WENDY GREUEL
CONTROLLER

June 27, 2013

Honorable Antonio R. Villaraigosa, Mayor
Honorable Members of the Los Angeles City Council
Board of Fire and Police Pension Commissioners
Los Angeles City Employees' Retirement System Board of Administration

The City's pension systems are among the most significant determinants of the City's fiscal sustainability, protecting both our City's employees and taxpayer dollars. Today, I am releasing interim reports on two of the City's pension systems, Los Angeles City Employees' Retirement System (LACERS) and Los Angeles Fire and Police Pension Fund (LAFPP). Both audits assessed the effectiveness of the Systems and whether they have successfully minimized the impact on taxpayer dollars for City contributions. The audits found that while both pension systems have made strides towards implementing past audit recommendations, there are still a number of changes that can be made to ensure the protection of taxpayer dollars.

The audit found that for LACERS, administrative costs were higher than other similar agencies, and alternate fund management options could have been used, potentially reducing the impact on the City's General Fund. The implementation of the audit recommendations could save LACERS millions of dollars, infusing desperately needed dollars into the City's core services. For the LAFPP, the audit found several ways to improve the evaluation of underperforming investment managers to ensure that the highest rate of return could be achieved.

The City must make every effort to protect and to maximize taxpayer dollars, and this means taking a close look at the City's pension systems, ensuring that every dollar is spent wisely, and decreasing the burden on the City's taxpayers. This also means further evaluating the pension system, looking for additional cost-sharing opportunities to protect the City's long term future. I urge both LACERS and LAFPP to implement the recommendations immediately.

Sincerely,

W. Greuel

WENDY GREUEL
City Controller

WENDY GREUEL
CONTROLLER

June 27, 2013

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 first Charter-mandated audit of the Los Angeles Fire and Police Pensions was issued on December 3, 2007 and contained 169 recommendations.

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. As a means to provide timely information to decision-makers and the public, the Joint Administrators determined that the audit results would be presented in two reports; an Interim Report and a Final Report.

The attached "Management Audit Interim Report of the Los Angeles Fire and Police Pension Fund" (LAFPP) is focused on five audit objectives, including an assessment of the implementation status of the prior audit recommendations. The Interim Report includes the following topics:

- Whether the administration of LAFPP resulted in minimizing City contributions;
- Whether administrative expenses have been properly defrayed and cost-sharing with the City's other pension systems has been pursued;
- LAFPP's investment performance evaluation process;

- Whether LAFPP has assessed the cost-benefits associated with active and passive management; and

- Determination as to whether investment consultants and asset custodian services can be consolidated with the Los Angeles City Employees' Retirement System to achieve savings.

Attached to the Interim Report is a response from the Department of Fire and Police Pensions which indicates agreement with all of the recommendations. The remaining audit objectives will be addressed in the Final Report that will be completed in the upcoming months.

Hewitt EnnisKnupp is conducting the management audit of LAFPP on behalf of the City. If you have any questions about the report, please contact Farid Saffar, Director of Auditing, at (213) 978-7392.

Sincerely,

WENDY GREUEL
City Controller

ANTONIO R. VILLARAIGOSA
Mayor

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

Enclosure

cc: Honorable Carmen Trutanich, City Attorney
Gaye Williams, Chief of Staff, Office of the Mayor
Raymond P. Ciranna, Interim General Manager, Dept. of Fire and Police Pensions
Miguel A. Santana, City Administrative Officer
June Lagmay, City Clerk
Gerry F. Miller, Chief Legislative Analyst
Independent City Auditors

Hewitt ennisknupp
An Aon Company

May 9, 2013

Joint Administrators
City of Los Angeles

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

Dear Joint Administrators:

Hewitt EnnisKnupp is pleased to present the attached *Management Audit Interim Report of the Los Angeles Fire and Police Pension Fund*. Please let us know if you have any questions or concerns.

Thank you for the opportunity to work on this important project. We look forward to completing Phase II of the Management Audit.

Sincerely,

Nancy A. Williams

Nancy Williams
Partner

Jeanna Cullins
Partner

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Management Audit

Interim Report

of the

Los Angeles Fire and Police Pension Fund

May 9, 2013

Hewitt ennisknupp
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Table of Contents

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Executive Summary

Hewitt EnnisKnupp (HEK) has been retained by the City of Los Angeles and its Joint Administrators[1] through a competitive bidding process to perform a Management Audit of the Los Angeles Fire and Police Pension Fund (LAFPP). The full scope of work for the Audit is found in Appendix B.

Upon request from the Joint Administrators, HEK expedited consideration of the following issues in this Interim Report.

- Progress toward recommendations made in the prior management audit
- Objective 2: Whether the administration of LAFPP resulted in minimizing City contributions
- Objective 4: Whether administrative expenses have been properly defrayed and if cost-sharing has been pursued
- Objective 7 (b) and (c): Whether the investment policies are clear and reasonable, manager performance is adequately evaluated, and how underperforming managers are dealt with
- Objective 9: Whether the costs and benefits of active versus passive management of assets have been adequately evaluated
- Objective 12 (e): Whether costs can be minimized by consolidating investment consultants and custodian bank services for LAFPP and LACERS

LAFPP administers the defined benefit retirement plan for almost 26,000 City of Los Angeles sworn employees, including police, fire, and certain port police. The LAFPP Board of Administration oversees a diversified investment portfolio holding assets exceeding $14 billion as of June 30, 2012. LAFPP has a staff of over 100 employees, with an administrative expense budget of nearly $17 million.

This Management Audit is to analyze LAFPP's administrative and investment policies, procedures and practices in order to provide information related to the objectives described above. The following is a summary of our analyses.

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[1] The Joint Administrators is composed of the Mayor, City Council, and Controller.

Overall Assessment

From our review we found that LAFPP implemented the vast majority of the prior management audit recommendations, but nine of the recommendations that they reported as completed were not fully implemented and should be revisited.

LAFPP has set a reasonable investment return assumption for actuarial purposes, which affects contribution amounts, but it should engage 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.

In comparing LAFPP's administrative expenses to its peers, one method of comparison results in a conclusion that its expenses are lower than average, while another method shows that expenses are higher. Conference travel expenses, however, are reasonable.

The investment processes we reviewed for the interim report were sound overall. Fees charged by their investment service providers were reasonable for the size and complexity of the investment program. We made several recommendations that could improve the investment policies and processes.

Prior Audit Recommendations Implementation

The last Management Audit conducted by Independent Fiduciary Services in 2007 resulted in 169 recommendations for LAFPP's consideration. The Board meeting materials indicate that it considered but took no action on 29 of the recommendations, and completed the remaining 140.

Our review of LAFPP's actions regarding the recommendations showed that several of the recommendations that the Board stated were completed did not entirely address the issues behind the recommendations. Although it is not necessary for the Board to fully complete all of the recommendations because reasonable minds can differ on what is a best practice, it is important to at least consider all of them. We did identify nine recommendations that were not fully implemented that we would encourage the Board to reconsider.

Objective 2

Our analysis in Objective 2 of whether the Board has taken appropriate steps to minimize the City's contributions looked primarily at the actuarial factors affecting the cost of the plan benefits. The other factors that can affect plan costs, administrative expenses and investment earnings, were analyzed in other objectives within this interim report or will be addressed in the final report.

LAFPP's actuarial cost method is used by 80% of public pension plans, and is appropriate. The actuarial assumptions the Board has adopted, including the expected investment return assumption of 7.75%, are proper and consistent with common practices in the public pension plan arena. LAFPP's unfunded actuarial accrued liabilities are scheduled to be retired within 30 years, which is consistent with Generally Acceptable Accounting Principles set for state and local governments by the Governmental Accounting Standards Board. The target of obtaining a 100% funded ratio is in line with best practice as established by the Government Finance Officers Association. Finally, the City's employer contribution has equaled 100% of the Annual Required Contribution from 2007 to 2012. Because the City contributions are primarily driven by the costs of the benefits and the investment earnings, the administration does not have a significant impact on the City's costs.

Our only recommendation regarding Objective 2 is that LAFPP perform asset/liability modeling every three to five years. LAFPP has not done asset/liability modeling for over ten years, and so may not have sufficient information on the underlying risks of the investment program and its implications for the plan's future costs.

Objective 4

For Objective 4 we analyzed whether LAFPP's administrative expenses, including travel expenses, were reasonable, and if there were untapped opportunities for cost-sharing that might lower those 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. Some of the possible reasons for the high cost-per-member include a very low number of inactive members, an emphasis on customer service, and the relatively high labor costs in Los Angeles.

LAFPP's trustee travel expenses were reasonable. The policies and procedures for requesting travel and reimbursement for any travel were consistent with the City Administrative Code, and provide more consideration of the expense and value of travel than most of the peers. LAFPP should continue to monitor the timeliness of reimbursement requests to ensure compliance with policy and the City Code.

The Board has engaged in some cost-sharing with the Los Angeles City Employees Retirement System (LACERS) by sharing some office space for Board and staff meetings and engaging the same outside legal counsel when both LAFPP and LACERS were making investments with the same investment manager. LAFPP also requires its investment managers to contractually agree to a fee structure that aggregates any investments made by LAFPP, LACERS and the Water and Power Employees' Retirement Plan (WPERP) when determining fees. LAFPP has no other cost-sharing arrangements, and the only other practical option we identified was sharing legal counsel for fiduciary education sessions.

Objective 7

Objective 7 focuses on the process LAFPP uses for evaluating investment performance. The Board Investment Policies clearly address the investment objectives, the criteria and frequency of investment manager evaluations, and the process for dealing with underperforming managers, including termination. We did, however, identify several recommendations that could improve the policies and the overall investment evaluation process.

LAFPP's process for evaluating investment managers and taking action regarding underperforming managers is also appropriate. The Board and staff closely monitor underperforming managers and take decisive action. The performance reports on which the Board and staff rely are comprehensive and provide significant information for manager monitoring. We did, however, make a few recommendations on additional information and processes that will be helpful.

Objective 9

Objective 9 provides an analysis of LAFPP's use of active versus passive management and the costs involved. Twenty-two percent of LAFPP's total assets are managed passively, which is higher than a peer group survey conducted by Greenwich Associates.[2] The survey showed that, on average, peers manage 18% of their assets passively. From a total portfolio perspective, LAFPP's investment manager fees for fiscal year 2011-2012 are reasonable for the size, complexity and structure of the investment program; the data was not available for us to analyze fees for the previous four years in this interim report, but it will be included in the final report. Our recommendations included a more regular analysis of the active versus passive management decision, including the related costs and benefits.

Objective 12

We analyzed the feasibility of consolidating investment consultants and custodian services with LACERS in Objective 12. LAFPP's use of a general investment consultant and specialty consultants is common among large public pension plans. LAFPP's consulting fees are reasonable, and we determined that while consolidating with LACERS may result in a small fee reduction, it would not be material when compared to overall expenses and LAFPP's assets under management. Further, LAFPP has a very competitive fee arrangement with its custodial bank, and consolidation would not be likely to reduce fees.

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

Recommendations from Interim Report

Item Number	Recommendations
1	Reconsider the completion of recommendations 2a/23, 2f/02, 2g/04, 3c/02, 3c/04, 3e/05, 3e/06, 3e/07 and 3e/12 from the prior management audit.
2	Conduct an asset/liability modeling every three to five years.
3	Continue to examine ways to become more efficient in processing benefits and collaborate with peers about their cost control efforts
4	Establish administrative budgets that more tightly control spending rather than budgets that are well beyond what is needed and actually spent
5	Continue to monitor the timeliness of travel expense reimbursement requests to ensure compliance with Board policy and the Los Angeles Administrative Code
6	Ensure that Trustees stay within the limit of six conferences per fiscal year
7	Continue to re-evaluate the value of various conferences and forgo attending those that are too expensive for the amount and type of education they provide
8	Include a description of liquidity needs and risk tolerance in the Board Investment Policies
9	Consider whether 80% NCREIF ODCE[3] Index (net) and 20% DJ[4] U.S. Select Real Estate Securities is a more appropriate real estate benchmark
10	Amend the Board Investment Policies to require a comparison of investment returns against a total fund policy benchmark that reflects the target asset allocation approved by the Board
11	Update the watch list quarterly and expand the watch list criteria to include longer term performance against benchmarks and peer rankings
12	Refine the policy for removal of a manager from the watch list
13	Document the due diligence process used in the ongoing monitoring of managers
14	Prepare documentation following each due diligence visit, including summaries of and any changes in organization, personnel, stategy, or style
15	Prepare and follow a schedule to update material portions of the Board Investment Policies
16	Include holdings-based style analyses in the consultant's quarterly reports
17	When evaluating the potential termination of a manager on the watch list or whose contract is up for renewal, increase focus on factors such as material changes in personnel, ownership, clients or assets under management, and investment style in addition to past performance
18	Enhance documentation from investment manager calls and meetings, even if there are no significant findings
19	Benchmark the overall allocation between passive and active management

[3] National Council of Real Estate Investment Fiduciaries Open-End Diversified Core Equity.
[4] Dow Jones.

Item Number	Recommendations
	against peers at least every five years as part of the portfolio structure review
20	Have the investment consultant provide a report that shows whether LAFPP is receiving adequate additional returns from active equity and fixed income managers
21	Clarify and document the role of Portfolio Advisors through an updated contract and seek lower fees, if appropriate

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.

Introduction

The Los Angeles City Charter Section 1112 requires a management audit to be performed on each of the City retirement systems every five years. Hewitt EnnisKnupp, Inc., (HEK) was selected pursuant to a request for proposals to conduct the management audit on the Los Angeles Fire and Police Pension (LAFPP) system. This report is an interim report designed to address specific issues requested by the Joint Administrators.

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 of nearly $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. We had available to us resources 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)[5] to some degree.

This report represents the work of HEK from December 2012 to April 2013 and includes its independent findings, analyses, conclusions and recommendations. The review was limited to those topics outlined in the preceding table of contents. It was not an all-encompassing examination or investigation of LAFPP. This report provides reasonable assurance that the practices set forth in the findings are accurate, but it should not be construed as an absolute guarantee that all of the 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 did not independently verify all facts that were provided by those third parties, including LAFPP; however, we did request that key sources 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 the LAFPP attempted to unduly influence the scope, findings, analyses, conclusions, or recommendations expressed in this report.

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

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Progress toward Recommendations made in the Prior Management Audit

Findings

In 2007 the Joint Administrators engaged a consulting firm, Independent Fiduciary Services (IFS), to perform a Charter-mandated management audit of the Los Angeles Fire and Police Pension Fund (LAFPP).[6] The audit period was July 1, 2000 through January 11, 2007. The Management Audit Report issued on November 27, 2007 provided 169 recommendations to the LAFPP for its consideration. The Board, certain Board committees, and executive staff at LAFPP worked collaboratively to review every recommendation and prioritized them according to importance. They systematically addressed the most critical issues first.

The LAFPP Board's Audit Committee conducted the initial review of the 169 recommendations. The Audit Committee reported to the full Board on March 20, 2008, that 88 of the recommendations were either completed or the Audit Committee recommended no action. The Board agreed with the Audit Committee's determinations regarding the 88 recommendations, and the remaining recommendations were assigned to the Board's standing committees or, in the case of investment-related recommendations, to the full Board. The Board has determined that every prior management audit recommendation has now been either completed or the Board has determined to take no action.

Analysis

HEK assessed the status of each recommendation by reviewing pertinent documents, addressing questions to staff, checking with outside service providers, asking questions to representatives from the City Attorney's Office, and discussing items with Commissioners on the Board. HEK's role was to assess the status and report progress and not to opine upon the validity or soundness of the prior recommendations. The chart in Appendix A summarizes our analysis.

Conclusions

In our professional judgment we believe LAFPP was prompt in reviewing and prioritizing the recommendations and made steady progress over a period of 5 years toward addressing each of them. We found that several of the recommendations that the Board determined were completed did not completely address the underlying recommendation or the reason behind the recommendation. In our opinion it is not necessary that LAFPP accept all recommendations because reasonable minds can differ regarding what is a best practice. From a fiduciary

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[6] Los Angles City Charter Section 1112.

standpoint, however, it is important that all be considered and either accepted (in whole or in part) or rejected with sound rationales to support the decisions.

Recommendation

1. Reconsider the completion of recommendations 2a/23, 2f/02, 2g/04, 3c/02, 3c/04, 3e/05, 3e/06, 3e/07 and 3e/12 from the prior management audit. If further consideration is given, the decisions and rationales for them should be documented and provided to the Joint Administrators.

I. Objective 2. Determine whether the administration of LAFPP resulted in minimizing City contributions.

Scope

The issues we reviewed for this objective include:

- The impact of LAFPP's actuarial cost method and assumptions on contributions
- The effect of the benefit structure on contributions
- LAFPP's analyses of the plan liabilities and its asset allocation

Investment performance can have a significant impact on pension costs and therefore contributions. It will be addressed in more depth in Objectives 3, 5, 6, 7, 9 and 12 of the final report. Administrative expenses are reviewed in Objective 4 of this interim report.

Findings

The California constitution applies to LAFPP and, in part, states:

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.[7]

Because the Board members' duty of loyalty is paramount to the secondary goal of minimizing employer contributions, the issue becomes whether the Board, while maintaining the primary duty of loyalty to the participants and beneficiaries, has taken appropriate steps to achieve the minimization of City contributions.

City and employee contributions are directly tied to pension costs. The universal equation for the long term pension costs of a public or private pension fund is the same.

Pension Costs = Benefits + Expenses – Investment Earnings

To minimize contributions, the three factors of benefits, administrative expenses in the operating budget, and net investment earnings must all be taken into account. The largest costs for pension funds are the benefits, which is the focus of this section of the report. City contributions are primarily impacted by the actuarial liabilities associated with the benefit

[7] California Constitution, Art. XVI, § 17. Section 1106 of the Los Angeles City Charter contains a similar requirement, as does the LAFPP's Governance Principles.

promises the pension fund supports and to some degree are impacted by the level of employee contributions. LAFPP has no control over either the benefits or the employee contributions; both are determined by the City through its development of the retirement plans. The administrative expenses have relatively little impact on the contributions.

The City is responsible for the pension costs that remain after taking into account the employee contributions and investment earnings. Thus, City contributions can go down if the investment earnings rise. Pursuing higher investment earnings, however, usually comes with increased risk. Therefore, it is best to optimize investment earnings within a reasonable level of risk.

In fiscal year 2011-2012, LAFPP had an investment loss of $802 million which directly impacted the City's contributions. The total effect on the unfunded actuarial accrued liability of that loss combined with the employer and member contributions and actuarial gains and losses is provided in table 2-A, below.

Table 2-A – Change in Unfunded Actuarial Accrued Liability from June 30, 2012 Actuarial Valuation.

1. Unfunded actuarial accrued liability at beginning of year	$2,278,806,857
2. Total normal cost at beginning of year	385,690,664
3. Actual employer and member contributions	-441,692,557
4. Interest	177,959,705
5. Expected unfunded actuarial accrued liability[(1)]: (1) + (2) + (3) + (4)	2,400,764,669
6 Actuarial (gain)/loss due to all changes:	
(a) Investment loss	802,393,983
(b) Salary increases less than expected	-277,758,910
(c) COLA increases less than expected for retirees	-108,995,547
(d) Other experience gain[(2)]	-37,484,543
(e) Total changes	378,154,983
7. Unfunded actuarial accrued liability at end of year: (5) + (6e)	$2,778,919,652

The employer and member contributions were just enough to cover the value of new benefits earned (or the normal cost). Since the investment earnings for the fiscal year ending June 30, 2012 was below the 7.75% actuarial assumption for investment earnings, the $802 million investment loss contributed significantly to the increase in the unfunded liability.

Analysis

To determine whether LAFPP has taken steps within its Constitutional and statutorily-defined authority to minimize the City's contributions, we must analyze the following:[8]

[8] "Developing a Pension Funding Policy for State and Local Governments," David Kausch and Paul Zorn (Gabriel Roeder Smith & Co., 2012).

