff member upon hire, is used in training, and serves as the basis for staff's current practices in reviewing disability pension applications. Staff updates the Desk Manual every twelve to eighteen months with a primary focus on the areas that have been identified where change or enhancement is needed.

While there are some turnaround times referenced which correspond with the Board's Operating Policies and Procedures[48], the Desk Manual does not uniformly address internal timing deadlines for which the LAFPP staff who work on a disability application must perform their respective processing duties. As an example, the Desk Manual contains thorough documentation on the steps for staff to take in performing a benefit calculation for a disability pension application, but there is not a stated target expectation for the turnaround time within which the calculation must be completed.

Through our interviews, staff acknowledged the lack of uniformity with respect to internal processing turnaround times and indicated that a review of the Desk Manual was already being considered, with the objective of incorporating such standards.

Staff provides the Board with a monthly summary on disability application processing as part of the General Manager's report, that includes information on the number of applications pending in the current year, and the average processing time. Staff believes that the average disability application processing time has decreased; however, the required interaction with numerous external parties, including the member, the member's attorney or representative (in certain cases), physicians, employer representatives, Worker's Compensation representatives, and the City Attorney's Office (in certain cases), among others, can make timeliness challenging.

The Board's practices primarily relate to conducting hearings for individual applications and reviews, approving or denying disability pension applications, determining whether the disability was service connected or non-service connected, determining the amount of award if granted, and identifying whether future review of a case is necessary. These align with the requirements of the City Charter, Administrative Code and the Board's Policy Manual.

[48] For example, the Board Operating Policies and Procedures state the timeframe and criteria by which a request for a rehearing be made, and the staff's procedure in the Desk Manual reflects that timeframe and criteria.

To facilitate the Board's involvement, staff prepares information for the Board's use, including a written recommendation regarding all components of the decision (i.e., award or deny, percentage amount, service connectedness, and status of future reviews) pertaining to each disability case. Board hearings are conducted during regularly scheduled Board meetings. Prior to each Board hearing, the member, and his or her legal representative, if applicable, is sent staff's written recommendation. The member must respond by stating his or her agreement or disagreement with staff's recommendation.

Through the course of our interviews, we identified that the Board has informally instructed staff to schedule no more than two disability pension hearings per Board meeting where the member is not in agreement with staff's recommendation. The rationale provided is that this type of disability hearing tends to be more difficult and takes longer to conduct[49]. This limitation means that staff often has to schedule hearing dates two months out from the time that the case is ready to go to the Board.

It was also noted that when issues of high priority arise, that scheduled hearings may be rescheduled to a later date. This action was reported to us as occurring at least once during the past twelve-month period.

Analysis

The California Constitution, which applies to LAFPP, requires prompt delivery of benefits and related services to participants and their beneficiaries[50]. To determine whether LAFPP's written policies, procedures, checklists and practices facilitate the timely review of disability pension applications, we reviewed the expectation that LAFPP has communicated to members.

LAFPP's website states that with respect to disability pension applications, "It may take up to a year or more from the date of filing an application until the final Board determination.[51]" However, we observed a stated timeframe of "6 months or longer" in multiple LAFPP publications[52], also available via LAFPP's website. Upon inquiry, staff confirmed that the expectation verbally set with members is the lengthier "one year or longer" standard. This information is important to members who are either seeking a disability pension or currently in the process, as they consider their own monthly income needs while their application is being processed.

To determine whether LAFPP has met its own stated timeframe for processing disability pension applications, we identified all disability applications for which the Board held a hearing between the period of January 2007 through December 2012, and determined the time elapsed

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[49] City Charter §1412(c)(2) , a provision of Tier 2 of the Plan, requires that the Board hold hearings for all disability pension applications. Similar Charter Provisions exist for Tiers 3, 4, 5 and 6.
[50]California Constitution, Art. XVI, § 17. Section 1106 of the Los Angeles City Charter contains a similar requirement, as do the LAFPP Board's Governance Principles.
[51] LAFPP Website "How to: Apply for a Disability Pension", http://www.lafpp.com/LAFPP/active_apply_dis_pension.html
[52] http://www.lafpp.com/LAFPP/plan_dis_pension.html. "Disability Retirement – General Information: Application – Processing – Options," Tiers 2 – 5.

between their initial application filing date and their corresponding final Board determination date. The outcomes are illustrated in the following table:

Table 4-A – LAFPP Disability Application Processing Times for the Period January 2007 through December 2012

Calendar Year	Number of Applications Heard by the Board	Average Processing Time	Applications Processed Within 12 months	Applications Processed Within 12 – 24 Months	Applications Processed in 24 Months or More
2007	73	543 Days / 1.49 Years	32	30	11
2008	64	435 Days/ 1.19 Years	28	27	9
2009	44	512 Days/ 1.40 Years	19	20	5
2010	32	512 Days/ 1.40 Years	12	12	8
2011	32	351 Days/ .96 Years	16	13	3
2012	24	471 Days/ 1.29 Years	7	13	4
Total	**269**		**114**	**115**	**40**

Within the five-year period, 42.4% of the cases were processed within a 12 month time period, 42.8% were processed between 12 and 24 months, and 14.9% of the cases took longer than 24 months to process. The number of disability applications has significantly decreased from 2007 levels. The time with which it takes the staff to process an application has also decreased. The average processing time was 1.49 years in 2007. In 2012 the average processing time was 1.29 years.

To determine LAFPP's average disability application processing time relative to market norms, we compare LAFPP's stated processing timeframe to those publicized by the following peer group systems.

Table 4-B – Peer Comparison Subset[53]

Peer	Asset Size	Membership[54]	Stated Average Processing Time[55]
Fire & Police Pension Association of Colorado	$3.41 Billion	31,169	120 days (4 months)
Los Angeles City Employees' Retirement Systems	9.23 Billion	48,269	6 months
Los Angeles Fire and Police Pension	**13.52 Billion**	**25,883**	**1 year or longer**
Ohio Police and Fire Pension Fund	10.47 Billion	54,447	4 to 6 months[56]
Orange County Employees Retirement System	8.69 Billion	39,116	9 to 12 months
Public Employee Retirement System of Idaho	12.83 Billion	126,621	3 to 7 months[57]
School Employees Retirement System of Ohio	10.98 Billion	204,968	3 to 5 months
Average Processing Time			**5.9 months to 7.5 months**
Median Average Processing Time			**4 months to 6 months**

Although LAFPP's average processing time has decreased during the scope period, it is still considerably longer than the average and median average processing times stated by the peer group systems. Compared with the majority of the peer group, it takes LAFPP nearly twice as long, on average, to process a disability application. We note that LAFPP's tracking time begins immediately upon submission of an application while other systems may not start tracking the cycle time for processing until they are in receipt of complete application documentation.

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[53] The systems used for purposes of this peer group comparison are a subset of the peer group used in the Interim Report. Only six (6) of the eleven (11) peer systems published their average processing times; therefore, only statistics from those six systems are reflected within this table.
[54] "Membership" includes actives, retirees, beneficiaries and inactive members.
[55] Peer systems noted that while most cases are processed within the stated timeframe, actual time may vary. Complex cases may take longer.
[56] Ohio Police and Fire Pension Fund states that it can take between 4 and 6 months before its Disability Evaluation Panel hears a case.
[57] The Public Employee Retirement System of Idaho states that it can take "several months" to process an application; however, that applicants whose cases are contested should expect at least 7 months for processing. For purposes of this comparison, we used three months as the equivalent of "several months."

Conclusions

From our interviews with staff, our review of the Board's Policy Manual, and excerpts of staff's Desk Manual, we conclude that LAFPP has adequate policies, procedures, and checklists to review applications for disability pensions in a manner that generally complies with its stated timeframe.

Although the average processing time decreased during the five-year scope period, it is considerably longer than the peer group. While strict adherence to processing times can be difficult to achieve due to the inherent need to rely on external parties for information and scheduling, and the complexity of some cases, improvements could be made in several areas to positively impact timeliness. They include the following:

- Staff's Desk Manual, although thorough, does not uniformly address turnaround times for internal processing where appropriate
- The inconsistency between LAFPP's website, member publications and staff's verbal communications to members relating to disability pension processing timeframes may serve to confuse members
- The Board's practice of limiting the number of disability pension hearings per meeting where the member does not agree with staff's recommendation may unintentionally lengthen the process

Recommendations

36. Add expected turnaround times for internal processing, where appropriate, to staff's Desk Manual (LAFPP Management)

37. Evaluate all member-facing information and publications to ensure that disability application processing turnaround times are consistently communicated (LAFPP Management)

38. Evaluate the informal practice currently used to schedule Board hearing dates and explore ways to enhance timeliness (LAFPP Board and Management)

Findings

<u>An evaluation of LAFPP's disability pension program administration</u>

- <u>A comparison of those procedures and processes relative to best practices and market norms</u>

LAFPP's procedures and processes with respect to reviewing disability pension applications are complex and interrelated. LAFPP staff handles all responsibilities related to the process internally, including case management, member counseling, evidence gathering, determining eligibility, calculating benefits, interpreting physician's reports, preparing recommendations for the Board, and following up periodically on disability status where required. Staff manages each case, guiding it through the process from the date of initial application to the date of final Board determination. In doing so, they must rely on information from outside parties, including the member, his or her attorney or representative (if applicable), LAFPP contracted physicians, employer representatives, and the City Attorney's Office (if applicable).

