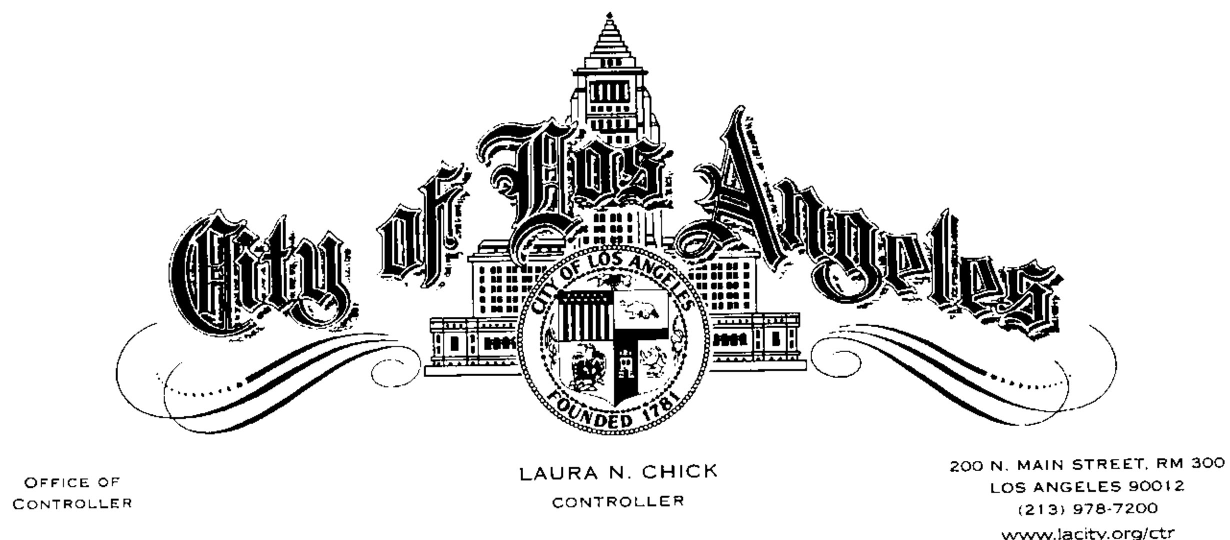

OFFICE OF
CONTROLLER

LAURA N. CHICK
CONTROLLER

200 N. MAIN STREET, RM 300
LOS ANGELES 90012
(213) 978-7200
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November 21, 2007

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 attached "Final Report on the Management Audit of the Los Angeles Fire and Police Pension System (LAFPPS) examines whether LAFPPS has been managed in an effective, efficient and economical manner. The audit included an evaluation of LAFPPS' governance, organizational structure and resources, benefit administration functions, processes to minimize City contributions (through its investment program) and administrative processes and costs.

Due to the leadership and efforts of LAFPPS' Board and staff, the audit found that LAFPPS was: generally operating efficiently and within best industry practices; providing good investment returns overall; utilizing reasonable actuarial assumptions and methods; and already funding its Other Post-Employment Benefits (which puts it ahead of most similar public plan sponsors).

AN EQUAL EMPLOYMENT OPPORTUNITY – AFFIRMATIVE ACTION EMPLOYER

Independent Fiduciary Services, Inc. conducted the management audit 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,

LAURA N. CHICK
Controller

ANTONIO R. VILLARAIGOSA
Mayor

ERIC GARCETTI
City Council President
13th Council District

Enclosure

cc: Honorable Rockard J. Delgadillo, City Attorney
Robin Kramer, Chief of Staff, Office of the Mayor
Sally Choi, Deputy Mayor
Michael A. Perez, General Manager, Department of Fire and Police Pensions
Karen L. Sisson, City Administrative Officer
Frank T. Martinez, City Clerk
Gerry F. Miller, Chief Legislative Analyst
Independent City Auditors

INDEPENDENT FIDUCIARY SERVICES, INC.

744 Broad Street ~ Suite 1120 ~ Newark, NJ 07102 ~ phone: 973-424-6400 ~ fax: 973-424-6419

October 18, 2007

Management Audit Oversight Committee
c/o Office of the Controller
City of Los Angeles
200 N. Main Street, Suite 460
Los Angeles, CA 90012

Re: Management Audit of the Los Angeles Fire and Police Pension System (LAFPPS)

Dear Oversight Committee Members:

Enclosed with this letter please find Independent Fiduciary Services® (IFS) Final Report on the Management Audit of the Los Angeles Fire and Police Pension System (LAFPPS). In accordance with your request, we are providing three bound copies. We have also provided by e-mail a .pdf file of the Report for ease of printing and distribution.

IFS greatly appreciates the opportunity to be of service to the City of Los Angeles and we hope that this Report will be a useful tool and provide significant benefit to LAFPPS.

Very truly yours,

Steven M. Harding
Senior Vice President

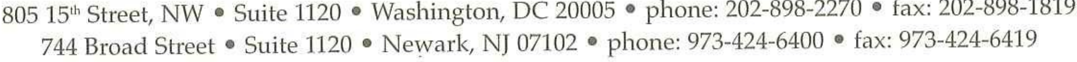
INDEPENDENT FIDUCIARY SERVICES, INC.

Independent Fiduciary Services®

Final Report

On the Management Audit of the
Los Angeles
Fire & Police Pension System
(LAFPPS)

October 18, 2007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Independent Fiduciary Services®

Final Report

On the Management Audit of the
Los Angeles Fire & Police Pension System
(LAFPPS)

Introduction

This Final Report is presented in four sections: Section I - *Executive Summary*; Section II - *Background, Review Methodology, and Limitations on the Report*; Section III - *Detailed Discussion and Analysis*; and Section IV - *Exhibits*.

Section I, Executive Summary, offers a high level overview of the major themes in the report. The Executive Summary should be used in the context of the full Final Report.

Section II, Background, Review Methodology and Limitations on the Report, describes IFS and the methodology we followed in performing this assignment. It then explains the overall format of the Final Report, and concludes with caveats and observations about the substantive sections of the Final Report.

Section III, Discussion and Analysis, constitutes the body of the Final Report. This section is divided into Task Areas 1 through 5 based on the scope of work. The Discussion and Analysis sets forth the topic, guiding principles, risks (that are typical for the topic but not necessarily risks applicable to LAFPPS), detailed observed conditions, and recommendations of IFS based on our audit.

Since the scope of work contains task areas that sometimes overlap (for example, the Governance task area affects other task areas), some sections have been combined for ease of reading.

Section IV, Exhibits, contains supporting material, tables and charts that are referenced within the body of the report. A summary of report recommendations is included as Exhibit A.

Section I.

Executive Summary

In accordance with the City Charter, the City of Los Angeles ("the City") is required to perform a periodic management audit of its pension Departments. In that regard the Mayor, the City Council and the City Controller hired Independent Fiduciary Services, Inc. ("IFS") to perform an independent, thorough and impartial review – a management audit – of the Los Angeles Fire and Police Pension System ("LAFPPS", "the Department", "the Fund", or "the System") and the Los Angeles City Employees' Retirement System. This Report only addresses LAFPPS. The audit period for purposes of the management audit encompassed July 1, 2000 through January 11, 2007 (the "review period"), with the focus on the latter part of the review period unless IFS determined, based initial results, that the period should be expanded.

LAFPPS is a defined benefit retirement plan, which has approximately 13,000 active members and 12,000 retired members. LAFPPS is governed by a nine-member Board of Commissioners. Five Commissioners are appointed by the Mayor. Two Commissioners are active sworn members (one from the Fire Department and one from the Police Department) elected by the active members of their respective departments. Two Commissioners are retired members (one from the Fire Department and one from the Police Department) and are elected by the retired members of their respective departments. The Board governs the System and, per the Los Angeles City Charter, has sole and exclusive fiduciary responsibility over the System's assets. The Board appoints a General Manager to oversee LAFPPS operations.

The high–level objectives of the management audit, as set forth in the City Charter, are to (1) examine whether the pension or retirement systems are operating in the most efficient and economical manner and (2) evaluate the asset allocation of the systems. Within those two stipulated objectives, the scope of work was refined to determine whether the Los Angeles Fire and Police Pension System has been managed in an effective, efficient and economical manner. Our management audit included an evaluation of the Department's governance, organizational structure and resources, benefit administration functions, processes to minimize City contributions (through its investment program) and administrative processes and costs.

This *Executive Summary* is provided to summarize some of the more notable sections of our Report. It is not intended to take the place of the full report. We encourage readers of this Report to examine the detailed narrative contained in the body of the full Report.

Fiduciary Standard of Care

Although public pension funds are not subject to the federal Employee Retirement Income Security Act of 1974 ("ERISA"), the ERISA prudence standard serves as a best practice

model. The statutory articulation of the prudence standard applicable to LAFPPS board members is virtually identical to the ERISA "prudent expert" standard. We highly support application of the ERISA fiduciary standard to public fund fiduciaries. In that regard, LAFPPS follows best practices when it comes to its fiduciary standard of care.

Board Policies

We found that the Board has adopted a series of comprehensive governance documents that are collectively referred to as the Governance Manual. With the assistance of an outside consultant, it is clear that the Board and staff expended a considerable amount of time developing and refining the policies that comprise the Governance Manual. The processes and procedures are clear and concise and serve as an important guide for the Board and staff in the efficient management of the system. Following our review period, the Board also informed IFS that it had completed its 2007-08 Strategic Plan, which we identify in our report as an essential component of a good governance program.

Some of the policies had not been fully implemented during the reporting period, due in part to the fact that many of the policies were adopted fairly recently by the Board. Nonetheless, the Board and staff are making significant strides in bringing LAFPPS' operations into conformity with the Board's written policies and procedures. We made recommendations on enhancements to some of these policies and procedures in our report.

Pursuant to a detailed Board Self-Evaluation Policy, the Board also conducts an annual board self-assessment. We commend the Board for recognizing the importance of reviewing and evaluating its own actions, procedures and processes.

Use of Legal Counsel

The City Attorney, who serves as the statutory attorney for the City of Los Angeles, is empowered by law to serve as legal counsel to LAFPPS, even though the City Attorney's interests at times may conflict with those of the retirement system. Granting the Board exclusive authority to contract for legal services is consistent with best practices. Our Report discusses this issue in detail. In addition to relying on the City Attorney for legal advice, we recommend that the Board seek legislative authority to select, hire and retain its own legal counsel and to hire outside counsel when specialized legal advice is required.

Fiduciary Liability Insurance

Directly and through the City Attorney's office LAFPPS has investigated whether the premium cost of maintaining a fiduciary liability insurance policy is justified. The clear conclusion has been that, given the coverage limitations in such policies, the likelihood of a

covered event occurring is limited, and possibility of collecting against it is small. Therefore the very high premiums such policies require are not justified. We agree with this conclusion.

Organizational Structure, Efficiency and Staffing Adequacy

Within LAFPPS the Investment Division has nine employees and a ratio of one manager (the Chief Investment Officer ("CIO")) to eight staff. Staff have responsibility for different asset classes and the CIO is responsible for oversight of the entire investment program. All staff appeared clear on their responsibilities and lines of reporting among CIO, the Board, and the General Manager ("GM"). Recently, LAFPPS has increased the complement of staff in the Investment Division by three staff. We believe this was a prudent move to provide additional back up and possible succession. The recent departure of one of the investment officers on an emergency appointment to another City Department underscores the necessity for sufficient staffing levels.

We have several observations in the benefits administration area regarding its organizational structure. These observations should be addressed through development of written documentation that would identify roles and assign responsibility for: establishing appropriate procedures to protect the privacy and security of member records and data; monitoring and ensuring compliance with regulations and laws; and, developing, revising and maintaining a business continuity plan.

In the area of efficiency and effectiveness, staffing adequacy and use of resources we have numerous observations and more than thirty recommendations for improvement. Please see Task Area 2c, 2d and 2e of Section III.

Opportunity for Joint Efficiency/Economy of Scale through Consolidation with the Los Angeles City Employees' Retirement System ("LACERS")

As discussed in greater detail in Section 2j, we recommend that the City consider consolidation of LAFPPS and LACERS investment programs. Consolidation would not reduce benefits or dissolve the current pension fund Boards. In fact, because of the potential for increased economies of scale, the ability to pay benefits should be enhanced and the Boards could become more focused. Appropriate enabling statutes and Charter amendments would be required. In that regard we encourage a dialog among all interested parties to begin exploring consolidation. We recognize that there may be several models for consolidation. Consequently, to promote unbiased consideration and avoid polarization, we have not proposed any particular model. We believe that through appropriate legislative and administrative processes and with voter approval, the City could successfully combine the investment programs and realize sizeable economic benefits. For the immediate future, we encourage the two Departments to seek synergies even if a formal consolidation is not undertaken.

Use of Investment Consultants and Provision of Contractual Services

We find LAFPPS maintains a reasonable approach to consulting services for a fund of LAFPPS' size and investment structure. LAFPPS recently retained a general investment consulting firm, Pension Consulting Alliance ("PCA"), having previously employed specialist consultants. Additionally LAFPPS retains a real estate consultant, The Townsend Group. The Board is in the process of determining their private equity consulting restructure.

We find that, in general, PCA is providing the required contracted services and is adequately assisting the Board, but that the Board could request more services from PCA without incurring additional fees. Additionally, we recommend that the standard of care and fiduciary responsibility be specified in the consultant's contract.

Our review of The Townsend Group's work product and our interviews with LAFPPS staff indicate that the consultant appears to have substantial knowledge and experience regarding real estate investment management and that the services specified in the contract are being provided in practice.

Asset Allocation Process, Diversification, Risk and Return

LAFPPS, with the assistance of their general investment consultant, used an appropriate process to determine their current asset allocation and we found the assumptions and resulting asset allocation to be generally reasonable. However, we recommend that LAFPPS consider requesting more analysis regarding the impact of the asset allocation policies on the liabilities and conducting a complete asset liability study. To test the efficiency of the asset allocation, IFS also performed a Mean Variance Optimization (MVO) analysis and determined that the newly adopted long-term target allocation is fairly efficient and is expected to meet or exceed the actuarially assumed rate of return. We also found that while the newly adopted long-term target asset allocation will achieve a higher return than the previous policy with a similar return/risk ratio, it has better risk characteristics when back-tested using historical benchmark return data. We recommend that LAFPPS ensure that Board members have access to and are satisfied with training and reporting on investment issues such as asset allocation and risk metrics.

Asset Allocation Re-Balancing Process

LAFPPS' Board has set policy target allocations and threshold ranges for asset classes and sub-asset classes and has approved a new rebalancing policy. While overall we believe the rebalancing policy adopted by LAFPPS is reasonable and in line with common practices at large public pension funds, as discussed in more detail in the Report, typical rebalancing strategies contain implicit and explicit bets and LAFPPS may want to consider adopting a more advanced approach in the future.

Investment Policy Statement (IPS) and Guidelines

The LAFPPS IPS is reasonable and complete in many essential respects; however, we identify several elements in the Report that we believe the Board should consider revising. The IPS contains several unclear or inconsistent elements, and we recommend a comprehensive review and edit of the document for consistency and clarity. We understand that staff and the general consultant are in the process of reviewing the IPS, and they are currently making revision recommendations to the Board. Additionally we recommend that the IPS clarify the standard of care assignments for all parties involved, and that the IPS 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.

Compliance with Investment Guidelines and Monitoring

The IPS does spell out many key requirements for monitoring and maintaining investment managers, such as requiring an annual review of each manager. The IPS does not spell out the guideline compliance monitoring process. We understand that, in practice, staff has responsibility for monitoring each investment manager's adherence to their investment guidelines. Recently, LAFPPS has engaged the custodian bank's "Compliance Analyst" portfolio monitoring software to flag guideline violations. The system emails a daily report which flags any violations to four staff members. We believe that the fund needs to document a policy regarding the ongoing monitoring process steps, which includes identifying responsible parties and a method of documenting the monitoring activity.

Investment Management Structure

We found that LAFPPS has diversified well-thought out investment programs for all of its asset classes and we discuss the few structural biases in our Report, although the future structure of the private equity allocation was uncertain at the time we did our due diligence for this Report. LAFPPS' general investment consultant provides detailed asset class investment structure reviews on a regular basis. Overall the number of managers employed by LAFPPS appears to be on the high side, but not unreasonable. This is at least partly due to the use of a few fund-of-fund managers to gain exposure to multiple emerging managers, although there may be a few opportunities to reduce the overall number of managers as noted in our Report. We also discuss how LAFPPS could consider implementing a portable alpha program in the large cap domestic equity space and using some amount of passive management for a portion of the developed market international equity allocation.

Custody of Securities

LAFPPS is nearing the end of its first three year contract with Northern Trust for securities custody, securities settlement (receipt, delivery, and payment processing for securities purchases and sales), and related services such as income and dividend processing, accounting and reporting. Service under the contract has been satisfactory. In such cases, it is common for staff to recommend, and for the Board to approve, renegotiating and continuing the relationship for an additional three year term; we expect this to happen. This is a reasonable middle ground between the contracting limits and the practical costs of conducting periodic searches via RFP.

Like the majority of large public pension funds, LAFPPS lends some of the securities it owns in order to increase overall investment returns by earning income on invested collateral for the securities on loan. The basic custody services contract is linked to the securities lending contract, with no explicit fees for any custody services as long as the exclusive securities lending relationship remains in place. LAFPPS has arranged for Northern to provide a number of additional services that feed off the basic custody data for no additional fee. Some of these services carry additional fees on the bank's standard pricing chart. Neither the providing of these services nor the detailed operating procedures and standards are reflected in the contracts, except through incorporation by reference of the RFP through which the bank was selected. We recommend developing specific detailed operating procedures and descriptions of the various additional services included under the contract and explicitly incorporating them into the legal document.