1. Is the actuarial cost method used by LAFPP appropriate?
2. Are the actuarial assumptions reasonable?
3. Does the asset valuation and smoothing of asset values make sense?
4. Is the length of the amortization period reasonable for the plan?
5. Is a funding target of 100% the right target?
6. Given the changing demographics, has the management of investment risk been handled properly?
7. Are long term costs well understood, has the intergenerational transfer of costs been avoided, and have actuarially determined contributions been made?

Actuarial cost method

LAFPP uses the "Entry Age Normal" (EAN) actuarial cost method, which calculates costs by projecting each member's service credit and salary to an assumed (expected) retirement date to come up with the expected benefits. The costs of those benefits are allocated over the member's working career as a level percentage of their pay. This is the best method for plan sponsors of ongoing plans, like governments, to use if they want to avoid volatility in the contribution rates.[9] EAN is used by about 80% of public pension plans.[10] We believe the EAN method is appropriate.

Actuarial assumptions

The Board sets the pension plan's actuarial assumptions (both demographic and economic) based on advice from its actuary. Demographic assumptions relate to mortality rates and patterns of service retirements, disability retirements, and terminations of employment, among other things. Economic assumptions are based on expectations of inflation, changes in wages, and future investment returns. While there is some flexibility in setting assumptions, the assumptions must be in line with the Actuarial Standards of Practice.[11]

The Segal Company is LAFPP's actuary. Segal performs annual actuarial valuations to determine required contributions. Every three years Segal conducts an "experience study" to review the current assumptions and, if warranted, recommend changes to those assumptions. The most recent experience study was conducted for the period from July 1, 2007 through June 30, 2010.

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[9] Alternative methods exist. The Projected Unit Credit (PUC) method is used by approximately 10% of public pension plans. Under the PUC method, future benefits are determined using increases in service for the current year and a projected salary as of an individual's retirement date. The required contribution can vary each year, and typically results in lower contributions than the EAN method at the beginning of a career and higher contributions later. The Traditional Unit Credit (TUC) method only looks at service and salary increases in the current year, and does not project them to retirement. The TUC method is not generally used for public pension plans.

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

[11] The Actuarial Standards Board (ASB) sets the standards. "[Actuarial Standards of Practice] are intended to provide actuaries with a framework for performing professional assignments and to offer guidance on relevant issues, recommended practices, documentation, and disclosure." "Introduction to the Actuarial Standards of Practice", (ASB, 2008).

To manage demographic risks, regular actuarial experience studies should be conducted. Those studies detect changes in the participants' demographics, such as mortality and retirement rates, and show how accurate the assumptions have been. If a system waits too long before discovering those changes, the result could have a dramatic impact on the system's funded status. Performing an experience study every year is too costly and unnecessary but performing one at least every five years is a best practice. LAFPP has an experience study conducted every three years, which is in line with common and best practices.

Of all the actuarial assumptions, the investment return assumption is the most important determinant of normal costs, actuarial accrued liabilities and, ultimately, the required contributions. The investment return assumption is what drives the discount rate used to calculate the present value of future liabilities. If the assumption is too high, the liabilities will be understated and the contributions will be too low. If the assumption is too low, the liabilities will be overstated and the contributions will be too high.

LAFPP has been using an investment return assumption of 7.75% since 2010; prior to that LAFPP used 8.00%. This change in the assumption was based upon advice from Segal and in-depth discussions among the Board and staff.

From our independent review of the investment portfolio from 2007 to June 30, 2012, and using our capital market assumptions, we believe that there is a 50% chance that the investment returns will be 7.56% (with an estimated range of 6.64% to 8.48% given a 30-year time frame). Because of the uncertainty around all such assumptions, we believe that the 7.75% investment return assumption is reasonable. While this assumption is unique to the specific asset allocation of LAFPP, it is interesting to note that in a recent survey of 126 large public pension funds across the country, 79% have investment return assumptions between 7.50% and 8.00%.[12]

Asset valuation and smoothing

The volatility of financial markets can create dramatic swings in the market value of a pension plan's assets. If contributions were based on the market value of a pension plan's assets, the contributions would also rise and fall dramatically depending on the financial markets. Mitigating those swings and calculating a reasonably consistent contribution level are typical goals for public pension plans.

One tool that pension plans can use to achieve those goals is to "smooth" investment gains or losses. "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

[12] "NASRA Issue Brief: Public Pension Plan Investment Return Assumptions", National Association of State Retirement Administrators (2013).

in the actual market value of a pension plan's assets, and helps maintain a consistent contribution level.

The length of the smoothing period is a Board decision and varies by pension plan. The professional standards that guide actuaries require them to use smoothing methods that result in values that fall within a reasonable range of the actual market values, and recognize any differences within an acceptable time period. For that reason, pension plans that use a smoothing period longer than five years usually also use "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.

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 also uses a 40% corridor on the actuarial value of assets. LAFPP increased the smoothing period and corridor range in 2009 in order to reduce the impact of volatile financial markets, including the market decline in 2008-2009, on the City's contribution level. We believe the seven-year smoothing period and 40% corridor are reasonable approaches to reduce the volatility of the contributions.

Amortization period

The phrase "amortization period" typically refers to the time frame over which a pension plan's unfunded actuarial accrued liability will be paid. The Governmental Accounting Standards Board, which establishes Generally Acceptable Accounting Principles for state and local governments, has set a maximum amortization period of 30 years for a public pension plan's unfunded actuarial accrued liability. If the amortization period is much shorter than 30 years, the volatility of the contribution level could be very high. If the amortization period is longer than 30 years, the gains and losses would be recognized too slowly and would increase the risk of transferring costs to future generations of employees, known as the "intergenerational transfer of costs".

According to LAFPP's June 30, 2012 actuarial valuation, the amortization period for any changes in surplus or unfunded liability due to actuarial gains and losses is 20 years. Based on the current schedule of amortizations, the longest remaining period of amortization as of June 30, 2012 is 29 years. The amortization periods are therefore reasonable and in compliance with the Governmental Accounting Standards Board's requirements.

Funding target

The Government Finance Officers Association has issued a statement that having a target of a 100% or more funded ratio is a best practice.[13] That statement is consistent with our

[13] "Sustainable Funding Practices of Defined Benefit Pension Plans", Government Finance Officers Association (2009).

understanding of funding target best practices. LAFPP's funding target of 100% is therefore appropriate.

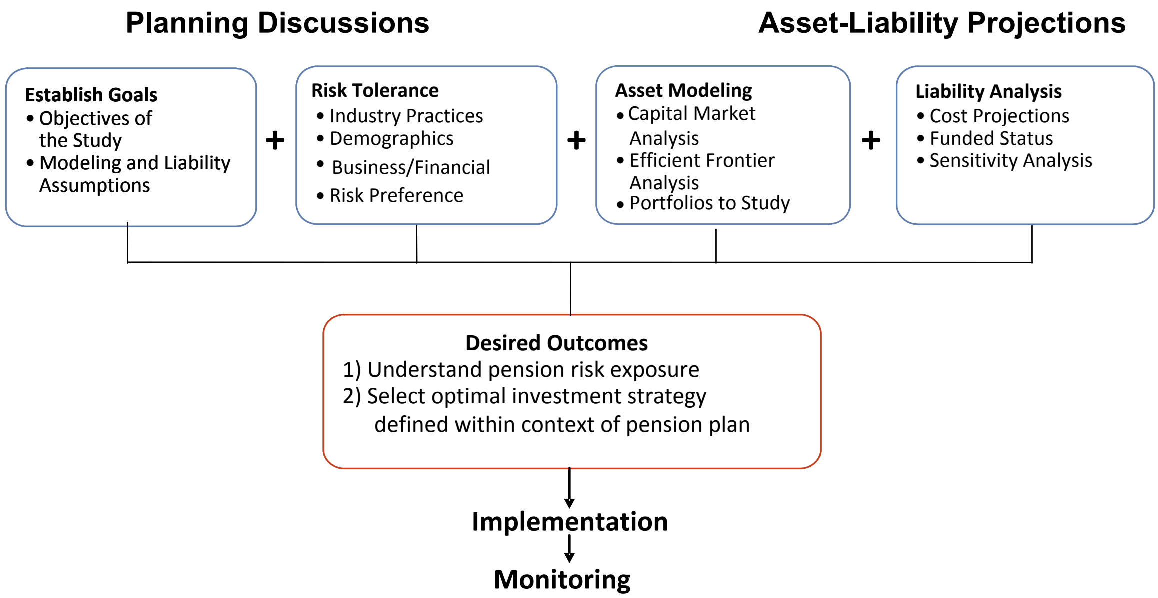
Investment risk

The careful management of investment risk, in light of demographic changes, can also provide stability in contribution rates and serve to minimize them. Investment risk is managed primarily by the types of asset classes used in the portfolio (stocks, bonds, real estate, etc.) and how assets are allocated to each. For a pension plan, its asset allocation drives the investment return assumption, which in turn impacts the required contribution rates. However, a plan's overall investment risk, while significantly influenced by the asset allocation, is assessed most effectively by looking through a multi-year, integrated asset/liability view.

The traditional approach of investing assets, focusing primarily on asset allocation without regard to the liabilities, funded status, or the level of interest rates, does not work well in today's challenging investment environment. Instead, to manage the plan's contributions and funded status requires in-depth analysis of the plan's liabilities and a strategy to manage the assets and liabilities together. For this reason, many of the large public pension plans use an integrated approach and have asset allocations that are an outcome of both asset/liability modeling and asset allocation studies.

Asset/liability modeling is a comprehensive process that models the possible future results of different asset allocations under a variety of conditions. The modeling does not assume the same conditions during the entire time period, but allows for changes in conditions during the period. Examples of "conditions" include good equity markets, poor equity markets, high inflation, low inflation, and other similar topics. The results are the costs that could be expected to be generated by a specific asset allocation. It provides information which allows for a more informed discussion about the appropriate asset allocation, and helps decision-makers understand the worst possible outcomes of a particular asset allocation so they can determine whether it is worthwhile to change the plan's risk exposure. Asset/liability modeling also provides a unique perspective since it incorporates the characteristics of the plan's cash flows (i.e., cash contributions and benefit payments). If the nature of the cash flows for the pension plan is ignored, the review of the plan's asset allocation would only address risk versus return of the individual asset classes and how they are correlated.

The chart below illustrates the steps in the development of an asset allocation which considers both assets and liabilities. This integrated approach provides a more holistic view. In our experience, asset/liability modeling and a formal asset allocation study are typically performed every 3-5 years. The best practice is every three years.



The LAFPP Board Investment Policies requires an asset allocation study at least every five years, which is consistent with common and best practices. As we noted earlier, asset allocation studies do not, however, take into account the liability characteristics of a pension plan. They only focus on the risk and return profile of the asset classes themselves, and help to create an asset allocation that provides the greatest return for a given amount of risk.

LAFPP has not done asset/liability modeling for more than ten years. Asset/liability modeling should be conducted to ensure that the level of risk being taken is reasonable, and the absence of such modeling in the development of the asset allocation is not in alignment with common and best practices of other public pension plans. Asset/liability modeling would provide additional insights so that the decision-makers can be assured that the future uncertainty of the plan's financial results has been quantified and are acceptable for them.

<u>Long term view</u>
To minimize the City's contributions it is important that the long term costs of benefits (including both increases and reductions) are well understood by the decision-makers. To maintain stability and fairness in contribution rates, benefits should be paid for as they are accrued. Costs should not be shifted to future generations of employees.

The level and stability of contributions is also impacted by whether the required actuarially-determined contributions were made on time. Over the long term, contributions should be sufficient to cover the normal costs and the amortization of the unfunded actuarial accrued liability. According to the 2012 actuarial valuation report, the actual employer contributions have equaled 100% of the normal costs (also referred to as the Annual Required

Contributions (ARC)) from 2007 to 2012 and have also included contributions to cover portions of the unfunded actuarial accrued liability.

The major benefit change over the past five years has been the addition of the Tier 6 pension plan in 2011. Determination of the costs of adding Tier 6 was the City's responsibility, not LAFPP's. The City Administrative Officer reported that the City commissioned ten actuarial studies as it considered possible changes to include in a proposed Tier 6, including the final Tier 6 provisions. The City Administrative Officer's October 15, 2010 report to the City Council and Mayor's office stated that, for every 1,000 new employees, Tier 6 would save the city $173 million over a 30-year period.

Conclusions

The City contributions are primarily driven by the costs of the benefits and the investment earnings, and to a lesser extent by administrative expenses.

With regard to the costs of the benefits and the resulting liabilities, we believe that the actuarial cost method and the assumptions are reasonable. The asset valuation and smoothing techniques are also reasonable and quite common. The amortization is in line with professional standards in the public fund industry. Having a 100% funding target is a best practice. Contributions from the City have been in line with the actuary's determination of normal costs and the amortization of the unfunded liability. Both the City and the employees have made contributions in a timely manner.

The management of investment risk can be improved by conducting asset/liability modeling to provide a more comprehensive picture of the impact of liabilities and cash flows on the future financial situation of the pension plan.

The long term view of the pension costs seems to have been carefully considered by the City when the new tier was created. LAFPP was not involved in the calculations of the costs of the new tier.

Recommendations

2. Conduct an asset/liability modeling every three to five years.

II. Objective 4: Determine whether administrative expenses have been properly defrayed and if cost-sharing has been pursued[14]

Scope

The issues we reviewed for this objective include:

- the operating budget of LAFPP, excluding investment-related expenses
- a comparison of the operating budget to those of peer organizations
- opportunities for cost sharing
- costs and reasonableness of Trustee travel
- compliance with travel laws and policies

Findings

Operating Budget

The LAFPP General Manager and staff create the proposed operating budget for LAFPP, which includes the City's contribution for the upcoming fiscal year. The Board Operating Policies require the General Manager to present the proposed budget to the Board and the Mayor, the City Administrative Officer, and the Controller by April 1 of each year. The Board's Audit Committee reviews the Budget and makes a recommendation to the Board. Once the Mayor and the City Council have approved the final budgets of the Police and Fire Departments, the Board does a final review of the proposed budget. The Board must adopt a final budget by June 30 each year. The final budget is submitted to the Mayor and City Council as an informational item.

The operating budget and actual operating expenses for LAFPP for the past five years are summarized in Table 4-A below. These expenses do not include any expenses related to investments except for the expenses for internal investment staff.

[14] The full text of Objective 4 is in Appendix B.

Table 4-A – Operating Budget and Actual Expenses for LAFPP Administration

Fiscal Year	Budget	Actual Expenses[15]	Increase in Actual Expenses Over Prior Year	Percent Increase Over Prior Year
2007-2008	$15,169,500	$12,373,185	$743,064	6.4%
2008-2009	17,226,500	13,362,266	797,320	8.0%
2009-2010	17,130,361	13,561,437	199,171	1.5%
2010-2011	17,156,299	13,442,947	(118,490)	-.9%
2011-2012	16,932,535	14,497,811	1,054,864	7.8%

Analysis

LAFPP has stayed within its budget each of the past five fiscal years.[16] The increase in actual expenses has averaged 4.6% per year, with a low of -.9% for fiscal year 2010-2011 and a high of 8.0% for fiscal year 2008-2009.

To ascertain the reasonableness of the LAFPP administrative expenses, we made comparisons to peer organizations. The peers were selected by HEK with input from the Joint Administrators and LAFPP. In making the peer group selection we took into account the asset size, membership size, geographic location, and the type of employees covered.

Below we list the peers in alphabetical order and summarize their information.

[15] Administrative expenses include the costs for administering the retiree health subsidy to be consistent with the budget numbers, which do not break out retirement versus retiree health subsidy costs.

[16] LAFPP reports that beginning in fiscal year 2012-2013 it has attempted to more closely align the budget projections with actual anticipated expenditures.

Table 4-B – Peer Comparison

Peer	Asset Size	Membership[17]	Fiscal/ Calendar Year	Administrative Expenses[18]	Cost Per Member	Basis Points
Arkansas Teacher Retirement System	$11.89 Billion	121,318	2010-2011	$7,548,959	$62.22	6.35
Employees' Retirement System of Georgia	15.48 Billion	179,249	2010-2011	21,465,000	119.75	13.87
Fire & Police Pension Association of Colorado*	3.41 Billion	31,169	2011	7,029,799	225.54	20.62
Los Angeles City Employees' Retirement System	9.23 Billion	48,269	2010-2011	13,232,000	274.13	14.33
Los Angeles Fire and Police Pension	**13.52 Billion**	**25,883**	**2010-2011**	**12,662,000**	**489.20**	**9.37**
Ohio Police & Fire Pension Fund***	10.47 Billion	54,447	2011	15,427,237	283.34	14.73
Orange County Employees Retirement System	8.69 Billion	39,116	2011	12,828,000	327.95	14.76
Public Safety Personnel Retirement System of Arizona	6.84 Billion	51,738	2010-2011	7,708,263	150.03	11.27
Public Employee Retirement System of Idaho**	12.38 Billion	126,621	2010-2011	6,077,880	48.00	4.91
Sacramento County Employees' Retirement System	6.14 Billion	12,434	2010-2011	8,207,000	660.05	13.37
San Francisco Employees' Retirement System*	15.60 Billion	52,299	2010-2011	16,965,000	324.38	10.88
School Employees Retirement System of Ohio***	10.98 Billion	204,968	2010-2011	24,040,061	117.29	21.89

*Also administers a 457 program
**Also administers a 401(k) program
***Assets and expenses include health plan assets and administrative costs that could not be separated out

[17] "Membership" includes actives, retirees, beneficiaries and inactive members.
[18] The administrative expenses exclude investment-related expenses except for investment staff, and expenses for administering a health plan or subsidy.

A common way to compare the administrative costs of retirement systems is to look at total administrative expenses compared to asset size, which is measured in basis points. LAFPP has the third-lowest ratio of costs to assets, at 9.37 basis points. That shows that LAFPP's administrative expenses compare favorably to its peers. Another way to compare retirement systems is to look at the administrative cost per member. When measured in that manner, LAFPP does not fare as well; LAFPP has the second-highest cost per member at $489.20. A number of factors could contribute to the higher cost per member, including:

- The complexity of LAFPP's retirement plans, including six different tiers of benefits
- The Deferred Retirement Option Plan (DROP), which adds another level of complexity to the administration of the retirement plans
- A very low number of inactive LAFPP members, who typically require the least amount of effort to administer
- Expenses related to significant recent information technology changes
- A "high-touch" level of service to its members which requires more staff time
- Labor costs in the Los Angeles area
- Staff time related to having two Board meetings per month, whereas the boards of most peers meet much less than that

Of the seven factors we note above, LAFPP only has or had control over two – the information technology changes and the level of service it provides its members. We do not find any of the factors to be unreasonable.

In addition to the peer comparison above, we reviewed two proprietary surveys. One examined administrative expenses for nine California public retirement systems. The costs per member in that survey ranged from $110 to $390. The other survey covered eleven public retirement systems nationwide, two of which were from California, and those costs per member ranged from $50 to $290.

While LAFPP's cost per member is high, the impact of administrative expenses is relatively small in the overall cost of the system. To put it in perspective, in the 2012 actuarial valuation, the total normal cost of benefits plus the amortization of the unfunded liability was $588 million. The administrative expenses for the same time were $12.7 million. Therefore, for every dollar of benefit funding, LAFPP spent about 2 cents on administration.

Conclusion

From interviews and meeting minutes we conclude that the Board carefully considers costs when setting the budget. The staff makes an effort to operate well within the budget, and has been successful all five years of this study; actual expenses have not exceeded the budget during the study period. While the actual expenses have never exceeded the budgeted amounts, the expenses have increased by an average of 4.6% per year.

In comparing the ratio of administrative expenses to plan assets with those of peers, LAFPP's administrative expenses are below most peers. However, in comparing administrative costs per member, LAFPP's administrative expenses are higher than most peers. Many factors could influence LAFPP's administrative cost per member. It is difficult to say which comparison is more meaningful.

The administrative expenses, while significant in dollar terms, are not large enough to have an impact on the unfunded liability or the City's contributions.