Section Supervisors maintain the roster of physicians used to perform medical examinations. Duties include conducting due diligence on new physicians added to the panel to ensure their qualifications comply with the Board's policy, addressing issues that arise with current panel physicians, and periodically vetting panel physicians to ensure continued eligibility based upon the Board's criteria.

The Board's involvement primarily pertains to conducting hearings for individual applications and reviews, approving or denying disability pension applications, determining whether the disability was service connected or non-service connected, determining the amount of award if granted, and identifying whether future review of a case is necessary. The Board conducts hearings for all cases, even if a member is in agreement with staff's recommendation.

Analysis

Public retirement systems that are similarly charged with the administration of disability benefits have several primary models from which to choose. Some systems outsource the administration of disability applications to a third-party administrator[58], which assumes the delegated duties of making initial determinations regarding eligibility and either granting or denying benefits, among others. In a recent survey conducted by the National Association of State Retirement Administrators (NASRA)[59], approximately 10% of responding systems reported use of this model.

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[58] Under this model, the Board's primary duties generally involve selecting and monitoring the third-party administrator, setting the performance standards to be met, gauging the efficacy of the service levels being provided, and providing a forum for hearing member appeals. The third-party administrator is responsible for maintaining adequate staffing, and having effective and efficient processes and procedures that comply with the law, along with investing in technology and internal controls necessary to support the performance its duties and protect highly sensitive medical information.

[59] National Association of State Retirement Administrators survey of disability benefit issues conducted in July 2011. Respondents included forty-seven (47) public retirement systems across thirty-six (36) states.

Most systems, including LAFPP, handle the complete administration of disability applications internally, thereby retaining the expense for staffing, technology, operations, information security, and internal controls as a cost of doing business. While a full 78% of systems responding to the NASRA survey reported processing disability pension applications internally, there are a number of variations as to who retains the decision-making authority for making disability determinations. As a result, it is difficult to clearly identify trends in practices that could be perceived as market norms.

For example, some systems have implemented a model whereby the staff is not only responsible for processing, and determining initial eligibility, but also for performing some of the decision-making functions for which the board would typically be responsible. Other systems retain physicians as medical advisors to board and staff, and delegate certain decision-making authority to a committee or panel made up of staff and system-retained medical advisors. Ultimately, the model selected by a system should continuously demonstrate efficiency, objectivity, and compliance with applicable legal requirements, as well as facilitate timely processing.

In making general comparisons of LAFPP's practices to that of other systems, we identified key differences with respect to the following practices:

– *Compiling Member Information.* LAFPP is responsible for gathering information that becomes part of a member's administrative file. Some systems require that the member, as part of the disability application package, provide all medical records from treating physicians (i.e., complete medical file history, including test results, reports of X-rays or other diagnostic procedures, treatment plans, etc.), as well as Workers Compensation records, and employment records. The processing timeline doesn't begin until the system is in receipt of the documentation. These systems also have and enforce strict deadlines within which the member must submit the information. Having stated expectations and deadlines for the submission of application documentation, along with the ability of the system to withdraw an application with advanced notice to the member if it is outstanding for more than a specified period of time makes for a more efficient process.

– *Making the medical determination regarding disability.* The LAFPP staff interprets the reports of examining physicians and makes a recommendation to the Board as to disability status, service connectedness, award percentage, and future disability review. The Board conducts hearings during regular Board meetings for every case, even when the member is agreement with staff's recommendation. Nearly 26% of systems responding to the NASRA survey reported that staff makes the medical determination of disability, and a full 34% reported that a medical review board makes disability determinations. It is our understanding that even within these survey results, the Board may still play a role, which may range from a mere ratification of actions or recommendations to a higher degree of involvement.

We also observed similarities between LAFPP's general processes and market norms. For example, conducting an initial interview with the member applying for a disability pension, requiring that the member sign an authorization form pertaining to the release of medical records, scheduling appointments for the member to be examined by the LAFPP selected physicians, interpreting the reports of the examining physicians, requiring a letter from the employer regarding position availability, and periodically reexamining the disability retiree, where appropriate, are consistent with common practice.

Staff's extensive use of standardized templates to correspond with internal and external parties throughout the process including the member, his or her attorney or representative (if applicable), examining physicians, and the Workers Compensation staff reflects a best practice in that it mitigates the risk for arbitrary handling between case managers while still providing the flexibility to deliver personalized service.

We observed that the Disability staff was knowledgeable, professional, took pride in the thoroughness of the program that they operated, and demonstrated an above average level of care for the quality of service to LAFPP's membership.

Conclusions

Based upon information collected through the interview process, along with our review of applicable documentation, we conclude that LAFPP's disability program is being administered in a manner that is generally consistent with market norms. Given its program volume and maturity, the in-sourced administration model LAFPP uses is reasonable. While best practice was observed with respect to procedural documentation and templates, and staff demonstrated dedication and commitment to providing high quality service to the membership, there may be opportunities to streamline the process and improve timeliness relative to peers in two key areas:

- LAFPP Disability staff bears the responsibility for compiling the majority of the initial information required for a member's administrative file, not the member

- With the exception of determining initial legal eligibility, the Board retains all decision-making authority for making medical disability determinations. While staff makes recommendations for each case based upon the results of the examining physicians' reports, neither it nor the Board uses a medical advisor or panel of medical advisors to aid the process

Recommendations

39. Shift some of the burden of information submission to the member as part of the disability application process(LAFPP Board and Management)

40. Determine what other common practices, such as delegating specific decision-making authority or retaining a Board medical advisor, could streamline the process, and what changes to governing law, policies or procedures would be necessary to do so (LAFPP Board and Management)

Findings

An Evaluation of LAFPP's Disability Pension Program Administration

- The Training Received by Disability Staff

Disability staff reported that the formal training they received primarily occurred upon hire, and was specific to their role within the Section. The training was conducted by a Disability Pension Section supervisor, was specific to the duties expected to be performed by the new hire, and included both classroom style and on-the-job learning formats. As an example, the last training conducted for a new Management Analyst who serves as a case manager for member disability applications took approximately six months to a year.

The classroom style training included a review and discussion of the entire disability Desk Manual. Specific prior cases were used to highlight applicable procedures and discuss the manner in which the work was performed. Although a case load was assigned immediately, all steps in the process were performed under the shadow of a supervisor, including preparing documents, checklists, and correspondence, as well as observing interactions with the member, the member's representative (if applicable) and physicians and their office staff. A new Disability Pension Section employee is not allowed to work on a case alone until the Section supervisors are confident in the employee's ability.

On an ongoing basis, the Disability Pension Section staff has impromptu trainings that are case specific with the objective of sharing key learnings on how to process certain types of cases. If there are any challenges or unexpected circumstances with a specific case, Disability staff seek individual coaching from the Section supervisors, who have long tenures in LAFPP's Disability Pension Section. In addition, computer based ethics training is required every other year for the level of section supervisor and above. Annual security training, which is also computer based, is required by all staff. Although staff reported that they were encouraged by management to attend appropriate external training events, only senior staff has done so.

As a result of a recommendation from the November 2007 management audit of the System, LAFPP recently developed a formalized training program with an emphasis on a curriculum specific to each employee's job classification. The program offers general and industry-specific training across multiple formats, including computer based training, workshops and conferences, as well as handbooks, manuals and guides. Disability Pension Section staff members reported that they are able to participate in any training provided under the new program by request.

Staff reported periodic contact with the staff of other public retirement systems, both within the state and outside of it, to discuss common practices and techniques to use in processing disability pensions.

It is important to note given the importance of the role of Disability Pension Section supervisors in the training process, that the Disability Pension Section faces the potential for above average turnover of key staff within the next three to five years[60]. While LAFPP does have a formalized succession plan, it does not address the replacement of key Disability Pension Section personnel. It was reported that management is aware that the high number of potential retirements in the Disability Pension Section could impact operations and has started working on a formalized succession plan.

Analysis

Staff training can be provided on-the-job, by other staff members or service providers, or obtained externally through attendance at industry conferences or from academic institutes. Based on the interview process, LAFPP Disability staff has a thorough process for training new hires. Ongoing training is primarily case and role specific, with the exception of the computer based ethics and security training. The recently approved formalized training program is in the early stages of implementation; and Disability Pension Section staff has the opportunity to participate if desired.

Staff members are provided the opportunity to attend various outside conferences, seminars, meetings, symposiums, and workshops for training and development. Senior staff periodically attends one to two conferences or trainings per year. The conferences/training opportunities that senior staff members participate in are well-known and useful, including for example the National Conference on Public Employee Retirement Systems Public Safety Conference, and the International Foundation of Employee Benefit Plans Annual Conference.

The Travel and Education Policy of the Board's Operating Policies and Procedures mandates "that Trustees and staff maintain a knowledge base that keeps them as informed as their peers." The Policy does not cap the number of educational conferences or seminars that staff may attend, which is common practice since approval of staff travel is not a policy function. Given the number of conferences attended, the training utilization rate for Disability Pension Section staff does not appear inappropriate.