Securities Lending

The Northern Trust securities lending program linked to the custody operation is largely satisfactory. The fee split is attractive even before considering its covering other custody fees. The basic contractual documents are standard forms that are adequate for such an arrangement. We have not had an opportunity to review the various attachments and exhibits, but based on our experience reviewing other Northern Trust securities lending relationships, we do not expect there are serious problems.

LAFPPS does not monitor the financial results of the securities lending program. They have concluded that participating in Astec, the industry standard cooperative peer benchmarking service, is not cost justified. We believe there are both fiduciary and potential long term financial benefits to tracking this data and if necessary discussing it with the lending agent, and recommend LAFPPS participate in this program.

Investment Management and Consulting Costs

Comparative surveys indicate that LAFPPS' generally paid within the same range as its peer group's average fees for external investment management. Some fee reductions may be

possible by negotiation with managers, and by placing a larger amount of assets with individual managers, and we find that LAFPPS may be able to reduce the number of managers in some asset classes.

LAFPPS incurs various investment consulting expenses. In our experience PCA's fee is on the high side relative to their scope of services which is more limited than most general consulting contracts. The real estate consulting fee is moderate in our experience. Previously, LAFPPS retained four private equity consultants simultaneously, which resulted in multiple fees for some overlapping services, and thus was expensive. LAFPPS is currently revising its private equity consulting structure.

Costs of Investment Transactions

LAFPPS monitors its transactions costs only indirectly as a part of total manager performance. They have concluded that the cost of obtaining direct measurement is not justified, because that factor alone would not drive a decision to retain or terminate a manager. LAFPPS has also concluded that monitoring best execution and the use of soft dollars is the responsibility of the investment manager, also ultimately becoming a factor in total return. While the general conclusion might be true, we disagree that monitoring is unnecessary and not cost justified. Small increments of total return can easily fall within acceptable performance limits where they cannot be identified, yet be material to the fund's total return and to the manager who can obtain direct or indirect benefit from them. We recommend that both manager directed and commission recapture trading costs and quality of execution be at least periodically measured by an independent service, the results evaluated, and as necessary discussed with the individual managers.

Actuarial

LAFPPS' contract actuary has performed annual valuations each year as per statutory and accounting requirements. The actuary has also performed experience studies that measured the actual economic and demographic experience of the plan every three years, with the most recent study dated June 30, 2004. Our review of the assumptions used indicates they are reasonable. The policy of doing experience studies on a three-year cycle is in keeping with best practices for public pension plans. The primary actuarial method applied by the actuary is reasonable. The overall funded status of LAFPPS is considered very good at approximately 95%. The experience studies performed periodically help LAFPPS make positive changes to the plan funded status, and they should continue to commission the experience studies every three years. In addition, the City should ensure that it makes the required contributions to be certain that the funded status is maintained at sufficient levels.

Other Post-Employment Benefits (OPEB)

LAFPPS has partially funded its OPEB liabilities. In that very important respect it is ahead of most public plan sponsors that have post-employment healthcare liabilities. We commend LAFPPS and the City for having the foresight to plan ahead to fund these obligations. Please see Section 4 of this Report for several important observations and recommendations.

Administrative Expense

LAFPPS' overall administrative expense is near the mean of a group of comparable sized funds. Please see our more detailed discussion in Section 5.

*   *   *

Please note that the above summary only highlights a few of the numerous observations and recommendations contained in the Report. Further, it is important to note that in some cases our recommendations can not be implemented by LAFPPS independently because a Charter change may be necessary and/or the involvement and cooperation of other branches of City government may be required.

IFS has performed numerous operational reviews of public pension funds over the past twenty years. The results of this review demonstrate that LAFPPS is doing very well with room for improvement in the areas specified in our recommendations.

We wish to thank Mr. Michael Perez, the Department's General Manager, Ms. Laura Guglielmo, Assistant General Manager, Ms. Tedi Florendo and Ms. Martha Zambrano, our liaisons with the Department, and the Department staff for their support, co-operation and participation during this extensive review. We also wish to thank Ms. Cynthia Varela, our primary contact from the Controller's Office and liaison with the Management Audit Oversight Committee.

Section II.

Background, Review Methodology, and Limitations on the Report

IFS specializes in evaluating the organization, administration, and investment programs of pension systems using combined expertise in investment practices, fund operations and fiduciary responsibility. In operation for almost 20 years, we have performed similar evaluations for numerous other public and private pension funds.

The analysis leading up to this Final Report progressed through the following stages:

Document Collection

In most sections of the Final Report, we set forth "standards" that we used as criteria for the area being evaluated. In some cases the standard(s) or criteria comes from "common" practice i.e., what most pension funds do in the course of structuring and operating its programs, or in other cases, may be based on IFS' experience of industry 'best" practice. A best practice is not what others are customarily doing. Rather, a best practice can be defined as what works most effectively and efficiently based on an experience-tested, repeatable, course of action to achieve a desired result. What is a best practice for one entity, or at a particular point in time, may not be a best practice for another. Identifying what the "best" practice is regarding a particular area under review can be derived from several distinct but interrelated authoritative sources, including but not limited to

- Legal standards (enacted and proposed)
- Respected industry publications.
- Pronouncements by professional industry organizations
- Industry expert practitioners and commentators
- Observations gleaned from special evaluative studies of pension funds' structure and administration (e.g. operational reviews or management audits) performed by industry experts[1]

[1] See, *Identifying and Adopting Best Practices for Institutional Investors*, written by Samuel W. Halpern and Andrew Irving of Independent Fiduciary Services, Inc., Chapter 11 of Portfolio Management: A Modern Approach for Professionally Managed Funds, J. Clay Singleton, McGraw-Hill, 2004.

It is important to note that a "common" practice may not be a "best" practice, and a "best" practice is often not a "common" practice. While a common practice may work, it may not be the most effective and efficient means of operating.

The analysis leading up to this Final Report progressed through the following stages:

Document Collection

The first stage in our process was collection – with the staff's cooperation – of information regarding the Board's operations, and investment program and practices. This included amassing extensive data and documents, such as the Board's enabling and related statutes, written operating policies and procedures governing the organization, written investment policies and guidelines, service provider contracts, and other materials. This phase was conducted from February through March, 2007.

Analysis & Interviews

The next stage of our process, which continued throughout the project, was analysis. In undertaking this review, IFS employed a team approach, assigning certain of its personnel to concentrate on particular subject areas. Throughout the process, we coordinated and integrated our efforts and maintained communication with representatives of the Management Audit Oversight Committee ("the Committee" was comprised of representatives of the Mayor's Office, Chief Legislative Analyst's Office for the City Council and the Controller's Office) and the Department. The main interview phase was conducted March 12 through March 23, 2007. Subsequent interviews were conducted by telephone. In addition, we conducted a web-based, anonymous survey of all investment staff and Board members.

Discussions

The third stage of the process was to hold a series of discussions with people directly associated with the Department. These included face-to-face and/or telephone interviews with the Board Members, the General Manager, staff members, Legal Counsel and the investment consultant. These discussions occurred from March through April, 2007.

Research

IFS performed research directed at 'peer' pension funds. The results of the research are incorporated in the Discussion and Analysis section of the Final Report.

Draft, Preliminary Review Report, Final Draft and Final Report

The written report also progressed through several stages. We submitted a first draft to the General Manager and the Committee on May 15, 2007. The purpose of the first draft was to obtain comments from the Department. Comments on the draft were received on June 29, 2007. The Preliminary Review Report was issued to the Committee on July 27, 2007. Comments were received and discussed with the Committee on August 29th, 2007 to arrive at the final draft. The IFS team presented the final draft at an Exit Conference on October 1, 2007. The Exit Conference was attended by the Department General Manager, several staff members, three LAFPPS Board members and all members of the Management Audit Oversight Committee. At the Exit Conference Department management and the Board Members provided a few additional minor comments and suggestions which we have incorporated into this Final Report where we believe a correction was necessary or where they added value. The Department has taken many steps already to implement recommendations from the draft report.

This process of draft, comment and redraft enabled relevant parties to point out matters that, in their view, were either factually or conceptually inaccurate, incomplete or misleading, and enabled us to obtain additional information and prepare a final report that takes into account all relevant comments. The final product reflects the combined analytical and writing efforts of a diverse team of professionals.

Report Caveats

This Final Report should be read and evaluated with several caveats in mind.

First, many of the subjects addressed in this Final Report are inherently judgmental and not susceptible to absolute or definitive conclusions. When we express a judgment or make a recommendation, we also set forth the observed conditions and rationale that led us to that viewpoint. Many of our conclusions are less in the nature of definitive recommendations than they are alternatives for the Board and staff to consider in light of LAFPPS' evolving investment program. Some of the recommendations state that LAFPPS should 'continue' doing something. These are meant as encouragement or support for the institutionalization of a process that was observed.

Second, in conducting this review, we necessarily relied on oral and written representations of the people we interviewed and on the contents of the documentary information we obtained. We sought to cross-verify certain information among different interviewees and documents, but the process of cross-verification was limited. We were not hired to detect or investigate fraud, concealment or misrepresentations and did not attempt to do so. We were not hired to, and did not attempt to conduct a formal or legal investigation or otherwise to use judicial processes or evidentiary safeguards in conducting our review. Our findings and conclusions are based upon our extensive review of documents, the interviews we conducted

with the Board, staff, and others associated with LAFPPS, independent analysis, and our experience and expertise.

Third, this Final Report does not and is not intended to provide legal advice.

Fourth, our observations are necessarily based only on the information we considered as of and during the period we performed our review. Our Final Report cannot and does not attempt either to assess the manner in which any of our recommendations may be implemented or observed in the future, or predict whether LAFPPS' practices, as represented to us, will be observed in the future. It is often the case that some recommendations contained in the Final Report have already been implemented prior to the Final Report issuance date. This is the case because the action(s) took place after the review period, as well as after the interview and initial comment phases. Where this is the case, LAFPPS has the ability to note such implementation in their response to the Final Report. It is also important to note that our Final Report does not supplant or reduce the ongoing independent fiduciary duty of the Board and staff to structure and evaluate their investment program or policies and procedures.

Fifth, although this Final Report sets forth observations and recommendations regarding limited aspects of LAFPPS' internal controls, we did not conduct – or attempt to conduct – a full or formal examination of LAFPPS' internal control system. This Final Report is not intended as a substitute for such an examination, if one is deemed to be appropriate. The scope of our work was limited by our contract with the City.

Sixth, our approach to various organizational issues in this Final Report is in terms of public pension policy, from the perspective of participants and beneficiaries. We have not attempted to assess such issues from all practical and political perspectives running across all aspects of California state government.

Finally, although we did discuss our findings with, and submit a prior draft version of our report to the Department's General Manager and staff, its final form and content reflect the independent judgment of IFS. In accordance with the City Charter, the extent to which our report and recommendations are adopted or implemented is the Board's decision.

Section III – Discussion and Analysis

Task Area 1 – Governance

(For purposes of this report, we have combined some elements of Task Area 1 and Task Area 2 because of the interrelationship between "governance" issues and "organizational structure" and "board policies, practices, procedures" issues.)

1a. Governance Standards

General Principles

Unlike private retirement systems that are governed principally by the federal Employee Retirement Income Security Act (ERISA), the investment and operation of public pension funds are governed by their respective state and local laws. Many of these public fund laws have not kept pace with and do not reflect modern investment practices. As a result, although the supervising fiduciaries are legally required to prudently invest the assets of the pension fund, and have been vested with exclusive authority and control over such assets, they may be unable to (a) optimize returns at an appropriate level of risk and (b) effectively and efficiently manage their investment organizations because of outdated statutory requirements.

In recognition of the changing environment faced by public retirement systems, the National Conference of Commissioners on Uniform Laws has developed two uniform laws.[1] The Uniform Prudent Investor Act (UPIA) was approved and recommended to all states on August 5, 1994, and the Uniform Management of Public Employees Retirement Systems Act (UMPERSA) was approved and recommended to all states on August 1, 1997. (UPIA and UMPERSA are collectively referred to as the "Acts.") These Acts effectively incorporate the major principles of portfolio management theory developed over the past 50 years. Most states have adopted UPIA[2], but not UMPERSA.[3] Nevertheless, the governance and investment

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[1] "Uniform" designation indicates that there is a substantial reason to anticipate enactment in a large number of jurisdictions and standardization is the principal purpose. By contrast, a "model" designation means uniformity is not the principal objective and a significant number of jurisdictions are not expected to adopt the Act in its entirety, since its purposes can be achieved by adoption of its principles.

[2] UPIA has been adopted by approximately 40 states

[3] Only Maryland and Wyoming have adopted UMPERSA. <u>See</u>, *2004-2005 Annual Report of the National Conference of Commissioners on Uniform State Law*s. A number of public pension fund organizations participated in the development of the law (e.g., the National Council of Public Employees Retirement Systems (NCPERS) the National Council on Teacher Retirement (NCTR), and various members of the National Association of Public Pension Attorneys (NAPPA). However, because UMPERSA did not address portability, pension board

concepts set forth in these uniform laws are viewed as "best practices" and are often used as models by public pension funds and investment boards to modernize their standards.[4] They include (but are not limited to):

- Granting fund board members exclusive authority to manage fund assets, which are maintained as a trust; and

- Granting autonomy, to fund board members by empowering the board to:

    - Make budget, personnel and procurement decisions (including salary levels for personnel and obtaining professional services and resources) solely in the interest of pension fund participants and beneficiaries, not in response to a more wide-ranging set of interests and not subject to the jurisdiction's general civil service, procurement or personnel laws; and

    - Contract for necessary services, including actuarial, legal and audit services, rather than relying on other agencies of government to provide those services.

Best practices advocate autonomy for Board trustees. The notes to UMPERSA provide the rationale for granting autonomy to the Board, indicating that "*the pension fund and its trustees should be endowed with more independence than other agents of the state or other state employees, because in exercising that independence the trustees are subject to a more extensive and stringent set of fiduciary obligations than other agents of the state or other state employees*." This principle is equally applicable with respect to locally created (or City Charter-based) pension funds. The pension fund is a "trust." The board members, as fiduciaries of the trust, are obligated to see that it is managed in the exclusive interest of the participants and beneficiaries. As stated by a recognized public pension fund executive director, "*in order to carry out [its] mission and pursue excellence in service delivery and risk management, it is critical that fiduciaries who have ultimate legal responsibility for the trust also have ultimate authority for and programmatic control over all system activities.*" [5]

The grant of autonomy to pension fund trustees should not be made in a vacuum. Rather, it must be balanced with accountability in the form of stringent fiduciary standards and duties, liability for failure to comply, and regular and significant reporting and disclosure requirements.

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representation, full funding, service credit purchase, disclosure and reporting proxy voting, contractual rights to benefits, and domestic relations orders, it was not endorsed by the public pension fund organizations that participated in its development.

[4] See, National Association of State Retirement Administrators, "*Model Practices for Trust Independence and Board Governance Identified in UMPERSA and UPIA,*" at http://nasra.org/resources/modelgovernancepractices.htm.

[5] *Glass Houses – It's Never to Late to Change*, by Gary Findlay, Plan Sponsor Magazine, September 8, 2003.

Public oversight, combined with adherence to rigorous standards of fiduciary responsibility, provide appropriate controls over a public pension fund.

Risks

A statutory design which imposes external constraints, rather than granting autonomy with oversight, can impair the trustees' ability to effectively and efficiently administer the retirement system and its investments in the interest of the system's participants and beneficiaries.

When autonomy is compromised, trustees may be forced to decide between fulfilling their fiduciary obligations to retirement system's participants and beneficiaries or complying with the directives of the executive or legislative branches of government, who have no fiduciary responsibility to the trust, and who often must respond to different and possibly conflicting interests, such as budget balancing dilemmas, enhancing the tax base through local investing or pressures to enhance benefits in an unfunded liability environment.

Observed Conditions

The Los Angeles Fire and Police Pension System ("LAFPPS" or the "pension fund" or the "retirement system" or the "Department) was established by the Los Angeles City Charter as a Department which is under the control and management of a board of commissioners.[6] LAFPPS is designated as a Department that "*has control of its own special funds*."[7] Among other things, the Charter grants authority to the Board to do the following:

- Supervise, control, regulate and manage the Department;
- Make and enforce all rules and regulations necessary for the exercise of the powers conferred upon the Department by the Charter;
- Provide suitable quarters, equipment and supplies for the Department, create necessary positions in the Department, authorize the necessary deputies, assistants and employees and fix their duties….; and
- Adopt an annual departmental budget and make an annual Department budget appropriation, covering the anticipated revenues and expenditures of the Department.[8]

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[6] See Los Angeles City Charter, Section 500 (a).
[7] See Los Angeles City Charter, Section 500 (c).
[8] See Los Angeles City Charter, Sections 506 and 511 (a) and (b).

The Board exercises its authority in accordance with a constitutional grant of "*plenary authority and fiduciary responsibility for the investment of moneys and administration of the system,"* as discussed more fully below.

Consistent with the need for autonomy discussed above, it is our understanding that the intent of the California Pension Protection Act, an amendment to the California constitution enacted in 1992 as Proposition 162 ("Proposition 162") was to insulate the administration of retirement systems from oversight and control by legislative and executive authorities and to grant retirement systems sole and complete authority over investments and administration of their systems, free of direction from state and local legislative and executive prerogatives.[9]

1. Fiduciary Standard of Care

General Principles

It is well established that pension fund board members are subject to a rigorous standard of fiduciary conduct when managing the pension fund's assets. One element of the fiduciary standard requires board members to act solely in the interest of the pension system's participants and beneficiaries, rather than in their own self-interest or the interests of their constituent group(s) or appointing authority, the public or taxpayers at large. This duty is commonly referred to as the "duty of loyalty."