Recommendations

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

Findings

Cost Sharing

The prior management audit made several recommendations to consolidate the investment functions of LAFPP and LACERS. As a result of those recommendations, the LAFPP Board directed staff to request a legal opinion regarding any limitations on the recommended consolidation. The legal opinion provided by Morrison Foerster analyzed the language added to the California Constitution by Proposition 162 that gives public employee retirement boards the sole authority over the investments and administration of their systems. Their opinion was that consolidation would not be possible without amendments to both the Constitution and the statutes that govern city public retirement system investments.

As a result of that opinion, LAFPP has actively pursued cost-sharing opportunities with LACERS and the Water and Power Employees' Retirement Plan (WPERP) to the extent that it believes it can, through investment manager contracts and some space-sharing. LAFPP requires investment managers, by contract, to give it a price break if two or more of the funds invest with the same manager within the same mandate (such as a small cap growth product). In that case, the manager will charge fees to LAFPP based on the aggregated amount, rather than LAFPP's individual amount, which may result in reduced fees. LAFPP and LACERS have made investments with the same manager in the past, and have achieved a small amount of fee savings as a result.

LAFPP and LACERS have never sought the same type of investment manager at the same time, which is why so few of their investments overlap. LAFPP does, however, monitor LACERS' investments and notes when LAFPP is considering a manager currently used by LACERS. Also, the two funds do share due diligence on managers when possible and this reduces staff time and costs. We provide additional discussion on the feasibility of consolidating investment consultants or custodian services in Objective 12.

LAFPP and LACERS had considered jointly purchasing a building, but LACERS chose to lease a new property instead, and is currently under a five-year lease with an option to extend it for five more years. Before LACERS vacated its space in the same building as LAFPP, the systems shared a large meeting room in the building for Board meetings and other large gatherings. LACERS recently moved to a different building, but despite this LAFPP still holds its Board meetings at LACERS' current facility in an effort to save costs. The cost for LAFPP to lease the Board meeting room space in its current building is $3,000 per month, which they are saving by using LACERS' facility.

LAFPP recently signed a purchase agreement for a building, and is currently going through the inspection process on that property. LAFPP performed an analysis of leasing versus ownership of its own building, and concluded that ownership was prudent for a number of reasons.

- The annual costs would be lower than for leasing
- LAFPP would experience equity build-up over time
- The space can be designed for the most efficient utilization
- LAFPP would have complete control over facility operations and security

LAFPP has previously considered occupying city-owned space, but was advised by the city that there was no suitable space available at the time.

LAFPP has not discussed cost-sharing possibilities regarding technology with the other City retirement systems. The LAFPP pension administration system has been customized to their particular retirement plan and the different tiers it administers. Since the last management audit, LAFPP has moved its pension administration system completely off of the City's mainframe, and is now responsible for hosting the system. The Board and staff believe this allows LAFPP to more closely control the reliability of the system, increases its ability to fulfill its responsibility to pay benefits in a timely manner, and ensures that business can continue in the event of a natural or man-made disaster.

Other types of services that all three Los Angeles City retirement systems use include actuarial and legal services, and medical professionals for disability-related claims. The systems are required to use the City Attorney's office for their general legal work, and contract with outside law firms for special purposes, such as investment contracts or fiduciary issues. The systems now pay for the City Attorney's work based on the work actually performed for the systems, and LAFPP monitors the City Attorney's invoices.

When LAFPP and LACERS have both made investments with the same investment manager in the same time frame, they have been able to realize cost-savings by using the same outside counsel to negotiate the contracts with the investment manager for both systems at the same time. There have been no other discussions between the systems regarding possible cost-sharing for outside counsel, actuaries or medical professionals.

Analysis

The Board has a fiduciary responsibility to incur only reasonable expenses for administering the system. Evaluating whether there are possibilities to reduce costs is therefore a prudent exercise.

Costs related to office space were discussed at numerous Board meetings. Staff's analysis of leasing office space versus purchasing a building provided the Board with a number of reasons to purchase. Those reasons included the overall cost of leasing versus purchasing, the possibility of enjoying increases in the value of the property, and increased efficiency and security. While LAFPP also identified some reasons not to purchase, such as property management and capital ownership issues, the Board determined that the reasons to purchase were persuasive. Unless the current purchase agreement is terminated for some reason, LAFPP will not be able to realistically consider any further options for office sharing.

The possibility for LAFPP to reduce costs through technology sharing with LACERS is very low. LAFPP and LACERS each administer very distinct retirement plans, and have pension administration systems that are customized to obtain data and perform calculations that are unique to each system and each tier within the system. Based on our experience, the expense and administrative effort to move both systems onto a common pension administration system would be excessive compared to the potential benefits of doing so.

The current way each of the three Los Angeles retirement systems pays for City Attorney services, on an hourly basis, is a significant improvement from previous practice, which was based on an estimate of time spent. Each system is only paying for the services it actually receives.

Outside legal services are compensated on an hourly basis. The expenses are generally for advice related to fiduciary issues/education and investments. Although the systems could negotiate with fiduciary counsel to provide joint fiduciary education presentations, for specific fiduciary questions they each would need their own counsel.

For investments, LAFPP and LACERS have been able to realize some cost savings by using the same outside counsel to negotiate investment manager contracts. Doing so is an efficient way to approach those negotiations, and may help the systems realize benefits other than cost savings because of the size of their combined investments. Those benefits may include obtaining better terms or other concessions as a result of their combined efforts.

The costs for actuarial services are for actuarial valuations, experience studies and actuarial audits. These are plan-specific and so no economies of scale can be achieved with these services.

The compensation for medical professionals involved with disability retirement determinations is based upon the number and type of disability cases they review. Accordingly, we do not see any potential cost-savings of co-contracting for these services.

Conclusions

LAFPP has been able to share costs with LACERS on occasion when using outside counsel to negotiate investment manager contracts. With the exception of sharing costs for fiduciary education sessions presented by legal counsel, we have not identified any other practical situation in which LAFPP could reduce administrative expenses by cost-sharing with the other City retirement plans.

Recommendations

No recommendation

Findings

<u>Board Travel Expenses</u>
Trustees are reimbursed for their reasonable travel expenses to attend educational conferences, but not mileage expenses to attend Board meetings.[19] The LAFPP Travel and Education Policy encourages Trustees to attend at least two educational conferences a year, and limits each Trustee to a maximum of six per year. The maximum was reduced from eight to six in September 2009. The California Association of Public Retirement Systems (CALAPRS) one-day Trustee Roundtable does not count toward the six-conference maximum. It should be noted that educational sessions are also conducted for the Board by staff and consultants during regular Board meetings and at the Board's annual retreat and not only at conferences.

All travel is pre-authorized. The Travel Guidelines for Trustees provides a helpful flow-chart for Trustees to follow regarding travel requests and reimbursement. The process is designed to conform to the travel reimbursement requirements of the Los Angeles Administrative Code.[20]

Requests for travel that have been included in the fiscal year budget are submitted to the Board as a consent agenda item, and must include an estimate of the total expenses.

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[19] Commissioners do not attend investment manager due diligence visits.
[20] Sections 4.242.1 through 4.242.9.

Requests to attend a conference that was not part of the fiscal year budget must be submitted to the Board for action on the regular agenda. Only conferences that have an average of five hours of substantive educational content per day are approved. The Board receives quarterly and annual reports on all Trustee (and staff) travel.

The cost for travel is dependent upon the number of conferences the Trustees attend. Table 4-C shows the lowest attendance rate for a Trustee, the highest attendance rate for a Trustee, and the average conference attendance per Trustee.

Table 4-C – Trustee Conference Attendance per Fiscal Year

Fiscal Year	Low	High	Average
2007-2008	0	8	3.5
2008-2009	0	7	2.5
2009-2010	0	5	3.5
2010-2011	0	7[21]	2
2011-2012	0	4	4

A sample of the conferences that the Trustees attended in the last five fiscal years is shown in the table below. While this table is not all inclusive, it does represent approximately 80% of the conferences. Many of the conferences are held within California, including conferences sponsored by the California Association of Public Retirement Systems, the State Association of County Retirement Systems, and the Stanford Law School.

Table 4-D – Sample of Conferences Attended by Trustees

California Association of Public Retirement Systems (CALAPRS)	Fiduciary College of Stanford Law School
State Association of County Retirement Systems (SACRS)	National Association of Investment Companies
National Conference on Public Employee Retirement Systems (NCPERS)	National Association of Securities Professionals
International Foundation of Employee Benefit Plans (IFEBP)	Alternative Investments Forum
World Pension Forum	Council of Institutional Investors (CII)

Trustees must submit a Personal Expense Statement within ten days of the conclusion of the trip or at the next scheduled Board meeting, whichever is later, for expense reimbursement. Trustees must provide original receipts for any single expenditure over

[21] The seven conferences one trustee attended in FY 2010-2011 did not include the CALAPRS Trustee Roundtable, and so was outside of the policy limit of six. The trustee's seventh conference was reviewed and approved by the Board.

$25.00 other than for meals, which are paid on a per diem basis. Board policy restricts the reimbursable amount of expenses as follows.

- Airfare – coach or economy fare
- Personal Vehicle – mileage costs based on IRS guidelines
- Ground Transportation – the least expensive or most practical form of transportation taking into consideration time, availability, and personal health or safety factors
- Meals – the highest allowable Federal per diem rate for any U.S. City according to IRS guidelines, reduced to 75% of that rate for first and last days of travel or when meals are provided at the conference
- Lodging – the conference rate, if any, or the most economical or practical accommodations
- Other travel expenses are allowable if they are deemed necessary for the conduct of LAFPP business.

All expense statements are reviewed by LAFPP's Chief Accounting Employee for compliance with the travel policy, including City Administrative Code provisions, before reimbursement is paid.

The total expenses for Trustee travel, including conference fees, are shown in the table below.

Table 4-E – Trustee Travel Expenses per Fiscal Year

Fiscal Year	Conference Expenses	Average Expense Per Trustee
2007-2008	$29,576.62	$3,286.29
2008-2009	49,508.23	4,125.69
2009-2010	57,427.36	5,220.67
2010-2011	40,516.10	3,683.28
2011-2012	64,441.71	8,055.21

The LAFPP Internal Audit Section conducted a travel expenditures audit in 2012 to evaluate whether travel expenditure reimbursements for fiscal year 2011-2012 were valid and administered consistently with City and LAFPP policies. The audit concluded that the reimbursements were valid and administered properly. The audit did identify two deficiencies. The first was in the accounting reports for travel, which were not structured in a manner that allowed the most efficient monitoring of the travel activities. The second was in the process for monitoring the timeliness of reimbursement requests, and following up with individuals who were late in submitting their documentation. Staff reports these deficiencies were addressed once they were identified.

According to Board policy, Trustees cannot accept a third-party's offer to pay travel expenses to attend a conference. Trustees may attend that conference at LAFPP's expense if attendance would benefit the system.

Analysis

The duty of prudence requires fiduciaries to be fully informed when making decisions affecting the trust and its administration. The duty of prudence, specifically the prudent expert standard, also states that the actions of trustees will be compared to those of other trustees charged with similar responsibilities. Knowing what others do is something that is gained at conferences. Travel and related costs for attending educational conferences are therefore legitimate expenses for LAFPP as long as the costs are reasonable and the conferences provide a sufficient level of education.

Conferences supplement the education provided by staff and outside consultants and service providers during Board meetings and retreats. The Board's internal education program provides basic information for the Trustees that helps them understand the additional education provided at conferences.

The LAFPP Travel and Education Policy recognizes the balance between the responsibility to be informed and the responsibility to only incur reasonable expenses for the administration of the plan. Pre-authorization of all travel through the budget process or specific agenda items allows Board oversight of travel costs and the educational benefit of the proposed conferences. Limitations on allowable expenses provide further assurance of the reasonableness of the travel costs.

LAFPP's minimum of two and maximum of six conferences per year is consistent with the four peer systems from which we received travel and education policies. The peers encourage a minimum of one to two educational conferences a year. One peer limits trustees to three out-of-state conferences per year or a maximum amount of $6,000, whichever is lower. Other peers allow up to six conferences per year, and one allows up to six but sets a cap of $10,000.

LAFPP Trustees must obtain Board approval for all travel in advance, which is more restrictive than most peers. Only one other peer requires Board approval for all travel; other peers only require Board approval for travel to conferences for which there is no blanket or automatic authorization.

The travel expense reimbursement process is consistent with the Los Angeles Administrative Code requirements. The Internal Audit Section's identification of issues relating to tardy expense reimbursement requests lead to positive changes to LAFPP's monitoring of those requests.

The conferences the Trustees attended over the five-year time period were primarily sponsored by well-known organizations and are respected in the industry. The programs at the Wharton school (through IFEBP) and Stanford are known to be some of the best in the country, and the CALAPRS, NCPERS and CII programs are also near the top of any list of informative educational conferences for trustees.

The Board has a policy that outside service providers (investment managers and consultants) cannot pay for any travel expenses. Although the policy may increase the costs to the system to attend educational conferences should Trustees choose to attend without the expense payment, the policy helps the Board avoid the conflict of interest questions that could arise from accepting travel expenses from service providers.

Conclusions

The Board Travel and Education Policy provides a good framework for ensuring that travel expenses are reasonable and for the furtherance of Trustee education and the interests of the system and its beneficiaries. The reimbursement process complies with Los Angeles Administrative Code provisions on travel expenses. Continued monitoring of the timeliness of expense reimbursement claims will ensure compliance with the Policy and the Administrative Code.

The travel approval process provides more consideration of the expenses and the value of educational conferences than most of the four peers. Requiring Board authorization prior to making travel arrangements ensures continuing oversight of the costs and benefits of the conferences. However, the seven conferences attended by one Trustee in fiscal year 2010-2011 was outside the policy limits.

The conferences attended by the Trustees are sponsored by well-known, well-respected organizations, and are known to provide informative sessions for pension plan trustees.

Prohibiting the acceptance of travel expenses from service providers helps prevent even the appearance of a conflict of interest. The avoidance of a potential conflict of interest is worth the incremental cost to the system of paying for the travel from system funds.

Recommendations

5. Continue to monitor the timeliness of travel expense reimbursement requests to ensure compliance with Board policy and the Los Angeles Administrative Code
6. Ensure that Trustees stay within the limit of six conferences per fiscal year
7. Continue to re-evaluate the value of various conferences and forgo attending those that are too expensive for the amount and type of education they provide

III. Objective 7: Investment performance evaluation process[22]

Scope

The issues we reviewed for this objective include:

- The Board Investment Policies related to investment objectives and manager evaluations
- The adequacy of processes to evaluate manager performance and address underperforming managers

Findings

Board Investment Policies
The Board Investment Policies contain the following sections that are pertinent to this Objective:

- Investment Objectives
- Performance Monitoring
- Manager Selection and Retention

The Investment Objectives section addresses the purpose of the LAFPP, the investment objectives, diversification requirements, manager account restrictions, Board and staff referral restrictions for potential new investments, and guidelines for cash, real estate and securities lending.

The Performance Monitoring section covers the frequency of performance evaluation, the methods of return calculation for stocks and bonds versus alternative investments, and comparison/benchmark platforms. The Board Investment Policies state that the total fund is to be compared against other pension funds as well as the actuarial rate of return. It also requires that individual investment managers be compared against their stated objectives and against managers of the same investment mandate.

The Manager Selection and Retention section covers the general attributes that managers are expected to possess and includes the qualitative and quantitative factors that will be used to select and monitor the managers. The Watch List Policy is included in this section and highlights the reasons an investment manager is added to or removed from the Watch List, how often the Watch List is updated, and the actions that are required to be taken once a manager is put on the Watch List. The Policy also lists the factors that the Board and staff

[22] The full text of Objective 7 is in Appendix B.

must analyze before making a final decision on whether to terminate a manager, which it has done in the past.

Eight of the fourteen sections of the Board Investment Policies require the Board to review them on specific dates. The other six sections either require review and revision as necessary, or do not contain a review statement.

Analysis

The Board Investment Policies contain most of the elements we expect in an ideal set of investment policies. One omission, however, is the lack of any information on the liquidity needs of the Plan. It is useful to recognize somewhere in investment policies that the liquidity needs are an important factor in setting the asset allocation and deciding upon the degree to which illiquid investments can be utilized.

Another objective that the Investment Policies do not address, which we ordinarily find in such policies, is a general description of the Plan's risk tolerance and the degree of volatility the Board is willing to accept for individual mandates as well as for the overall portfolio. This was also a recommendation in the prior management audit (number 3e/05). That recommendation was not adopted.

One of the primary functions of pension plan fiduciaries is to study and articulate an appropriate level of risk for the portfolio. From a quantitative standpoint, the first step in developing the risk posture is asset/liability modeling which takes into consideration the nature of the liabilities, sensitivity of the liabilities and assets to varying market and economic conditions, plan demographics, need for liquidity, etc.

The Board's Investment Policies do not clearly state the need to conduct asset/liability modeling as a precursor to the asset allocation decision. There is some risk analysis that is conducted as part of the asset allocation study; however, the analysis is fairly rudimentary in that it assesses the expected risk of the portfolio, but does not address the issue of what is the prudent level of risk for the fund. Without in-depth asset/liability modeling, there is the potential that the level of risk that the fund is bearing may be too low or too high for its circumstances.

The Performance Monitoring section of the Board Investment Policies appropriately describes the frequency and method of monitoring performance. The benchmarks appear to be appropriate for the specific asset classes, with the minor exception of the real estate. The current real estate benchmark is a blend of 85% of the NCREIF ODCE Index (net) and 15% of the DJ U.S. Select Real Estate Securities. The use of a blended benchmark is appropriate as well as the use of the net version of the NCREIF ODCE Index, as it is a better fit. However, the actual percentages of each index component should be reviewed.

Based on LAFPP’s 9% target and actual June 30, 2012 allocation to real estate (7% private, 2% REITS), a split of 80%/20% may be more appropriate.

The most thorough investment policies also require a comparison to the total fund policy benchmark. This provides a more meaningful performance comparison because it is the truest measure of the risk/return profile that a board has chosen.

The Manager Selection and Retention policy provides helpful detail regarding parameters that staff and the investment consultant must use when evaluating new managers as well as monitoring current managers. One deviation from best practices relates to LAFPP’s “watch list” which contains names of investment managers with sub-par performance. The watch list is not updated consistently. Managers may be placed on the watch list at any time due to stylistic or organizational changes. However, when the concern is performance-related, managers are only placed on and removed from the watch list annually. Once a manager is placed on the watch list for any reason, the manager must stay on the watch list until the next annual watch list review. Although the watch list summary includes the most recent quarter's performance for those managers on the watch list, the actual list does not change quarter to quarter. A reader of the quarterly reports might be led to believe the list is updated more frequently since it appears in every quarterly report.

We understand from discussions with staff that the reason it is only updated annually for performance issues is that LAFPP believes more frequent updating does not present the entire picture on which a retention or termination decision should be made.

LAFPP’s current criteria for placing managers on the watch list is when their performance is below the median of their peer group over the trailing one-year period, or when significant changes occur in portfolio management personnel or the manager’s style. Short term poor rankings in the universe should not be the major reason for placing a manager on watch. Other performance factors should be evaluated in conjunction with recent peer rankings. These include the manager’s 1-, 3- and 5-year performance against the benchmark along with the 3- and 5-year peer rankings.

In addition, the only reasons stated in LAFPP’s watch list criteria for removing a manager from the watch list are that the short- and long-term performance has sufficiently improved, or the contract has been terminated. Additional criteria should be considered for removal of a manager from the watch list if the investment performance changes so that it meets or exceeds its investment benchmarks. Managers could also be removed if the Board understands why the investment manager is not meeting or exceeding its stated benchmark and is comfortable that the fund is still meeting the objectives for which it was chosen. Additionally, managers could be removed from the watch list if the qualitative factor which put them on the list has been rectified or the Board understands and feels comfortable with the investment manager's action to address the issues.

We understand the staff has an informal, ongoing due diligence process in place for investment managers, including reviewing performance attribution of the fund, evaluating the rationale of the manager's decisions, and assessing the fund's role in the overall investment program. However, no formal due diligence process is documented in the Board Investment Policies. While it is not absolutely necessary that the due diligence process be part of the Board policies, it is best practice to have it documented. At the very least it should be a documented staff procedure.