[60] Two of the seven Section staff, including the Section Head, are eligible to retire now. Of the five that remain, one is eligible within five years, and three others currently have 25 years or more of City service.

Conferences and workshops are only part of the picture when it comes to ongoing education. Certification and advanced degrees are another way to build skills and improve knowledge. Through its Tuition Reimbursement and Specialized Training Policy, LAFPP provides reimbursement for approved expenses relating to educational and specialized training courses, subject to the availability of budgeted funds. Based upon our interviews, Disability Pension Section staff has not taken any educational or specialized training that would qualify under the Policy.

Conclusions

The training opportunities and the tuition reimbursement programs offered are comparable with the common practices of public pension funds; however, the Disability staff's utilization of the training has not been extensive, to date.

The lengthy tenures and number of Disability staff soon to be retirement eligible presents a risk given the complexity associated with administering the program, and the length of time needed to bring a new employee up to speed. Measures to mitigate the risk of potential turnover and ease the impact to the organization should be taken.

Recommendations

41. Continue to develop a formalized succession plan for key Disability Pension Section staff, specifically including an individual development plan for each staff member in that Section (LAFPP Management)

Findings

<u>An Evaluation of LAFPP's Disability Pension Program Administration</u>

- <u>The manner by which LAFPP supervisors evaluate disability staff and the performance measures used.</u>

LAFPP staff is regularly evaluated pursuant to the Employee Performance Evaluation Policy (the "LAFPP Evaluation Policy"). The City's performance evaluation system and its performance evaluation templates are used in the evaluation process for all LAFPP staff, including those in the Disability Pension Section. The LAFPP Evaluation Policy calls for the direct supervisor of an employee to conduct a formal performance evaluation annually. Through this process, the employee's immediate supervisor rates each employee on general performance measures including work habits, demonstrated skills, knowledge and abilities, and communication and interpersonal skills. In addition, goals for improving performance and continuing development are completed. The employee is given an overall rating of competent, needs improvement, or unsatisfactory.

LAFPP has developed and documented high-level performance metrics for the Pensions Division and Disability Pension Section, which staff reported were incorporated within the evaluation process. The metrics do not appear to tie back to the goals of the LAFPP strategic plan[61].

Once the formal evaluations are complete, they are reviewed by the employee's second level supervisor who has direct knowledge of the employee's performance as well as a member of management. A discussion is held between the supervisor and the employee to review the ratings and comments. Beyond having an opportunity to respond in writing to his or her performance review, the employee is not required to complete a self-assessment. Ultimately, all evaluations are reviewed and approved by the General Manager before being filed in an employee's personnel file.

The LAFPP Evaluation Policy also calls for supervisors to informally evaluate employee performance on an ongoing basis so that employee achievements may be rewarded timely and poor performance may be corrected before the department's service to members suffers.

Analysis

Performance evaluations are a fundamental management tool, and an instructional tool used to assist staff members in developing their goals and objectives and benchmarking work performance. In best practices, they are not performed less than annually and status meetings are done on a quarterly or semi-annual basis to provide an assessment of each employee's work for the time period since the last evaluation and to find out whether the employee is making progress toward meeting their goals and objectives.

During the interview process, we were informed that some Disability Pension Section employees had not received an annual performance evaluation. [62] Interviewees also described the criteria being used for evaluation purposes as limited, because it does not formally incorporate specific metrics regarding the attainment of objectives specific to the goals stated in LAFPP's strategic plan. We found that while some performance standards and metrics exist for the Disability Pension Section as a unit, they are primarily driven by timeliness versus quality, and do not appear to tie back to the strategic plan.

In addition, the performance evaluation process lacks a self-assessment component, which is a common practice that can help engage the employee and promote more effective dialogue between employee and supervisor about performance, priorities and challenges, among other benefits.

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[61] LAFPP has a three-year strategic plan covering fiscal years 2013-14 to 2015-16, adopted by the Board on April 18, 2013.

[62] Consistent with the Scope of Work for this project, the analysis was limited to a review of the evaluation process used for the employees of the LAFPP Disability Pension Section.

Staff did acknowledge that discussions on individual employee performance regularly occur outside of the standard performance evaluation cycle. While staff is not subjected to quotas due to the unique nature of each case, supervisors regularly monitor the status of claims and address issues with staff pertaining to timeliness or quality as they arise.

Conclusions

Disability staff performance evaluations are, for the most part, occurring as prescribed by Policy; however, due to the general nature of performance evaluations, and the lack of tie-in by employee role and the Section to LAFPP's strategic plan, the process may be perceived as a formality rather than constructive and meaningful.

Recommendations

42. Ensure that each Disability Pension Section staff member receives a performance evaluation no less than annually (LAFPP Management)

43. Expand the Disability Pension Section performance metrics and standards so that they incorporate service quality (LAFPP Management)

44. Explore how to meaningfully tie individual performance evaluations and Section performance into the stated goals of LAFPP's strategic plan(LAFPP Management)

VI. Objective 5: Determine whether LAFPP's fiduciaries are properly fulfilling their responsibilities.

Scope

The issues we reviewed for this objective include:

- The applicable fiduciary responsibilities
- Whether LAFPP's fiduciaries are fulfilling those responsibilities, including examining the Board's deliberative process and governance documents to determine whether they are prudent, the documents are clear, and the Board is adequately monitoring its delegations

Findings

Fiduciary Responsibilities and Training

The applicable fiduciary responsibilities for LAFPP are found in the California Constitution, which states in part:

Notwithstanding any other provisions of law or this Constitution to the contrary, the retirement board of a public pension or retirement system shall have plenary authority and fiduciary responsibility for investment of moneys and administration of the system, subject to all of the following:

(a) The retirement board of a public pension or retirement system shall have the sole and exclusive fiduciary responsibility over the assets of the public pension or retirement system. The retirement board shall also have sole and exclusive responsibility to administer the system in a manner that will assure prompt delivery of benefits and related services to the participants and their beneficiaries. The assets of a public pension or retirement system are trust funds and shall be held for the exclusive purposes of providing benefits to participants in the pension or retirement system and their beneficiaries and defraying reasonable expenses of administering the system

(b) The members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the system solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system. A retirement board's duty to its participants and their beneficiaries shall take precedence over any other duty

(c) The members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the system with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims

(d) The members of the retirement board of a public pension or retirement system shall diversify the investments of the system so as to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly not prudent to do so[63]

Section 1106 of the Los Angeles City Charter contains similar provisions, including the duties of loyalty, prudence, and diversification of investments. City and State ethics laws also apply to the Board members.

The training on fiduciary responsibility for the Board members occurs in three ways: new board member orientation, periodic in-house training sessions during board meetings, and public retirement conferences that the board members attend.

LAFPP has a standardized curriculum of 17 topics that are to be covered during the new Board member orientation, which are listed in Table 5-A, along with the estimated time each topic will take. LAFPP has been using that curriculum since 2008. Fiduciary responsibility is one of those topics. Staff maintains a record of the training that has been completed on each topic for every new board member. We received training records for seven of the nine current Board members – records for two Board members do not exist because they began their service before LAFPP began using its curriculum.

[63] California Constitution, Art. XVI, § 17.

Table 5-A – New Board Member Orientation Topics

Topic Description	Estimated Time (hrs)
Role and expectations of Board members	2.00
Fiduciary duties of board members	0.50
Conflict of interest guidelines/Ethics Policy	1.00
Open meetings laws, Proposition 162, other laws	1.00
Board governance policies and practices	2.00
Overview of the organizational structure and roles of staff, actuary, investment consultant, custodian bank, investment managers, attorneys and auditors	2.00
Overview of member services	0.50
Disability application process	2.00
Benefit structure, delivery & Board authority (inc. health)	1.00
Investment and funding policies of the System	1.00
Structure of the current investment program & portfolios	0.50
Current asset allocation process	1.00
Investment manager selection & due diligence process	0.50
Travel policies and procedures	0.50
Strategic plan process & goals	1.00
Budget process	0.50
Audit process	0.50

The records show that none of the seven current Board members for whom we received records have completed the entire orientation curriculum, and have only received training on between one and eight of the topics, with the average being less than five of the topics. Only three of the Board members actually received the new member orientation training on the fiduciary duties of board members.

The full Board received three formal training sessions on fiduciary responsibility and three sessions on ethics since August 2009. In addition, the Board members reported that they receive ad hoc training on specific fiduciary issues when necessary for a particular decision, and those who have attended educational conferences have also received fiduciary education as part of the curriculum.

In general, the Board members felt they had a firm grasp of their fiduciary responsibility, especially in regard to investment decisions and disability cases. The Board members varied in their views of the fiduciary training during the orientation process. Most Board members recalled the annual in-house fiduciary training sessions but some did not.

LAFPP staff members who have fiduciary responsibilities do not receive formal education on the legal standards associated with those responsibilities.

Deliberative Process

To assess the deliberative process a member of our team attended a Board meeting, and we listened to a random sample of meeting recordings. We reviewed meeting agendas and the minutes from the meetings. Meeting agendas contained action items and non-action items, including reports from staff and Committees. Disability cases were identified in the agendas, as were the topics of closed session items.

Meeting minutes listed the names of meeting attendees, along with their title, if known. Items discussed during the meeting are summarized, along any resulting resolution. The minutes reflect who made the motion to approve the resolution, who seconded the motion, and the vote.