A second critical element of the fiduciary standard of care imposes on pension fund trustees a "duty of care." Under the traditional law of trusts, a trustee is expected to act merely as a prudent person would act when handling his/her own affairs. This common law standard is less demanding and has evolved over time to the higher standard which ERISA imposes on the board members of private sector pension funds. Under the ERISA prudent person standard (commonly referred to as the "prudent expert" standard), a fiduciary must operate with the "care, skill, prudence and diligence under the circumstances then prevailing that a prudent [person] *acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims*" (emphasis supplied). Trustees are not required to be "experts" (unless the trustee has represented that he/she has greater skill than that of a man of ordinary prudence).[10] However, if fiduciaries are not "familiar with such matters" they are allowed to retain experts and to delegate fiduciary authority.

While public pension funds are not subject to ERISA, and each state can and does formulate the fiduciary standards for the trustees of its public pension funds, the ERISA "prudent

[9] See, Singh v. Board of Retirement, 41 Cal.App. 4th 1180, 1192 (1996).
[10] See Annot., Standard of Care Required of Trustee Representing Itself to Have Expert Knowledge or Skill, 91 A.L.R. 3d 904 (1979) & 1992 Supp. At 48-49.

expert" standard has become the best practice model. General acceptance of the concepts embodied in the ERISA standard is further reinforced by UMPERSA's use of a virtually identical standard of care formulation.[11]

UMPERSA also authorizes public fund trustees to "delegate functions that a prudent trustee or administrator acting in a like capacity and familiar with those matters could properly delegate under the circumstances."[12] A trustee who elects to delegate functions must use "reasonable care, skill and caution" in selecting and monitoring the agent, and establishing the scope and limits of the agent's authority. Again, the UMPERSA standards parallel provisions of ERISA authorizing the division of fiduciary responsibility among multiple fiduciaries, and the delegation to "investment managers" of a trustee's authority to manage plan assets.

Risks

In the absence of rigorous fiduciary standards and without having the ability to delegate, and obtain expert advice, Trustees will not carry out their fiduciary responsibilities in a prudent manner. This could result in mismanagement and impair the financial integrity of the plan assets under their control, which could then lead to lower benefits and/or higher contribution levels.

Observed Conditions

In 1992, the voters of California adopted the California Pension Protection Act of 1992 ("Proposition 162" or the "Act"). As explicitly stated in Section 3(e) of the Act, one of the legislative "purposes and intents" of the new legislation was "*to give the sole and exclusive power over the management and investment of public pension funds to the retirement boards elected or appointed for that purpose, to strictly limit the Legislature's power over such funds, and to prohibit the Governor or any executive or legislative body of any political subdivision of this state from tampering with public pension funds."*

Consistent with best practices, LAFPPS' assets are held in trust. The Act defines the assets of the retirement system as "*trust funds, held for the exclusive purposes of providing benefits to, participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system."* (California Pension Protection Act, Section 17 (a)) While LAFPPS is not subject to ERISA, defining the assets of the pension fund as "trust funds" is consistent with the ERISA requirement that plan assets be held in trust to prevent the commingling of plan assets with non-plan assets or property and to ensure that LAFPPS is operated for "the exclusive benefit of …employees and their beneficiaries."[13] The

[11] UMPERSA Sec. 7.
[12] UMPERSA Sec. 6.
[13] 29 U.S.C. Section 1103(a).

City Charter also acknowledges that the assets of LAFPPS are a trust fund "*separate and apart from the other money of the City.*"[14]

The fiduciary obligations imposed on LAFPPS board members are also consistent with best practices. Specifically, section 17 of Proposition 162 provides members of the retirement board with "*plenary authority and fiduciary responsibility for investment of moneys and administration of the system,*" subject to (1) a "*prudent person*" standard of care; (2) a duty of loyalty *"to 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;"* and (3) a duty to *"diversify the investments of the system so as to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly not prudent to do so."*[15]

Although framed in terms of "*plenary authority,"* it has been determined that the Board's authority is not without limitation.[16] The provisions of Proposition 162 and the City Charter, which also governs the retirement system as a Department of the City, must be harmonized unless they clearly conflict. Consequently, the legal and practical limitations of Proposition 162 are somewhat ambiguous, differing among the various retirement systems based on the deference afforded by the other executive and/or legislative entities with control over the retirement system. For example:

- One explicit Proposition 162 limitation is found in Section 17(f), which states as follows:

> *"The Legislature may by statute continue to prohibit certain investments by a retirement board where it is in the public interest to do so, and provided that the prohibition satisfies the standards of fiduciary care and loyalty required of a retirement board pursuant to this section."*[17]

This is a very broad carve-out by the Legislature and an incursion into a Board's "*plenary authority"* to prudently manage and invest the assets of the fund. Although the Legislature's power in this regard is limited to situations in which the prohibition "*satisfies the standards of fiduciary care and loyalty required of a retirement board pursuant to this section,*" the law is silent on the question of *who* will determine whether the proposed prohibition satisfies the fiduciary requirements and *how* that determination will be made.

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[14] Article XI, §1152(f)
[15] Article XVI, Section 17 and Section 17 (a) (b) (c) and (d).
[16] Westly v. California Public Employees' Retirement System Board of Administration (2003) 105 Cal.App.4th 1095.
[17] Article XVI, Section 17 (f).

While the Board's duty of loyalty extends to "minimizing employer contributions", the City Charter explicitly states that this obligation is secondary to the Board's "duty to its participants and their beneficiaries."[18]

LAFPPS' adherence to the more rigorous ERISA "prudent expert" standard of care is consistent with best practices. The language of the standard of care set forth in Proposition 162 is virtually identical to the prudence standard found in ERISA and UMPERSA (which, as discussed above, is commonly referred to as the "prudent expert" standard) and, as further noted above, is a higher standard than the common law prudent person standard. This standard of care is also set forth in Article XI §1106 (c) of the City Charter.

The LAFPPS governance documents track the statutory language regarding the standard of care applicable to the board members, recognizing that the legal standard is a prudent person "*acting in a like capacity and familiar with such matters.*" This formulation acknowledges that the board members are subject to a higher standard than the common law "prudent person" standard.

Consistent with best practices, the LAFPPS Board is empowered to adopt any rules, regulations or forms it deems necessary to carry out its administration of the pension system or assets under its control. (*Article V, Section 506 (b) of the Administrative Code.)*

Also, consistent with best practices, LAFPPS has "*sole and exclusive power to provide for actuarial services in order to assure the competency of the assets of the public pension or retirement system.*" (*Article XVI, Section 17 (e*).)

2. Common Public Sector Constraints

Principles

As noted earlier, public sector retirement systems often operate within a statutory framework that constrains to some degree their ability to manage their investment programs. Examples of common restrictions which do not apply to other participants in the financial markets include:

- "Legal lists" requiring that system assets be invested only in designated asset classes, with percentage limitations applicable to each;

[18] See, Article XVI, Section 17(b) and Section 1106(a) of the LA City Charter.

- Requiring the retirement system to rely on other branches of government for essential services, such as legal counsel and procurement of external services;

- Limiting the retirement system's ability to employ, attract and retain qualified staff by limiting the system's fiduciaries' authority to set salaries and define the staffs' job classifications;

- Directives requiring or compelling investments in local business enterprises, or engaging local service providers;

- Directives requiring or compelling the engagement of woman-owned or minority-owned service providers; and

- Open Meeting and Freedom of Information laws which require that virtually all of the Board's deliberative processes, including discussions of investment strategies, be open to the public.

IFS acknowledges that by virtue of its designation as a "Department" within the City statutory structure, LAFPPS cannot be managed in a way that is wholly devoid of public policy considerations. Simply acknowledging that public sector constraints exist does not mean that they can or should be eliminated. What is paramount is that the potential effect of such constraints, when they cannot be avoided, are acknowledged and managed. This is particularly important at LAFPPS, where the City Council has afforded the Board a measure of autonomy (although limited in some respects) in managing the retirement system and investing its assets. Perceived abuse of that autonomy could jeopardize its continuation.

Notwithstanding the above comment, based on our interviews, we found that both the LAFPPS Board and the General Manager are sensitive to these structural issues and are working diligently to manage them appropriately.

Risks

Investment decisions can have negative consequences for a fund if considerations other than the risk and return characteristics and other financial and portfolio construction aspects of particular investment options are taken into account by investment decision-makers.

The effectiveness and efficiency of an investment program can be compromised if the resources required to manage that program are insufficient and/or unavailable due to considerations external to the retirement system.

Observed Condition

Consistent with best practices, California law does not impose a "legal list" requirement on LAFPPS with respect to its investment decisions.

A number of Charter-imposed requirements generally applicable to Departments under the management and control of the Mayor apply to LAFPPS. These include the following:

- Staff salaries are set by the City Council, unless otherwise set by, among other things, collective bargaining agreements, which must also be approved by the Council;[19]
- LAFPPS is required to follow the City's procurement rules and regulations with respect to contracts for goods and services;[20]
- Contracts entered into by LAFPPS for a term longer than three years must be approved by the City Council;[21] and
- Each contract awarded by LAFPPS must be approved as to form by the City Attorney.[22]

LAPPS has indicated that the provisions of the State Constitution and the Charter give the Board sole and exclusive fiduciary obligation over the assets of the System as well as sole and exclusive responsibility to administer the System in a manner that will assure prompt delivery of benefits and related services to System participants and their beneficiaries. Consequently, LAFPPS opines that the have substantial flexibility in negotiating its contracts for goods and services. LAFPPS may contract with independent contractors when it determines "*that such work can be performed more economically or feasibly by independent contractors than by City employees*." [23] However, this authorization has not been deemed to be applicable to the hiring of legal counsel.

- The LAFPPS Board has been deemed unauthorized to hire its own legal counsel unless it first receives approval from the City Attorney. Charter Section 275, which governs the employment of legal counsel by the pension fund, states in relevant part: "*Upon recommendation of a board enumerated in Section 272 (c),*

[19] City Charter, *Section 219*.
[20] Chapter 1, Article 1 of the Administrative Code (*Sections 10.1, et.seq*.)
[21] Chapter 1, Article 1 of the Administrative Code, *Section 10.5*
[22] Chapter 1, Article 1 of the Administrative Code, *Section 10.2*.
[23] Chapter 1, Article 1 of the Administrative Code, *Section 10.23*.

> *(which includes the* LAFPPS *board) and the written consent of the City Attorney, the City may contract with attorneys outside of the City Attorney's Office…."*

Other retirement systems within California, including CALPERS and CALSTRS, are authorized to independently select their own legal counsel. For example, LACERA is authorized to "*secure legal representation, on such matters as the board of retirement or the board of investment may specify, from other than the county counsel."*[24] Moreover, retirement systems in any of the twenty counties that are subject to the County Employees Retirement Law of 1937 (commonly referred to as the "37 Act Counties"), such as the San Bernardino, Orange, Kern, San Joaquin and Santa Barbara retirement systems, among others, have explicit authority to "*contract with the county counsel or with attorneys in private practice or employ staff attorneys for legal services."*[25]

a. Budgetary Authority

As a Department of the City, LAFPPS participates in the City's budget process, which is controlled by the Mayor and the City Council, and the City's audit process, which is conducted by the City Controller. However, the budget, although submitted for informational purposes, has not been deemed to require approval of the Mayor or the City Council. That said, it does appear that the City Council has discretion over the inclusion of the Department's administrative expenses.

The LAFPPS Board is authorized to establish the Department's administrative budget, which may include, *at the discretion of the City Council*, the administrative expenses of the Department. The budget must be submitted to the Mayor and the City Controller. (Section 1160 (a), emphasis added; Administrative Code Section 511 (b).)

The need for reporting and disclosure of the LAFPPS budget is consistent with best practices as it facilitates full transparency and is a means of balancing the autonomy of the board members. However, Section 1210 of the City Charter does not specifically state that the LAFPPS budget is not subject to the discretion and/or approval by the Mayor, Controller, or the City Council. Other sections of the City Charter specifically exempt LAFPPS from inclusion.[26]

The absence of explicit exemption language in the Charter gives rise to the potential need for legal interpretation. For example a legal opinion was necessary regarding whether the Los Angeles City Controller could question the reasonableness of the demand for payment of certain

[24] California Government Code Section 31529.1.
[25] California Government Code Section 31529.9.
[26] Charter §245(d)(3) and §1114, and §1112(b)

expenses incurred by the LAFPPS commissioners.[27] While the legal interpretation concluded that the Controller lacked the authority to refuse to approve the demand for payment approved by the Board, a legal interpretation and opinion was nevertheless necessary. Notably the legal opinion stated that "*where a City pension or retirement board takes action concerning the administration of the pension or retirement system, [City] Charter Section 1106 implies that the governing board shall not be subject to limitations set forth elsewhere in the Charter.*"[28] To avoid the need for implication or interpretation, the Board members authority should be explicit, where possible.

Task Area 1a Recommendation 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.

b. Personnel Authority

Proposition 162, §17(a) provides that the board shall have *sole and exclusive responsibility to administer the system in a manner that will assure prompt delivery of benefits and related services to the participants and beneficiaries.* However, LAFPPS does not have sole and exclusive authority over its staff. For example, the City Charter authorizes the LAFPPS Board to appoint a General Manager. However, this authorization is subject to confirmation by the Mayor and the City Council. Furthermore, the Board's authority to remove its General Manager is subject to confirmation by the Mayor. (City Charter §1108(b).) The General Manager may appeal such removal to the City Council.

The General Manager serves as the chief administrative officer of the Department (City Charter §509 (a)). The provisions of Article X of the Charter (Civil Service Employment Provisions) apply to all employees of the City of Los Angeles, except for those employees that are specifically exempted from its requirements. According to staff, the General Manager and two Assistant General Managers are the only exempt employees at LAFPPS.

The Board's ability to compensate the General Manager is subject to guidelines established by the City Council. (See LA Administrative Code Division 4. *See also*, Ordinance #177,761, effective August 10, 2006.) The LAFPPS staff is subject to salary standardization also

[27] Memo dated October 3, 2000 from Judith Reel, Deputy City Attorney, to Gary Mattingly, General Manager, Department of Pensions
[28] *Id*, at p. 2.

determined pursuant to the City Council. Thus, while the Board members are charged with sole and exclusive responsibility to administer the system, their ability to attract and retain the staff necessary to carry out that responsibility is constrained.

The Board is required to evaluate the performance of its General Manager annually (City Charter §1108 (c)). Based on information obtained during the interview process, the Board members are complying with that requirement. The General Manager is highly respected by the members of the Board and viewed as a strong and capable leader. The Board's annual evaluation and salary determination for its General Manager must be transmitted to the Mayor and the City Council. IFS was informed that the salary determination for the General Manager is submitted to the Mayor and the Council for informational purposes only.

Oversight of the selection process for the General Manager (or comparable position as administrative head of the pension fund) is a common public sector constraint that is inconsistent with the Board's responsibility to prudently manage LAFPPS. However, a number of California funds are not subject to this constraint and are allowed to directly appoint their CEOs (the equivalent of the General Manager), including but not limited to, CALPERS, CALSTRS and LACERA.[29] Actually, even before the passage of Proposition 162, both the CALPERS and CALSTRS Boards had authority to directly appoint their Executive Directors.[30] Following the passage of Proposition 162, their authority was expanded to include the ability to also select the CIO[31] as well as to establish the compensation levels for both positions. Nevertheless, initially all compensation requests still had to be submitted to the Department of Personnel Administration (DPA). Subsequently, a number of key management positions were exempted from Civil Service, and in 2002, DPA delegated authority to establish compensation to CALPERS and CALSTRS. Examples of positions in addition to the CEO and CIO which have been designated as managerial positions include the Deputy CEO, Chief Counsel, System Actuary, the Investment Officers, and the portfolio managers. Other examples of public pension fund boards that have sole authority to select their Executive Director/Administrator include San Diego City, San Bernardino and Contra Costa County.[32]

Task Area 1a Recommendation 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

[29] CALPERS, CALSTRS, and LACERA are respectively the acronyms for the California Public Employees Retirement System, the California State Teachers Retirement System and the Los Angeles County Employees Retirement Association.

[30] The position was exempt from Civil Service. Section 22204, Chapter 893. Statutes of 1993.

[31] The CIO position is also exempt from civil service.

[32] California Government Code Section 31522.2

Task Area 1a Recommendation 2

set the General Manager's compensation at the level it deems appropriate, and the pay schedule for its staff.

Duties and responsibilities of the "chief administrative officer" or, in this case, the general manager, are set forth in the Charter. They include the following: "*the chief administrative officer administers the affairs of the department"* (Section 507); and Section 509: *[the general manager shall] "administer the affairs of the department; appoint, discharge, suspend, or transfer the employees of the department or bureau…., all subject to the civil service provisions of the Charter; issue instructions to employees, in the line of their duties, all subject to the civil service provisions of the Charter; expend the funds of the department…in accordance with the provisions of the budget appropriations or appropriations made after adoption of the budget; recommend to the board of the department …an annual departmental budget…; certify all expenditures of the department…; file with the board and the Mayor a written report on the work of the department…; and exercise any further powers in the administration of the department as may be conferred upon him or her by the board of the department."*

The LAFPPS Board has added further definition to the role and responsibilities of the General Manager in its Board Governance Policies, where the specific day-to-day duties and responsibilities of the General Manager are enumerated. (See page 23 of the Board Governance Policies.)