Staff extends an open invitation to all current managers to visit the LAFPP office, but this procedure does not ensure research coverage of all investment managers. It is a best practice to conduct a formal due diligence review on managers annually, particularly for the public market asset classes, in addition to the quarterly performance monitoring. This due diligence process should be documented in policy.

Conclusions

The Board Investment Policies clearly articulate LAFPP's investment objectives and establish clear criteria and the frequency for conducting investment manager evaluations, the process for dealing with underperforming managers, and circumstances for manager termination. The Policies also define how performance should be measured, at both the total fund and individual manager levels. Total fund performance is compared to other pension funds and the actuarial assumed rate of return, but not to a total fund policy benchmark.

The Board Investment Policies with regard to manager selection and retention are thorough and cover most foreseeable contingencies; however, the watch list is only updated once a year, and the policies do not fully address the due diligence process. The best investment policies require quarterly updates to the watch status and contain a formal due diligence process.

In order to assure that the Board Investment Policies 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 and the entire document should be regularly reviewed by staff and the Board.

Recommendations

8. Include a description of liquidity needs and risk tolerance in the Board Investment Policies
9. Consider whether 80% NCREIF ODCE Index (net) and 20% DJ U.S. Select Real Estate Securities is a more appropriate real estate benchmark
10. Amend the Board Investment Policies to require a comparison of investment returns against a total fund policy benchmark that reflects the target asset allocation approved by the Board

11. Update the watch list quarterly and expand the watch list criteria to include longer term performance against benchmarks and peer rankings
12. Refine the policy for removal of a manager from the watch list
13. Document the due diligence process used in the ongoing monitoring of managers
14. Prepare documentation following each due diligence visit, including summaries of and any changes in organization, personnel, stategy, or style
15. Prepare and follow a schedule to update material portions of the Board Investment Policies

Findings

Manager performance evaluation processes

The Board Investment Policies require investment performance to be reviewed and evaluated quarterly using an outside performance measurement firm. The Board's general investment consultant, RV Kuhns, provides those quarterly investment performance reports and also conducts initial manager searches. The LAFPP staff is primarily responsible for maintaining ongoing relationships with the Fund's current managers.

RV Kuhns' reports provide detailed analytics for each manager and a summary of managers on the watch list. The reports include remarks about managers' trailing performance records and peer group rankings, but they do not provide analysis or commentary detailing any additional reasons for a manager being on the watch status. Additionally, the quarterly reports do not provide an analysis of the managers' styles and whether those styles have changed over time.

To monitor each investment manager's compliance with their specific investment guidelines, LAFPP utilizes the Northern Trust Compliance Analyst monitoring system. That system allows LAFPP to establish investment parameters for each investment manager which the system continuously monitors. If the system identifies a violation of an investment manager's guidelines, it immediately sends staff a notification of the violation.

Underperforming investment managers are placed on the watch list and are requested to make a presentation at a Board meeting within a year after they are initially placed on the watch list. After this initial meeting, additional meetings and follow-ups are conducted at the Board's discretion. In a few cases, the Board has had certain managers appear at meetings to discuss their performance and circumstances.

Board and staff prepare thorough reports reviewing investment manager contract renewals and terminations. Contract renewals are generally for a three-year period. These reports include background information of when and why the manager was hired, an overview of the manager's investment style, a brief summary of the manager's growth and current assets under management, key personnel, any personnel changes, along with a brief overview of performance – leading to the conclusion to renew or terminate the contract.

Analysis

The generalist consultant, RV Kuhns, produces quarterly performance reports which are comprehensive and detailed. However, the information on why a particular manager is on the watch list is limited to the managers' trailing performance records and peer group rankings. An ideal performance report would also include additional information and analysis about why a manager is struggling and falling below expectations. The best performance reports also include holdings-based style analytics in order to ensure that a manager is demonstrating style consistency over time.

When reviewing a manager's underperformance, it is a common and best practice to consider the manager's particular strategy in the context of the overall economic and market environment. Often, underperformance can be explained by the fact that the current environment isn't rewarding a particular investment strategy. In this case, a hasty termination of a manager would not be warranted.

The role and fit of the manager within the overall portfolio needs to be considered at all times, too. There may be instances when it is appropriate to keep an underperforming manager who operates in a non-traditional or illiquid asset class where there are few other managers to choose from, or when it is too expensive to transition to a new manager.

Staff's reports on investment manager contract renewals and terminations are detailed, and generally involve a manager due diligence visit as part of the review process. While the consultant does not consistently participate with staff in these due diligence visits, they do review the reports and indicate whether they support staff's recommendation to renew or terminate a particular manager. In the course of their work for other clients, RV Kuhns often has contacts with LAFPP's managers.

With the exception of contract reviews, and legal or investigative action concerning investment managers, staff does not prepare and maintain post-meeting notes. It is our understanding that the consultant also does not provide regular manager research or formal ratings for the managers in LAFPP's investment program. A best practice is for both staff and consultants to maintain manager research documents and notes from each manager visit to summarize findings and opinions.

When the Board and staff consider manager renewals, performance and fees are considered. Other important qualitative factors, including the strength of the organization and team, investment process, compliance systems and controls, are not given as much consideration in the decision-making process. These factors can provide useful information to a fiduciary when they are considering whether to renew a manager's contract.

Conclusions

The Board and staff appear to comply with the Board Investment Policies. They are diligent about monitoring and meeting with underperforming managers and they take decisive action when it is called for, including adding managers to the watch list and terminating them when necessary. In addition, LAFPP utilizes the Northern Trust Compliance Analyst monitoring system to further monitor whether managers are trading within their established investment guidelines.

The consultant's quarterly performance reports are comprehensive, but could be more beneficial to the Board and staff if they also included an analysis on why certain managers are underperforming. Including information on managers' holdings-based style would be useful, too.

Staff maintains ongoing dialogue with investment managers, and prepares reports at the time of contract renewals to document their due diligence. Evidence of the ongoing due diligence activities could be strengthened by documenting and maintaining notes after routine interactions with investment managers, even if there are no material developments. Thorough documentation is best practice not only for formal on-site meetings, but also for informal updates during telephone calls. It serves to demonstrate prudence should the fiduciaries ever be challenged on the wisdom of their decisions.

Consideration of investment manager contract renewals appears to be accompanied by adequate information for the Board to make sound decisions, with the exception of a thorough evaluation of the manager's qualitative factors. When evaluating whether to renew a manager's contract, LAFPP should also assess the strength of the organization and team, the manager's investment process, and systems in place for internal controls and compliance.

Recommendations

16. Include holdings-based style analyses in the consultant's quarterly reports
17. When evaluating the potential termination of a manager on the watch list or whose contract is up for renewal, increase focus on factors such as material changes in personnel, ownership, clients or assets under management, and investment style in addition to past performance
18. Enhance documentation from investment manager calls and meetings, even if there are no significant findings

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IV. Objective 9: Assess cost-benefits associated with active and passive management.

Scope

The issues we reviewed for this objective include:[23]

- Percentage of active versus passive management used by LAFPP compared to peers
- Size of allocation to a single manager
- Investment management fees by asset class
- LAFPP's cost-benefit analysis of active versus passive management

Findings

<u>Current level of active and passive management</u>
Table 9-A reflects the breakdown of LAFPP's passive versus active management by asset class. Only the traditional marketable securities (public equities and fixed income) were used. This is because alternative asset classes represent skill-based asset classes and, as such, passive investments across these asset classes generally do not exist.

Table 9-A - Passive vs. Active Management by Asset Class - *As of June 30, 2012 ($, in millions)*

	Domestic Equity		International Equity		Fixed Income		TOTAL	% of TOTAL
Passive	$ 2,100	43%	$ 426	16%	$ 532	16%	$ 3,058	28%
Active	$ 2,825	57%	$ 2,207	84%	$ 2,796	84%	$ 7,828	72%
TOTAL	$ 4,925		$ 2,633		$ 3,328		$ 10,886	100%

- 28% of LAFPP's traditional assets are passively managed. If the alternative assets (private equity, real estate and hedge funds) were included, the overall passive portion of the LAFPP portfolio would decrease to 22% from 28%.

  – Approximately 7% of LAFPP's total assets were invested in domestic equity enhanced indexing strategies, which some refer to as "passive plus", but we categorize as active strategies.
  – The passively managed large cap equity assets of $2 billion constituted 43% of LAFPP's total domestic equities.
  – The passively managed international equity assets of $426 million constituted 16% of LAFPP's international equities.

[23] The full scope of this objective is provided in Appendix B.

– The passively managed fixed income assets of $532 million constituted 16% of LAFPP’s fixed income exposure.

LAFPP’s single largest exposure to any single investment management firm is with Alliance Capital, which manages the Fund’s passive large cap equity allocation. As of June 30, 2012, Alliance Capital managed three passive mandates of approximately $2.1 billion: the LAFPP’s S&P 500 portfolio, a large cap domestic value equity index portfolio (Russell 1000 Value Index), and a large cap domestic growth equity index portfolio (Russell 1000 Growth Index). The goal of each portfolio is to achieve benchmark returns at the lowest possible cost within LAFPP’s targets for tracking error. Each of these portfolios has achieved the stated goal over time.

The passive portfolios managed by Alliance represent approximately 15% of LAFPP’s total assets. The Board Investment Policies state that no investment management firm shall manage more than 20% of the Total Fund assets, except for passively managed index funds. Although, Alliance falls within the exception as a passively managed index fund, it still manages less than 20% of the Total Fund.

Blackrock and Northern Trust manage LAFPP’s two additional passive mandates. Blackrock manages LAFPP’s international equity passive allocation – an EAFE Index portfolio. As of June 30, 2012, the Blackrock passive mandate represented approximately $426 million, or 3% of the LAFPP’s total assets. Northern Trust manages LAFPP’s passive fixed income allocation, which, as of June 30, 2012, was approximately $532 million, or 4% of the LAFPP’s total assets.

Table 9-B reflects the fees paid for passive versus active management by asset class. For the reasons noted earlier, alternative asset classes are excluded.

Table 9-B – Fees paid for Passive vs. Active Management by Asset Class – *As of June 30, 2012 ($, in millions)*

Strategy	Domestic Equity	Fees (in bps)	International Equity	Fees (in bps)	Fixed Income	Fees (in bps)	TOTAL
Passive	$ 0.238	1.1 bps	$ 0.157	3.7 bps	$ 0.229	4.3 bps	$ 0.624
Active	$ 7.807	27.6 bps	$ 10.058	45.6 bps	$ 5.113	18.3 bps	$ 22.978
TOTAL	$ 8.045		$ 10.215		$ 5.342		$ 23.602

The investment management fees associated with LAFPP’s passive mandates were approximately $624,000. The active management fees for traditional marketable securities were approximately $22,978,000.

Table 9-C lists the total investment management fees for the LAFPP investment program by asset class using the June 30, 2012 total assets and allocation.[24]

Table 9-C - Investment Management Fees - ***As of June 30, 2012 Assets ($, in millions)***

Asset Class	Assets	Fees	Fees as a % of TOTAL ASSETS
Domestic Equities	$ 4,925	$ 8.046	5.7bps
International Equities	$ 2,632	$ 10.215	7.2bps
Fixed Income	$ 3,327	$ 5.341	3.8bps
Hedge Funds	$ 570	$ 5.698	4.0bps
Private Equity	$ 1,192	$ 12.988	9.1bps
Real Estate – REITS	$ 262	$ 1.163	0.8bps
Private Real Estate	$ 987	$ 7.865	5.5bps
Cash	$ 302	--	--
TOTAL	**$ 14,200**	**$ 51.316**	**36.1bps**

The investment management fees associated with the LAFPP's investment program amount to approximately $51 million per year, or roughly 36 basis points (bps) of the LAFPP's total asset base.

Table 9-D lists LAFPP's aggregate costs in managing the investment program: investment management fee plus related investment costs (e.g. consultant and custodian costs).

Table 9-D - Aggregate Costs Investment Management

Fee Category	Amount
Investment Management	$ 51,316,173
General Consultants[25]	$ 375,000
Other Consultants[26]	$ 225,000
Custodian[27]	$ 0
Total	$ 51,916,173
Total as % of Total Assets	**0.37%**

The aggregate costs associated with managing the LAFPP's investment program is 37 basis points per year.

[24] Fees for July 1, 2007 through June 30, 2011 were not available in time for analysis in this report.
[25] LAFPP's General Consultant is RV Kuhns
[26] The Other Consultant's fees includes LAFPP's Real Estate consultant the Townsend Group
[27] There is a zero cost agreement with the custodian Northern Trust, contingent upon LAFPP's utilization of Northern Trust's securities lending program.

Analysis

As of June 30, 2012, Alliance Capital managed approximately $2.1 billion in passive mandates for LAFPP, which represented nearly 15% of LAFPP's total assets. This percentage is consistent with the LAFPP's Board Investment Policy percentage limitations. While the large exposure to one single investment manager may appear unusual, given the nature of passive management we believe that the allocation – both in absolute terms and as a proportion of total assets – is appropriate and in-line with best practices. Index funds offer low-cost, broadly diversified exposure to a particular asset class or segment of an asset class. Larger index funds offer economies of scale to their investors since the costs associated with managing the funds are spread across a larger asset base. Further, investment managers with larger funds that also have a widely diversified base of investors offer their investors the ability to minimize costs associated with trading since an investor's trade order may be offset against that of other investors.

A significant use of indexation within an investment program not only provides broadly diversified exposure to the asset classes, it also helps maintain low investment management fees. Approximately 33% of LAFPP's total domestic and international equity investments were managed on a passive basis. In addition, roughly 16% of LAFPP's fixed income assets were managed passively.

With respect to the active managers used within the program, we note that the assets are broadly diversified among a number of external managers, and no single investment manager constitutes more than 6% of LAFPP's total assets. Most equity portfolios are 3% of total assets or smaller, and the largest of the fixed income actively managed portfolios is approximately 4.7% of total assets.

The Greenwich Associates 2012 Market Trends Analysis reported that the 46 large public pension funds (those with over $5 billion in assets) held an average of 39% of their domestic equities portfolios in index mandates, and 18% of their international equities portfolio in index mandates, as compared to 43% and 16% respectively for LAFPP. Thus, compared to the Greenwich Associates peer group of large public pension funds, LAFFP has a higher allocation to passively managed assets within the domestic equity portfolio, and a lower allocation to passive investments within the international equity portfolio.

Sixteen percent of LAFPP's fixed income portfolio is passively managed. This is higher than the 13% for the Greenwich Associates survey of large public pension funds.

Conclusions

The large exposure to Alliance is acceptable, given that all accounts managed by Alliance are passively managed. The LAFPP's exposure to active management is well diversified, with no significant exposure to any one investment manager.

Fee comparisons are provided in Tables J through N, below, and show that the aggregate investment management costs of LAFPP are reasonable relative to peers. This is due in part to the size of the investments LAFPP places with investment managers, allowing it to take advantage of maximum break points.

LAFPP's use of passive investments and indexation helps to keep the cost of the investment program low and also provides diversification. As part of its portfolio structure review, LAFPP may want to evaluate a greater allocation to passive mandates across equities as a means of lowering cost further and gaining diversified exposure to the broad markets.

Note: In the Final Report, we will examine whether the active managers have generated value net of fees.

Recommendations

19. Benchmark the overall allocation between passive and active management against peers at least every five years as part of the portfolio structure review
20. Have the investment consultant provide a report that shows whether LAFPP is receiving adequate additional returns from active equity and fixed income managers

Findings

<u>LAFPP's Use of Active and Passive Management and the Related Costs</u>
Third party industry data provides the following information for comparison with LAFPP.[28]

Table 9-E - Target Allocation

	LAFPP Target Allocations as of June 30, 2012	Greenwich Average – Large Public Funds > $5 Billion[29]
Domestic Equity	29%	27%
International Equity	21%	22%
Fixed Income	22%	27%
Commodities	5%	1%
Real Estate	9%	7%
Private Equity	9%	7%
Hedge Fund	4%	4%
Cash	1%	1%
Other	--	4%
TOTAL	**100%**	**100%**

The LAFPP target allocations as of June 30, 2012 are in line with allocations of public funds > $5 Billion in assets in the 2012 Greenwich survey.

Table 9-F - Passive Investments as a Percentage of Domestic Equities[30]

Greenwich Average – Public Funds > $5 Billion	39.0%
Greenwich Average – Corporate DB Plans > $5 Billion	30.7%
Greenwich Average – Endowment Funds	39.7%
LAFPP	**42.6%**

As of June 30, 2012, the passively managed large cap equity assets of $2.1 billion constituted 43% of the LAFPP total domestic equities.

[28] For the final report we will add information gained from the peer survey.
[29] This data is pulled from the Market Trends 2012: United States Investment Consulting Business report conducted by Greenwich Associates
[30] This data is pulled from the Market Trends 2012: United States Investment Consulting Business report conducted by Greenwich Associates. While Endowment Funds and Corporate Plans are not perfect comparisons, they are provided as a reference.

Table 9-G - Passive Investments as a Percentage of International Equities[31]

Greenwich Average – Public Funds > $5 Billion	18.0%
Greenwich Average – Corporate DB Plans > $5 Billion	25.0%
Greenwich Average – Endowment Funds	17.6%
LAFPP	**16.2%**

As of June 30, 2012, the passively managed international equity assets of $426 million constituted 16% of the LAFPP's total international equities.

Table 9-H - Passive Investments as a Percentage of Fixed Income

Greenwich Average – Public Funds > $5 Billion	13.0%
Greenwich Average – Corporate DB Plans > $5 Billion	8.7%
Greenwich Average – Endowment Funds	5.7%
LAFPP	**16.0%**

As of June 30, 2012, the passively managed fixed income assets of $532 million constituted 16% of LAFPP's total fixed income assets

Table 9-I - Passive Investments as a Percentage of Total Assets[32]

Greenwich Average – Public Funds > $5 Billion	17.8%
Greenwich Average – Corporate DB Plans > $5 Billion	15.2%
Greenwich Average – Endowment Funds	12.4%
LAFPP	**21.5%**

As of June 30, 2012, almost 22% of the LAFPP total fund assets were invested passively.

Table 9-J ***- Average Investment Management Fees in Basis Points (2012)***[33]

Greenwich Average – Public Funds > $5 Billion	48 bps
Greenwich Average – Corporate DB Plans > $5 Billion	45 bps
Greenwich Average – Endowment Funds	81 bps
LAFPP	**36 bps**

[31] This data is pulled from the Market Trends 2012: United States Investment Consulting Business report conducted by Greenwich Associates. While Endowment Funds and Corporate Plans are not perfect comparisons, they are provided as a reference.
[32] This data is pulled from the Market Trends 2012: United States Investment Consulting Business report conducted by Greenwich Associates. While Endowment Funds and Corporate Plans are not perfect comparisons, they are provided as a reference.
[33] This data is pulled from the Market Trends 2012: United States Investment Consulting Business report conducted by Greenwich Associates. While Endowment Funds and Corporate Plans are not perfect comparisons, they are provided as a reference.

As of June 30, 2012, the LAFPP paid approximately 36 basis points to external investment managers.