Governance Documents

Governing documents are found in the Board Governance Policies, the Board Operating Policies and Procedures, and the Board Investment Policies. These policies show they are updated periodically. However, as with the Board Investment Policies addressed in the Interim Report, three of the twenty Board Governance Policies and nine of the ten Board Operating Policies and Procedures do not have formal review periods, but are only to be reviewed "as needed" or do not address a formal review at all.

The Board Governance Policies state the duties and responsibilities of the Board, the various Board committees, the General Manager, and the City Attorney. The Board Governance Policies also have the Board Education Policy, policies for the evaluation of the General Manager, City Attorney, and Investment Consultant, the Monitoring and Reporting Policy, the Board Operations Policy, which addresses how Board meetings are to be run, and the Strategic Planning Policy, among others.

The Board Operating Policies and Procedures contain information on the ethical responsibilities of the Board and staff, the LAFPP budget process, board education, travel, pension processing, the conduct of hearings, member account processes, Board member elections, and actuarial matters.

The Board Investment Policies cover the duties of the parties involved in the investment program, asset allocation, investment guidelines, and all of LAFPP's policies relating specifically to the investment program.[64]

The Board's primary delegation of duties is to the General Manager, who, by written policy, is "ultimately responsible to the Board for the entire operations of the System." The General Manager is further required to ensure the proper delegation of duties to staff.

Monitoring

The Board's Monitoring and Reporting Policy requires certain reports to be presented to the Board at specific intervals to enable the Board to monitor its delegations and the overall operations of LAFPP. The policy requires a monthly report from the General Manager addressing investment performance, asset allocation, budget compliance, and any status reports on Board assignments to staff made at previous meetings. The General Manager's monthly report also contains a variety of staff workload indicators, including disability case processing and DROP entries and exits. Staff credentials are provided to the Board when new LAFPP staff is introduced during the Board meetings. Ongoing staff training is reported to the Board quarterly.

The Internal Audit Section conducts audits of the timeliness and accuracy of benefit calculations to assist the Board in its monitoring function. In addition, the Internal Audit Section does an annual risk assessment of operations and makes recommendations for improving operational efficiency.

To further monitor benefits administration, LAFPP asks members to complete "point-of-service" surveys to determine member satisfaction and shares results with the Board. Members are also able to communicate their satisfaction or dissatisfaction with LAFPP through letters or directly at meetings during the public comment portion of the agenda.

Another significant delegation made by the Board is to investment managers. The monitoring of investment activities and performance is covered by written policies. From a review of the minutes, as well as conversations with Board members and staff, it appears that the policies are being followed.[65]

[64] The Board Investment Policies were addressed in detail in Objective 7 of the Interim Report.
[65] We provided a detailed assessment of LAFPP's investment manager performance monitoring in Objective 7 of the Interim Report.

Analysis

Fiduciary Responsibilities and Training

Fiduciary responsibility has been called the highest duty imposed by law.[66] The moment an individual is sworn in as a Commissioner on the LAFPP Board, the new Commissioner assumes all of the responsibilities and potential liabilities imposed on fiduciaries. Some of LAFPP's staff members also have fiduciary responsibility. Requiring fiduciary training for new Board members and appropriate staff and ongoing training for all fiduciaries is therefore essential.

The Board's policy requiring that new member orientation must include information on fiduciary responsibility is appropriate and a best practice. However, the training records show that the fiduciary responsibility orientation training has not been provided to most of the Board members for whom we received training records. This is not only inconsistent with the Board Education Policy but also falls short of best practice.

Board members differ on their impression of the in-house training sessions during Board meetings. Nonetheless, the meeting minutes confirm that the training is occurring, and we believe the materials given to the Board members at those sessions are appropriate. From the minutes and our conversations with Board members, staff and the Assistant City Attorney we understand that fiduciary education also takes place on an ad hoc basis as specific issues arise. This and the sessions at conferences that reinforce the information are the standard ways fiduciaries are trained in this complex area of the law.

There is no required fiduciary responsibility training for LAFPP staff. While this is not that unusual, it is inconsistent with best practice, and is a potential risk for LAFPP and the fiduciaries.

Deliberative Process

The Board meeting agendas clearly set forth information-only items, action items and consent items. The agenda does not set time-frames for each of the agenda items, which allows the Board to adequately discuss the items without an artificial time limit.

The Board's deliberative process at board meetings is the best way to determine whether the basic fiduciary duties of prudence and loyalty are understood and being followed. From meeting attendance and listening to audio recordings of a random sample of meetings we found that the Board deliberates effectively and asks appropriate questions. The time the Board took to consider the action items appears to be reasonable for sound deliberations, and the Board did not appear constrained during the meetings. The extent of the Board's deliberations varies

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[66] See, e.g., Ben-Israel v. Valcare Medical, 78 CPR (3d) 94, 1997.

depending on the underlying facts of each topic, as we would expect. For example, in non-controversial disability cases where the staff, the applicant, and the reviewing doctors all agree on a particular outcome, there is little or no discussion. In other cases where there is a disagreement on the facts, the Board will hold a hearing, listen to testimony provided under oath, and engage in significant deliberation.

Overall, we found the deliberative process to be appropriate for the topic being addressed. The Board members are not reluctant to question staff or outside parties who are presenting information. Board members also appear comfortable disagreeing with one another, but keep those disagreements professional and focused on the Board's responsibilities regarding the issues before them. The conduct and discussions during Board meeting deliberations indicate that the Board members generally understand their fiduciary responsibilities.

When reviewing the audio tapes of the Board meetings, at times it was apparent whether a particular Commissioner was appointed by the City or elected by the membership based on their comments made during the deliberations. The duty of loyalty requires trustees to make decisions based solely on the best interests of the members and beneficiaries. In our experience, one of the hardest things for trustees to do is ignore where they came from or how they came to be trustees. But in order for trustees to comply with the duty of loyalty, they must ignore that they were appointed by the Mayor or elected by a certain constituency and instead base their decisions solely on the best interests of the entire membership of LAFPP. This is an area of fiduciary responsibility where the Board may benefit from additional education.

Governance Documents

The Board governance documents provide detailed delegations to staff and other outside service providers. We did not identify any staff uncertainty on the responsibilities delegated by the Board. The documents also clearly state the ethical responsibilities of the Board and staff. Establishing a written review period for all of the Board's policies will ensure that they continue to reflect those responsibilities.

Monitoring

Beyond being trained on the basic legal tenets of fiduciary responsibility, we believe that board members ought to be well-versed in fundamental aspects of the pension plan in order to meet the high standard of prudence imposed upon them. Although not exhaustive, the following list sets forth areas that fiduciaries should understand and regularly monitor:

- Funded status of the defined benefit plans, and the progression of the funded status
- The level and timing of employer and employee contributions
- Investment risk and returns by asset class and total portfolio
- Budget reasonableness and compliance with the established budget
- Federal, state and local legislation that may affect the system

- Audit results and the adequacy of internal controls
- The efficiency and risk management of internal operations
- The accuracy and timeliness of benefit payments
- Legal issues, ethical compliance and litigation
- Staff and Board member compliance with ethical standards and policies
- Customer service and member satisfaction
- Work force effectiveness

From our review it appears that actuarial information, including the funded status and level and timing of contributions, is provided annually through the actuarial valuation presented by the Board's actuary. The monthly General Manager report and the quarterly performance reports from R.V. Kuhns address investment risk and returns. The General Manager's report also addresses budget issues and legislation.

The External Financial Audit and the Annual Report discuss audit issues and internal controls. The Internal Audit Section's audits provide information to the Board on operational risks and the accuracy and timeliness of benefit payments.

The Legal Affairs quarterly report discusses legal issues, litigation, and potential legislation. Annual disclosures by Board members and staff help the Board monitor compliance with ethical standards and policies.

The Board monitors member satisfaction through appropriate member survey information and comments the Board receives directly from the members and the public. Finally, the General Manager and staff provide staff effectiveness data to the Board on an ongoing basis, and the Board's 2013-2014 Strategic Plan includes an effort to increase its focus on performance metrics. From discussions with Board and staff as well as our review of the meeting agendas, minutes and other documents, we believe the Board receives reports that cover all of the topics in the above list.

Conclusions

The applicable fiduciary responsibilities are contained in the State Constitution and the City Charter, which has parallel language. No inconsistencies about the fiduciary standards exist in the written laws.

LAFPP's written curriculum for new trustee orientation is comprehensive and reflective of current best practices. Unfortunately, new Board members are not actually receiving most of that training, and most of the Board members were not actually given the new trustee training on fiduciary responsibility. The lack of training, especially training on fiduciary responsibility, is a significant departure from best practice. It does not appear that Board members and the LAFPP staff have made new trustee orientation a priority.

The regular in-house training for Board members on ethics is a common and best practice.

The lack of any fiduciary responsibility training for LAFPP staff members is inconsistent with best practice. The best approach is to provide fiduciary training for new staff that have fiduciary responsibilities, and annual training sessions thereafter.

The Board's deliberative process is effective; however, the deliberations show that some Board members may not fully understand the fiduciary duty of loyalty. Accordingly, additional training on the duty of loyalty would be appropriate.