All LAFPPS employees report to the General Manager, who is responsible for selecting, evaluating and setting each employee's level of compensation, all within the City's applicable civil service guidelines. The General Manager also assigns work responsibilities. The Board appropriately plays no role in these processes.

The role of the General Manager and the scope of his authority are clearly articulated in the Board's Governance Policies. The duties and responsibilities of the General Manager are comprehensive and consistent with the City Charter provisions relating to general managers of pension and retirement systems in the City of Los Angeles.

c. Open Meetings Law

The statute governing public access to meetings of non-State governmental bodies in California is commonly known as the Brown Act (Government Code Sections 54950-54962). The Brown Act is the "local agency" analog, as defined in the statute, to the State's Bagley-Keene Act,[33] which governs state boards and commissions. While the intent of both Acts is

[33] California Government Code Section 11126. Although passed approximately 14 years after the Brown Act, the Bagley-Keene Act was intended to be virtually identical to the Brown Act.

virtually the same, it is the opinion of some that the Brown Act provides more public access than the Bagley-Keene Act. The City Attorney has determined that the Brown Act applies to the LAFPPS.

While there are a few categorical exceptions to the requirement that meetings be open to the public (each as further qualified within each category), such as personnel matters, pending litigation, labor negotiations, property negotiations and for such "other" purposes specified in the Act, as a general rule, meetings of the LAFPPS Board are open to the public. We note also that the City Attorney informed IFS that they take the position that the Board may hold closed sessions for the limited purposes of considering specific investments, noting that this exception to the Brown Act does not extend generally to all investment matters.[34]

Open meetings laws by definition impose restrictions on the manner in which business is conducted by the pension system; however, IFS generally views "Sunshine Laws" as a positive requirement in that they foster transparency in the Board's operations.

Notwithstanding the above general comment, the mere breadth of the Brown Act provides very little opportunity for closed door sessions. It also impedes the ability of the board members to exchange ideas openly among themselves fearing that any such gathering of more than four members would constitute a "public meeting." In this context, the Brown Act serves to inhibit unfettered discussion and deliberation by the Board which is often needed regarding complex investment issues.

Task Area 1a Recommendation 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.

[34] The Bagley-Keene Act allows the following matters to be conducted in closed session: (a) the appointment, employment, or dismissal of a public employee; (b) matters pertaining to the recruitment, appointment, employment, or removal of the Chief Executive Officer or pertaining to the recruitment or removal of the Chief Investment Officer; (c) to confer with, or receive advice from, legal counsel regarding pending litigation when discussion in open session concerning those matters would prejudice the position of the Board in the litigation; and (d) to consider investment decisions, although with regard to investment decisions, the Board shall attempt to consider most investment matters in open session unless such consideration would jeopardize execution of the investment or cause harm to the economic value of the investment. Investment decisions, which are made in the closed session, must be made by roll call. The roll call vote shall be entered into the closed session minutes of the meeting. The Board shall endeavor to release the roll call vote to the public once the transaction is closed, or sooner if it is determined the investment will not be harmed by such release.

1b. Fiduciary Liability Insurance

Principles

A fundamental principle underlying the investment of pension and other benefit funds is that of fiduciary responsibility as fully described in the preceding section of this Report.

An inherent component of fiduciary responsibility is personal responsibility. Under federal and state pension and trust laws fiduciaries may be held personally responsible for their actions.

Mitigating this risk, fiduciary standards generally are process rather than results focused. If fiduciaries make decisions in good faith within the scope of their authority they are judged on whether the process was prudent, not whether the result achieved the objectives. In addition, under certain circumstances the employer or sponsoring organization is permitted to indemnify fiduciaries against the cost of defending themselves against allegations of fiduciary breach.

The ultimate fiduciary is the sponsoring and contributing entity. In many situations that entity spreads the fiduciary risk through delegation of authority and responsibility to other fiduciaries. Some of those fiduciaries are compensated adequately for taking that risk; others are not. Uncompensated fiduciaries typically need and demand protection against personal fiduciary risks.

The typical and most appropriate standard for indemnifying fiduciaries is to limit the protection to actions taken or not taken by fiduciaries within the scope of their position that did not involve fraud, self-dealing, or other criminal acts. In plain terms, indemnification is intended to protect fiduciaries for doing what they are supposed to do in the way they are supposed to do it, but not for doing what they are not supposed to do.

Indemnification is not a risk. It is a mechanism for transferring risk from one party to another. Typically a risk is transferred down to a sub-fiduciary through delegation and then in part transferred back up through indemnification.

Such risks may be able to be transferred through purchase of insurance to a non-fiduciary party in part or in full.

Fiduciary liability insurance covers only part of the risk. The balance is by definition self-insured.

Risks

Risk of loss, whether investment, fiduciary, or otherwise, is borne by the benefit plan initially and ultimately by the sponsoring and contributing entity such as the City.

Through delegation, portions of that risk may be passed down to sub-fiduciaries, such as Boards, professional staff, investment managers, consultants, and custodians. Some of these fiduciaries are compensated through fees for taking this risk. Others – particularly Board members and staff – are not. Fiduciaries bear fiduciary risk, and that risk is personal. This is fundamental.

The risk is not only that of a fiduciary breach having occurred. Any allegation of such a breach needs to be defended. The cost of defense is as much a part of the risk as the cost of the penalty on finding that a breach occurred.

Absent transference of risk many qualified people would be unwilling to take uncompensated fiduciary responsibility under any circumstances. Even without any breach occurring, the cost of defending against an accusation of breach is likely to be beyond most qualified person's ability and willingness to bear personal risk. Under such circumstances appointing qualified Trustees and hiring qualified senior staff could prove cost prohibitive or even impossible.

Such transference of risk may be in the form of an indemnity, an insurance policy, or both.

Indemnities not only need to be in place, they need to be effective. They need to provide:

- Qualified independent representation to each fiduciary subject to the allegation, recognizing that any such allegation may be made against multiple fiduciaries whose interests and defenses may not be aligned.

- Protection not only covering defense against an alleged breach, but protection against any penalty imposed for an actual breach that does not involve criminal activity on the fiduciary's part.

- A mechanism to continue to provide and cover the defense cost until criminal activity is established, and then to recover that cost.

Carrying or not carrying insurance against certain risks is a financial risk, not a fiduciary risk. Any insurance decision is fundamentally based on an analysis of cost and benefit.

Observed Condition

For the LA City retirement systems the ultimate cost of fiduciary breach is borne by the City and its taxpayers who partially fund city employees' pensions. While nominally the cost may be incurred at the fund level, shortfalls in assets are eventually covered by benefit contributions and funds for expenses from the City.

California Government Code establishes the basis and conditions for a public entity to provide indemnification to employees. In particular Government Code Sections 825-825.6 and 995-996.6 cover the circumstances and limitations under which that indemnification occurs. These conditions are typical and reasonable for such an indemnification, including conditions defining control over the defense against any claim.

Section 995 and its sub-sections set forth several exceptions to the public entity's providing defense costs. These largely focus on situations where the employee may have acted outside the scope of their work: where fraud, corruption or malice occurred; where there is a conflict of interest between the employee or public entity, and similar circumstances. It also provides that the public entity determines whether to use employee counsel or independent counsel when it does handle defense.

In situations where the public entity determines not to handle and pay for defense, the employee has to cover that cost. If ultimately the process determines that the City should have covered the cost, the employee is reimbursed.

Under the City Charter Section 200, the Commissioners of LAFPPS are considered "employees" for indemnification eligibility.

In 2003 the City Attorney's office issued a memorandum outlining the conditions of indemnification under the Charter and the Government Code. The memorandum was written "in response to the concerns raised regarding the decision of the Board not to renew the Fiduciary Liability Insurance." The memorandum mentioned but did not discuss implications for the affected employee of the Section 995 exceptions to providing legal defense. It did not discuss the functions and limitations of the insurance policy form.

In June 2006 LAFPPS conducted further research into the question of using insurance to transfer part of the fiduciary risk. This research included the earlier legal memorandum supplemented by a short memorandum setting forth a legal basis for the decision whether to insure. It also included a survey of other California fund practices in this regard and a set of comparative quotes for LAFPPS coverage. This further research was covered by a recommendation from Fund Staff recommending not purchasing insurance based on (1) absence of compelling need given indemnifications in place, (2) structure in which LAFPPS would pay

the premium but the City would receive the benefit, (3) low probability of need based on the internal controls and absence of past significant losses, and (4) the high premium cost.

LAFPPS Commissioners overall expressed a high level of comfort with the indemnification provisions protecting them in the event of breach. They were generally not concerned about exceptions to the defense requirements. We also inquired whether the same degree of comfort applied to the quality and independence of representation from the City Attorney's office in defending an individual fiduciary. The responses were generally affirmative as well, although some doubt was sometimes expressed in the event the accuser might be the City itself or another entity represented by the City Attorney.

As there is no current policy in place, we did not have a set of coverage limits and exclusions to review. We are generally familiar with such policies, however. We agree that the circumstances of coverage under a policy generally follow those to which the indemnification applies and largely follow the circumstances under which the City is obligated to provide defense. However, we believe that certain exceptions, notably those in which the City deems there to be a conflict or an action between the City and an employee, do not follow.

Whether legal defense is controlled by the City Attorney or an insurance carrier's attorney, the employee has relatively little influence over the quality of representation unless the employee turns down covered representation and secures his or her own.

We concur with the process and conclusion through which LAFPPS determined not to purchase fiduciary liability insurance. Given that the ultimate beneficiary under most circumstances is the City, the question whether to self insure or transfer some of the risk through an insurance policy is the City's, not LAFPPS.

As a sub-category of our general concerns over legal representation (discussed in Task Area 2) we are concerned about a staff or Board fiduciary having paid access to highly qualified independent counsel, particularly where there is a conflict or even just a separation of interests between the City and LAFPPS or fiduciary. However, we believe this can be addressed sufficiently through changes in the right to paid independent legal counsel and that it would not likely be addressed in a cost effective manner through insurance.

1c. Board Policies, Practices, and Procedures

(The principles, risk, observations and recommendations related to the board's various policies, practices, and procedures were consolidated with the discussions related to LAFPPS' *governance (in Section 1), organizational structure and resources (in Section 2a entitled "Board Governance – Policies, Practices and Procedures) and investment program (in Section 3)).*

Task Area 2 – Organizational Structure and Resources

2a. Board Governance – Policies, Practices & Procedures

The organizational and management structures and processes utilized by an organization for decision-making, implementing its decisions, and for monitoring and assessing performance define its governance. An organization with good governance has structures and processes which enhance the organization's efficiency and effectiveness while minimizing both the potential and the impact of mismanagement. A good governance structure is generally composed of the following principal elements:

- adherence to law and rules;
- accountability;
- predictability;
- participation;
- consensus;
- transparency;
- responsiveness;
- inclusiveness;
- equity; and
- effectiveness and efficiency.

These principal elements are necessary to the governance of all types of organizations, including public pension plans, and remain the same irrespective of the type or size of a pension plan.

Principles

It is well-documented that the value of poorly performing companies improved significantly following the institution of good governance practices.[1] We believe the same is true for public pension funds. The need for good public pension fund governance arises from the same types of issues that give rise to the need for good corporate governance.

[1] Wilshire study of "CALPERS effect." Steven L. Nesbitt, Long-Term Rewards From Shareholder Activism: A Study of the "CalPERS Effect", J. of Applied Corp. Fin. (Winter 1994). and Steven L. Nesbitt, The "CalPERS Effect": A Corporate Governance Update, July 19, 1995. The 1994 and 1995 studies were more extensive and supported Wilshire's initial 1992 study indicating that a company's stock performance appeared to improve as a result of CalPERS' focus.

A statement of governance articulating the allocation of authority to recommend, to monitor and to decide among the various key participants enables each segment of leadership to focus on performing its tasks, confident that all key governance tasks are covered. The absence of such a statement can result in both duplication of effort and gaps in carrying out those functions.

Risks

Poor governance is an internal threat that can unnecessarily expose a pension fund to the possibility that policies and procedures may not be implemented properly and that the assets under the authority and control of the Board will not perform to expectations.[2] Poor governance is typically ranked as the principal barrier to excellence within an organization, followed by inadequate resources and lack of focus or a clear mission.[3]

In an organization with numerous interrelated parties responsible for various interrelated functions, a clear delineation of their various roles, lines of authority and reporting responsibilities could assist the organization in effectively and efficiently achieving their objectives.

Set forth below are some of the essential documents that define a pension fund's organizational and management structures and processes:

- **A Mission Statement**;
- **A Strategic Plan** – a document that summarizes LAFPPS' short and long-term goals and objectives. It defines where an organization is going, how it is going to get there, and how it will know if it got there or not;
- **Bylaws**;
- **Resolutions (Actions on Motions)** - documenting the decisions of the Board;
- **Minutes** – recording the proceedings at the Board's formal meetings;

[2] Public Pension Systems Statements of Key Risks and Common Practices to Address Those Risks, July 2000. Endorsed by the Association of Public Pension Fund Auditors (APPFA), the National Association of State Retirement Administrators (NASRA), and the National Council of Teachers Retirement (NCTR).
[3] Source: "Excellence Shortfall in Pension Fund Management: Anatomy of a Problem" by Keith Ambachtsheer, Craig Boice, Don Ezra and John McLaughlin – October 1995.

- **A Governance Statement** – a document that clearly defines the appropriate roles, responsibilities and permissible conduct of the "key players." It should describe who has authority over whom and who is responsible for what and when;

- **A committee structure** with "charters" defining their roles and responsibilities;

- **An Investment Policy Statement** and **Investment Guidelines** – documents that define and clarify the Board's investment objectives, tolerance for risk, liquidity needs and permissible (impermissible) investment strategies, asset classes, and instruments. (See Task Area 3e (Investment Policy Statement).);

- **A Standard Operating Manual** – a compilation of the organization's policies, procedures, and practices, as well as functional position descriptions of the organization's staff;

- **An educational policy –** a policy setting forth processes for trustees and key staff to obtain access to programs providing information about developments related to investment of pension fund assets;

- **A well-defined ethics policy**; and

- **A Board and staff travel policy**.

Our examination of the LAFPPS organizational and management structures – governance – focused on the appropriateness of the governance documentation, identifying ways in which the roles and procedures of the various parties work effectively or pose problems, the sufficiency of the nature and functions of the various committees utilized by LAFPPS, and comparing the stated duties and procedures of each Committee against the actual performance. As part of our examination, we also interviewed Board members and staff and reviewed board agendas, minutes and other documentation from prior meetings.

General Observation

The LAFPPS Board is required to hold regular meetings at least twice a month.[4] In addition, members of the Board may be assigned to one or more standing committees. Additional committee assignments may exist if the Board authorizes the creation of new standing or ad hoc committees, such as the Office Space Planning Committee. Investment decisions are made by the full Board. We were informed that regular meetings are purposely held on the same day as

[4] City Charter, Section 503 (b).

committee meetings. This practice facilitates the probability and efficiency of member attendance at meetings.

Taken together, the Board members spend an impressive amount of time in Board meetings and on Board matters. Some Board members acknowledged to IFS that preparing for board meetings can be difficult given the considerable amount of review time commissioners have to allocate to disability cases. They also noted that discussion of disability cases in the board meetings can be very time-consuming. Nonetheless, Board members generally agreed that the board materials were given to them sufficiently in advance of board meetings to allow for a thorough review of the entire board package. They uniformly stated that they are not overwhelmed by or concerned about the amount of time they are required to devote to Board meetings.

The Board does not currently hold an annual off-site board meeting to discuss long-range and strategic planning. An annual off-site meeting would provide the Board with an excellent opportunity to have focused discussions on the Board's planning initiatives, goals and objectives. We encourage the Board to consider holding an annual meeting for these purposes and any other purposes the Board deems appropriate, including adding additional educational training sessions for its members.

Task Area 2a Recommendation 1
LAFPPS should consider including an annual off-site board meeting in its annual meeting schedule.

Board members indicated that they received their board packages approximately one-week prior to each Board meeting and believe this schedule affords them ample time to prepare for Board meetings. There was further consensus among the Board members that the Board materials were always timely and well-prepared. The Board members were also very satisfied with the investment-related reports and other documentation provided to the Board by staff and its investment consultants.

The Board members uniformly remarked that the Board meetings are open and collegial and that all commissioners have an opportunity to raise questions and issues. They believe Board meetings are run efficiently. Several Board members felt that the Board and staff could benefit from obtaining more education regarding some of the more complex investment strategies and products that are coming before the Board.

Task Area 2a Recommendation 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.

1. Governance Documents

The Governance Manual

The Board adopted a series of governance documents on June 8, 2006, which individually and collectively play an integral role in the Board's comprehensive governance structure. These three documents listed below, which we will consider separately, are collectively referred to as the "Governance Manual":

- The Board's Governance Policies;
- The Board's Operating Policies and Procedures; and
- The Board's Investment Policies.

Dividing the Governance Manual into three discrete substantive areas facilitates easy reference, review and revision of the various component parts of the Board's governance program. In their current iteration, each section of the Governance Manual provides a clear operational framework for the implementation and management of the Board's responsibilities.

The Board retained Cortex Applied Research Inc. to assist the Board and staff in the development of the Governance Manual. It is evident that a significant amount of staff and consultant time went into preparation of the Governance Manual.