Table 9-K – *Fees paid to Active Domestic Equity Managers (in bps)*[34]

Greenwich Average – Public Funds > $5 Billion	38 bps
Greenwich Average – Corporate DB Plans > $5 Billion	46 bps
Greenwich Average – Endowment Funds	63 bps
LAFPP	**28 bps**

Table 9-L – *Fees paid to Active International Equity Managers (in bps)*[35]

Greenwich Average – Public Funds > $5 Billion	44 bps
Greenwich Average – Corporate DB Plans > $5 Billion	56 bps
Greenwich Average – Endowment Funds	80 bps
LAFPP	**46 bps**

Table 9-M – ***Fees paid to Active Fixed Income Managers (in bps)*[36]**

Greenwich Average – Public Funds > $5 Billion	20 bps
Greenwich Average – Corporate DB Plans > $5 Billion	24 bps
Greenwich Average – Endowment Funds	36 bps
LAFPP	**18 bps**

Table 9-N - *Asset Class Fees as a Percentage of Total Assets (in bps)*

Asset Class	**LAFPP Fees**	**SACRS Public Fund Universe with Assets between $10 - $20 Billion[37]**
Domestic Equities	5.7 bps	5.2 bps
International Equities	7.2 bps	6.3 bps
Fixed Income	3.8 bps	3.7 bps

The June 30, 2012 Public Fund Universe Analysis Report for the State Association of County Retirement Systems (SACRS) prepared by RV Kuhns indicated that the costs directly associated with the investment program (including investment management,

[34] This data is pulled from the Market Trends 2012: United States Investment Consulting Business report conducted by Greenwich Associates. While Endowment Funds and Corporate Plans are not perfect comparisons, they are provided as a reference.
[35] This data is pulled from the Market Trends 2012: United States Investment Consulting Business report conducted by Greenwich Associates. While Endowment Funds and Corporate Plans are not perfect comparisons, they are provided as a reference.
[36] This data is pulled from the Market Trends 2012: United States Investment Consulting Business report conducted by Greenwich Associates. While Endowment Funds and Corporate Plans are not perfect comparisons, they are provided as a reference.
[37] These values are pulled from the Public Fund Universe Analysis Report that RV Kuhns prepared in June 2012

custody, and consultant fees), for plans with assets between $10 billion and $20 billion amounted to an average of 31 basis points.[38] The LAFPP aggregate investment cost of 37 bps is higher than the average for the SACRS Public Fund Universe.

Analysis

LAFPP's total passive investments of 22%, as of June 30, 2012, was more than the 18% reported by Greenwich Associates for large public pension plans. While LAFPP's use of passive investment management is higher within US equities and fixed income, and lower within non-US equities when compared to peers, we believe that the overall passive allocation is reasonable.

Based on LAFPP's total asset base of approximately $14.2 billion, the investment management fees associated with LAFPP's investment program are approximately $51 million per year, or 36 basis points. We believe that the LAFPP's investment management fees are reasonable given the size, complexity and structure of the LAFPP investment program. This is especially true when comparing the investment management fees that LAFPP paid to its active U.S. equity and fixed income managers, as those fees are significantly lower than peers across these asset classes. LAFPP's investment management fees as a total plan were significantly lower than others. On a total program level that takes into consideration investment management, custody, and consultant fees, the LAFPP fees of 37 basis points was higher than fees reported by other public funds.

As the tables above indicate, LAFPP's use of passive investments across the traditional publicly traded asset classes (equities and fixed income) is broadly comparable to that of its peers. While it is instructive to review peer information on active and passive management, there is no single "right answer" on the active/passive mix that a fund should maintain. Each fund should develop a portfolio structure that best suits its objectives and reflects its beliefs about whether the risk and cost of active management will be rewarded.

The market for publicly traded securities is very efficient and it is difficult for active managers to add value across the publicly traded asset classes on a consistent basis. In a recent research paper that HEK published, titled "Conviction in Equity Investing", we found that less than 2% of domestic equity active managers have added value net of their fees on a statistically significant basis. The study is robust in that it adjusts for manager style to provide style consistency and eliminates the survivorship bias that exists in many studies of this nature. Research that HEK and others have conducted across the domestic equity and fixed income asset classes reach similar conclusions.

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[38] This is an aggregate fee. It includes investment management, custody and consultant fees and excludes administrative and legal fees.

We have not yet conducted a detailed review of LAFPP's success with active management across the broad asset classes for this report; however, we will do a detailed analysis and provide our observations in the Final Report.

Conclusions

Both the LAFPP allocation of active versus passive allocation by asset class and the associated investment costs are reasonable compared to other similar plans that were surveyed in 2012.

Recommendations

No recommendations

Findings

Whether LAFPP Performed a Cost- Benefit Analysis of Active versus Passive Management
Through discussions with the Chief Investment Officer of LAFPP, we confirmed that RV Kuhns provided a presentation on active versus passive management in February 2013 entitled "*Active vs. Passive Management: Not Either, or, but Rather Where, When, and Why*". It provided a discussion of the pros and cons of passive and active management, compared LAFPP to other funds, and included several academic articles and historical data.

Additionally, in the fourth quarter of 2012, the LAFPP performed a fee analysis to determine whether a more passive approach could reduce costs. LAFPP found it difficult to compare data because different funds account for investment fees in different ways. For instance, some plans only report budgeted management fees that are paid directly out of the plan in the form of a billable invoice, which excludes management fees from partnerships. Other plans report all management fees except performance fees. Despite these differences, LAFPP believes that it paid lower management fees than the average plan sponsor in most sub-asset classes.

Analysis

A portfolio structure review typically addresses issues such as the number and types of managers, the level of active and passive investments in each asset class, and the allocation of fees and active risk between and among asset classes consistent with expectations for adding value. The goal of a prudent portfolio structure is to ensure that the design of each asset class conforms to the stated goal of the asset class.

Our advice is usually that clients conduct a formal portfolio structure review every two to five years and review portfolio structure on an ongoing basis.

Conclusions

LAFPP had not performed a cost benefit analysis of active versus passive management until recently, February 2013. While the analysis was somewhat enlightening, it did not meet common standards of large public pension funds that undertake more formal portfolio structure reviews every two to five years.

Recommendations

See above recommendations for Objective 9.

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V. Objective 12: Determine where investment consultants and asset custodian services can be consolidated for Fire and Police Pensions and LACERS to achieve savings.

Scope

The issues we reviewed for this objective include:[39]

- the feasibility of consolidating investment consultants and custodian services with LACERS

Findings

LAFPP has contracted with a generalist investment consultant, RV Kuhns & Associates, and two specialist consultants, The Townsend Group and Portfolio Advisors.

In its capacity as LAFPP's general consultant, RV Kuhns is responsible for:

- preparing asset allocation studies,
- establishing performance benchmarks and guidelines for investment advisors,
- reviewing on a quarterly and annual basis the current and historical investment performance of the portfolio, and
- assisting the Board in selecting firms to provide consulting, investment management, custody and other investment services at a relatively high level.

RV Kuhns' services do not cover advice with respect to LAFPP's real estate or private equity investments, which are provided by specialist consultants. The annual base fee paid to RV Kuhns is $375,000. Specific services not covered in the base annual fee that are billed separately include:

- manager searches (beyond the first three searches in a year)
- transition manager searches
- securities lending review
- custody searches (leading the efforts in conducting and managing the search process, and evaluating proposals received), and
- asset/liability modeling

[39] The full scope of this objective is provided in Appendix B

The Townsend Group is LAFPP's specialist real estate consultant and they are responsible for:

- preparing quarterly investment reports and presenting to the Board as requested
- reviewing the Board's real estate investment policies, guidelines and portfolio on an ongoing basis and recommending modifications
- reviewing and making recommendations on real estate strategy and investments
- reviewing commingled/pooled real estate funds, providing recommendations for new investments and conducting the hiring and review of new investments
- soliciting contract bids, selecting qualified real estate appraisers and negotiating contracts for separate account portfolios
- reviewing and providing written recommendations for the purchase and sale of separate account portfolios, conducting site visits and local market expert meetings and interviews

Townsend's annual fee is $216,000.

Portfolio Advisors serves as the consultant for LAFPP's private equity portfolio responsible for:

- assisting in the development and determination of private equity investment goals, objectives, strategy and policy
- assisting in the development of appropriate annual commitment targets and determining projected cash flows
- conducting due diligence reviews
- monitoring all investments not being actively monitored by another advisor by attending partnership annual meetings and reviewing all proposed partnership amendments and extension requests
- monitoring and managing all in-kind distributions received from those private equity partnerships being monitored
- analyzing and providing performance reporting for the entire portfolio of private equity investments on a quarterly and annual basis
- presenting before the Board an annual review of the private equity program

Portfolio Advisors' annual base fee at the beginning of the relationship was $400,000. At the beginning of year two, the base annual fee increased to $500,000, and it increased to $600,000 in year three. The total annual fee is capped at $1,300,000.

Portfolio Advisors' contract is scheduled to expire at the end of March 2013. Over the course of its current contract, Portfolio Advisors' role has changed from discretionary to non-discretionary, which means that it previously had the authority to make investments on behalf of LAFPP independently, but now must obtain the Board's approval for all investments. The contract was not modified to reflect the change in role.

Portfolio Advisors also charges fees for new private equity commitments that are approved by the Board and closed in each 12-month period (based on the contract anniversary date) according to the following schedule:

Commitments	Fees
First $100,000,000	30 bps
Next $150,000,000	15 bps
Over $250,000,000	10 bps

The Northern Trust Company serves as the custodian for both LAFPP and LACERS. For LAFPP they are responsible for:

- establishing an account to hold the Fund's assets that are transferred to it
- establishing and maintaining one or more separate accounts for cash, securities and other property of the Fund received by them
- selecting and appointing as its agent a foreign custodian to hold the assets of any separate account established by LAFPP for investment in foreign securities
- investing United States dollars in a separate account on a short-term basis pending permanent investment
- collecting all interest, dividends, proceeds of called and matured securities and all other moneys due LAFPP from investments and crediting such collections to the account
- receiving and paying for securities purchased and delivering the securities sold by LAFPP or its investment managers
- executing all necessary certificates of ownership that may be required by the United States income tax regulations
- keeping detailed accounts of all investments, receipts, disbursements and other transactions and furnishing LAFPP with periodic statements or valuations of assets
- providing a written account of all investments, receipts, disbursements and other transactions effected by it as agent on behalf of LAFPP
- forwarding proxies to the designated voter having investment responsibility for the underlying security

LAFPP has a zero fee schedule for all basic custodian services listed above. The fees, however, are contingent upon LAFPP's continued use of Northern Trust's securities lending program. As lending agent for the securities held in the portfolio, Northern Trust retains 10% of the aggregate lending income and LAFPP receives 90% of the income. Northern Trust also charges a separate 5-basis point fee for a cash management in their Short Term Investment Fund (STIF).

Analysis

As the investment landscape has become more complex, a predominant number of large public funds use one or more consultants. According to Greenwich Associates, 79% of large public funds (assets greater than $5 billion) use one or more investment consultants to act as an extension of staff, to advise on investment policy issues, or to assist in manager search activity.[40] An increasing trend in large public funds is to move beyond the generalist consulting model to one that incorporates multiple, specialist consultants as LAFPP has done.

The extent to which public plans use consultants varies widely. Plans with relatively small internal staff resources tend to rely heavily on consultants to drive the investment process, such as leading asset allocation discussions, initiating manager search activity, and setting board agendas. For larger plans with more sophisticated internal resources, it is not uncommon for staff to drive the investment process. In these cases, the in-house experts on staff can often keep consulting costs relatively low while also having a rewarding career with interesting and challenging work. For large plans such as LAFPP where internal staff leads the investment process, consultants are often used to “double check” or provide a second opinion to ensure all issues are appropriately considered before decisions are made.

LAFPP follows a hybrid approach that is common among large plans. Internal staff plays an active role in managing the overall investment program and is responsible for conducting ongoing investment manager due diligence, whereas RV Kuhns leads the efforts for new manager searches. In addition, RV Kuhns leads the review and analysis of new asset classes, asset allocation studies, and conducts ongoing education sessions for the Board and staff.

The fees that public funds pay for generalist consulting services vary to a great degree based on the scope of services. According to Greenwich Associates, the 2012 mean fee paid to the investment consultants of public funds with more than $5 billion in assets was $541,000.

Based on the above survey data, and considering the basic services that RV Kuhns provides, the retainer fee of $375,000 (not including additional project fees) appears to be reasonable. Although LAFPP is to pay extra for certain services, for fiscal years 2011 and 2012, LAFPP did not incur any additional costs from RV Kuhns for additional services.

The Townsend Group does not currently consult with LACERS, but they confirmed that LAFPP’s fee for real estate consulting would decrease should the two plans be consolidated. The approximate annual savings to LAFPP would be $50,000, with LACERS

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[40] 2012 Greenwich Associates Market Trends report.

recognizing a similar fee discount. LACERS will be issuing a request for proposal for real estate consulting sometime in 2013.

As noted above, LAFPP's relationship with Portfolio Advisors (PA) changed from fully discretionary to non-discretionary. PA now brings investment ideas to the Board for its approval. Typically fees can vary depending on whether the relationship is discretionary or non-discretionary, so we would expect the fees to have been changed when the relationship changed. Neither the contract nor fee arrangement has been modified with the change in the relationship. The lack of clarity about whether PA is discretionary or not makes it difficult to determine whether the fees are reasonable and whether consolidation of LAFPP and LACERS assets in private equity would result in lower fees.

Consultants generally set their fees based upon the time and expertise required for the scope of work and not upon the amount of assets under advisement. Because of this, savings on consulting fees through any consolidation would be relatively small. Further, the consolidation of consultants will not eliminate the need for each Plan to have its own asset allocation that is customized to its unique circumstances, liabilities, risk tolerance, liquidity needs, etc. Nor would it reduce the need to have a specific type or number of investment managers for each asset class. Unless LAFPP and LACERS were seeking to hire the same type of manager, economies of scale from using the same consultant would not be realized.

Where there is commonality in investment managers, more favorable fee schedules could be used because of the size of the combined assets of LAFPP and LACERS. Manager fees are typically asset-based fees. This issue has already been addressed by the provisions added to contracts that each of the Plans has with investment managers. They are entitled to a discounted fee schedule based on the aggregate assets of all three Plans combined. Despite this favorable contract provision, we found very little overlap of managers used by LAFPP and LACERS from our review of LACERS' June 30, 2012 public securities portfolio report. Therefore, the resulting cost savings have not been great. While there is also some overlap in each funds' private equity investments, it has not been enough to result in any savings.

LAFPP and LACERS use the same custodian bank, Northern Trust, under separate contracts. Based on our current knowledge of what the major custodian banks charge and their increasingly higher fees, LAFPP already has a very competitive fee, which is the result of using Northern Trust for securities lending. Consolidating custodian services is unlikely to reduce costs with the possible exception of achieving a more favorable split in the securities lending income. The 5-basis point fee for Northern Trust's management of the STIF account is also very reasonable; those fees typically are between 15 to 20 bps for plans the size of LAFPP.

Conclusions

We conclude that LAFPP's use of multiple consultants is consistent with the common practices of other large public plans having alternative investments. The scope of the consultants' work appears to be reasonable and their fees are comparable to what other leading firms would charge for the same services. However, the change in Portfolio Advisors' role without any modification to their contract is an issue.

Any cost savings that might be realized by sharing general investment consultants with other City Plans would be relatively small. In advising on asset allocations, no economies of scale can be realized because each plan has its own demographics and circumstances. For new manager searches, economies of scale could only be realized if the Plans would be seeking the same type of manager simultaneously, which is unlikely.

LAFPP already has a favorable fee agreement with Northern Trust in place and we don't believe significant fees could be saved if a joint contract with another Plan was pursued. In addition, many custodians are commanding sizable rate increases in the current environment.

Recommendations

21. Clarify and document the role of Portfolio Advisors through an updated contract and seek lower fees, if appropriate

Appendix A

Item	Recommendations	Status	HEK Comments
Task Area 1 – Governance			
1a. Governance Standards			
1	So as not to conflict with the Board's plenary authority, yet recognizing the need for transparency, the City, supported by LAFPPS, should seek through appropriate legislative processes, an amendment to (1) Section 1106 of the City Charter to add the establishment and approval of the budget as one of the specific powers and duties of the board and (2) to amend Section 1210 to clarify that the budget is submitted for purposes of review and information only and is not subject to approval by the Mayor, Controller, or City Council.	N/A	This was a recommendation made for City action
2	The City, supported by the LAFPPS Board should seek through appropriate legislative processes, an amendment to the City Charter to, at a minimum, authorize the pension board to have ultimate decision-making authority (1) to appoint the General Manager; (2) to terminate the General Manager; and (3) to set the General Manager's compensation at the level it deems appropriate, and the pay schedule for its staff.	N/A	This was a recommendation made for City action
3	The City, supported by LAFPPS should seek through appropriate legislative processes, an amendment to the Brown Act to explicitly exclude from its coverage investment-related issues, individual or specific investments (e.g., information related to private equity investments, information that could result in front running, etc.) so that this legal interpretation will be embedded permanently in law.	N/A	This was a recommendation made for City action
Task Area 2 – Organizational Structure			
2a. Board Governance-Policies, Practices & Procedures			
1	LAFPPS should consider including an annual off-site board meeting in its annual meeting schedule.	Implemented	The LAFPP Board and staff have held annual off-site meetings since 2009 and intend to continue this practice.
2	The Board should direct staff to develop, in conjunction with the Board's general investment consultant, additional educational seminars on investment strategies and products and risk management.	Implemented	At off-sites and regular Board meetings, the staff and consultants have presented educational seminars about a wide variety of investment topics including new strategies and risk management.
3	The Board should make implementation of the governance policies, practices and procedures found in the Governance Manual a top priority and take whatever steps are necessary to ensure that the Board and staff adhere to the policies, practices and procedures established therein.	Implemented	The Board Governance Policies have been a top priority for the Board, the Governance Committee and the staff. The Board Governance Policies have been regularly updated each time new policies are adopted or amended by the Board. The policies contained in it have been updated regularly.

Item	Recommendations	Status	HEK Comments
4	The Board should direct the General Manager to ensure that the Governance Manual is updated whenever a new policy or procedure is adopted by the Board and that the Manual be periodically reviewed by the Board to ensure that it remains up-to-date. (For example, if the Board updates the Chart that lists all reports that are required to be submitted to the Board pursuant to the Board's Monitoring and Reporting Policy, the Governance Manual should be updated to reflect those changes.)	Implemented	The Board Governance Policies have been regularly updated each time new policies are adopted by the Board. The policies contained in it have been updated regularly.
5	Staff, with the assistance of appropriate service providers, including legal counsel and LAFPPS' investment consultants, should hold one or more educational training sessions on the entire Governance Manual to, among other things, (1) ensure that Board members and staff understand the relationship between a strong, written governance structure and the Board's statutory responsibility to prudently manage the assets of the pension fund; and (2) ensure that all Board members and appropriate staff are aware of and understand the policies, practices and procedures that the Board has adopted.	Implemented/ Ongoing	Board training has been provided on aspects of the Board Governance Policies during several presentations since the last management audit. Staff reports that the education is ongoing. Given the size and scope of the Board Governance Policies, we agree that the education will need to be ongoing.
6	Since the Brown Act is implicated whenever the Board holds a Board or committee meeting, to make the legal summary complete, the Board should add Appendix 1 from the Board Operations Policy to the Appendix of Charter Provisions.	Implemented	The Brown Act summary from Appendix 1 of the Board Operations Policy has been added to the Board Governance Policies immediately after the Appendix containing the Charter Provisions.
7	The Board should consider enhancing its succession plan to include other senior staffing in addition to the GM and CIO.	Not Implemented	The Board considered expanding the succession plan beyond the General Manager and the Chief Investment Officer and has included it as a strategic plan goal, but has not yet expanded the plan.
8	The Board should amend its Governance Policies to include a description of the duties and responsibilities of LAFPPS' Chief Investment Officer, actuary, custodian, investment consultant(s), investment managers, legal counsel and auditors. To the extent these responsibilities are described elsewhere in the Board's written documentation, the Board should direct the General Manager to ensure that the Governance Policies include a cross-reference to the appropriate document.	Partially Implemented	The duties of the CIO, the CIO's staff, and investment related service providers other than the consultant are set forth in the Board Investment Policies. The duties of the legal counsel are provided in the Board Governance Policies. The investment consultants' duties are found in their contracts, and evaluation criteria on what is expected of the consultants is in the Board Governance Policies. The responsibilities of actuaries and auditors appear in their contracts but not in policies. We do not see any cross-referencing.
9	The Board should incorporate its mission statement into the Board's Governance Documents and into the Strategic Plan.	Implemented	The Mission Statement is included in the Board Governance Policies and in the Strategic Plan.
10	The Board should amend its Governance Documents to include a general reservation of authority provision.	Partially Implemented	In policies, the Board has retained the authority to hire, monitor and terminate investment managers, but there is no general reservation of authority.
11	The LAFPPS Board should amend its Governance	Implemented	Rebalancing is addressed in the Board Investment