In order to assure that the Board Governance Policies and Board Operating Policies and Procedures are kept current by reflecting evolving best practices and actual practices, it is best to have a review schedule in each material section of the policies to ensure that all of the policies are regularly reviewed by staff and the Board.

Monitoring by the Board of essential information and the duties it has delegated encompasses all of the topics we would expect of fiduciaries for a public pension system.

Recommendations

45. Require that each new Commissioner receives prompt training on all topics stated on the New Board Member Orientation table, and provide additional training on the duty of loyalty (LAFPP Board)

46. Establish a fiduciary responsibility training requirement for new staff who have fiduciary responsibilities, and provide ongoing training annually (LAFPP Management)

47. Establish and follow a regular review schedule for the Board policies that do not currently have formal review periods (LAFPP Board)

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VII. Objective 6: Determine whether LAFPP has adequate procedures for long-term financial planning to ensure timely decision-making.

Scope

The issues we reviewed for this objective include:

- Discussions that have occurred with the plan sponsor regarding the long-term financial impact of the LAFPP
- How future investment earnings may impact plan sponsor contributions

Findings

Long-Term Financial Impact Discussions

Through Board and staff interviews and reviewing documents obtained from LAFPP, we learned that communication between the City and LAFPP regarding LAFPP's financial impact on the City's budget has occurred throughout the audit period. For example, the Office of the City Administrative Officer invited LAFPP representatives to participate in discussions regarding the creation and implementation of Tier 6,[67] a retirement plan change that increased the employee contribution and slightly altered the available pension amount at retirement. After the voters approved Tier 6, the City Administrative Officer requested LAFPP's and its actuary's assistance in determining how to allow current active members to transfer into Tier 6 in a cost-neutral manner.

LAFPP also communicated with the City Administrative Officer, the City Council, and the Mayor regarding LAFPP's adoption of new actuarial methods intended to reduce the impact to the City of the extreme market losses in 2008-2009. LAFPP increased the smoothing period from five to seven years, and widened the market value corridor from 20% to 40%.[68] LAFPP made these changes in order to slow the contribution increases required from the City as a result of the market losses.

The communication between the City and LAFPP is ongoing. On February 27, 2013 the Board received a five-year illustration of contributions, funding ratio and unfunded accrued actuarial liabilities (UAAL) from the Segal Company (Segal), its consulting actuary, based in part on a

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[67] At that time, LAFPP's actuary, the Segal Company (Segal), was also the actuary for the City, and performed the calculations for the City regarding the impact of Tier 6. Segal is no longer the actuary for the City.

[68] These changes were discussed in the Interim Report. "Smoothing" recognizes only a portion of the actual gains or losses each year. For example, if a system has a five-year smoothing period, only one-fifth of the system's actuarial gains or losses are recognized each year. This reduces the impact of large swings in the actual market value of a pension plan's assets, and helps maintain a consistent contribution level. "Corridors" that limit how far the actuarial value of assets can deviate from the market value of assets. For example, if a system uses a 40% corridor, the actuarial value of assets can only vary from the market value of assets by at most 40%; any additional variance must be immediately recognized.

request from the City Administrative Officer. This information was furnished to the City Administrative Officer.

As noted in the Interim Report, LAFPP monitors the financial condition of the defined benefit pension plan through annual actuarial valuations. The results of the annual actuarial valuations are communicated to the City Administrative Officer shortly after their receipt. LAFPP verifies the appropriateness of the actuarial assumptions used for those valuations every three years through an experience study. LAFPP also receives formal quarterly reports from its investment consultants on the performance of its investments, and informal investment performance information every week so that the Board and staff can monitor the returns and compare them with the assumed rate of return.

Analysis

The long-term financial impact of LAFPP on the City's budget is reflected in the City contributions that are required to fund the system into the future. Those contributions are directly tied to pension costs. The universal equation for the long term pension costs of a public pension fund is:

Pension Costs = Benefits + Expenses – Investment Earnings

The largest costs by far for pension funds are the benefits; administrative expenses are comparatively small costs. The City directly determines how expensive the benefits will be through its creation of the benefit structure, and indirectly through compensation increases to active members.

Although LAFPP's primary responsibilities are to its participants and beneficiaries, it still has a vested interest in the financial viability of the plan sponsor. Communication between the City and LAFPP regarding the ongoing cost of the defined benefit pension plan and LAFPP's efforts to reduce dramatic increases in employer contributions reflects a sensible sharing of information between the parties.

The processes LAFPP has in place to monitor the financial condition of the pension systems are appropriate and reflect best practices. Annual actuarial valuations help LAFPP track the funding level of the systems and determine the resulting required contributions. Regular actuarial experience studies determine the continued viability of the actuarial assumptions underlying the valuations, and allow LAFPP to make changes when warranted. Investment performance monitoring allows LAFPP to assess the impact of market fluctuations on the trust assets and prepare for any consequences. Together, these tools provide the necessary information for LAFPP to discover and address financial problems in a timely manner, as well as keep the City appraised of its financial situation.

Conclusions

LAFPP has appropriate processes in place to monitor and address its financial condition. Communication between LAFPP and the City has occurred throughout the audit period, and is ongoing. That communication has addressed the significant events that occurred during the audit period, including the financial impact of the market downturn in 2008-2009, LAFPP's efforts to mitigate the impact of that downturn on the City's budget, and the creation and implementation of the new Tier 6.

Recommendations

No recommendations

Findings

The Impact of Future Investment Earnings on Contributions

On February 17, 2012, Segal, LAFPP's actuary, issued a report showing a "six-year illustration of contributions, funding ratios and Unfunded Actuarial Accrued Liabilities (UAAL)" for the pension plan and the retiree health plan. As requested by LAFPP, Segal's report showed the results of four different investment return scenarios. Those scenarios assumed four different one-year returns for fiscal year 2011-2012 (7.75%, -7.75%, 0%, and 15.5%), and a 7.75% return for the next five years. The results of those scenarios on the combined pension plan and retiree health plan for the last fiscal year of the analysis, fiscal year 2018-2019, are in Table 6-A.

Table 6-A – Segal Investment Return Scenario Illustrations

Return	City Contribution Rate[69]	Funded Ratio[70]	UAAL (In Thousands)
7.75%	50.57%	81.6%	$4,785,982
-7.75%	64.57%	72.0%	7,301,783
0%	57.56%	76.8%	6,043,608
15.5%	43.57%	86.5%	3,528,380

According to Segal's analysis, the impact of a 7.75% change in investment return in the first year results in approximately a 7% change in City contribution rate at the end of the six-year period. For example, as shown in Table 6-A, if LAFPP realized a 7.75% return the first year, the City's contribution rate at the end of the six-year period would be 50.57%. If LAFPP instead realized a 15.5% return the first year, an increase of 7.75%, the City's contribution rate at the

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[69] As a percentage of payroll.
[70] LAFPP's funded ratio for fiscal year 2010-2011, the year prior to the beginning of the analysis, was 79.4%, as stated in the report and the fiscal year 2010-2011 actuarial valuation.

end of the six-year period would go down to 43.57%, a reduction of exactly 7%. On the other hand, if LAFPP had a 0% return the first year, the City's contribution rate would increase to 57.56% - an increase of 6.99% from the 7.75% return calculation.

Segal's analysis also assumed that payroll would grow at a rate of 4.25% per year. Segal noted that if payroll increases are less than that amount, the contribution rates will be higher because the "UAAL for the plan will have to amortize over a smaller future payroll". Segal did not provide an analysis of differing payroll growth rates and the effect on City contributions, and was not requested to do so.

Analysis

From our analysis of Segal's report we believe it provides a reasonable projection of the impact of the four different investment returns on future City contributions. We agree with the conclusion that there is an approximately 7% change in City contribution rate at the end of the six-year period for each of the investment return scenarios. Segal's report provides LAFPP and the City with a practical tool to estimate the impact of differing investment returns on the City's future contributions.

Segal's report is limited to changes in investment returns, which is exactly what it was requested to do. As Segal noted, changes in payroll growth can also have an effect on funded status and contribution levels. So can other deviations from LAFPP's actuarial assumptions. For instance, in the Fiscal Year 2011-2012 Actuarial Valuation, Segal calculated that LAFPP had an actuarial gain of over $108 million as a result of cost of living adjustments that were lower than the actuarial assumption. Analyzing the impact of potential deviations from all of LAFPP's actuarial assumptions would result in so many different permutations and expected results that it would not be helpful for financial planning efforts. Further, the purpose of the actuarial experience study that LAFPP has its actuary perform every three years is to keep its actuarial assumptions as close to real-world results as possible. We do not believe that having Segal analyze additional deviations from actuarial assumptions would provide enough significant information to justify the cost.

One tool that LAFPP does not currently use that can provide additional useful information is asset/liability modeling, as we recommended in the Interim Report. Asset/liability modeling provides information on the likelihood of different investment returns based on changes to the plan's cash flows and other economic conditions, all of which are allowed to vary during the applicable time period. It shows a more comprehensive sensitivity of the contribution rate to the uncertainty of asset returns than is provided in the Segal report. Performing asset/liability modeling every three years is a best practice, as we previously recommended.

Conclusions

Segal's analyses of the four different return scenarios over the six-year period provide reasonable projections of the impact of those scenarios.