The development and implementation of good governance processes is a well-established best practice. Both the commissioners and staff credit the General Manager with spearheading the Board's effort to develop a sound governance structure. We commend the Board and the General Manager for recognizing the need for a written governance framework and for achieving this goal.

As discussed further below, IFS reviewed the Department's Governance Manual and found it to be comprehensive, thorough, and reflective of "best practices." That notwithstanding, it has been almost a year since its adoption and the Governance Manual has not yet been fully implemented by the Board. For example, based on information obtained during the interview process, it appears that the Board's self-evaluation and the General Manager's annual evaluation

processes did not fully conform to the procedures found in the Governance Manual due, in part, to timing constraints. On the positive side, however, these evaluations did take place.

We also found that the Board and staff have made significant progress in finalizing certain policies and procedures, such as the Strategic Plan and the Ethics Policy, but the Board is not adhering to all of its policies at this point. During our interviews, staff and some commissioners referred to the Governance Manual as a "work-in-progress." Thus, it appears that some have not embraced the need for or the importance of having a written Governance Manual. We recognize that a Governance Manual is a "living document" that is subject to revision and update, and that the Board has a number of competing priorities, but we would encourage the Board to make implementation of the procedures found in its Governance Manual a top priority.

Task Area 2a Recommendations 3-4
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.
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.)

The Governance Manual was formally adopted by Board Resolution on June 8, 2006. It is critical for the minutes to evidence the prudence of the organization's decision making process, i.e., the minutes should ideally document not only the action taken but also its deliberative process. The Governance Manual is a key document. However, the discussion contained in the June 8th Board minutes is sketchy. According to the minutes, the Chair of the Board's Ad Hoc Governance Committee made a "presentation" to the Board on the adoption of the Board's Governance Manual at the June 8, 2006 Board meeting. Actions were taken regarding several individual policy matters within the Manual. However, the minutes did not reflect any discussion on the rational supporting the policies forming the Governance Manual. A new commissioner was appointed to the Board in May, 2006, merely one month prior to "presentation" of the Governance Manual to the Board for approval. Demonstrating that the rationales supporting the policies contained in the Manual were specifically discussed supports the prudence of a new trustees voting on such a key document rather than abstaining.

Some commissioners suggested that a formal educational seminar(s) on the Governance Manual would be beneficial. We concur.

Task Area 2a Recommendation 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.

The Board's Governance Policies

The foundational document governing the Board's administration of the pension fund is entitled "Board Governance Policies" (the "Governance Policies"). A good foundational document should clearly delineate the roles and responsibilities of the key decision-makers and key decision-making bodies and circumscribe their responsibilities.

We found that the Governance Policies are very organized. Of particular note, each document found in the Governance Policies, including each Board policy, (1) contains a historical reference so that Board members and staff know when the Board adopted or last updated the policy or document; (2) contains a Board-imposed review schedule for each policy or document; and (3) indicates the next scheduled review date. This type of documentation is excellent.

The Governance Policies begin with an Appendix of Charter Provisions, which is a summary of the relevant laws that apply to the administration of the pension fund. The Appendix tracks the law and serves as a handy reference guide for Board members. The Board's power and authority to manage the pension fund flows from these provisions of law. This serves as an excellent tool to facilitate Board members, staff and interested parties' understanding of the extent of the Board's legal authority to manage the system. Such an understanding is vital to the development of sound Board policies and procedures that are in harmony with the Legislature's directives.

The Appendix indicates that the Board must exercise its "*plenary authority*" in conformity with a "Prudent Person" standard of care (see page 6 – Defined Terms). As discussed earlier in Task Area 1 (Governance), the commissioners are subject to a higher standard of care than the common law "prudent person" standard, as is evident from the statutory definition of prudence. It is important that the Board members understand that the higher "prudent expert" standard is applicable. We were informed that although the Board uses the phrase "prudent

person," it recognizes that it is subject to the "prudent expert" standard. To avoid the potential for confusion, it is advisable to use the appropriate terminology.

We note that the Board Operations Policy contains a summary of the Brown Act in Appendix 1. In addition to its current location, we see no downside to adding this summary to the Charter Provisions found in Appendix 1 here as well. Addition of the Brown Act provisions would complete the statutory summary found in the Appendix of Charter Provisions.

Task Area 2a Recommendation 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.

LAFPPS' Governance Policies contain the Board's guiding governance principles (the "Governance Principles"). In addition to the Board's statutory requirements and consistent with best practices, the Governance Principles acknowledge that:

1. *The Board is most effective when it focuses on setting policy and providing oversight, rather than on operational details, which are better carried out by staff; and*

2. *The Board has ultimate responsibility for the prudent and effective administration of the System; its authority is vested in the entire Board rather than in individual board members or committees; and*

3. *Effective, ongoing Board education and orientation is crucial to the Board's success and requires a strong commitment by both the Board and individual Board members.*

Regarding the Board's duties and responsibilities, we note that the Board's duties and responsibilities include a requirement that the Board "ensure that appropriate succession plans are in place to provide continuity among the System's staff." The Department has a plan for the succession of its GM and CIO.

Task Area 2a Recommendation 7
The Board should consider enhancing its succession plan to include other senior staffing in addition to the GM and CIO.

Consistent with best practices, the Governance Policies appropriately include detailed monitoring and oversight responsibilities of the Board.

We were informed during our interviews that staff prepares for the Board a Monthly Report of outstanding matters that serves as a useful summary of "pending action items" and allocations of responsibility for completing assignments. In fact, the General Manager has institutionalized a process whereby key staff members convene immediately following each Board meeting to ensure that action items are understood and properly delegated.

Also consistent with best practices, the Board's Governance Policies clearly describe and delineate the duties, responsibilities and lines of authority of the following decision-makers or decision-making bodies, consistent with relevant statutes:

1. Benefits Committee;
2. Governance Committee;
3. President of the Board;
4. Vice President of the Board; and
5. General Manager.

The Board uses a consistent, user-friendly format to describe the duties and responsibilities of the above persons or bodies which includes an introduction, operational rules, duties and responsibilities, history of the policy, and establishment of a review period. However, we believe the Governance Policies should be enhanced in the following areas:

- We understand that the Chief Investment Officer reports to the General Manager. However, due to the unique and significant role the Chief Investment Officer plays in assisting the Board to fulfill its fiduciary responsibilities to LAFPPS, we believe a separate section of the Governance Policies should be devoted to the duties and responsibilities of the Chief Investment Officer.

- The Governance Policies do not describe the duties and responsibilities of the key service providers, such as the actuary, the custodian, the investment consultant(s), investment managers, legal counsel, and auditors, although there are references to the Board's selection, oversight and monitoring responsibilities relating to these providers in both the Board's Governance Policies and in the Board's Investment Policies. We note also that the Board has described the duties and responsibilities of its real estate investment managers, its real estate consultant and its legal counsel (with respect to real estate investments only) in the Board's Real Estate Strategic Plan, which is a part of the Board's Investment Policies.

Task Area 2a Recommendation 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.

General Manager's Role

In addition to the delegation of day-to-day administrative authority to the General Manager, the duties and responsibilities of staff who report to the General Manager are generally addressed in the Governance Policies. (See comments regarding the Chief Investment Officer above in this Section.) Pursuant to the Governance Policies:

> *"The General Manager is the executive ultimately responsible to the Board for the entire operations of the System and is therefore expected to provide executive leadership for the System in implementing the programs necessary to achieve its mission, goals and objectives" (see Duties and Responsibilities – General Manager, Section 8.2).*

The Board has a mission statement, which is found on its website; however, the mission statement is not included in the Board's Governance Manual. We note that the Board's Strategic Planning Policy indicates that the Strategic Plan will include a mission statement.

Task Area 2a Recommendation 9

The Board should incorporate its mission statement into the Board's Governance Documents and into the Strategic Plan.

The General Manager is required to "*coordinate fiduciary education*". We received mixed comments regarding whether or not the Board had a formal educational training program. During the interview process, a number of individuals indicated that while Board members participate in educational sessions on topics such as fiduciary law and investments, the Board does not have a formal educational training program. We were also informed that, although it could be enhanced, the Board does have a formal educational training program. The Board has adopted a Board Education Policy. (See comments and recommendations on Board Education below in this Section.)

The Board has explicitly retained authority to hire, renew and/or terminate contracts for the Board's general consultant, real estate consultant and alternative investments consultant. (See Duties and Responsibilities – General Manager, Section 8.15.) However, pursuant to Section 8.8 of the Duties and Responsibilities of the General Manager, one of the General Manager's responsibilities is:

> *"…providing information to allow the Board to make a decision <u>but not make recommendations, unless specifically requested by the Board</u>, in regard to hiring, renewing or terminating contracts for the general consultant, real estate consultant and alternative investment consultant."*

We question why the Board felt compelled to explicitly retain authority with respect to the hiring, renewal and termination of various investment consultants when it does not typically retain authority in written form elsewhere in the Governance Documents. To avoid confusion regarding the Board's retained authority, we propose that the Board include a general reservation of authority by the Board provision in its Governance Documents, except as the Board may delegate such authority to others.

Task Area 2a Recommendation 10
The Board should amend its Governance Documents to include a general reservation of authority provision.

During our interviews with Board members and staff, we received contradictory information regarding the Board's rebalancing policy. Confusion regarding delegations of authority and roles and responsibilities is indicative of the need to have and be familiar with the Board's policies and procedures governing the administration of LAFPPS. Pursuant to Section 8.8 of the Duties and Responsibilities – General Manager, the responsibility to rebalance the fund's portfolio has been delegated by the Board to the General Manager. We did not find a written delegation from the General Manager to the CIO regarding the authority to rebalance. Another document we reviewed, prepared by the Investment Consultant, indicates that the CIO is responsible for portfolio rebalancing.

Task Area 2a Recommendation 11
The LAFPPS Board should amend its Governance 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.).

We understand that the Board established an Audit Committee after we had conducted our interviews. We suggest the Board also consider establishing and assigning an internal audit function to staff, as discussed in more detail in Task Area 2i.

The Board has made a conscious decision not to have an Investment Committee. Board use of a committee structure is typically viewed as preferable. Notwithstanding, we are aware of many public funds that utilize a committee of the whole format for their Investment Committees. The Board's procedure for review and discussion of investment matters is found in the Board's Operations Policy. The Policy states:

> *"Because the Board has elected not to have an investment committee, investment matters involving policy decisions or service provider selection or termination will normally be considered by the Board at two separate meetings. At the first meeting, investment matters shall be presented to the Board for information purposes only. The Board may take formal action only at the second meeting at which the item is considered.*
>
> *Notwithstanding the above, the President and General Manager may agree to schedule a particular investment matter for board action at the first meeting at which it is to be considered, if they believe it is prudent to do so under the circumstances. Such agreement shall be reflected in the minutes of the Board meeting."*

While we believe a committee process for review of investment issues is often more efficient, IFS attended and observed an LAFPPS Board Investment Committee meeting at which all members of the Board were present. We found that the Board's current two-step process for review and discussion of investment matters by the entire Board works well and is consistent with the Board's Operations Policy

Board Education Policy

Principles

To enhance the likelihood that the organization will operate effectively and efficiently, it is critical that board members and staff have the appropriate skill sets, experience, and training to perform their assigned job functions. If they do not, it exposes the organization to governance and operational risk.

Ongoing training and development should be an integral part of every organization and is critical to its success.

Training can take many forms, including required job-specific leadership development. This type of training can be provided in-house, for example, by using staff or pension fund service providers or through the use of external providers such as academic institutions or industry conferences.

Risk

Inadequately trained board members and staff places an organization at risk

Observed Condition

We understand the Board's Education Policy has not been implemented. However, we note that the LAFPPS' current written document contains the essential components of a thoughtful and practical education policy.

The Board's Education Policy describes a formal Board Education Program, consisting of (1) a new Board member orientation; (2) an in-house training and education protocol, as well as (3) a list of recommended educational conferences (*Board Education Policy, Sections 9.5-9.15).*

The Education Policy establishes a formal, structured two day orientation program for new Board members and outlines the content of the course. The orientation program described in the Policy will address the following areas:

- Roles and expectations of Board members;
- Fiduciary duties of Board members, conflict of interest guidelines, open meeting laws, Proposition 162, and other relevant laws to be provided by the City Attorney;
- Overview of organizational structure and the roles of staff, and key service providers including the actuary, investment consultant, custodian, investment managers, attorneys and auditors;
- The disability application process;
- Overview of member services;
- Board governance policies and practices;
- Benefit structure of the System, delivery, and Board authority;
- Health benefits program structure, delivery and Board authority;
- Investment and funding policies of the System;
- Structure of current investment program and portfolios;
- Current asset allocation process;
- Investment manager selection and due diligence process;
- Budget process; and
- Audit process.

In addition, new commissioners will receive a binder of relevant Board-related materials, including:

- A Board Reference Manual, the contents of which are to be determined by staff;

- A listing of recommended conferences;
- Suggested reading material; and
- Other relevant information and documentation.

Orientation and on-going training of board members is a best practice. If this formal orientation program is implemented and the course outline is followed, the LAFPPS Board members will be well-served by the new orientation program. Nevertheless, because educational programs are typically held at venues that must be interesting and large enough for the conference planners to attract and accommodate sizable number of participants, travel is always going to be a sensitive subject that will be subject to heightened scrutiny. In light of this, it is imperative that public fund organizations have a written travel and education policy. Most public pension funds do not have a written travel policy. The fact that LAFPPS has a written Education Policy is reflective of best practices. Conference pre-approval is required and members are required to present a report regarding the subject matter of the conference following attendance. Further, the LAPFPPS travel and education report reflects the names of the members in attendance as well as the name, location, and purpose/subject of the conference. LAFPPS is to be applauded for having these processes in place.

The Education Policy also formalizes the Board's ongoing in-house training and education program. We believe that coordinating the education effort with "*other systems and CALAPRS" (see Section 9.10 B)* is sensible and will ensure that the Board has access to a broad range of options for educational courses, seminars and training resources.

With respect to conferences, we note that Board members are allowed to attend up to eight conferences per year. Based on the travel and education reports we reviewed, which are periodically prepared, we did not find that any of the Board members had taken the maximum number of trips authorized in a given year. Nevertheless, while we believe that continuing education is essential for the Board members in order to be knowledgeable about the subject matter they must evaluate, based on our experience we found the number of authorized conferences per year to be high.[5]

Task Area 2a Recommendation 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.

[5] LACERA trustees are authorized to take seven trips per year, one of which may be non-domestic. If a trustee sits on both the LACERA Board of Retirement and the LACERA Board of Investments simultaneously, the trustee is authorized to take ten trips per year.

The Policy encourages board members to complete a conference evaluation form, which is to be reviewed by the General Manager and used in determining whether the conference will be placed on the Board's list of recommended conferences.

Task Area 2a Recommendation 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.

The Board has a process in place to review and approve all travel by commissioners for educational purposes. All travel by Board members must be approved by the Board. Board members are provided with travel details, including costs, prior to meetings in which action on the travel plans will be taken. In addition, as an essential monitoring component, the Board's Education Policy includes a requirement that the General Manager submit an annual report to the Board on each commissioner's educational and travel activities for the year.

Board Self-Evaluation Policy

We commend the Board for conducting an annual, confidential Board self-evaluation and for developing a Board Self-Evaluation Policy that, consistent with best practices, establishes and thoroughly describes the process the Board will follow in conducting its annual review. The Board Self-Evaluation is a very progressive governance tool that IFS enthusiastically supports. The Self-Evaluation should generate useful information that will enable the Board to identify ways to improve the effective and efficient administration of LAFPPS.

We were informed that the Board's governance consultant assisted staff in preparing the Board's Self-Evaluation survey and that the Self-Evaluation survey was given to the Board for review and comment prior to finalization. It is our understanding that the survey was provided to Board members as a model rather than as a final document for adoption. Nevertheless, the Board completed the survey without modification. Some Board members commented that the Board Self-Evaluation could be improved upon by asking more insightful questions.

Task Area 2a Recommendation 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.

The Policy places primary responsibility for the implementation and oversight of the self-evaluation process with the Governance Committee.

Pursuant to the Board's Self-Evaluation Policy, the Self-Evaluation process is conducted through the use of a written Board Self-Evaluation Survey, which each commissioner must complete and submit to the Chair of the Governance Committee. To ensure complete candor, the Survey is confidential and upon completion of the Self-Evaluation process, the survey forms are to be destroyed by the Chair of the Governance Committee.

The Self-Evaluation Policy contains the process for annually reviewing and updating the survey.

In addition to specific questions, the Survey allows for narrative comments and responses from Board members and provides opportunities for the commissioners to suggest changes or improvements to the form. It also allows the commissioners to make additional comments on issues not covered in the Survey. As part of the Self-Evaluation process, the Governance Committee also reviews each commissioner's record of attendance at Board meetings.

Following completion of the Self-Evaluation and tabulation of the results of the Survey, the Chair of the Governance Committee is responsible for presenting a summary of the Survey results to the full Board, with appropriate recommendations. Staff informed IFS that the results of the Board Self-Evaluation are discussed in an open session of the Board. Results of the Board's discussions regarding the Survey results and any related Board action are recorded in the Board's minutes.

As discussed above, the Self-Evaluation process is an excellent management tool and consistent with best practices.

Evaluation of General Manager

The Board members that we interviewed uniformly described the General Manager as highly competent and effective. They also praised his initiative and efforts to formalize and document the Board's practices and procedures. The General Manager was also commended for making training a priority for his staff.

The Board is required to annually review the performance of the General Manager.[6] This is a particularly significant responsibility that involves full Board participation since the Board has delegated broad authority for the day-to-day management of the pension fund to the General Manager.