Item	Recommendations	Status	HEK Comments
	Policies to clarify the level and extent of rebalancing authority (i.e., who has authority to rebalance, when General Manager or Board authority is required, etc.).		Policies and it is clear who has the authority to rebalance and when rebalancing is to be addressed.
12	The Board should lower the maximum number of conferences Board members are authorized to attend each year. The maximum allowable should only be exceeded only upon (a) a showing of exigent circumstances and (b) approval by a two-thirds majority of the Board.	Implemented	The Board Education Policy has been amended to limit the maximum number of conferences to six per year for each Commissioner, excluding the one-day Trustee Roundtable sponsored by the California Association of Public Retirement Systems. The previous maximum number was eight. In the past five years, one Commissioner exceeded the maximum with Board permission.
13	In addition to evaluating the conference, Board members should provide a verbal report to the Board following attendance at a conference or seminar as an additional way of sharing educational information with the Board members.	Not Implemented	The Board Governance Policies encourage Board members to complete a "Conference Attendance Report" after returning from a conference, but do not suggest that Board members provide a verbal report to share any information gained.
14	The Board, staff and the Board's governance consultant should review the current self-evaluation form to ensure that the board's self-evaluation survey questions are tailored to the needs of the LAFPPS Board, and that the questions will elicit useful information and provide precise feedback that can be used by the Board to improve its management and oversight of LAFPPS.	Not Implemented	The Board repealed its self-evaluation policy and no longer engages in this activity.
15	The Board should establish a clear timeline relating to the evaluation of the General Manager. The General Manager should be required to submit a self-evaluation as part of the Evaluation Package. In addition, the Board should allocate time to review the performance of the General Manager in private – outside the presence of the General Manager – to ensure that the evaluation process allows for a full, candid and objective review of the General Manager's performance. The evaluation of the General Manager should be performed subsequent to the Board's self-evaluation.	Partially Implemented	The General Manager Performance Evaluation Policy has established a clear timeline for the General Manager's evaluation, as well as criteria for the evaluation and a detailed evaluation process. The General Manager is not required to submit a self-evaluation, but may do so. The General Manager is allowed to attend evaluation discussions. The Board has repealed its self-evaluation policy.
16	The Board should review the Chart found in the Appendix to the Monitoring and Reporting Policy annually (a) to ensure that the reporting obligations mirror the requirements set forth in each of the Board's governance documents, which are amended from time to time; and (b) to update the reporting requirements with any newly requested Board reports or requirements, as necessary.	Partially Implemented	The Board has elected to review the Monitoring and Reporting Policy and its appendix every three years.
17	The LAFPPS Real Estate Strategic Plan should be cross-referenced in the overall LAFPPS Strategic Plan and reviewed during the strategic planning process described in the LAFPPS Strategic Planning Policy to ensure consistency.	Not Implemented	The LAFPP Strategic Plan and Real Estate Strategic Plan do not cross-reference each other

Item	Recommendations	Status	HEK Comments
18	The Board should continue to treat its Ethics Policy as a top priority and make every effort to finalize this document as soon as possible. We further recommend that the Ethics Policy incorporate the legal and regulatory framework in which the Board is operating with respect to conflicts of interest, starting with the Political Reform Act of 1974 and the Government Code and related regulations; define terms to be used in the Code of Ethics; clearly delineate prohibited activities; include annual reporting and disclosure requirements; and include oversight and monitoring requirements.	Implemented	LAFPP has adopted a comprehensive policy entitled Ethics Responsibilities for Board Members, the General Manager, and Staff. The policy addresses the legal framework regarding conflicts of interest, provides definitions of terms, delineates prohibited activities, includes annual reporting and disclosure requirements, and provides for oversight and monitoring.
19	The Board should, with the assistance of the City Attorney, develop a comprehensive conflict of interest and disclosure policy for its service providers and incorporate an annual certification requirement into the policy. The Board may also wish to clarify in this policy whether the City's lobbying laws apply to service providers.	Implemented	LAFPP has adopted a comprehensive Contractor Disclosure Policy that is incorporated into its contracts with service providers. The policy requires periodic disclosures ranging in time frame from quarterly to bi-annually. Disclosures related to lobbyists are required, but the policy does not address whether the City's lobbying laws apply to service providers because not all service providers are covered by the City Ethics Commission's definition of "lobbyist".
20	The Board should review and update the Securities Litigation Policy to include additional criteria for consideration by the Board in evaluating potential cases, including, but not limited to, the costs of participating in the litigation, the quality of the case, participation in the case by other potential institutional investors, special circumstances that may distinguish LAFPPS from other potential plaintiffs, the venue of the litigation, the availability of resources to pay a settlement, the relationship of the LAFPPS' claims to the Board's corporate governance initiatives, the potential for a nonmonetary recovery, and the overall costs to LAFPPS to participate in the litigation.	Partially Implemented	The current version of the Securities Litigation Policy includes some of the recommended provisions, and LAFPP has stated that the City Attorney and LAFPP's securities litigation counsel takes into account the remainder of the suggestions in making their recommendations to the Board.
21	The Board should determine a specific periodic review timeframe for the Securities Litigation Policy as it has done with other written policies.	Implemented	The current version of the Securities Litigation Policy states that it will be reviewed bi-annually.
22	The Board's Reporting and Monitoring Policy should be updated to include on-going reports to the Board, as appropriate, pursuant to the Board's Securities Litigation Policy.	Implemented	The Securities Litigation Policy requires ongoing status reports by the City Attorney, and the Reporting and Monitoring Policy requires quarterly reports from the City Attorney.

Item	Recommendations	Status	HEK Comments
23[41]	The Board's Securities Litigation Policy should be amended to incorporate Claims Filing & Monitoring Procedures.	Not Implemented	The Securities Litigation Policy does not contain claims filing or monitoring procedures.
24	The Board's Investment Policies should acknowledge that the System's investment consultants and investment managers are fiduciaries.	Partially Implemented	The Fund of Hedge Fund Program Investments Policy states that the consultant shall act as a fiduciary, but that requirement is nowhere else in the Board Investment Policies. The Private Equity Investments Policy states that managers serve as fiduciaries to the fund, but no other policy addresses a manager's fiduciary responsibility. Investment managers and RV Kuhns have agreed to be fiduciaries in their contracts.
25	LAFPPS should support legislation requiring that one of the Board members appointed by the Mayor be a person with investment experience or expertise and one with benefits experience or expertise. In the absence of legislation, the Board should recommend that the Mayor fill one or more of his or her vacancies on the Board as they arise with individuals with investment and benefits expertise.	Not Implemented	The LAFPP Board and staff considered the recommendation to support legislation requiring that at least one appointed member have investment experience and one other have benefits experience, and decided not to accept it because in the Board and staff's opinions the Mayoral appointments already generally follow the recommendation's guideline.
	2b. Organizational Structure		
1	The Department should identify roles and assign responsibility for establishing appropriate procedures within LAFPPS for protecting the privacy and security of member records and data. If the role currently exists, communicate it to the organization, along with current policy on privacy and security.	Implemented	The LAFPP's Security Policy identifies appropriate roles regarding the protection of member records and data.
2	The Department should identify roles and assign responsibility for monitoring and ensuring compliance with regulations and laws that apply to LAFPPS (such as data privacy and protection). If the role currently exists, communicate it to the organization. Clarify whether the City Attorney's Office or LAFPPS management are primarily responsible for monitoring and ensuring LAFPPS' compliance with applicable regulations and laws.	Implemented	The Security Policy identifies the parties responsible for complying with data security and those who monitor that compliance. The Internal Audit Section also has responsibilities to ensure compliance with applicable provisions.
3	The Department should identify roles and assign responsibility for the development, regular revision and maintenance of a business continuity plan for LAFPPS. If the role currently exists, communicate it to the organization. (LAFPPS does report that a business continuity planning effort is currently anticipated/ under way.)	Implemented	LAFPP has adopted a business continuity plan and has designated a staff person who is responsible for maintaining the plan and developing training for staff.
4	The Department should consider establishing a Call Center as a single contact point for members.	Not Implemented	The LAFPP Board and staff considered the recommendation to establish a call center and decided not to accept it because current member

[41] Yellow-shaded recommendations are those we suggest the Board reconsider.

Item	Recommendations	Status	HEK Comments
			surveys show that members are satisfied with the services provided, and a new call transferring procedure has further increased the accuracy of call transfers.
5	The Department should review the organizational structure as part of long term planning and assess whether LAFPPS should evolve to a member-facing structure or continue with a functional structure.	Implemented	The Pensions Division was reorganized, and during that process staff determined that a functional structure was most appropriate. The Board affirmed staff's determination.
6	The Department should consider replacing the current Assistant Retirement Plan Manager – Benefits with a Chief Benefit Analyst or equivalent position. Consider including Active Member Services within this reporting unit.	Implemented	LAFPP hired a Chief Management Analyst in August 2007, which is an equivalent position to the recommended Chief Benefit Analyst. The Active Member Services division reports to the Chief Management Analyst.
7	The Department should continue to evolve the web site as a source of benefit, counseling, and self-service resources.	Implemented	LAFPP's website contains a significant amount of benefit, counseling and self-service resources, including online access to account information.
	2c. Organizational Efficiency and Effectiveness		
1	LAFPPS should develop an assessment tool for measuring the effectiveness of group, individual, and self-service counseling tools.	Implemented	LAFPP conducts point-of-service member surveys for group and individual counseling sessions and online self-service tools, which indicate that members are pleased with the service they receive from LAFPP.
2	LAFPPS should consider developing "Important Fact" checklists for use in counseling sessions to alert members in writing of the potential impact of specific decisions they are making that can impact their benefits or the benefits of their survivors or partners to minimize member confusion. Maintain a signed copy of the checklist in the member's file.	Implemented	Checklists for use in counseling sessions have been developed, implemented, and a signed copy is maintained in the member's file.
3	LAFPPS should clarify the status of current IT projects such as OnPoint, and the roles of the various systems section units so that Benefits Administration personnel understand roles, responsibilities, and current project status on systems projects that affect their area.	Implemented	OnPoint has been implemented. LAFPP has formed an internal group to help with IT issues which also publishes a bimonthly newsletter to keep staff updated on the current status of IT issues. An IT Oversight Committee has also been formed to monitor further IT projects.
4	LAFPPS should consider subscribing to an Administrative Benchmark Data source to acquire comparative efficiency data. (It may wish to consider doing this jointly with LACERS to share costs.)	Not Implemented	The LAFPP Board and staff considered the recommendation to subscribe to an Administrative Benchmark Data source and decided not to accept it because it was too costly to implement.
5	LAFPPS should establish internal and member based instruments for assessing quality of service delivery, and monitor and track trends over time.	Implemented	LAFPP conducts point-of-service member surveys and monitor trends in member satisfaction over time.
6	LAFPPS should establish service delivery metrics and track and monitor service delivery performance over time, including department and individual efficiency and error rates in order to improve benefits administration efficiency and effectiveness.	In Progress	The July 1, 2010-June 30, 2013 strategic plan addressed the implementation of metrics, but none have yet been established.

Item	Recommendations	Status	HEK Comments
7	LAFPPS should assign a strong project manager to the process documentation project; set firm deadlines; and bring this project to completion. This will help LAFPPS capture institutional knowledge and provide a baseline for maintaining stable operations.	Implemented	LAFPP assigned a project manager to the process documentation project and adopted a project implementation plan in 2007. Desk manuals detailing internal processes have been created.
8	LAFPPS should develop a long term staffing plan that identifies likely retirement dates of key personnel, and institutes a program to capture the institutional knowledge of these long-term employees.	Implemented	Staff indicates they identified retirement-eligible staff members, and desk manuals documenting processes have been developed.
9	LAFPPS should develop a formal cross-training program to ensure that there is a designated backup employee with the skills and training to fill any critical gaps caused by normal or unexpected turnover or absences.	Not Implemented	LAFPP's internal cross-training program continues to be informal.
10	LAFPPS should establish formal goals and measures and metrics for each section that will capture the timeliness, accuracy, cost, and resource utilization for each key service provided.	In Progress	The July 1, 2010-June 30, 2013 strategic plan addressed the implementation of metrics, but none have yet been established.
11	LAFPPS should establish metrics for measuring the cost-effectiveness and quality of the health plans that are funded through subsidies.	Implemented	An audit of the available health plans by Segal revealed that they were quality plans and reasonably cost-effective.
12	LAFPPS should explore alternative health plan administration options including combining with LACERS and/or LA City for economies of scale to reduce costs or increase benefit level provided for current expenditure levels.	Not Implemented	The LAFPP Board and staff considered the recommendation to explore alternative health plan administration options and decided that the addition of health plan administration functions was not desired.
13	LAFPPS should consider establishing a department wide case/transaction tracking system to track status, manage time to completion and backlogs, and minimize the number of places/systems where member data is stored.	Not Implemented	The LAFPP Board and staff considered the recommendation to establish a department-wide case tracking system and decided not to accept it because it was not cost-effective given the current member satisfaction with staff services.
14	LAFPPS should prepare a department wide inventory of ad hoc spreadsheets, databases, and manual tracking systems and logs and review for backup, security and access control, and develop a plan for minimizing the number of ad hoc systems required for benefits administration. Ensure that each system is documented and backed up, and develop life cycle management plans where appropriate. (Management notes that it believes all databases are documented backed up and sent offsite and that they are hiring a contract programmer to assist in reducing duplicative data stored in various databases. Our interviews and the absence of a master list of ad hoc databases and spreadsheets and tracking systems reflecting a backup strategy suggest that this area needs further review by LAFPPS.)	Implemented	LAFPP has created an inventory of all spreadsheets, databases and tracking systems and logs, and has deleted those that are unnecessary.

Item	Recommendations	Status	HEK Comments
15	LAFPPS should conduct a data inventory of member data elements present in each system including ad hoc databases and spreadsheets and manual tracking systems to identify opportunities for reducing redundant data entry and storage, and for ensuring data protection and privacy protection policies are consistently enforced. (LAFPPS notes that it has received approval to hire a contract programmer to assist in remediating this issue.)	Implemented	LAFPP has created a data inventory of member data elements, and the information security policy has been implemented and compliance is monitored.
16	LAFPPS should develop a business continuity plan for benefits administration and the systems that support it, and communicate roles, responsibilities, and communications methods to all employees.	Implemented	LAFPP has created a business continuity plan and all staff has been trained on their roles and responsibilities.
17	LAFPPS should develop a physical and electronic data security plan for benefits administration and member data.	Implemented	LAFPP has adopted an appropriate Security Policy including procedures for safeguarding information.
18	LAFPPS should develop a privacy protection plan and processes to ensure that LAFPPS complies with applicable HIPAA and other privacy regulations.	Implemented	LAFPP has adopted a Security Policy designed to protect both electronic and hard-copy information. However, LAFPP has received a legal opinion stating that HIPAA does not apply to health information contained in employment records such as those maintained by LAFPP.
19	LAFPPS should review how policies are developed, tracked, communicated and stored for reference to ensure the historical information is appropriately available, and that policies developed in response to individual member cases are communicated.	Implemented	The “history” section of the policies reflects the dates the policies were adopted or modified, and previous versions of the policies are retained.
20	LAFPPS should establish procedures to ensure that outgoing supervisors prepare interim performance review information for direct reports before their change in duty assignment/departure.	Not Implemented	The LAFPP Board and staff considered the recommendation to establish interim performance reviews and decided not to accept it because the current evaluation procedures are satisfactory.
21	LAFPPS should consider conducting an end to end review of benefits administration processes upon completing the current process documentation process to identify opportunities for improving efficiency and effectiveness.	Implemented	The LAFPP Internal Audit Section conducted an audit of benefits determinations and processes in 2011. Staff also performed a review once the new benefit payment system was implemented.
22	LAFPPS should consider revisiting the policy on using the higher of RAP or OnPoint benefit calculations. Consider having the actuary review and certify the calculations in OnPoint and making OnPoint the system of record for calculations.	Implemented	RAP has been discontinued, and OnPoint has been designated as the system of record for benefit calculations. The Internal Audit Section has audited the benefit calculations to confirm their accuracy.
23	LAFPPS should consider developing processes and skills training to aid section heads and management in managing multiple projects and should consider establishing standard ways to assign and communicate responsibilities.	Not Implemented	The LAFPP Board and staff considered the recommendation to establish processes and skills training on multiple-project management and decided not to accept it because project management and supervisory training are available to appropriate staff.
24	LAFPPS should explore how to best establish (improve on) a culture within LAFPPS that encourages open discussion and communication in all directions supported by effective communications of key decisions made and the reasoning behind	Implemented	LAFPP has improved communication to staff regarding key decisions through post-Board meeting discussions and section meetings, although a recent reduction in space will postpone some of those meetings until LAFPP can acquire more space.

Item	Recommendations	Status	HEK Comments
	them, to reduce the amount of speculation and rumor present within the organization.		LAFPP has hired a change management firm that will provide assistance with the communication effort.
25	LAFPPS should establish an internal quality assurance process that includes both internal self assessment and external (i.e., internal audit) assessment of each section's functions.	Implemented	LAFPP's internal quality assurance process includes the internal audit function (created in response to the prior management audit), the external audit function, an external assessment function, and divisional quality assurance processes. Divisional quality assurance processes are developed by division or section and include supervisory review, monitoring, and exception reporting requirements.
26	LAFPPS should establish a life cycle management approach to LAFPPS' key systems (including those such as RAP that are LA City systems at or near the end of their life cycles) to minimize the need to maintain multiple systems that require duplicate data entry (e.g., RAP and OnPoint duplication). (Management notes that OnPoint is the replacement application for RAP. However, we did not observe any life cycle plan for the replacement, a target date for OnPoint to fully replace RA, or a life cycle plan for RAP retirement.)	Implemented	RAP has been retired; OnPoint is now the pension administration system for LAFPP, and is coordinated with the Benefit Payment Passport system with The Northern Trust for pension benefit payments. The strategic planning process addressed the lifecycle review project for OnPoint. LAFPP's IT steering committee is monitoring IT system lifecycles.
27	LAFPPS should establish performance goals and metrics for each Section Head that include both transactions-based and long term project goals and metrics, and develop a system of accountability that encourages completing both short term and long term goals.	Not Implemented	The LAFPP Board and staff considered the recommendation to establish performance goals for section heads and decided not to accept it because the current performance review system is functioning well, the work assignment tracking system allows timely monitoring of project progress, and the Division Management meets with Section Managers biweekly to discuss assignments.
28	LAFPPS should consider the addition of two to three staff positions that can provide long term project support to the sections for projects such as process documentation and improvement and developing user requirements for OnPoint and Documented projects.	Implemented	Two additional project support staff positions were authorized and hired as part of the 2011-12 budget process.
29	LAFPPS should consider establishing a 1st level call center to handle routine inquiries from members. (This recommendation has also been noted under Organization Structure and is repeated here because of its potential impact on efficiency and effectiveness.)	Not Implemented	The LAFPP Board and staff considered establishing a call center and decided not to do so because current member surveys show that members are satisfied with the services provided, and a new call transferring procedure has further increased the accuracy of call transfers.
	2d. Staffing Adequacy		
1	LAFPPS should evaluate the active employee count needed to effectively process current work volumes and determine a "minimum filled" position count needed to operate effectively.	Implemented	The staff performs an analysis of necessary staffing in light of volume of work annually during the budget process.
2	LAFPPS should consider establishing a project support group of two to three people initially to provide support to sections in completing non-transaction and long term projects such as process	Not Implemented	The LAFPP Board and staff considered establishing a project support group and decided not to do so because staffing is currently appropriate, overtime or temporary staff reassignment can occur during peak