Recommendations

No recommendations

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Appendix A –Final Report Scope of Work

Objective 1: Determine whether the asset allocation process is sound and the diversification is appropriate so that risk is minimized and returns are maximized over different market cycles

A. Assess the process used to establish LAFPP's current asset allocation, including the methodology and inputs employed and the asset liability studies performed

B. Review the reasonableness of the estimates of expected returns, volatility (standard deviation) and assumed correlation of returns among asset classes and sub-classes

C. Review the appropriateness and suitability of the asset allocation and the overall investment strategy, including whether investments are suitably diversified and the development of expected returns and risk ranges using HEK's capital market assumptions

D. Analyze the portfolio rebalancing process, including who makes the decision, the criteria for adjustment and the frequency

E. Compare LAFPP's investment performance for each asset class and the total fund to appropriate benchmarks and other similar plans

F. Evaluate R.V. Kuhns' performance attribution analysis to determine whether it is an effective tool for monitoring risk and returns, and determine whether LAFPP is effectively using that analysis

Objective 2: Determine whether LAFPP adequately considers costs when making investment decisions and when it evaluates investment performance

A. Expand on Objective 9 from Interim Report by providing an analysis of returns net of fees for active versus passive investments

B. Compare LAFPP's returns and fees to relevant benchmarks and peers

C. Examine LAFPP's fees and determine whether investment returns are reported net of fees and expenses

D. Analyze investment management fees

Objective 3: Assess the adequacy of actuarial methods in order to assure the validity of actuarial assumptions.

A. Review LAFPP's actuarial methods, including the frequency and reason for making any changes

B. Use LAFPP's past valuations and experience studies to assess the reasonableness of the actuarial methodology and assumptions

C. Assess whether LAFPP's actuary followed the actuarial standards of practice.

Objective 4: Ensure that benefits have been provided to LAFPP members as required by the applicable City Charter provisions and in a timely manner.

A. Review the plan provisions, administrative rules, policies and procedures used to process service and disability retirement payments

B. Disability and regular retirement files

1. Test eligibility, benefit calculations and timeliness, and assess the effectiveness of quality controls

2. Determine whether LAFPP has the proper controls over the signatory process for payments and disbursements

3. Determine whether LAFPP has adequate controls to ensure invoices and payments for members' health benefit premiums are based on accurate calculations

C. Disability retirement files

1. Compare LAFPP's disability review procedures to best practices and market norms

2. Assess how errors and disputes are resolved

3. Assess the disability staff training and how supervisors evaluate disability staff and the performance measures used

Objective 5: Determine whether LAFPP's fiduciaries are properly fulfilling their responsibilities

A. Verify the applicable fiduciary responsibilities

B. Evaluate whether LAFPP's fiduciaries are fulfilling those responsibilities by examining the Board's deliberative process and governance documents to determine whether they are prudent, the documents are clear, and the Board is adequately monitoring its delegations

Objective 6: Determine whether LAFPP has adequate procedures for long-term financial planning to ensure timely decision-making.

A. Determine what discussions have occurred with the plan sponsor regarding the long-term financial impact of the LAFPP

B. Evaluate LAFPP's actuary's calculation of how future investment earnings may impact plan sponsor contributions

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Appendix B - Active Manager Peer Universes

Total Fund – Public Funds > $1 Billion Net

Total Domestic Equity – eVestment Alliance US All Cap Equity Net
FIS Group Emerging Managers – eVestment Alliance US All Cap Equity Net
Robeco Large Cap Value Equity – eVestment Alliance US Large Cap Value Equity Net
Chicago Equity Enhanced Core Index – eVestment Alliance US Large Cap Core Equity Net
Research Affiliates Enhanced Core Index – eVestment Alliance US Large Cap Core Equity Net
LA Capital Enhanced Growth Index – eVestment Alliance US Large Cap Growth Equity Net
Daruma Asset Small Cap Equity – eVestment Alliance US Small Cap Equity Net
Attucks Group Emerging Managers – eVestment Alliance US Small Cap Equity Net
Frontier Capital Small Cap Growth – eVestment Alliance US Small Cap Growth Equity Net

Total International Equity – eVestment Alliance ACWI ex-US All Cap Equity Net
Brandes International Large Cap Equity – eVestment Alliance ACWI ex-US Large Cap Equity Net
Fisher Asset International Equity – eVestment Alliance ACWI ex-US All Cap Equity Net
Principal Global Investors Emerging Equity – eVestment Alliance Emerging Markets Equity Net

Total Fixed Income – eVestment Alliance All US Fixed Income Net
Reams Asset Management Fixed Income – eVestment Alliance US Core Fixed Income Net
LM Capital Group Fixed Income – eVestment Alliance US Core Fixed Income Net
Loomis Sayles Long Duration Fixed Income – eVestment Alliance US Long Duration FI Net
MacKay Shields High Yield Fixed Income – eVestment Alliance US High Yield FI Net
Bridgewater Portable Alpha US TIPS – eVestment Alliance TIPS / Inflation Indexed FI Net
Western Asset US TIPS – eVestment Alliance TIPS / Inflation Indexed FI Net

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Appendix C - 2012 SACRS Survey Database of Respondents[71]

1. Alameda County Employees' Retirement Association
2. Big Spring Firemen's Relief & Retirement Fund
3. California Public Employees' Retirement System
4. California State Teachers' Retirement System
5. Chicago Teachers' Pension Fund
6. City of Fresno Retirement Systems
7. City of Grand Rapids General Retirement System
8. City of Grand Rapids Police & Fire Retirement System
9. City of Phoenix Employees' Retirement System
10. Civilian Employees' Retirement System of the Police Department of Kansas City, Missouri
11. Colorado Public Employees' Retirement Association
12. Contra Costa County Employees' Retirement Association
13. County Employees' Annuity & Benefit Fund of Cook County
14. District of Columbia Retirement Board
15. Educational Employees' Supplementary Retirement System of Fairfax County
16. Employees Retirement System of Texas
17. Fire & Police Employees' Retirement System of Baltimore
18. Fire and Police Pension Association of Colorado
19. Florida State Board Administration
20. Fort Worth Employees' Retirement Fund
21. Fresno County Employees' Retirement Association
22. Georgia Division of Investment Services
23. Gila River Indian Community Retirement Plan
24. Illinois Municipal Retirement Fund
25. Illinois State Board of Investment
26. Imperial County Employees' Retirement System
27. Iowa Public Employees' Retirement System
28. Kansas Public Employees' Retirement System
29. Kentucky Retirement Systems
30. Kentucky Teachers' Retirement System
31. Kern County Employees' Retirement Association
32. Los Angeles County Employees Retirement Association
33. Los Angeles Fire and Police Pension System
34. Los Angeles Water & Power Employees Retirement Plan
35. Marin County Employees' Retirement Association
36. Mendocino County Employees' Retirement Association
37. Merced County Employees' Retirement Association

[71] R.V.Kuhns Public Fund Universe Analysis for the period ending June 30, 2012

38. Metro Water Reclamation District Retirement Fund
39. Milwaukee Employees' Retirement System
40. Montana Public Employees' Retirement System
41. Montana Teachers' Retirement System
42. Municipal Employees' Annuity and Benefit Fund of Chicago
43. Navajo Nation Retirement Plan
44. Nevada Public Employees' Retirement System
45. New Mexico Educational Retirement Board
46. New York State Common Retirement Fund
47. Ohio Public Employees Retirement System
48. Orange County Employees Retirement System
49. Pennsylvania Municipal Retirement System
50. Pennsylvania Public School Employees' Retirement System
51. Pennsylvania State Employees' Retirement System
52. Police Retirement System of Kansas City, Missouri
53. Public Education Employee Retirement System of Missouri
54. Public Employees Retirement Association of New Mexico
55. Sacramento County Employees' Retirement System
56. San Bernardino County Employees' Retirement Association
57. San Diego City Employees' Retirement System
58. San Diego County Employees Retirement Association
59. San Joaquin County Employees' Retirement Association
60. San Mateo County Employees' Retirement Association
61. Santa Barbara County Employees' Retirement System
62. Sonoma County Employees' Retirement Association
63. South Dakota Retirement System
64. Stanislaus County Employees' Retirement Association
65. State of Michigan Retirement Systems
66. State of New Jersey Pension Fund
67. State Retirement and Pension System of Maryland
68. State Universities Retirement System of Illinois
69. Teachers' Retirement System of Louisiana
70. Teachers' Retirement System of the State of Illinois
71. Texas Municipal Retirement System
72. The Public School Retirement System of Missouri
73. Tulare County Employees' Retirement Association
74. Utah Retirement Systems
75. Ventura County Employees' Retirement Association
76. Virginia Retirement System
77. West Virginia Investment Management Board
78. Wyoming Retirement System

Appendix D - Interviews:

LAFPP Commissioners
Sam Diannitto
Dean Hansell, President
Gregory Lippe
Wayne Moore
Ruben Navarro, Vice President
Raul Perez
Belinda Vega