[6] See City Charter, Section 1108 (c).

Consistent with best practices, the Board has established a General Manager Performance Evaluation Policy to guide the process for evaluating the General Manager. As with the Board's Self-Evaluation process, the annual evaluation of the General Manager is coordinated by the Governance Committee and a meeting to discuss the results of the General Manager Evaluation is conducted by the Board in closed session.

Although we believe the General Manager Performance Evaluation Policy is also very complete, we would suggest changes in a few areas that center around the following issues:

- It is unclear how the timeline for establishing the general manager evaluation criteria works. The timeline should be clear and unambiguous.

- The General Manager may, at his or her option, submit a self-evaluation as part of the Evaluation Package that the General Manager is required to submit to the Board members.

- The Board has adopted a two-step approach to reviewing the results of the General Manager Survey: First, the results are discussed at the Governance Committee level. While this meeting is held in closed session, the General Manager is present throughout the closed session. Following this meeting, the Governance Committee prepares a summary report of the meeting and makes recommendations for the full board's consideration. The report was prepared by staff.

- Next, as step two, the results and recommendations from the Governance Committee are discussed with the full Board, again in the presence of the General Manager and in closed session. The Board is never afforded an opportunity to review and discuss the General Manager's performance outside the presence of the General Manager.

Task Area 2a Recommendation 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.

Monitoring and Reporting Policy

The Board has adopted a formal policy setting forth the requirements and timeframes for submission of reports to the Board. The list of required reports is found in a chart found in the Appendix to the Monitoring and Reporting Policy. The Chart includes the name of the report, the frequency with which the report must be presented to the Board, the party in charge of preparing the report and a summary description of the contents of the report.

The Monitoring and Reporting Policy, particularly the chart that lists all of the Board's required reports, is another example of an excellent management tool for both the Board and staff. The General Manager, staff and the Board's service providers are required to produce a number of reports during the calendar year pursuant to various Board policies. The Chart found in the Appendix to the Monitoring and Reporting Policy is a clear and organized consolidation of all of these reports into a single document for easy reference.

The Board is required to review the Monitoring and Reporting Policy at least every three years. (See Task Area 2a and related recommendation regarding updating of the Governance Manual.)

Task Area 2a Recommendation 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.

Board Operations Policy

The Board Operations Policy describes the Board's internal administrative procedures pertaining to the conduct of business. The procedures cover typical operational matters, such as:

- appointment of officers;
- meeting and agenda requirements;
- voting requirements;
- establishment of committees; and
- attendance and compensation of commissioners.

We note that the Board Operations Policy includes a very good summary of the Brown Act and its application to the Board's meetings.

The Board Operations Policy clearly documents in summary form the Board's administrative procedures and we have no recommendations in this area.

Strategic Planning Policy

The Strategic Planning Policy outlines the process for developing the Board's strategic plan, defines the universe of possible operational and governance matters to be included in the plan, describes the format of the strategic plan and sets the timeframes for completing each stage of the process, which culminates in the presentation of the strategic plan to the Board for review.

The objectives of the Strategic Planning Policy are threefold:

- To ensure that planning occurs in a rigorous and systematic manner;
- To articulate clear and appropriate roles for the Board and staff in the planning process; and
- To facilitate the communication of the System's strategic direction throughout the organization and to interested external parties.

To ensure proper Board oversight of the strategic planning process, the Strategic Planning Policy includes a requirement that staff update the Board on the implementation of the strategic plan at a minimum on a semi-annual basis.

The strategic planning cycle is appropriately tied to the Department's fiscal year to enable the Board to take budget considerations into account and align strategic initiatives with funding resources that may be necessary to meet those objectives.

At the time of our interviews, the Board had not adopted a Strategic Plan, although we understand staff is nearing completion of a Strategic Plan for submission to the Board.[7]

We note also that the Board has a separate Real Estate Strategic Plan, which, as it should be, is part of the Board's Investment Policies.

Task Area 2a Recommendation 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.

[7] The Board adopted the 2007- 08 Strategic Plan on March 22, 2007.

2. Ethics

Principles

A conflict of interest arises when a person, such as a public sector employee, is influenced by personal considerations when doing his or her job. Consequently, decisions are made for the wrong reasons. Perceived conflicts of interests, even when the right decisions are being made, can be just as damaging to the reputation of an organization and erode public trust as an actual conflict of interest.

Conflicts of interest are inherent in the financial services industry. The potential for conflicts are numerous. Therefore, it is important that those who provide these services have processes in place to properly manage these conflicts, by, for example, eliminating them when possible, disclosing them and/or putting in place an acceptable ethics wall. Best practice is to avoid actual and perceived conflicts of interest when possible.

It is essential that a pension fund have the confidence of its members, the taxpayers, and the plan sponsor in the integrity of the pension fund's operations, particularly with regard to decisions which could have an impact on the financial stability of the fund. Public confidence can be undermined if the fund does not have policies and procedures in place designed to prevent improper conduct.

Ethical leadership begins at the highest level of an organization.[8]

To hold personnel accountable pursuant to vague or ambiguous principles and standards is contrary to fundamental rules of fairness.

Risk

Failure to establish, monitor and maintain effective conflict of interest and ethical standards is inconsistent with good governance, exposes the fund to headline risk and thus could erode trust and confidence of its members and the taxpayers in the integrity of a fund's operations.

Observed Condition

We were informed that the Ethics Policy applicable to LAFPPS Board members and staff is a top priority and is currently being drafted.

[8] Asset Manager Code of Professional Conduct, CFA Centre for Financial Market Integrity.

Board members and staff informed IFS that the City's Ethics Commission provides an annual on-line ethics training for all City employees, including LAFPPS Board members and employees. An annually mandated ethics training program tailored to the LAFPPS' unique circumstances, duties and responsibilities is consistent with best practices.

The Board does not have a comprehensive conflict of interest and disclosure policy for service providers (e.g., investment managers or investment consultants). We were informed that consultants (or service providers) are required to file Form 700. However, according to instructions on the Form 700, "[t]he obligation to file Form 700 is always imposed on the individual who is providing services to the agency, not on the business or firm that employs the individual." A comprehensive conflict of interest and disclosure policy for service providers should cover the individual consultant(s) and the consultant's firm and its affiliates, if any.

Task Area 2a Recommendations 18-19
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.
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 clarity in this policy whether the City's lobbying laws apply to service providers.

Securities Litigation Policy

The Board adopted a Securities Litigation Policy on August 21, 2003. It does not appear that the Policy has been reviewed since that time.

The Policy contains many of the basic components of a Securities Litigation Policy that would be reflective of best practices. However, several of the provisions of the current LAFPPS Securities Litigation Policy could be enhanced to ensure that procedures and processes are adequately documented and that the criteria that apply to the Board's decision-making process in this area are clear.

Once the Board has determined that its losses exceed the established loss threshold (or $1 million in this case), the Securities Litigation Policy identifies certain additional factors that the

Board must consider in deciding whether to actively participate in a litigation matter. For example, the Policy states that the Board shall consider the following:

- Whether or not the Plan's participation or action will increase the net monetary value of the settlement;
- the potential effect on the value of the Plan's investment portfolio;
- whether the Plan's active participation will add value to the potential recovery.

Areas of enhancement that we would suggest include the following:

- The Board's evaluation of a potential case should include consideration of additional factors that directly bear on a decision to pursue litigation. Those factors include:
    - ***Costs of Participation*** – whether the fund's potential losses are significant enough to warrant expenditure of resources and whether participation will add value;
    - ***Quality of the Case*** – whether the case raises meritorious claims which are likely to withstand a motion to dismiss; strength of claims, including an evaluation of the potential defenses;
    - ***Other Institutional Investors*** – qualifications of other lead plaintiff candidates and their counsel, and likelihood that LAFPPS would be selected lead plaintiff;
- Special circumstances that distinguish LAFPPS' claims from those of other class members;
- Venue of the litigation;
- Availability of resources to pay a significant recovery (e.g., financial condition of the target company, availability of insurance, third party or other defendants such as auditors, underwriters, etc.);
- Relation of LAFPPS' claims to other corporate governance issues of special interest to LAFPPS or its participants, and the impact on its other fund holdings;

- Potential for non-monetary remedies of special importance to the pension fund which other class members/lead plaintiffs may not pursue; and

- Costs to LAFPPS of separate litigation or lead plaintiff status, such as discovery, staff/Board time and resources needed to monitor litigation more actively.

Task Area 2a Recommendations 20-21
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 non-monetary recovery, and the overall costs to LAFPPS to participate in the litigation.
The Board should determine a specific periodic review timeframe for the Securities Litigation Policy as it has done with other written policies.

The City Attorney is required to provide on-going reports to the Board on the status of securities litigation matters.

We note that the City Attorney is required to provide the Board with quarterly reports on "*significant litigation, potential litigation, and on potential changes to legislation that would significantly affect the System*" (see Monitoring and Reporting Policy). If the pension fund becomes actively involved in a securities litigation matter, reporting by the City Attorney more frequently than on a quarterly basis may be appropriate.

Task Area 2a Recommendation 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.

Claims Management Process

Principles

Claims Management – A claim should be filed on behalf of the pension fund in connection with every securities class action litigation settlement in which the pension fund is a

qualified member of the class, unless the Board (or a Committee of the Board established for this purpose) determines, based on expert advice, that it is in the interest of LAFPPS not to do so.

Responsibility – This function is typically performed by the custody bank but it may also be performed by a securities class action monitoring firm. The responsible party should accept fiduciary responsibility for filing proofs of claim for all settlements in which the pension fund is an eligible class member.

An Effective Claims Management Process – (a) assures that the responsible party has the list of pension fund claims over the threshold in order to consider whether to object/comment/opt out, and timely forwards proposed settlements of such claims to the designated party (e.g. evaluation counsel) for evaluation; (b) assures that claim payments are accurate; (c) provides guidelines for the custodian regarding investing and accounting for proceeds of claims; (d) provides for a claims reconciliation process and an internal audit process to check accuracy of claim filing activity;[9] and (e) requires that the pension fund's custodian provide monthly reports, with an annual cumulative report, to the pension fund, for each notice of settlement received. The report should identify:

- Name of security and date notice of settlement received;
- Class period for each notice;
- Due date for claim filing;
- Date claim filed;
- Identification of accounts to which the settlement proceeds will be credited;
- Date payment received and amount of payment; and
- Distribution of proceeds for investment.

Task Area 2a Recommendation 23
The Board's Securities Litigation Policy should be amended to incorporate Claims Filing & Monitoring Procedures.

Fiscal Administration

The Board has adopted a Fiscal Administration Policy covers the Department's day-to-day administrative functions. These functions and responsibilities are addressed in more detail in Task Area 2h and 2i.

[9] The details of the securities litigation internal audit process should be set forth in a separate audit procedure.

<u>Board Investment Policies</u> (See Task Area 3e)

Although the Board's Investment Policies are discussed in detail in Task Area 3e, we add one comment here: each Policy should include an acknowledgement that the respective investment consultant and the respective investment manager is a fiduciary, subject to the applicable statutory standard of care.

Task Area 2a Recommendation 24
The Board's Investment Policies should acknowledge that the System's investment consultants and investment managers are fiduciaries.

3. The Board

The LAFPPS Board consists of nine members: five members are appointed by the Mayor, subject to the approval of the City Council; and four members are elected. Of the elected members, one member represents active members of the Police Department, one member represents retired members of the Police Department, one member represents active members of the Fire Department, and one member represents retired members of the Fire Department.

Each board member is appointed or elected to a five year term; however, as a practical matter, mayoral appointees to the board serve at the pleasure of the Mayor.

The Board has delegated authority to the General Manager and to various standing and ad hoc committees. (See comments above in Task Area 2 regarding board committees.)

LAFPPS has some position descriptions on file, but for the most part, as confirmed in our interviews, the position descriptions mirror those found in the civil service regulations. Because the Department is bound by civil service laws with respect to hiring and firing of staff, the Department has limited flexibility in hiring matters. Nonetheless, we were told that staff is working on updating position descriptions and updating the review and evaluation of staff procedures, which will include the periodic review of position description.

The table of Board composition of 66 public retirement systems appearing on the website of the National Association of State Retirement Administrators (the "NASRA Table") shows that 37 of those 66 systems are governed by a seven, eight, or nine person board. The average and median Board size for the retirement systems in the NASRA Table was nine.

The law sets forth specific terms for each LAFPPS board member and does not indicate that a member must tender their resignation when a new Mayor takes office. However, we were informed that as a matter of practice this is the tradition. Thus, notwithstanding the specific language of the statute which provides a five year term for appointed members, as a practical

matter, appointed members serve at the pleasure of the Mayor. As a result, every four years the Board faces the possibility of four new appointed members due to potential changes in the mayoralty. This practice is contrary to best practice as well as common practice. It subjects the appointed member to potential political pressure, elevates the Board's operational risk, potentially affects continuity as well as the level of expertise among appointed board members, and could result in significant disruption to the Board's governance processes. Best practice calls for members to serve their statutorily stated terms, subject only to voluntary resignation or removal, typically pursuant to a super majority vote of the Board upon a showing of a fiduciary breach of duty.

While the LAFPPS Board does not include elected officials, a majority of the Board is appointed by an elected official. It is common for public retirement system boards to include board members appointed by elected officials. However, it is atypical for public pension board members to serve at the pleasure of the appointing authority.

The composition of the Board also includes stakeholders in the pension system: active participants and retirees. Mayoral appointees represent a majority of the Board with five members.

Our interviews with Board members and staff and our analysis of the Board's decision-making process indicate that the Board's size enhances its ability to effectively and efficiently manage the pension fund. Based on our interviews, the Board members believe the Board functions quite well. They were also of the view that the board meetings are run professionally and efficiently.

The Board's President and Vice-President are elected annually by the Board[10]. Having an elected President, as opposed to a president designated by an outside appointing authority, is consistent with fostering the Board's autonomy.

The City Administrative Code requires the Mayor to seek diversity in his appointments. Specifically, the Code reads: "*Unless otherwise provided in the Charter, the Mayor, Council or other appointing authority shall strive to make his or her overall appointments to appointed boards, commissions or advisory bodies established by the Charter or ordinance reflect the diversity of the City, including, but not limited to, communities of interest, neighborhoods, ethnicity, race, gender, age and sexual orientation.*" [11]

California law does not however impose a requirement that members of the Board have particular investment or benefits expertise or experience. While IFS believes that requiring some Board members to have investment expertise is beneficial to the Board and more states are

[10] Board Governance Policies, page 10.
[11] See Section 501 of the Administrative Code.

beginning to require such experience, the absence of a statutory requirement that members of the LAFPPS Board have investment or benefits experience is not unusual or distinctive. Further, it appears that the current and prior mayors have been cognizant of the value of having members with investment knowledge.

Furthermore, we acknowledge that there may be some downside to statutorily imposing a requirement that certain board members have investment expertise. One concern is that members with investment expertise will be inclined to concentrate on investment issues to the exclusion of other important business of the Board. In addition, compliance with the conflict of interest and ethics rules applicable to the Board members may make it difficult to find active investment professionals who are eligible to serve. On balance, however, there is significant value in having individuals with financial or investment expertise on the Board. While it is clear from the current composition and history of the Board that appointing Mayors have, as a practical matter, included members with investment expertise, this practice needs to be statutorily required. An investment expertise requirement for one or more[12] members of the Board would enhance the Board's ability to set and to revise investment policy and to monitor its execution.[13]

Task Area 2a Recommendation 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.

4. Delegation

The LAFPPS Board has delegated authority to the General Manager for the day-to-day management and administration of the System. (See Task Area 2h regarding the role and responsibilities of the General Manager.)

[12] There is no magic formula for establishing how many Board members should have investment expertise. Our Recommendation speaks of legislation requiring "at least one" of the Mayor's appointees to have investment expertise. The Mayor would be free, of course, to appoint more than one person with investment expertise to the Board, and even adding one such Board member would likely improve the Board's effectiveness as an investment decision-maker.

[13] We acknowledge a concern exists that having a Board member with investment expertise could create conflicts, depending upon the member's affiliations in the financial industry. IFS believes that certain types of investment professionals would be less prone to conflict, e.g., a finance professor or retired professional, and that appropriate recusal procedures would mitigate or eliminate potential problems.

At the time this audit commenced, two standing committees were authorized by LAFPPS. However, as noted earlier, since the inception of our audit, the Board has established an Audit Committee. Thus, now the Board has three authorized committees: the Benefits Committee, the Governance Committee and the Audit Committee. In addition, we were informed during our interviews that the Board has authorized participation on a joint ad hoc Office Space Planning Committee with members of the Los Angeles City Employees Retirement System Board. Assignments to each committee are made by the Board President and committee members elect the Chair or Vice-chair of their respective committees.

As is typical among public pension funds, the Board's committees are purely advisory and do not have decision-making authority. Each committee reviews, reports to the Board and makes recommendations to the Board with respect to the subjects within its jurisdiction, and the Board then acts on the recommendations.

This practice of establishing advisory sub-committees, followed by written recommendations and action by the full board is commonplace among public funds. The practice assures that final decision-making authority on all matters requiring Board action rests with the entire Board.

Although we are not aware of a legal requirement that committee meetings occur on the same day as the regular Board meeting, this is the Board's practice. Some Board members indicated that this structure was adopted by the Board members as a convenience, to facilitate attendance at committee meetings. While the meetings process may facilitate attendance at sub-committee meetings, it also eviscerates the principle advantage of the committee structure – the use of small groups of Board members to conduct a preliminary analysis of critical issues, developing an expertise in the areas on which they focus. We recognize, however, that regular attendance at both bi-monthly and sub-committee meetings enhance a Board member's knowledge and understanding of the issues.