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	documentation and improvement.		demand periods, and extra positions are not cost-effective.
3	LAFPPS should consider developing a multi year projection of expected transaction work loads to develop a long term staffing plan, based on examining age and time in service of current active members to estimate future workloads.	Implemented	LAFPP has developed a projection of upcoming retirements and DROP exits to identify potential workload spikes in an effort to ensure staff coverage of those events.
4	LAFPPS should consider developing a contingency plan for covering the duties of section heads and other key benefits administration personnel during temporary vacancies or while replacements are being recruited.	Implemented	LAFPP has identified key positions and implemented an informal cross-training program to develop staff to ensure coverage of those positions in the event of a vacancy.
5	LAFPPS should consider creating "bench" positions of one to two benefits specialists, senior clerk typists, and other positions that typically have vacancies so that you will have "swing" personnel on staff to fill vacancies as they occur or support sections during peak demand or special transaction project periods. (Civil service procedures might impact how this is implemented.)	Not Implemented	The LAFPP Board and staff considered creating support-specific staff positions and decided not to do so because staffing is currently appropriate, overtime or temporary staff reassignment can occur during peak demand periods, and extra positions are not cost-effective.
	2e. Use and Sufficiency of Resources		
1	LAFPPS should consider developing formal skills and knowledge based training programs for new hires with a design objective to reduce the time from hire to effectiveness.	Implemented	LAFPP has developed a training program for new hires.
2	LAFPPS should consider establishing training in duties and processes of multiple sections for select employees to increase LAFPPS flexibility in assigning personnel across section boundaries to help in backlog or special project situations.	Implemented	LAFPP currently has an informal cross-training program.
3	LAFPPS should clarify roles, responsibilities, and duties required of benefits administration personnel in the event of a business disruption and ensure personnel are aware of how communications will occur in such an event.	Implemented	LAFPP's Business Continuity Plan clarifies the roles, responsibilities and duties of all staff, and staff has been trained on the applicable requirements.
	2f. Use of Investment Consultants and Provision of Contractual Services		
1	The Board should specify in the contract that the consultant provide periodic review and recommendations regarding commission recapture, brokerage discount practices, proxy voting, etc.	Not Implemented	The contract with the current general investment consultant, RV Kuhns, does not specifically address commission recapture, brokerage discount practices, or proxy voting. The contract does include a general statement requiring the consultant to perform such other services as may be normally considered to be within the scope of a full service investment consulting mandate.
2	The Board should review the IPS and contract for consistency and solidify vague requirements as noted in our Report.	Not Implemented	The contract with RV Kuhns contains the same language that the prior management audit considered vague. Some sections within the Board Investment Policies have scheduled review dates, while other sections are to be reviewed "as necessary". Many

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			have been revised several times since 2007.
3	The Board should include an annual or bi-annual asset allocation study as a specific task in the consultant's contract.	Not Implemented	An annual or bi-annual asset allocation is not specifically required in the RV Kuhns contract.
4	The Board should expand PCA's contract to include specific, periodic review and advice on the quality and effectiveness of, and if appropriate, selection of: ● Custodial operations and services; ● Securities lending services; ● Brokerage services; ● Transition management services; and ● Proxy voting services.	Partially Implemented	The contract with RV Kuhns requires the consultant to assist the Board in the selection of a custodian bank as part of the general services, and states that securities lending review and transition manager searches are also available with an additional fee. The contract does not address a review of brokerage services or proxy voting services, or specifically address a review of the quality or effectiveness of any of the listed services other than a securities lending review.
5	The Board should organize and document the Board's annual review of the consultant to include checking all contractual deliverables and services to ensure that the consultant performed on all requirements; the Board should also include reviewing the consultants on their timeliness, depth of research, understandability of their material, and their overall availability.	Implemented	The Investment Consultant Evaluation Policy addresses timeliness, depth of research, understandability of their material, and their overall availability, and requires an evaluation two times in a three-year contract period.
6	The Board should amend the consultant contract to specifically provide periodic education to ensure LAFPPS' current practices remain valid.	Partially Implemented	The contract requires RV Kuhns to furnish information, advice and recommendations as requested by the Board but does not specifically require periodic education.
7	The Board should specify the standard of care and fiduciary responsibility of the General Investment Consultant in their contract.	Implemented	RV Kuhns, LAFPP's general investment consultant, has agreed to be a fiduciary in the most current contract.
8	The Board should include the requirement that the consultant submit at least annually a certification regarding conflicts of interest, and that the consultant must provide notification as soon as a conflict arises.	Implemented	The RV Kuhns contract states that the consultant must comply with the LAFPP Contractor Disclosure Policy, which requires quarterly reports for several types of conflict situations and a report within 21 days of a change in circumstances that creates a conflict as provided in the Policy.
	2g. Use of Legal Counsel		
1	The Board should seek authority to hire its own internal legal counsel, who should report to the General Manager. The autonomy we contemplate would include the authority to decide to use the City Attorney for certain issues that do not raise potential conflicts, and as to which familiarity with California law would render reliance on the City Attorney prudent.	Not Implemented	The LAFPP Board and staff considered the recommendation to hire internal legal counsel and decided not to accept it because it was too costly to implement and would require a City Charter change.
2	Prior to hiring its own attorney, the Board should evaluate the responsibilities and legal skill sets required and then evaluate the economics of hiring an in-house lawyer versus the shared expense cost of maintaining the current arrangement.	Not Implemented	The LAFPP Board decided not to hire its own attorney, and so did not accept this recommendation.

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3	If the Board hires its own attorney, the Board should address in its Governance Manual the scope and limits of that attorney's authority, as well as the relationship between the LAFPPS' in-house attorney and the City Attorney's Office.	Not Implemented	The LAFPP Board decided not to hire its own attorney, and so did not accept the recommendation to define the attorney's role or authority.
4	The Board should work with the City Attorney to develop and institutionalize, in advance, a process that will be invoked in the event a potential conflict of interest arises.	Disagree	The Board Governance Policies related to the City Attorney mention the use of outside counsel, but do not specifically address applicable procedures to use when conflicts of interest arise.
5	LAFPP should establish, coordinate and track the usage of services provided by the City Attorney's Office. The Board should evaluate its usage of the City Attorney's Office to assess whether its cost sharing continues to be equitable relative to LACERS and the Water and Power Board. Since it appears that the City Attorney has the systems in place to track attorney hours by Department (it does so for Water and Power), LAFPPS should request that it be billed on that basis rather than an outdated allocation formula.	Implemented	Although LAFPP presented the City Attorney's office with a draft memorandum of understanding addressing cost sharing with LACERS and the Water and Power Board, the City Attorney did not respond. The LAFPP Board later adopted a Compensation of Legal Fees, Benefits, and Expenses for the City Attorney Legal Services Policy that states that LAFPP will reimburse the City Attorney based on the time spent on LAFPP business rather than an allocation formula.
6	If the status quo is maintained, then the current allocation should be reviewed and established in a written document. In addition, procedures should be in place to monitor the costs and expenses paid to the City Attorney (and any other law firm(s) that provides legal services to the fund) for legal services and related costs and expenses.	Implemented	The Compensation of Legal Fees, Benefits, and Expenses for the City Attorney Legal Services Policy establishes the Board's position on LAFPP's relationship with the City Attorney, and requires LAFPP to review all City Attorney invoices and conduct periodic audits of the City Attorney's timekeeping entries and invoices.
7	We recommend that LAFPPS conduct a meeting with the City Attorney's Office to discuss how to enhance the overall effectiveness of the City Attorney's Office service delivery.	Implemented	LAFPP has had numerous meetings with the City Attorney's office regarding the overall effectiveness of the services, and the parties continue to have discussions on how to improve services. LAFPP also uses the City Attorney Performance Evaluation Policy to evaluate and document the services provided by the City Attorney, and provides the results of the evaluations to the City Attorney.
8	If the status quo is maintained, the Board should seek the cooperation of the City Attorney's Office, to establish procedures to ensure that the Board plays an integral role in determining the number of attorneys and the level of expertise of attorneys assigned to provide legal support to the pension fund.	Implemented	LAFPP has had discussions with the City Attorney's office regarding the number and qualifications of attorneys assigned to provide services to LAFPP, and continues to pursue an agreement with the City Attorney.
9	Under the current structure, the Board should have more autonomy in determining when there is a need for outside legal assistance and, if a need arises, the Board should be allowed to participate in the process for selecting a law firm(s) to provide those services.	Implemented	The process for selection of outside counsel was amended to allow the Board to actively participate, as provided in the Board Governance Policies.
10	The LAFPPS Board and the City Attorney should execute a formal memorandum of understanding which specifically identifies the process for selecting	Partially Implemented	The selection of outside counsel is addressed in the Board Governance Policies, but termination is not included in the policies and a memorandum of

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	and terminating outside counsel. This process should also be incorporated into the Board's Governance Manual.		understanding on outside counsel is not in place.
11	The Board should discuss procedures with the City Attorney's Office on how best to work directly with the outside legal counsel and to keep the Board informed at the same time.	Implemented	The LAFPP Board receives advice directly from outside counsel when appropriate.
12	If the current structure is maintained, the Board's Governance Manual should be revised to clearly define the role and responsibilities of the City Attorney, including the role of the designated general counsel and other attorneys assigned by the City Attorney to LAFPPS.	Not Implemented	The Board Governance Policies do not define the role of General Counsel or make that the responsibility of the attorneys assigned by the City Attorney.
13	The Board should request legal counsel to update the current standardized contract template.	Partially Implemented	The current investment contract template requires the investment manager to be a fiduciary and defines that responsibility, and requires the manager to comply with guidelines that are provided by LAFPP and to notify LAFPP of the loss of key persons, but does not have a space to specifically designate who the key persons are.
14	The Board should conduct a legal compliance review with the City Attorney's Office. Alternatively, LAFPPS might consider establishing an internal compliance function and hire a staff to perform such responsibilities.	Not Implemented	The City Attorney's Office reviews every LAFPP contract "as to form", but has not conducted a legal compliance review of the LAFPP contracts. LAFPP has not established an internal compliance function.
	2h. Appropriateness of Staffing Skill Sets and Review of Position Descriptions		
1	LAFPPS should upgrade job specs for the CIO and senior investment officers to specify and require business degrees in appropriate subjects and advanced degrees for senior investment managers.	Not Implemented	The position descriptions do not require business degrees in appropriate subjects or advanced degrees for senior investment managers.
2	LAFPPS should require the CFA professional designation for senior investment officers and the CIO.	Not Implemented	The position descriptions for senior investment officers and the CIO do not require a CFA designation.
3	LAFPPS should increase salary levels commensurate with required upgraded job specs. LAFPPS should take steps to reclassify the CIO and senior investment officer positions to 'exempt' titles in order to accomplish this recommendation	Partially Implemented	None of the investment staff have been reclassified as exempt. LAFPP was successful in obtaining a pay increase for the CIO, and a new Investment Officer III position is also set at a higher pay grade. None of the other senior investment officers have received increased salaries other than through regular raises.
	2i. Span of Control (Reporting Relationships)		
1	LAFPPS should carefully consider plans to establish a second Assistant General Manager position as it does not appear to be indicated currently by reporting ratios, and is not typically present in similar sized organizations.	Not Implemented	Two Assistant General Manager positions currently exist, although one is now vacant.
2	LAFPPS should consider reducing the number of direct reports reporting to the General Manager.	Implemented	The LAFPP organization chart shows three direct reports to the General Manager, excluding administrative staff, instead of the previous four.

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3	LAFPPS should consider an organization structure that has the existing Assistant General Manager Position assume some of the direct report responsibilities currently reporting to the General Manager if the incumbent has the required skills to assume those responsibilities.	Implemented	One of the previous General Manager direct-reporting positions has been reassigned to report to an Assistant General Manager.
4	LAFPPS should consider establishing a formal or informal team structure within sections when their size approaches a 1:10 or greater supervisor: staff ratio.	Implemented	The retirement services section, which is the largest section within LAFPP, has been divided into two groups in order to limit the supervisor to staff ratio.
5	The Board should establish an Internal Audit activity in conformity with Professional Standards for the Practice of Internal Auditing. The internal auditor should report directly to the Board and administratively to the Executive Director. The internal auditor should be responsible for the development and implementation of a comprehensive internal financial, procedural and compliance audit program that includes, in addition to administrative management of the internal audit function, evaluation of internal controls, policies, and information systems. Additionally, the internal auditor should be responsible for reporting conditions that pose a risk of loss and for bringing to management's attention any irregularities, fraud or other acts that are subject to detection through the application of normal audit procedures.	Implemented	An Internal Audit Section has been established, and reports directly to the Board.
6	The Internal Auditor should be at a sufficient level within the organization, i.e., at least at or above the level of the senior departmental managers and should be part of the LAFPPS executive management team.	Implemented	The Internal Auditor is a senior department manager and is part of the executive management team.
2j. Joint Opportunities with LACERS for Enhanced Efficiency and Effectiveness			
1	With the primary objective of creating cost savings through new economies of scale, the City should consider, through appropriate legislative and administrative processes, consolidation of LACERS and LAFPPS, either in whole or in part. Consolidation would not reduce benefits or dissolve the current pension fund Boards.	Not Implemented	The LAFPP Board requested an opinion from outside fiduciary counsel on consolidation, and was advised that consolidation could not take place without both a change to the California Constitution and the Los Angeles Charter.
2	The City should as a first step in the consolidation process consider the creation of a combined investment function. Appropriate enabling statutes would be required.	N/A	This was a recommendation made for City action.
3	The City should consider the eventual creation of a combined benefits administration function as a second step in the consolidation process.	N/A	This was a recommendation made for City action.

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Task Area 3 – Investment Program[42]			
3b. Appropriateness of Investment Performance Benchmarks			
1	When the Board decides to change the benchmark for the Total Fund or an asset class, LAFPPS should continue to use the returns from the "old" benchmark and link those returns to the "new" benchmark for the period it was implemented.	Implemented	The consultant is linking historical return information into the quarterly performance reports.
2	The Board should consider measuring the international equity segment against the MSCI All Country World Index ex-US.	Implemented	The Board Investment Policies currently measure the international equity against the MSCI All Country World Index ex-US.
3	The Board should consider measuring the performance of Brandes Mid Cap International Equity to a more style specific benchmark such as the FTSE World ex-US Medium Cap Index.	N/A	The manager discussed in this recommendation has been terminated, so the recommendation is no longer relevant.
4	The Board should consider measuring the real estate segment against a blended benchmark of 85% NCREIF +1% and 15% of the DJ Wilshire REIT Index.	Implemented	The Real Estate composite custom benchmark as shown in the 6/30/2012 performance book is 100% NCREIF Property Index + 1% through 3/31/2012, and 85% NCREIF ODCE Index (Net) + 0.50% / 15% Dow Jones US Select RE Securities Index thereafter. This is different than the recommendation, although it shows that a reasoned change was implemented
	3c. Asset Allocation, Diversification, Risk and Return		
1	The Board should request that the consultant provide more discussion on how proposed asset allocation policies will likely impact funding ratios and contribution levels.	Not Implemented	The Board discusses asset allocation annually, including the returns that are expected from the allocation, but does not otherwise receive information from the consultant relating to the impact on funding ratios or contribution levels.
2	The Board should consider conducting a complete asset liability study every five to ten years.	Not Implemented	Asset allocation studies have been regularly conducted, but no asset/liability modeling has been performed. The Board has considered it but decided against it because it was not of enough value for the cost.
3	The Board should ensure that Board members have access to and are satisfied with training and reporting on investment issues such as asset allocation and risk metrics.	Implemented	The Board has had sixteen sessions on investment issues since January 2010, including asset allocation, which includes some discussion on risk metrics. Board members seem somewhat satisfied overall with the investment education.
4	The Board should consider working with the General Consultant to develop and implement an annual risk budget for the Total Fund and each asset class.	Not Implemented	The LAFPP Board and staff considered the recommendation and decided not to accept it because they believe a formal risk budgeting process has not proven to be of value.
3d. Asset Allocation Process and Re-balancing Process			
1	The Board should consider adopting a SMART rebalancing strategy to rebalance the asset	Not Implemented	The LAFPP Board and staff considered the recommendation and decided not to accept it

[42] Task Area 3 did not contain any 3a recommendations.

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	allocation.		because the recommended system was not cost-effective and LAFPP already has an internal rebalancing policy.
3e. Investment Policy Statement (IPS) and Guidelines			
1	The Board should perform a comprehensive review and edit of the IPS for consistency and clarity.	Implemented	LAFPP's previous general investment consultant completed a comprehensive review of the Board Investment Policies, and LAFPP adopted the suggested revisions in May 2007.
2	The Board should expand the IPS discussion on Purpose to include a statement on the mission and purpose of LAFPPS and clarify the Board's fiduciary responsibility.	Implemented	The mission and purpose of the LAFPP, and the Board's fiduciary responsibilities, are reflected in the Board Investment Policies.
3	The Board should include in the IPS the additional investment objective to achieve total returns in excess of the Policy Index.	Not Implemented	The LAFPP Board and staff considered the recommendation and decided not to accept it because the performance reports reflect this information.
4	The Board should include overall cost control as an objective in the IPS.	Not Implemented	A cost control objective was in the previous Board Investment Policies but was removed because LAFPP believed the City Charter requirement for cost control was adequate.
5	The Board should insert a discussion on risk in the IPS to describe and clarify the Board's risk tolerance, including reference to LAFPPS' time horizon, liquidity needs, etc.	Not Implemented	The Board Investment Policies do not contain a general discussion on risk or clarification of the Board's risk tolerance, LAFPP's time horizon, or liquidity needs.
6	The Board should acknowledge LAFPPS' level of risk with some discussion of how its risk level was developed, and include specific guidelines on how to identify and measure risk.	Not Implemented	LAFPP discusses risk as part of the asset allocation process, and the fund's asset allocation reflects the fund's level of risk, but no additional information regarding how to identify or measure risk was added to the Board Investment Policies.
7	The Board should consider developing a detailed practical risk management policy/procedure document.	Not Implemented	Aside from discussing risk during the asset allocation studies there is no other risk management policy.
8	The Board should add a description of the roles and responsibilities of the various parties (e.g., Board, staff, service providers) relative to all investment categories in the IPS and clarify the standard of care applicable to each party.	Partially Implemented	The roles and responsibilities of the Board, Staff and most service providers are all adequately detailed in the Board Investment Policies, but the policies still contain a reference to a specialist manager selection consultant and a performance consultant, neither of which LAFPP currently uses. LAFPP has indicated they may use them in the future.
9	The Board should review and update all stated roles and responsibilities to reflect the restructuring of consultant responsibilities done last year.	Partially Implemented	The Board Investment Policies still refer to a specialist manager selection consultant and a performance consultant, neither of which LAFPP currently uses, and the functions of those consultants are now the responsibility of the generalist consultant. LAFPP has indicated they may use those types of consultants in the future.
10	The Board should clarify the asset allocation review and monitoring process as distinct from performing the analysis and executing a new study.	Implemented	LAFPP has consistently reviewed its asset allocation on a quarterly basis, and asset allocation studies have been completed at least every five years. These are clearly stated in the Board Investment Policies

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			and LAFPP issues a quarterly report on asset allocation status.
11	The Board should require an annual review of the asset allocation and a complete asset allocation study at least every five years.	Implemented	LAFPP reviews its asset allocation on a quarterly basis, and asset allocation studies have been completed at least every five years.
12	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 IPS.	Not Implemented	LAFPP did not add information regarding an asset allocation index to the Board Investment Policies because the performance reports contain information relating to an asset allocation index.
13	The Board should include a more detailed description of the manager search, due diligence and hire process in the IPS or a reference to a separate manager search policy document.	Implemented	Selection criteria vary for each asset class, which is documented in the Manager Selection and Retention Policy, and LAFPP has a stand-alone document that outlines the search process.
14	The Board should update its IPS to reflect that a third-party specialist administers the proxy process in accordance with Board policy.	Implemented	Staff, rather than a third party, administers the proxy process according to LAFPP's detailed proxy guidelines. Through the Board Investment Policies, the Board delegated the authority to vote U.S. securities to the General Manager, and the authority to vote non-U.S. securities to the international equity advisors.
15	The Board should expand the IPS to define clearly how brokerage commissions should be monitored and what types of arrangements (e.g., commission recapture) are permissible or include reference to a separate brokerage policy document.	Not Implemented	LAFPP did not accept this recommendation because staff monitors brokerage commissions and determined the recommendation to add brokerage commission monitoring to the Board Investment Policies was unnecessary.
16	The Board should require managers to submit an annual report on brokerage activity to staff.	Not Implemented	LAFPP did not accept this recommendation because staff is able to generate monthly trading reports.
	3f. Compliance with Investment Guidelines and Monitoring		
1	The Board should develop a written policy for monitoring investment manager guideline compliance and specify procedures, including identifying responsible parties and detailing a method to document monitoring activity.	Implemented	LAFPP has developed an extensive procedure for using the Northern Trust's Compliance Analyst system to monitor manager position deviations from the guidelines and report to staff when deviations have been identified.
2	Staff should review the investment manager guidelines to ensure that all of them contain the essential elements, even if some elements are also listed in the manager's contract. Such items include, for example: the requirement to report guideline violations, reconcile with the custodian bank, fiduciary standard of care and proxy voting policy.	Implemented	The Board Investment Policies contain broad guidelines, and the manager contracts and manager instructions book contain the elements that the prior management audit cited.
3	Staff should reconcile the emerging manager program managers' guidelines with the Emerging Manager Policy.	Not Implemented	LAFPP did not accept this recommendation because the emerging manager guidelines were designed to be separate and easier to modify than the Emerging Manager Policy.
	3g. Investment Management Structure		
1	The Board should continue to monitor its style and capitalization biases.	Partially Implemented	Capitalization data is reported in the consultant's quarterly performance books; however, style biases are not reported.