LAFPP Staff
Diana Anderson, Senior Management Analyst
Chris Annala, Senior Management Analyst
Raymond Ciranna, General Manager
Caroline Dinu, Senior Management Analyst
Yolanda Huang, Department Chief Accountant
Erin Kenney, Internal Auditor
Tom Lopez, Chief Investment Officer
Gail Matsumura, Management Analyst
James Napier, Deputy City Attorney
Carleen Payne, Senior Clerk Typist
Tom Puchaslski, Senior Management Analyst
William Raggio, Assistant General Manager
Joseph Salazar, Assistant General Manager
May Simmons, Senior Management Analyst
Lady Smith, Management Analyst
Carmen Steward, Management Analyst
Anthony Torres, Senior Management Analyst
Joan Washington, Payroll Supervisor
Robyn Wilder, Chief Management Analyst
James Yeung, Internal Auditor
Tina Zipper, Senior Management Analyst

Los Angeles City Staff
Alan Manning, Managing Assistant City Attorney

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Appendix E - Summary of Documents Reviewed:

- Applicable Constitutional, Statutory and Charter provisions
- Audits performed by external auditor, internal auditor and actuary
- LAFPP summary plan descriptions, comprehensive annual financial reports, actuarial valuations, actuarial experience studies, and Board meeting agenda information and documentation and meeting minutes
- Legal opinions provided to LAFPP
- LAFPP Board Governance, Operating and Investment policies
- Member file information
- Contracts with service providers, including investment consultants and managers
- Investment performance reports
- Board meeting materials
- Prior management audit and its recommendations
- Asset allocation materials

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Appendix F - Glossary of Terms:

Terms defined in this glossary are defined for quick reference and convenience, and do not supersede specific meanings as they are used and defined in applicable law, rules or regulations.

Active Management
Investment management where the portfolio manager actively makes investment decisions and initiates buying and selling of securities in an effort to maximize returns.

Actuarial Accrued Liability
Total accumulated cost to fund pension benefits arising from service in all prior years.

Actuarial Cost Method
Technique used to assign or allocate, in a systematic and consistent manner, the expected cost of a pension plan for a group of participants to the years of service that give rise to that cost.

Actuarial Present Value of Future Benefits
The amount which, together with future interest, is expected to be sufficient to pay all future benefits.

Actuarial Valuation
The study of probable amounts of future pension benefits and the necessary amount of contributions to fund those benefits.

Actuarial Value of Assets
The value of assets considered in the actuarial valuation of a pension plan and used to determine the required annual contribution and funded ratio. (This is not equal to market value when smoothing methodology is used.)

Actuary
A professional statistician that predicts future events based upon past occurrences. A person professionally trained in the technical and mathematical aspects of insurance, pension and related fields. The actuary estimates how much money must be contributed to a pension fund each year in order to support the benefits that will become payable in the future.

Annual Required Contribution
The sum of the “normal cost” (defined below) and the amortized unfunded actuarial accrued liability.

Asset Allocation
An initial stage of the investment process which is concerned with (1) the key asset classes into which funds can be invested and (2) the amount of money to be invested in each class.

Asset/Liability Modeling
A projection of a retirement plan's financial situation by making assumptions concerning the future such as demographic trends, effects of inflation, and anticipated return on investments.

Asset Class
Distinct market segments for investing. For example, stocks (equities), bonds (fixed income), real estate, and cash equivalents are considered to be separate asset classes. Sub-asset classes within equities would include small- or large-capitalization stocks, and within fixed income would include long- or short-duration bonds.

Attribution Analysis
A tool used by institutional investors to analyze investment performance by visually depicting the relative drivers of performance.

Basis Point (bp)
One-hundredth of a percentage point.

Benchmark
An objective standard against which investment performance and/or trading execution can be measured and evaluated. The most widely used benchmark is the total return of the Standard and Poor's (S&P) 500 Stock Index.

Bond
A certificate of debt (i.e., an IOU or promissory note) issued by such entities as corporations, municipalities, and the government and its agencies, in multiples of $1,000 to $5,000 which represent a part of a loan to the issuer, bears a stated interest rate, and matures on a stated future date. A bondholder is a creditor of the issuer and not part owner, as is a stockholder. Short term bonds issued for five years or less from the issuance date are often called notes.

Brokerage
A fee charged by a broker for execution of a transaction; an amount per transaction or a percentage of a total value of the transaction; usually referred to as a commission fee.

CAFR
Comprehensive Annual Financial Report

Capital Market Assumptions
Projections of future returns for the various asset classes.

Common Stock
Securities which represent an ownership interest in a corporation. If the company has also issued preferred stock, both common and preferred have ownership rights. The preferred normally is limited to a fixed dividend but has prior claim on dividends and in the event of liquidation, assets. Claims of both common and preferred stockholders are junior to claims of bondholders and other creditors of the company. Common stockholders assume the greater risk, but generally exercise the greater control and may gain the greater reward in the form of dividends and capital appreciation. The terms common stock and capital stock are often used interchangeably when the company has no preferred stock.

Defined Benefit (DB) Plan
DB Plans are traditional retirement plans. The plan promises a retirement benefit based on age and total years of service. The member receives a flat monthly benefit upon retirement. Under this type of plan, the employers make the contributions and are responsible for ensuring that assets are available to provide the pension that each member is promised.

Defined Contribution (DC) Plan
Under this type of plan, the member is not promised a set benefit or pension at retirement. Rather, an individual account is established in the member's name, and his or her final benefits depend on how much is contributed and the rate of return earned by the account's investments. Members typically direct the investment of the account.

Diversification
The spreading of investment funds among classes of securities and localities in order to distribute the risk.

Due Diligence
Describes the careful investigation necessary to ensure that all material information pertinent to an issue has been disclosed before a decision is made. The term originated in securities law, but is now generally used in all investment and financial matters.

Efficient Market
An investment hypothesis that describes a securities market in which prices accurately reflect all available knowledge and adjusts immediately to any new information. The Efficient Market Hypothesis maintains that a professional money manager operating in such a market can only achieve consistently superior investment results by taking greater than market risk.

Equities
Ownership interests possessed by shareholders in a corporation. Examples include common stock and preferred stock.

Execution Costs
Execution costs are comprised of three parts: (1) the actual dollars paid to the broker in commissions; (2) the market impact – i.e., the impact that a manager's trade has on the market price for the stock; and, (3) the opportunity cost that is the result of not executing the trade instantaneously. Also referred to as transaction costs.

Expected Return
Best estimates of what returns might be over some future time period.

Fiduciary
Any person who (1) exercises any discretionary authority or control over the management of a plan, (2) exercises any authority or control concerning the management or disposition of its assets or (3) has any discretionary authority or responsibility in the administration of the plan. Fiduciary status extends not only to those persons named in law as having express authority and responsibility in the plan's investment or management but also covers those persons who undertake to exercise any discretion or control over the plan regardless of their formal title.

Fixed Income
A security that pays a fixed rate of return, and usually refers to a government, corporate, or municipal bond.

Funding Ratio
Ratio of the assets of a pension plan to its liabilities.

Governance
The policies and processes by which an entity is directed and controlled, and the monitoring of their proper implementation by the entity's governing body.

Index Fund
A passively managed portfolio designed and computer controlled to mirror the performance of a certain index, such as the S&P 500. By definition, such funds should perform within a few basis points of the index.

Industry Norms
For every industry, there is a set of normal ratios, which reflect the average value for the given type of business.

Investment Manager
An individual or organization that provides investment management services, for a fee, on a fully discretionary or nondiscretionary basis.

Investment Policy Statement (IPS) (“Board Investment Policies” for LAFPP)
A written document that sets forth the investment goals of the organization, its risk tolerance, asset allocation, due diligence processes, benchmarks, frequency of performance measurement, and roles and responsibilities.

Liquidity
A concept which prescribes that sufficient cash, or cash-like securities, be available at times of disbursement for retirement payments and refunds.

Market Capitalization
The value of a company determined by multiplying the number of outstanding shares of common stock by the current market price per share.

Market Inefficiency
Failure of the market to properly price a security due to a lack of full knowledge. This typically occurs with securities that are not closely followed by Wall Street analysts.

Modern Portfolio Theory (MPT)
An investment theory that deals with the rationale for and methods of diversifying portfolios to develop the optimal combination of assets in an investment portfolio in order to produce the highest possible return for a given level of risk; or the least possible risk for a given level of return. Investments are evaluated based on how they will affect the rest of the portfolio.

Non-traditional Asset Classes
Asset classes such as hedge funds, real estate, commodities and private equity.

Normal Cost
That portion of the actuarial present value of benefits assigned to a particular year in respect to an individual participant or the plan as a whole.

Passive Management
Investment management where the portfolio manager oversees a fixed portfolio that structured to match the performance of a particular segment of the market.

Proxy
A written authorization given by a shareholder to someone else to vote his shares at a stockholder's annual or special meeting.

Proxy Statement
Information required by the Securities and Exchange Commission to be given to stockholders as prerequisite to solicitation of proxies for a security subject to the requirements of the Securities Exchange Act.

Proxy Voting
The act of shareholders of a corporation authorizing a specific vote on their behalf at corporate meetings – such proxies normally pertain to election of the board of directors or to various resolutions submitted for shareholders' approval.

Prudence
The prudent person standard requires a fiduciary to discharge their duties with respect to a retirement system with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims.

Rebalancing
Buying or selling securities that have changed values in order to restore their designated proportion within a portfolio.