5. Board Minutes

Principles

As noted earlier, trustees are judged in light of their decision-making process. The minutes of an organization document this deliberative process.

A public pension fund board should maintain minutes that memorialize its decision-making process. The minutes should establish the lines of reasoning the Board explored, the rationale used, and the decisions the Board ultimately reaches. Well-maintained minutes create the permanent historical record of those decisions, which is necessary both for reference

purposes and for transparency of the Board's decisions. Thus, minutes are an excellent tool that can be used to disclose the facts on which board members deliberated and acted.

As a management tool, the minutes should serve as a reference point to assist staff in understanding the Board's objectives and in implementing the directives of the Board. Minutes can also serve as a benchmark for the Board and staff to measure subsequent progress (or lack of progress) relative to Board's actions, objectives and directives.

Risks

Without documentation of the deliberative process, the ability of a fiduciary to substantiate that a particular decision was prudently derived is more difficult and thus the likelihood of successfully defending a challenge of the outcome is jeopardized.

Observed Conditions

The minutes clearly reflect the matters considered and the actions taken. According to staff, board meetings are "recorded, using a digital recording system." In addition, staff takes manual notes of each meeting. The minutes reflect the general substance of the Board's discussions and actions. However, documentation of the deliberative process supporting the actions taken is limited. The level of detail that should be reflected in the minutes of an organization is a point of debate and judgment.

Staff uses a standardized format for both the minutes and for Board resolutions. This is a good approach. It facilitates consistency and increases the likelihood that required procedural matters are followed in each meeting. It further enables the Board to conduct its business in an orderly manner.

A stenographer is used to record the portion of a board meeting in which disability cases are discussed; otherwise notes are taken at each meeting by staff and subsequently summarized.

Based on our interviews, the Board members believe the minutes capture the essence of the Board's deliberations and they are very pleased with the quality and timeliness of the minutes.

Staff also informed us that Board resolutions are prepared in advance of each meeting.

Given the judgmental aspect of the level of detail appropriate for minutes, we have no recommendations regarding the Board's minutes.

2b. Organizational Structure

1. Background

LAFPPS currently serves a population of approximately 24,700 members as of fiscal year end 2006, with approximately 8,900 active non-vested members, 4,000 active vested members, and 11,800 retirees and pensioners. In addition, LAFPPS serves approximately 1,300 enrollees in the Deferred Retirement (DROP) program[14]. LAFPPS does so with an authorized staff count at the time of our on-site visit of 112, of which 97 positions were filled. Since our visit, LAFPPS has revised their staffing structure and it currently consists of 103 regular positions, of which 93 are filled (July 2007).

The Benefits Administration area, including Active Member Services, Communications and Retirement Services, has an authorized staff count of 54 as of our review, with five vacancies. Since our on-site work was performed, LAFPPS has revised its organization structure and management reports that the current organization structure includes 52 regular positions within the Benefits Administration area, of which six positions are vacant. Select indicators of annual volume for the Benefits Administration area include (based on June 2006 Board Report, the end of the last complete fiscal year):

- Disability Pension Claims Submitted to Board for Action: 78
- Service Pension and Surviving Spouse Pension Applications Granted: 190
- Contribution Refunds for Non vested Members Leaving System Processed: 98
- Medical Subsidies Paid: $53,103,284

The Benefits Administration staff also processes DROP enrollees and exits, provides regular counseling sessions to Active Members and new employees graduating from training status, and handles a large number of recurring and special projects such as absorbing members of other systems (e.g., Port Police), and processing annual COLA adjustments. The staff is currently preparing for the mass exit of more than 200 participants in the DROP program who will reach their five year "must exit" point in May 2007.

[14] DROP is a voluntary program that allows qualified members to work and receive pay and benefits as an active employee for up to five years while accumulating service pension payments in a separate account which earns a guaranteed annual interest rate of 5%. DROP participants are considered "retired" for purposes of pension calculation, so they must be eligible to retire. At the conclusion of the five year period, participants may receive a lump sum distribution, roll over the entire amount into an IRA or take a partial lump-sum/partial roll over.

Principles

A public pension fund should have an organizational structure that provides clear lines of authority and accountability, spans of control that are reasonable for each executive or manager, and reporting ratios that neither over nor under utilize a manager. Relationships and responsibilities among Board, staff, and professional service providers should be clearly articulated in writing. The fund's written governance and investment policies and other written procedures should be clear and unequivocal in regard to delegation of responsibility and decision making authority. In the investment area a fund typically deals with significant pools of assets and implements Board investment decisions. The implementation normally occurs through a combination of internal and external management programs. Where external management is the primary means to accomplish the implementation of Board strategy and policy, the organizational structure of the investment area is usually straight-forward, with investment staff reporting to a senior investment officer or chief who reports directly and administratively to some combination of the Board and the fund's chief executive. On the benefits administration side, where the fund deals with the member retiree and beneficiary payroll function, the structure is a function of the size of the plan, i.e., the number of members served, and the complexity of the plan of benefits, e.g., number of plans, number of tiers, number of employers, etc. Good internal controls over the benefits organization also requires adequate separation of duties to reduce the ability of any one person to commit fraudulent activities.

In an optimally configured organization, operating managers will have a clear picture of which area is responsible for each key function, because like functions are typically grouped together. The size of the organization and the complexity of the work play a large role in determining how managers should design work processes and allocate responsibilities as they coordinate diverse organizational tasks and outputs of internal departments, and seek to optimize the flow of information throughout the organization.

Optimally configured organizations will also have clear accountability for key functions and projects, with the exception of cross-organizational projects whose nature crosses section or department boundaries.

Spans of control (i.e., the number of supervisors per employee in an organization) are measured in two dimensions: (1) reporting relationship ratios and (2) breadth and complexity of knowledge required to effectively supervise the reporting functions. At senior levels, high performing organizations generally have a manager to direct report ratio of 1:5, while at section levels for administrative/processing functions, the federal government has set supervisor to staff ratios of up to 1:15 as targets for efficient departments. We use these standards for our baseline assessment. Like functions should also be grouped together to promote economies of scope and scale, to encourage sharing ideas internally, and to support customer and stakeholder ease of access to the appropriate part of the organization.

Risks

A public pension fund with a non-optimal organization structure is exposed to greater potential risk of fiduciary breach and liability, and fraud or malfeasance. The fund would also be exposed to decreased effectiveness and efficiency resulting from increased time to resolve issues, lower morale due to lack of access to upper management or delays in receiving information or answers, insufficiency of managers to provide appropriate supervision and support, and higher error rates. These areas of increased risk expose the organization to potential increases in cost.

A public pension fund that does not clearly delegate authority and assign all key responsibilities and communicate those assignments throughout the organization is at risk of failure to comply with legal and fiduciary requirements of its operation, along with the risk of less than optimal resource utilization.

Observed Condition

Investments

Within LAFPPS the Investment Division has nine employees and a ratio of one manager (the CIO) to eight staff. Staff have responsibility for different asset classes and the CIO is responsible for oversight of the entire investment program. All staff appeared clear on their responsibilities and lines of reporting among CIO, the Board, and the GM.

The portfolio is divided between two teams – one for Fixed Income and Alternatives, and the other for Equities and Real Estate. Fixed Income and Alternatives has three Investment Officers and one Management Analyst. Equities and Real Estate has one Investment Officer and one Management Analyst. During the review the Investment Officer in Equities left LAFPPS to take an emergency appointment at the Water and Power Pension Department. This left a gap that is going to be covered by the other members of the Division. The CIO and the Investment Officers back each other up when one is absent.

The Investment Consultant (PCA) serves as a third party to perform additional oversight of the fund.

The investment decision making authority remains with the Board and this is clear to the CIO and investment staff. (However, please see discussion in Task Area 3d on rebalancing authority and our recommendations to enhance the IPS.)

The overall span of control in the Investment Division is appropriate for LAFPPS given its extensive use of external management.

Recently, LAFPPS has increased the complement of staff in the Investment Division by three staff. We believe this was a prudent move to provide additional back up and possible succession. The recent departure of one of the investment officers underscores the necessity for sufficient staffing levels.

Recommendation
None.

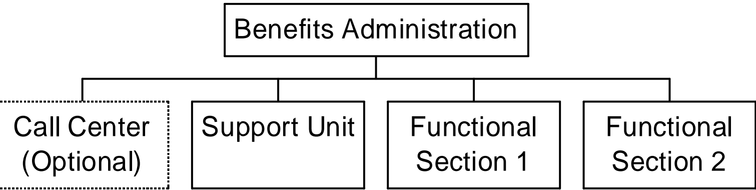
Benefits Administration

Two organizational structures commonly used in benefits administration areas include: (1) a function based structure where sections or units are established to handle specific types of transactions, and (2) a member-facing structure, organized primarily by member status, with units organized to process most transaction types required by members in a particular status (e.g., Active Members, Members in Transition, and Retired Members).

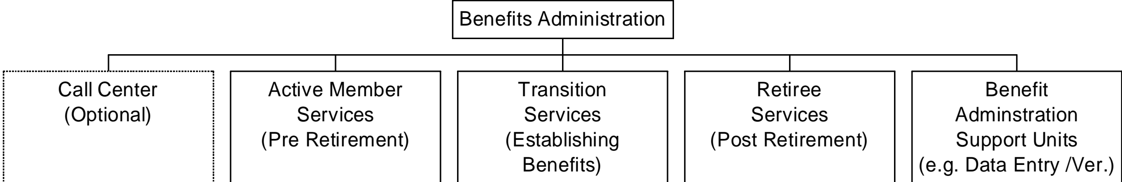
In a member-facing structure, services for each member status type are consolidated under the appropriate member facing unit, with common support functions (such as input and data verification) often located in a support unit that supports all member facing units. In an organization that establishes member facing units, a specialized role of counselor is sometimes created as the primary interface of the member with that unit.

A function based structure, when like transaction types are combined within a section, can often achieve efficiencies based on volume that may not be achieved in a member-facing structure. A member-facing structure can often achieve higher levels of customer service and member satisfaction through a "single point of contact" approach for members in each status type. Call centers, when used in either environment give members a single point of contact for routine transactions, with specialists in the sections handling complex or higher level transactions.

Typical Benefits Administration Organizational Structures
Functionally Based Structure



Customer Facing Structure
(Organized by Member Status)



Based on the organization charts LAFPPS provided, their current organizational structure is typical of a function based structure used by many benefits administration organizations.

LAFPPS' benefits administration area is currently organized by the following function specific sections:

Table 2b-1: Area	**Employee Counts**
Communications/Special Projects*	3
Active Member Services	9
Retirement Services:	
- Medical and Dental Benefits Section	7
- Service Pensions Section**	10
- DROP/Retired Member Services Section***	12
- Disability Pensions Section	12

* We include Communications because of the role it plays in communicating benefits programs to active and retired members.
**Eight regular authorities plus two substitute authorities
*** 10 regular authorities plus 2 substitute authorities

The units shown under Retirement Services report to a currently vacant Assistant Retirement Plan Manager for Retirement Services position, who in turn reports to the Assistant Retirement Plan Manager for the Pension Division along with Active Member Services and Communications/Special Projects. (Note: Since our on-site work was performed, LAFPPS reports that the organizational structure has changed, and Retirement Services units now report to a Chief Management / Benefits Analyst, who in turn reports to the Assistant General Manager.)

In the absence of any customer satisfaction metrics, we are unable to determine whether the current structure at LAFPPS is adequately serving members. Staff members interviewed, however, report few cases of member complaints.

In a typical retirement fund organization, most major units report into the Assistant General Manager/Assistant Retirement Plan Manager level, with Chief Analyst or equivalent positions heading the major sub units. The structure adopted by LAFPPS as depicted in its June 2007 organization chart reflects this level of reporting with two AGM positions, replacing the currently vacant Assistant Retirement Manager position with a Chief Benefits Analyst position. The June chart reflects appropriate separation of pension, administrative and investment operations.

If LAFPPS were to consider evolving to a member-facing structure, the member population LAFPPS serves can be categorized into four groups: (1) Active Members, who have not yet retired and who may be vested or non-vested; (2) Transition Members, who are approaching or going through the service or disability retirement process including DROP; (3) Retired Members and qualified survivors, who are receiving pensions; and (4) Spouses, domestic partners, and ex-spouses and partners of members who may be entitled to some portion of the member's benefits, and who may interact with LAFPPS during active, transition, and retiree stages.

LAFPPS recently consolidated the Deferred Retirement Plan (DROP) and Retired Member Services Sections under one supervisor, and plans over time to further consolidate Service Pensions with the DROP/Retired Member Services unit. Three of the five units that serve pensioners and those approaching service or disability retirement will then be consolidated, which should promote efficiency and improve "single point of contact" capabilities. Currently LAFPPS plans to keep the Disability Pensions Section and Medical and Dental Benefits Section separate due to the unique nature of their functions.

Currently members must call the general LAFPPS phone number, or call directly into the section that handles each particular request. A member's ability to identify the correct section is based on the information available in member publications, on the LAFPPS web site, or in letters and other communications sent out by LAFPPS. LAFPPS does not track call volumes, transfers, or misdirected calls, and we are unable to determine whether the current arrangement causes confusion.

LAFPPS recently revamped its web site. The web site currently provides directory information along with comprehensive counseling, benefit, and downloadable form information to assist members in locating the correct information or contact points.

Unlike many benefits administration organizations, including LACERS, LAFPPS does not have a call center, although each section maintains a section specific inquiry number. Incoming calls and inquiries from members are routed directly to staff in each section based on the type of inquiry, and each section sets its own methodology on how to handle incoming calls. Organizations that adopt a call center structure generally find higher levels of customer satisfaction, more consistency in responses, less "shopping" by members among specialists, and

a better ability to handle call spikes due to notifications or other "mass" issues. Through proper training, call centers can deliver a consistent high quality experience. We note that most section heads interviewed thought that a call center structure "could if properly implemented" be effective at LAFPPS. There is debate within the organization over whether members would be better served with this structure.

In benefits administration organizations that have adopted a call center structure, the call center handles calls of a general nature, questions about plan features, requests for forms, setting appointments, status questions about cases, and other first level calls, including most calls whose answers can be found in summary plan descriptions. More complex questions about cases in progress (other than status) are generally referred to a specialist unit in a call center situation. In the absence of any tracking data on call volumes, we were unable to assess whether call volume is sufficient to support a call center structure at LAFPPS.

Within the Benefits Administration area, section heads and employees are generally aware of the functions of each section and key personnel and report that other sections within Benefits Administration are generally accessible and helpful.

The Benefits Administration area generally has a clear understanding of what transactions happen within each section, and section boundaries are clearly delineated. LAFPPS publishes internal and web based information to serve as a directory for LAFPPS employees.

LAFPPS also publishes a Desk Manual that outlines the key functions of each section to communicate roles and responsibilities of the Benefits Administration sections, including who to contact for different transaction types.

While not entirely a Benefits Administration area function, and therefore partially outside the scope of this audit, we note that there are no specific units with responsibility for department wide quality assurance, physical and data security, performance goals and metrics, or measuring member and stakeholder satisfaction within LAFPPS. These functions are usually found in organizational structures of highly performing Benefits Administration organizations.

We were unable to identify managers with day-to-day responsibility for a number of functions including legal compliance (with both pension and privacy regulations), physical security within the LAFPPS premises including physical security of member records, files, and other data, business continuity in the event of disaster or local outages or disasters affecting key vendors (such as LA City and Buck Consulting), contract administration of key contracts (including setting performance standards and monitoring compliance for key vendor relationships), vendor relations, quality assurance, and performance goals and metrics, although many of these responsibilities are in the portfolio of the Assistant Retirement Plan Manager – Executive Officer.

We note that some of these functions may, in fact, be assigned to managers outside the scope of those interviewed within the Benefits Administration review. LAFPPS management states that they believe that the City Attorney is responsible for legal compliance, however the City Attorney's office assigned to LAFPPS did not concur during our interviews. The City Attorney's office described its role as limited to providing opinions and information on applicable laws and regulations, with responsibility for compliance and compliance monitoring residing with LAFPPS staff and management.

LAFPPS management also notes that under the recently revised organizational structure with changes at the Assistant Retirement Plan Manager level, responsibility for physical security of the premises, business continuity, and contract administration lies with the new Assistant General Manager for Administration Operations Division position.

However, within the Benefits Administration organization, staff are not aware of who is responsible for these functions, or in general, where to report or respond if there were a significant business disruption. LAFPPS management notes that staff has been informed of business disruption procedures. At the time of our visit, however, this could not be confirmed during our interviews with staff. LAFPPS management also notes that the City Controller shares responsibility for disaster preparedness regarding the RAP (retiree payroll) legacy system. However, LAFPPS staff interviewed were not aware of specific contingency plans, if any, in the event of a sustained RAP outage.

Benefits Administration personnel are less clear about the organizational structure outside Benefits Administration, especially with regard to the systems functions within LAFPPS.

Authority and accountability for systems issues, OnPoint, Employee Self Service, and other key systems are unclear to most interviewees, and are reported inconsistently by incumbents interviewed within the systems area. We note that the organizational structure of the systems area is outside the scope of this audit. The impact observed within the Benefits Administration area is confusion over who within LAFPPS is responsible for ensuring smooth and adequate systems support and for resolving implementation issues with OnPoint. OnPoint is the core member data, and benefit calculating system for LAFPP and is scheduled to become the payroll system for LAFPPS.