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2	The Board should work with its consultant to determine if it can reduce the number of domestic equity managers.	Implemented	The number of domestic equity managers was reviewed in 2007 and LAFPP looks at this on an ongoing basis, but there have been no reductions.
3	The Board should consider implementing its absolute return allocation through a portable alpha program in the large cap equity area.	Implemented	The Board considered several strategies and implemented several hedge funds and one portable alpha investment.
4	The Board should continue to work with its consultant to determine if it can reduce the number of international equity managers over time.	Implemented	The number of international equity managers was reviewed in 2007 and LAFPP looks at this on an ongoing basis, but there have been no reductions.
5	The Board should continue to work with its consultant to determine if it can reduce the number of fixed income managers over time.	Implemented	LAFPP had its investment consultant review LAFPP's fixed income manager structure in 2008, which did not result in a reduction in managers, and another review was scheduled for March 2013.
6	The Board should consider focusing the real estate program on commingled fund/limited partnership investment vehicles going forward.	Implemented	LAFPP's portfolio still contains separately-managed real estate holdings, but now has more commingled funds.
7	When determining the ultimate structure of the private equity program, the Board should consider the potential administrative burden and cost structure associated with the various options.	Implemented	LAFPP has restructured the private equity program twice since the management audit, and has reduced the administrative burden and cost of the program.
8	Over time, the Board should consider adding passive investment management in international equity developed markets for some portion of the international equity portfolio to replace under-performing active managers and/or to serve as a core exposure to developed markets.	Implemented	LAFPP has added several passive international equity investment managers and continues to discuss the benefits of active management versus passive.
3h. Custody Relationships and Fees			
1	LAFPPS staff should define detailed procedures and policies for basic custody services such as crediting income, handling proxies, and investigating and compensating for delivery fails in the body or in an appendix or other form incorporated into the custody agreement.	Implemented	LAFPP uses broad terms to describe services in the investment manager contracts and a more detailed set of guidelines tailored to each manager, and each manager is given a document entitled "Instructions for Investment Managers" with goes into further detail on the issues addressed in the recommendation.
2	LAFPPS staff should develop a detailed set of operational procedures and standards for custody operations and incorporate it into the custody agreement.	Implemented	The services portion of the current custodian contract is detailed and includes operational procedures and standards.
3	The Board should amend the contract to establish in detail the products and services being obtained from the bank under the contract and the financial basis under which they are being used.	Implemented	The Northern Trust custodian contract provides sufficient detail regarding the services provided, along with the fees.
4	Staff should evaluate the full range of supplemental monitoring and control services available according to a standard that includes risk reduction as well as return enhancement relative to cost.	Implemented	LAFPP appears to be receiving necessary monitoring and control services from its providers, and evaluates the cost/benefit tradeoff of each service that LAFPP considers.
3i. Securities Lending Program and Fees			
1	LAFPPS should resume active participation in Astec, obtain program activity information from Northern Trust, and thoroughly analyze the results	Not Implemented	LAFPP previously participated in the Astec program, and did not find that it provided information that was useful. The specific choice of vendor, if any, used for

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	of the program against peers and expectations on a regular basis.		monitoring should be based on the evaluation of vendors' capabilities, fees, and LAFFP's needs.
Task Area 4 – Benefits Administration			
4a. Reasonableness of Actuarial Methods			
1	The Board should continue to commission the actuarial experience studies every three years to monitor and justify the assumptions. In addition, the City should continue making the required contributions so funded levels remain at an acceptable percent of liabilities.	Implemented	LAFPP commissions an actuarial experience study every three years that addresses the continued viability of the actuarial assumptions. The City has made the required contributions for each of the years since the last management audit.
	4b. Benefit Payment Testing		
1	LAFPPS should consider ways to identify and prevent processing times in excess of 90 days.	Implemented	The Benefit Payment Process system has been implemented and is designed to identify and prevent processing delays.
2	LAFPPS should make a major attempt to scan member data to get closer to a paperless environment.	In Progress	The document scanning project is progressing, and all new member information is immediately scanned into the system.
3	As soon as is feasible LAFPPS should make available to the retirement staff, a copy of the conversion factors and methodology of their usage on converting from one form of benefit to another form of benefit election. This will allow LAFPPS to continue to verify that the OnPoint system continues to calculate the correct benefit.	Not Implemented	The LAFPP Board and staff considered the recommendation and decided not to accept it because the OnPoint system is correctly calculating benefits.
	4c. Disability Pension Application, Review, Approval and Appeal Procedures		
1	LAFPPS should explore ways to reduce the time it takes to process disability applications. For example, LAFPPS could establish and monitor a maximum turnaround time of examinations for pension doctors.	Implemented	LAFPP monitors the processing time for all disability files, including doctor turnaround time, and explores ways to increase efficiencies.
2	LAFPPS should explore the feasibility of automating as much of the disability review procedures as practical to help expedite the process and to help provide a recovery backup if paper files were destroyed.	Not Implemented	The LAFPP Board and staff considered the recommendation and decided not to accept it because they believe it is difficult to automate review procedures and back-up systems exist for the data.
3	LAFPPS should adopt and implement safeguards to protect the privacy of applicants' medical records.	Implemented	A Security Policy has been adopted that addresses both electronic and hard-copy data security, and the ability to secure physical documents has been increased. Compliance with the policy is monitored regularly.
4	The Board should develop an orientation program to train Commissioners on how to efficiently and effectively assess the materials contained in the disability packages provided them.	Implemented	The Board Governance Policies encourage Board members to obtain orientation and training on the disability program and the Board members stated that disability training is taking place.
5	The Board should evaluate whether to delegate responsibility for disability cases to hearing officers given their time constraints.	Not Implemented	The LAFPP Board and staff considered the recommendation and decided not to accept it because they believe that hearing examiners are

Item	Recommendations	Status	HEK Comments
			prohibitively expensive and would prolong processing time.
6	The Board should request written clarification on LAPD's policy regarding essential job functions required for disabled officers.	Partially Implemented	LAFPP uses a disability rating worksheet for disability evaluations, but has not requested LAPD to clarify essential job functions for disabled officers.
4d. Reasonableness of Calculations and Actuarial Methods Used for Projecting Future Retiree Health Benefits			
1	Data on marital status at retirement and age difference of spouses should be examined more closely by LAFPPS. This can be a more significant factor in an OPEB valuation than in a retirement valuation.	Implemented	LAFPP's actuary analyzed marital status at retirement and the age difference of spouses while conducting the June 30, 2007 experience study.
2	A mortality table reflecting expected future improvements in longevity should be considered by LAFPPS, possibly a generational mortality table that "automatically" projects future improvement.	Implemented	LAFPP's actuary analyzed longevity improvements while conducting the June 30, 2007 experience study, and recommended an updated mortality table, which the Board adopted. Because LAFPP has an experience study conducted every three years, the Board determined that a generational mortality table was not necessary.
3	LAFPPS should consider the impact of a higher trend scenario on the cost of the plan. For example, changing the grading from 1% per year to 0.5% per year to the same ultimate 5.0% would result in a significant increase in liabilities and cost.	Not Implemented	The LAFPP Board and staff considered the recommendation and decided not to accept it because the Board has already examined the existing trend rate and has adopted its consultant's recommendation.
4	There may be an understatement of liabilities as a result of the manner in which the trend assumption is applied, and this should be reviewed by LAFPPS.	Implemented	The LAFPP Board and staff sought its consultant's opinion and were assured that the trend assumption is being applied correctly.
5	Additional analysis of experience should be undertaken by LAFPPS in the election of medical coverage, the percentage of spouses, who will be covered, and the age difference of retirees and their spouses.	Implemented	LAFPP's actuary analyzed the election of medical coverage, marital status at retirement and the age difference of spouses while conducting the June 30, 2007 experience study.
6	If assets are tracked separately, it would provide useful information to include these exhibits for OPEB separately.	Not Implemented	The LAFPP Board and staff considered the recommendation to track OPEB assets separately and decided not to accept it because it was not practical given the organization's current circumstances.
7	Segal should be asked to describe whether an implicit rate subsidy exists, and to document their analysis by which they made their determination.	Not Implemented	The LAFPP Board and staff considered the recommendation to obtain an opinion on whether an implicit subsidy exists and decided not to accept it because it was not practical given the organization's current circumstances.
8	The latter basis, contributions paid at the end of each pay period, presumably the one that is being followed, should be the sole measure used by LAFPPS in the report.	Not Implemented	The LAFPP Board and staff considered the recommendation to determine contribution rates based solely on whether the contributions are made at the end of each pay period and decided not to accept it because it was not practical given the organization's current circumstances.
9	The Medicare Part D subsidy should be described in the actuarial valuation report and an estimate of the value of the subsidy should be included in the	Not Implemented	The LAFPP Board and staff considered whether the Medicare Part D subsidy should be described in the valuation and whether a value of the subsidy should

Item	Recommendations	Status	HEK Comments
	report.		be reported and decided not to do that because it is inconsistent with the consultant's understanding of GASB requirements.
5a. Significant Expense Analysis			
1	The Board should review the manager fees by portfolio, and in the few cases where fees are high, consider a renegotiation with the investment manager.	Implemented	Staff monitors and constantly negotiates and renegotiates fees with investment managers. The LAFPP Board and staff are very aware of manager fees.
2	LAFPPS should engage a recognized firm to conduct at least occasional evaluations of its outside managers' quality of execution and use the results as one component of evaluating them.	Not Implemented	LAFPP did not accept this recommendation because they believe the most appropriate way to measure manager performance is returns, which takes into account quality of execution.
3	LAFPPS should thoroughly evaluate the net benefit of the commission recapture program including the quality of execution of trades by brokers designated by the managers.	Not Implemented	LAFPP did not accept this recommendation because they believe the most appropriate way to measure manager performance is returns, which takes into account commission recapture and quality of execution.

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Appendix B

Scope of the Audit

The audit scope will also include a general assessment of the implementation status of the prior audit's 169 recommendations for LAFPP for the purpose of determining the impact on the current audit.

Objective 2: Determine whether the administration of LAFPP resulted in minimizing City contributions

Objective 4: Ensure that expenses of administering the pension/retirement system have been defrayed properly, including expenses related to Board travel activities. This would include determining whether LAFPP should pursue opportunities to minimize administrative expenses by cost-sharing with the City or the City's other pension systems.

(a) Contractor will evaluate LAFPP's administrative expenses to make sure they are reasonable and necessary and both prudent and in the best interest of the members and beneficiaries.

(b) Contractor will identify overall costs of administering LAFPP and any cost sharing arrangements.

(c) Contractor will identify any additional cost-sharing vehicles that could be used, including but not limited to exploring the cost/benefit of using City owned office space, office sharing, aggregating assets for purposes of calculating fees for investment managers, sharing technology, and cost – sharing of the investment consultants and custodial services.

(d) Contractor will compare administrative costs to other public funds and industry survey data.

(e) Contractor will evaluate travel expenses to ensure they are in accordance with statutory requirements and Board-approved procedures to determine:

1. Whether there is a process in place to prevent or mitigate potential abuse;

2. Whether travel taken is in furtherance of relevant Trustee education and the interests of the members and beneficiaries;

3. Whether current practices are in compliance with applicable statutory requirements;

4. Whether the existing process is being followed in practice;

5. How the process compares to other well-run public retirement systems. We will look at administrative expenses rather than investment expenses for the interim report, but will possibly expand to investment advisors (consultants).

Objective 7: Evaluate whether investment activities and plans are in compliance with established investment objectives and policies for the pension/retirement system, and that investment managers' performance is evaluated periodically (i.e., over a market cycle of 3-5 years). What actions has LAFPP taken to remove poor performing investment managers?

(b) Contractor will determine whether the IPS clearly articulates LAFPP's investment objectives, sets forth clear criteria and frequency for conducting investment manager evaluations, process for dealing with underperforming managers and circumstances for manager termination.

(c) Contractor will review and report on the frequency with which performance was evaluated and what actions were taken for underperforming managers and advise on whether the processes are adequate.

Objective 9: Assess the adequacy of the System's evaluation of the ongoing cost-benefits associated with participation in actively managed funds as compared to passively managed funds. The need to both diversify system investments and maximize return on investment is critical to the System, however, there are significantly more costs associated with actively managed funds.

(a) Contractor will review LAFPP's current level of active versus passive management employed in various asset classes and the associated costs.

(b) Contractor will compare LAFPP's use of active and passive management and the related costs to other comparable public funds.

(c) Contractor will perform a document review and interviews to determine whether LAFPP formally performed a cost benefit analysis of active versus passive management.

Objective 12: Determine whether the pension system adequately evaluates investment performance with costs to ensure costs are minimized. This includes determining where investment consultants and asset custodial services can be consolidated for Fire and Police Pensions and LACERS to achieve savings.

(e) Contractor will explore the feasibility of consolidating investment consultants and custodial services currently used by LAFPP and LACERS and determine whether cost savings can be realized.

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Appendix C

Interviews:

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

<u>LAFPP Staff</u>
Erin Kenney, Internal Auditor
Tom Lopez, Chief Investment Officer
William Raggio, Interim General Manager
Joseph Salazar, Assistant General Manager

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Appendix D

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, and actuarial experience studies
- Legal opinions provided to LAFPP
- LAFPP Board Governance, Operating and Investment policies
- 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 E

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.

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.

Asset Class
Distinct market segments for investing. For example, stocks, bonds, real estate, and cash equivalents are considered to be separate asset classes.

Basis Point (bp)
One-hundreth 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

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.

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.

Governance

The processes and systems 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)
The statement of policy is the communication of a risk policy to the fund's investment manager(s). It states unambiguously the degree of investment risk which fiduciaries are willing to undertake with pension trust assets.

Liquidity
A concept which prescribes that sufficient cash, or cash-like securities, be available at times of disbursement for retirement, disability or separation. The ease with which an asset can be converted into cash with little or no change in value.

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.

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.

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.

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").

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.

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: 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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ASSISTANT GENERAL MANAGERS

TOM LOPEZ
CHIEF INVESTMENT OFFICER

May 14, 2013

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

Dear Ms. Greuel:

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

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 dedicate our professional lives to the administration of retirement plan benefits through a prudent investment program and efficient, effective cost controls. We welcome this independent evaluation of the administration of these benefits.

We believe the findings and conclusions of the Interim Report are reasonable and thoughtful, and we pledge to work with staff and the Board of Fire and Police Pension Commissioners to give full consideration to each recommendation. Some of our suggested actions refer to staff working with consultants to study the recommendations. We will take each recommendation seriously and commit to perform the appropriate level of due diligence in order to bring forth supported recommendations to our Board.

We appreciate your assessments that investment processes are sound overall and investment fees are reasonable, and we also thank you for providing clear recommendations designed to strengthen these areas.

The analyses of investment return assumptions, asset valuation, actuarial cost methods, amortization periods, administrative costs, and conclusions regarding impact to the unfunded liability and the City's contributions are logical, insightful, and considerate of our administrative and fiduciary responsibilities.

We wish to formally document our acceptance of each of the 21 recommendations as indicated below.

Recommendations and actions

Recommendation 1
Reconsider the completion of recommendations 2a/23, 2f/02, 2g/04, 3c/02, 3c/04, 3e/05, 3e/06, 3e/07 and 3e/12 from the prior management audit. If further consideration is given, the decisions and rationales for them should be documented and provided to the Joint Administrators.

LAFPP will present the reconsideration for each recommendation to the Board of Pension Commissioners.

Recommendation 2
Conduct an asset/liability modeling study every five years.

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

Recommendation 3
Continue to examine ways to become more efficient in processing benefits and collaborate with peers about their cost control efforts.

Agreed. This will continue to be done on an ongoing basis.

Recommendation 4
Establish administrative budgets that more tightly control spending rather than budgets that are well beyond what is needed and actually spent.

Agreed. We have taken steps in the budgets for Fiscal Years 2012-13 and 2013-14 that more closely reflect actual expenditures. We also have created a project in our 2013-14 Three-Year Strategic Plan to explore performance based budgeting.

Recommendation 5
Continue to monitor the timeliness of travel expense reimbursement requests to ensure compliance with Board policy and the Los Angeles Administrative Code.

Agreed. This will continue to be done on an ongoing basis.

Recommendation 6
Ensure that Trustees stay within the limit of six conferences per fiscal year.

All trustee travel, including that above the limit of six conferences per year, will continue to be presented to the Board.

Recommendation 7
Continue to re-evaluate the value of various conferences and forgo attending those that are too expensive for the amount and type of education they provide.

Agreed. This will continue to be done on an ongoing basis.

Recommendation 8
Include a description of liquidity needs and risk tolerance in the Board Investment Policies.

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

Recommendation 9
Consider whether 80% NCREIF ODCE Index (net) and 20% DJ U.S. Select Real Estate Securities is a more appropriate real estate benchmark.

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

Recommendation 10
Amend the Board Investment Policies to require a comparison of investment returns against a total fund policy benchmark that reflects the target asset allocation approved by the Board.

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

Recommendation 11
Update the watch list quarterly and expand the watch list criteria to include longer term performance against benchmarks and peer rankings.

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

Recommendation 12
Refine the policy for removal of a manager from the watch list.

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

Recommendation 13
Document the due diligence process used in the ongoing monitoring of managers.

Agreed.

Recommendation 14
Prepare documentation following each due diligence visit, including summaries of and any changes in organization, personnel, strategy, or style.

Agreed.

Recommendation 15
Prepare and follow a schedule to update material portions of the Board Investment Policies.

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

Recommendation 16
Include holdings-based style analyses in the consultant's quarterly reports.

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

Recommendation 17
When evaluating the potential termination of a manager on the watch list or whose contract is up for renewal, increase focus on factors such as material changes in personnel, ownership, clients or assets under management, and investment style in addition to past performance.

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

Recommendation 18
Enhance documentation from investment manager calls and meetings, even if there are no significant findings.

Agreed.

Recommendation 19

Benchmark the overall allocation between passive and active management against peers at least every five years as part of the portfolio structure review.

Agreed.

Recommendation 20

Have the investment consultant provide a report that shows whether LAFPP is receiving adequate additional returns from active equity and fixed income managers.

Agreed. On April 30, 2013, our consultant and staff provided a report to the Ad Hoc Managers Fees Committee regarding returns, manager fees, and active versus passive approaches. The report was requested by the Committee late last year. This practice will continue, with committee recommendations being presented to the Board.

Recommendation 21

Clarify and document the role of Portfolio Advisors through an updated contract and seek lower fees, if appropriate.

Agreed.

Finally, we appreciate the recognition that City contributions to the system are primarily driven by the costs of benefits and investment earnings, and that administrative expenses are not large enough to have a material impact on the unfunded liability or the City's contributions. LAFPP will continue to seek ways to control costs, mitigate investment and operational risks, and improve administration of plan benefits to our members. We thank you and sincerely look forward to the second phase of the audit.

Very truly yours,

Raymond P. Ciranna

Raymond P. Ciranna
Interim General Manager

RPC:WSR:EJK