Securities Lending
A practice whereby owners of securities either directly or indirectly lend their securities to primarily brokerage firms for a fee, and against which either cash, securities, or a letter of credit is pledged to protect the lender. Securities are borrowed to cover fails of deliveries, cover short sales, provide proper denominations, and enable brokerage firms to engage in arbitrage trading activities.

Soft Dollars
Payment for value-added services through commissions generated from security trades as opposed to direct cash ("hard dollar") payments.

Style Categories
Classification of managers by type of investment approach (i.e. "growth", "value", "large cap", "small cap").

Summary Plan Description (SPD)
An easy-to-read written statement describing the provisions and features of a retirement plan.

Systematic Risk
Investment risk associated with macro (pervasive) factors such as the national economy. Investment managers can do little to affect this type of risk. Examples of systematic risk include interest rate risk and market risk.

Target Asset Allocation
The asset allocation adopted for a particular investment portfolio.

Third Party Administrator
An outside party to an employee benefit plan that provides administrative services to the plan.

Tracking Error
A divergence between the price behavior of a position or a portfolio and the price behavior of a benchmark resulting in an unexpected profit or loss.

Transaction Costs
The cost of executing a particular transaction. Transaction Costs are comprised of three parts: (1) the actual dollars paid to the broker in commissions; (2) the market impact - i.e., the impact that a manager's trade has on the market price for the stock; and, (3) the opportunity cost that is the result of not executing the trade instantaneously.

Trustee: A person who has fiduciary responsibility over financial aspects of a trust. In the case of a public pension plan it includes the receipt, disbursement, and investments of plan contributions.

Unfunded Actuarial Accrued Liability
The portion of the actuarial accrued liability not offset by plan assets.

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DEPARTMENT OF FIRE AND POLICE PENSIONS

360 EAST SECOND STREET
SUITE 400
LOS ANGELES, CA 90012-4203

(213) 978-4545
(800) 787-CITY(2489)
FAX (213) 978-4450
TDD (213) 978-4455

EMAIL: PENSIONS@LAFPP.COM

CITY OF LOS ANGELES

CALIFORNIA

ERIC GARCETTI
MAYOR

RAYMOND P. CIRANNA
GENERAL MANAGER

WILLIAM S. RAGGIO
EXECUTIVE OFFICER

JOSEPH SALAZAR
ASSISTANT GENERAL MANAGER

TOM LOPEZ
CHIEF INVESTMENT OFFICER

January 6, 2014

Hon. Ron Galperin, Controller
Controller's Office
200 N. Main Street, Room 300
Los Angeles, CA 90012

Dear Mr. Galperin:

Thank you for the opportunity to respond to the Final Report of the Management Audit of the Los Angeles Fire and Police Pensions (Final Report). We thank you, your staff, and the staff of Hewitt EnnisKnupp, Inc., for the courtesy, professionalism, and consideration extended throughout the course of this audit, specifically for both the Interim Report and now, the Final Report.

Our mission is to advance the health and retirement security of those who dedicate their careers to serve and protect the people of Los Angeles. We administer benefits according to various authoritative instruments, including the City Charter, the Administrative Code, and the State Constitution. As with the Interim Report, we welcome this independent evaluation of the administration of these benefits.

The City Charter requires this audit to examine whether the pension system is operating in the most efficient and economical manner and to evaluate our asset allocation. We are committed to continuous improvement, and your recommendations to strengthen our administration of benefits were highly anticipated.

We believe the Final Report is clear, concise, and reasonable. We will work with the Board of Fire and Police Pension Commissioners to give full consideration to each recommendation.

We appreciate your recognition of our strong funded-level as compared to other plans, and that our investment management fees are generally in line or favorable when compared to peers. We appreciate your conclusions that our actuarial methods and assumptions are appropriate, and that our long-term financial planning is proper.

We wish to formally document our acceptance of each recommendation as indicated below.

Recommendations and actions

Recommendation 22
LAFPP Management should promptly update the investment policies so they accurately reflect the Board's most recent decision on asset allocation.

Agreed.

Recommendation 23
LAFPP Management should review and revise the "Current Board Allocations Within Major Asset Classes" section of the Board Investment Policies.

Agreed.

Recommendation 24
The LAFPP Board should remove the restriction on rebalancing once every three months.

Agreed. We will work with the Board to analyze and discuss changes to the rebalancing policy.

Recommendation 25
The LAFPP Board should rebalance back to the target allocation for the applicable asset class, unless there is some ancillary tactical or cost reason to do otherwise.

With our consultant, staff will research the matter and bring a supported recommendation to the Board.

Recommendation 26
The LAFPP Board should benchmark the Fixed Income component (Core Fixed Income and High Yield) to a weighted benchmark of 84% Barclays U.S. Universal Index and 16% Barclays U.S. Long Government/Credit Index.

With our consultant, staff will research the matter and bring a supported recommendation to the Board.

Recommendation 27
LAFPP Management should require R.V. Kuhns to display net of fees returns in the performance reports.

With our consultant, staff will research the matter and bring a supported recommendation to the Board.

Recommendation 28

LAFPP Management should continue to compile all benefit determinations received to date, including precedents set by court decisions, Board decisions, management decisions and legal opinions, in one central repository.

Agreed. This will continue to be done on an ongoing basis in our document imaging system.

Recommendation 29

LAFPP Management should develop and furnish a Summary Plan Description for Tier 6 as soon as possible.

Agreed.

Recommendation 30

LAFPP Management should consolidate the paper-based member files into a centralized filing room within the new LAFPP office space.

Staff will research the matter and bring a supported recommendation to the Board.

Recommendation 31

LAFPP Management should organize paper-based member files so they include all of a member's information, correspondence, and transactions with LAFPP.

Agreed. This will continue to be done on an ongoing basis in our document imaging system.

Recommendation 32

LAFPP Management should subject the healthcare subsidy program to the same accounting verification process as all other monthly pension roll payments.

Agreed. Staff implemented an accounting verification process for the health subsidy program beginning with the November 2013 pension roll.

Recommendation 33

LAFPP Management should examine what additional measures could be adopted to enhance physical security in the current office space.

Agreed. LAFPP will explore what additional measures can be taken and perform a cost benefit analysis of those additional measures.

Recommendation 34
LAFPP Management should develop a comprehensive physical security plan for the new LAFPP office space.

Agreed. Management is already incorporating a comprehensive security plan into the design of the new office building.

Recommendation 35
LAFPP Management should continue the search process for a successor technology system which can integrate the components of the benefit administration process including calculations, automated workflow administration, controls, as well as the payment process.

Agreed.

Recommendation 36
LAFPP Management should add expected turnaround times for internal processing, where appropriate, to staff's Desk Manual.

Agreed.

Recommendation 37
LAFPP Management should evaluate all member-facing information and publications to ensure that disability application processing turnaround times are consistently communicated.

Agreed.

Recommendation 38
The LAFPP Board and Management should evaluate the informal practice currently used to schedule Board hearing dates and explore ways to enhance timeliness.

Agreed. Staff will work with the Board to enhance the timeliness of disability hearings.

Recommendation 39
The LAFPP Board and Management should shift some of the burden of information submission to the member as part of the disability application process.

Staff will research the matter and bring a supported recommendation to the Board.

Recommendation 40
The LAFPP Board and Management should determine what other common practices, such as delegating specific decision-making authority or retaining a Board medical advisor, could streamline the process, and what changes to governing law, policies or procedures would be necessary to do so.

Staff will research the matter and bring a supported recommendation to the Board.

Recommendation 41
LAFPP Management should continue to develop a formalized succession plan for key Disability Pension Section staff, specifically including an individual development plan for each staff member in that Section.

Agreed. Management will continue to develop a succession plan on an ongoing basis.

Recommendation 42
LAFPP Management should ensure that each Disability Pension Section staff member receives a performance evaluation no less than annually.

Agreed.

Recommendation 43
LAFPP Management should expand the Disability Pension Section performance metrics and standards so that they incorporate service quality.

Staff is fully committed to implementation of performance metrics and accordingly, will research the matter and bring a supported recommendation to the Board.

Recommendation 44
LAFPP Management should explore how to meaningfully tie individual performance evaluations and Section performance into the stated goals of LAFPP's strategic plan.

Staff will research the matter and bring a supported recommendation to the Board.

Recommendation 45
The LAFPP Board should require that each new Commissioner receives prompt training on all topics stated on the New Board Member Orientation table, and provide additional training on the duty of loyalty.

Agreed. Staff will work with each new Board member to ensure prompt training is provided.

Recommendation 46
LAFPP Management should establish a fiduciary responsibility training requirement for new staff who have fiduciary responsibilities, and provide ongoing training annually.

Agreed.

Recommendation 47
The LAFPP Board should establish and follow a regular review schedule for the Board policies that do not currently have formal review periods.

Agreed.

Finally, we appreciate the recognition of the significant impact of economic downturn in 2008-2009, and LAFPP's efforts to mitigate its impact on the City's budget. Without LAFPP's efforts to help the City mitigate the effects of the downturn, the City's financial position would have been substantially weaker during that time. Knowing that pension contributions continue to be at historic levels, we will continue seeking ways to efficiently manage the System to control administrative costs, mitigate investment and operational risks, and improve administration of plan benefits to our members.

Very truly yours,

Raymond P. Ciranna
General Manager

RPC:EJK:CD