The ConSEPPS team, responsible for OnPoint implementation has made significant progress in becoming the single point of contact for OnPoint issues. However, Employee Self Service, which relies on the OnPoint system, is directed by the acting Director of Systems. Because the acting Director of Systems is a Senior Systems Analyst II acting in lieu, the incumbent cannot directly supervise the Fiscal Systems Specialist II in charge of ConSEPPS because it is a peer classification, which may be a root cause of some of the organizational confusion. (See the discussions under Organizational Effectiveness and Efficiency and Sufficiency of Resources.)

We note that LAFPPS has recently engaged an IT Consultant who is working with the General Manager, Systems, and Benefits Administration to resolve these issues.

We also note that many of these issues have been identified in the Draft Strategic Plan recently submitted to the Board for approval.

In observing processes for quality assurance and separation of functions, we noted that all sections reported a double check process for key calculations to minimize errors and for reviewing payroll and reimbursement runs for accuracy. We did not observe any organizational structural instances where processes were combined within a section that would raise unusual opportunities for malfeasance.

We note that in the absence of fully documented procedures, we were unable to review processes for appropriate separation of duties.

Task Area 2b Recommendations 1-7
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.
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.
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.)
The Department should consider establishing a Call Center as a single contact point for members.
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.

Task Area 2b Recommendations 1-7
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.
The Department should continue to evolve the web site as a source of benefit, counseling, and self-service resources.

2c. Organizational Efficiency and Effectiveness

Principles

Public pension funds assess benefits operations, in terms of timeliness and accuracy of the performance of the operation's key functions while minimizing the time, effort, and costs involved. The evaluation of these functions should include establishing reasonable performance goals and metrics to assess:

- Accuracy and timeliness of preparation of the pension payroll, including on boarding of new retirees;
- Accuracy and timeliness of preparation of medical/health reimbursement payments; and
- Comprehensiveness and completeness of counseling and enrollment services for active members and members approaching retirement.

The effectiveness of high performing organizations is characterized by a number of factors, including: clearly communicated organization objectives and individual performance goals; performance metrics; strong internal communications (i.e., both "bottom up" and "top down"); workflow controls including systems that track the presence of and timely case completion and transaction requests; and well documented procedures. The presence and use of these indicators are significantly correlated to effective and efficient organizations.

In addition, effective organizations are characterized by a strong quality control focus, as demonstrated by processes that encourage quality, internal measurement systems that track the quality of service delivery, and external measures that evaluate member and stakeholder satisfaction with the quality of service delivery.

An efficiency assessment focuses on whether the organization consistently delivers its key services on a cost effective basis in terms of labor and other resources expended to achieve

its goals. For an organization to approach "best practice" levels in efficiency, it must meet a number of criteria:

- Awareness of the resource cost of delivering each service;
- Management and staff focus on how to streamline and improve the efficiency (and effectiveness) of service delivery; and
- A performance management system that encourages efficiency and effectiveness.

In an organization that operates primarily within a civil service system, efficiency is sometimes impacted by civil service rules that limit the ability of an organization to flexibly deploy personnel due to the rules that govern working out of grade or assignment.

Risks

If a public pension fund is not optimally effective, it will have a direct negative impact on its members. This type of problem may result in numerous issues such as: delays in timely processing of payments and other requests; members' selection of non-optimal retirement benefit configurations due to insufficient or incomplete counseling; and additional costs incurred to correct errors.

An inefficient fund will not properly use resources held for its members, and incur larger than necessary administrative costs, potentially resulting in the need for the Plan sponsor to pay larger contributions. In addition, the inefficiencies may distract management from focusing on more important issues that could improve overall the effectiveness.

Observed Condition

Currently LAFPPS does not subscribe to CEM Administrative Benchmark data, and does not generate any internal statistics that track timeliness, transaction costs, labor/resource cost per transaction for major transaction types, backlogs, or other performance metrics (other than transaction counts). In addition, LAFPPS does not have standard measurement systems in place to track quality of service delivery or member satisfaction. Therefore we are unable to statistically assess the effectiveness of LAFPPS' operations or evaluate member and stakeholder satisfaction with service delivery. We draw our observations and conclusions from interviews with staff only, which are subjective without independent statistical confirmation. Other indicators that are typically found in high performing organizations, include:

- A strategic plan with time bound, specific, measurable organizational goals, used as a management tool to drive organizational focus and performance;

- Clearly communicated organization, section, and individual performance goals and appropriate performance metrics;
- Strong internal communications (both bottom up and top down);
- Workflow controls including systems that track the presence of and timely completion of cases and transaction requests;
- Well documented procedures;
- Strong quality control focus, with processes that encourage quality, internal measurement systems that tract the quality of service delivery, and external measures that evaluate satisfaction of members and other stakeholders in the quality of service delivery;
- Strong project management processes and procedures;
- Clear procedures for determining and communicating policy; and
- Personnel management systems and practices that encourage regular performance reviews, long term staffing planning, and planning for turnover of key personnel.

These indicators significantly correlate to effective and efficient organizations.

Accuracy of Pension Calculations

Our review of pension calculations did not identify any significant errors or miscalculations. Our review of the timeliness of pension calculations shows that in 90% of the cases examined, calculations were completed on a timely basis within 45 days. 10% of the cases reviewed appeared to take more than nine months to complete, and future review is suggested. Our findings are presented in detail in our discussion of our audit of specific pension calculations (see *Review of Retirement Calculations for Accuracy and Compliance with Plan Provisions*) later in this Report.

LAFPPS staff reported insignificant error rates in its transaction processing, and all sections interviewed noted duplicate (and occasionally triplicate) checks on all calculations. No supervisor reported significant time spent on error corrections beyond normal reconciliation reviews of transaction logs. In the absence of statistical data, we are unable to independently asses this, as LAFPPS does not generate statistics on accuracy or errors.

Health Reimbursement and Subsidies

LAFPPS retired members are eligible to receive a subsidy for health maintenance organization premiums (if they live within the areas serviced by retiree health plans) or reimbursement up to the subsidy amount if they live outside the service area and purchase their own insurance. Members are required to subscribe to Medicare parts B & D when they reach eligible age. The plans themselves are administered by various Fire and Police associations, and LAFPPS provides premium reimbursement to the associations in accordance with plan guidelines. In addition, LAFPPS does administer premium reimbursement directly to eligible beneficiaries living outside the areas covered by existing plans. In both cases, LAFPPS' role is to calculate and validate individual subsidy and reimbursement amounts according to plan requirements, and to validate the subsidy and reimbursement roles and process the payments to each of the administrators and to the individuals seeking reimbursement for premiums. In addition, LAFPPS deducts excess premiums from pension checks if required. LAFPPS also validates that the amount of reimbursement does not exceed the actual insurance cost, and that all members eligible for Medicare have applied for the appropriate Medicare parts.

LAFPPS has included auditing the plan administrators as part of its draft strategic plan. As part of the audit, it should explore whether LAFPPS would be able to reduce subsidies by either (a) contracting directly for insurance, (b) combining with LACERS for the purchase of health coverage, or (c) combining with LA City. We did not review the individual health plans' summary plan descriptions for commonality of benefits with either LACERS or LA City. Because of the magnitude of expense (over $53 million per year), LAFPPS' plan to pay additional attention to the plan administrators is important.

Verbal descriptions of the reconciliation, validation, and benefit coordination processes described by department members appear to be sound, but in the absence of complete process documentation we were unable to compare the "as-is" and "as-documented" processes. Validating specific reimbursement calculations was outside the scope of this audit.

Counseling

LAFPPS provides counseling to members at a number of points in their life cycle, including graduation from training academy (when they become members), and throughout their active careers. LAFPPS reports monthly to the Board on scheduled training sessions and their attendance. A wide variety of counseling materials is also available on the LAFPPS web site for self-service use, covering retirement lifestyle, budgeting, investment planning and plan specific topics. In addition, LAFPPS provides individual counseling on request as members approach retirement and prepare to make their final selections for DROP or pension options. Counseling covers plan options, purchase of lost service, injury, and training time, and DROP options. The frequency of training session offerings and the availability of individual counseling are

consistent with a high level of customer service. In the absence, however, of customer survey data, we are unable to independently validate the effectiveness of counseling.

A review of selected correspondence of members requesting exceptions to filing and selection deadlines suggest that LAFPPS might consider a FAQ covering critical deadlines, choices, and their implications for each of its key programs, including a signed checklist where the member acknowledges that they have received counseling and understand each choice and its implication as part of the counseling process if this does not currently exist. A signed acknowledgement and checklist can serve as documentation that adequate counseling was provided.

Indicators of Highly Performing Operations

We observed the following in assessing the LAFPPS benefits administration area against the indicators of highly performing organizations noted at the beginning of this section:

- **Presence of Strategic Plan:** LAFPPS recently prepared its first Strategic Plan for Board Approval. The Strategic Plan acknowledges and identifies as priorities many of the areas of improvement opportunity noted in this audit, and sets time bound goals for assessing issues and preparing an organizational plan to address those issues. Assessing the effectiveness of the Strategic Plan in driving improvement is premature as the plan has just been submitted to the Board for approval.

- **Performance Goals and Metrics:** LAFPPS does not have clearly communicated section, organizational or individual performance goals. This opportunity for improvement is noted in the Draft Strategic Plan.

  - All interviewees stress that LAFPPS is universally committed to serving its active and retired members, and this message is communicated consistently at all levels of the organization. LAFPPS is highly focused on completing transaction requests in house in time for the next payroll run, and interviewees report no significant difficulties in meeting this goal.

  - LAFPPS does not collect performance or cost metrics beyond actual expenses vs. budget and transaction counts. Highly performing organizations typically collect statistics such as turnaround time, cost per transaction, labor time per transaction, backlogs, and error rates to monitor, manage, and reward performance. This opportunity for improvement is noted in the Draft Strategic Plan.

- Interviewees did not report sensitivity to any informal performance goals other than the critical goal of processing transactions accurately and in time for the next payroll run. No interviewee mentioned tracking any measures of efficiency, although a number of interviewees mentioned changes to processes that helped improve efficiency.

- **Internal Communications:** LAFPPS' efforts to date to promote strong internal communications and an open environment where employees feel comfortable raising issues and concerns and in working together to resolve those concerns have met with mixed response according to interviewees, although some interviewees noted that the environment was improving. Younger employees tended to assess the communications environment more positively than employees with longer tenure. We did not note any formal programs that promote the desired environment.

  - There is general agreement among those interviewed that LAFPPS would benefit from improving its internal communications and fostering an environment that encourages open exchanges of ideas and approaches. Areas noted for potential improvement include: better communications to the organization on the status of projects and initiatives; improvements in how the organization makes and communicates policy decisions; better historical tracking of policy decisions and their rationale; more open discussions of alternate approaches to issues; and encouraging thoughtful challenges to "as is" processes in an environment that rewards continual improvement.

  - There appears to be insufficient or muddled communications within LAFPPS over issues such as the appropriateness and status of such projects as the OnPoint computer system, changes in calculation methodology as part of the OnPoint implementation, and changes in organization structure (combining Retired Member Services and the DROP unit). There appears to be much speculation among supervisors interviewed on a variety of these types of issues. Thoughtful improvement in internal organization communications, and regular updates by senior management on key issues could significantly reduce speculation. Management reports that it holds regularly scheduled Manager/ Staff meetings with Benefits Administration section heads to keep section managers informed.

  - Some supervisors mentioned receiving little or no feedback on analyses performed and forwarded to senior management, and no feedback on changes ultimately implemented that appeared to be based on these analyses, again indicating the potential for LAFPPS to significantly improve internal communications.

- **Workflow Controls and Tracking:** LAFPPS does not have systems based workflow and case tracking for transaction work in house. The OnPoint system is the system of record, but does not contain any workflow or case management capabilities. Each section has developed its own methods for tracking work in progress, and the methods range from informal databases (Access or Excel based) to physical filing and manual records systems that record work in house and its status.

  - The IT Systems area supports ad hoc database requests, and is tracking some of the several ad hoc databases that LAFPPS relies on for daily processing. However, there does not appear to be a comprehensive list of databases available, any system-wide life cycle management plan for these databases, documentation on their maintenance or use, source code control or controls over the backing up the data they contain. We note that the ad hoc spreadsheets and databases may be automatically backed up if they reside on a departmental server rather than individual computers, but we are not aware of any policies to ensure this, or security procedures in place to control access. We also note that IT Systems is reviewing a limited number of specific databases and is considering selective enhancement/replacement. The large number of ad hoc database, spreadsheets, and manual systems suggests that there is significant duplication of data and data entry across the benefits administration area.

  - LAFPPS has purchased licenses for, and is in the early stages of a workflow and document management project based on Documentum, one of the industry standards for document management and document based workflow. As part of the project, LAFPPS is in the early stages of a process to flow chart existing process to document "as is" conditions. LAFPPS has the opportunity to use this as a tool in encouraging reflective redesign of processes. However, we are not aware of a process review and redesign project at present.

- **Procedure Documentation:** While LAFPPS does not have a complete set of documentation for its core processes and procedures, it has identified creating a complete set of documentation as an organizational priority. Interviewees note that LAFPPS has not enforced deadlines for completion, and that the documentation process is a low priority within their sections. Different sections are at different stages in their documentation process with some sections (such as Disability) having complete (though not recently updated) processes, and other sections having selected processes and procedures at various stages of drafting. This has been identified as a priority in the draft Strategic Plan. LAFPPS reports that the Disabilities Pension Section has completed two procedure manual updates since 1980. The version provided to us for review shows page revision dates of 1988 and

1990, but does not contain a revision history, publication date or "last reviewed" date.

- Many sections stated that they did not have sufficient time or staff to focus on process documentation, and that leadership had not emphasized it as a priority. LAFPPS may wish to consider engaging a consultant or adding one or more staff members to facilitate the completion of this project.

● **Quality Assurance Culture and Measurement:** The LAFPPS organizational culture, universally confirmed by all interviewees is a culture that promotes accuracy, timeliness, and high quality delivery of service to LAFPPS members. LAFPPS is to be applauded on clearly communicating this organization goal. However, LAFPPS does not currently have internal service delivery standards and measurements and does not produce metrics to assess its performance in this area, nor does it regularly assess member satisfaction with service delivery.

- Interviewees reported generally low error and complaint rates that they attribute to processes and procedures that require all data entry and calculations to be performed twice or double checked against input source documents. In the absence of metrics, we are unable to independently confirm this self-assessment. Our Commissioner interview did not note any concerns in this area that had risen to the Board level.

● **Project Management:** During our assessment of the Benefits Administration Area's project management processes and procedures, we did not identify any standard methodology used within LAFPPS to manage projects to successful completion. LAFPPS uses a non-standardized combination of spreadsheets, monthly reports, and other tracking systems. There does not appear to be consequences to missing deadlines. Symptomatically, our observations of delays in the processes documentation area, and in lackluster support from some areas of Benefits Administration for the OnPoint project suggest that LAFPPS would benefit from developing stronger organization wide and section project management and tracking skills, and exploring whether improvements in status reporting are indicated.

● **Determining Policy:** LAFPPS has informal procedures in place for determining and communicating policy. When a section determines the need for policy clarification, the section will generally request clarification from the Assistant General Manager. Often, the section will develop a background paper or position paper to provide supporting detail for the issue in question. The policy question may, if appropriate be referred to the City Attorney's office for an opinion, or may be handled in a formal or informal internal meeting. In many cases, the policy

question is related to a specific member's request, while in other cases it is related to establishing or modifying procedures to reflect new charter or administrative code requirements or requirements to comply with new state laws or regulations.

- Interviewees note that LAFPPS would benefit from a stronger system to document and provide historical reference manuals that contain and track past policy decisions, and to expand answers to member specific policy questions to more general policy guidelines.

- Our review of sample historical documents related to specific policy questions shows sample decisions that are generally supported by significant background data, member specific research and legal opinions; the issue memos we reviewed also discussed pros and cons of alternate decisions, along with a rationale for the approved option. Examples of correspondence to members requesting clarification of policies were generally complete and easy to understand.

● **Performance Feedback and Management:** LAFPPS shows a strong commitment to providing regular feedback to employees through the annual performance review process, and with few exceptions, interviewees reported receiving performance reviews that were useful within the past year. However, LAFPPS does not appear to have processes in place for long term human resource planning, projecting future volume growth based on system demographics and member ages, or for systematically capturing institutional knowledge of and grooming replacements for section heads and other key personnel who plan to retire in the next 12–24 months.

- LAFPPS Executive Leadership has emphasized the importance of regular performance reviews, and all supervisors interviewed noted that they receive notification of pending reviews. Most recipients of reviews acknowledged their usefulness and felt the process was worthwhile in acknowledging and improving performance. Most supervisors noted they were aware of and/or up to date on conducting performance reviews with their direct reports.

- However, with turnover and transfer of supervisors a regular occurrence, there is not a consistent handoff procedure to ensure that affected subordinates receive a complete performance review incorporating feedback from their old as well as new supervisor. Some supervisors report informal efforts to capture data from the former supervisor in preparing for the review. This becomes problematic if the former supervisor has left LAFPPS.

- A number of section heads/senior managers have noted that they are within one or two years of retirement from the Department. LAFPPS does not appear to

have an articulated plan for capturing their institutional knowledge or identifying or training their successors. While some institutional knowledge will reside in other members of the sections, there are some sections, such as DROP, with very few long tenured employees. There may not be sufficient backup to replace critical institutional knowledge, and we encourage LAFPPS to explore increasing its efforts in this area.

- There is not a formal cross training program in place, and employees do not have formal backup duty positions. This differs from best practice. However, due to the movement of personnel between sections, a number of staff have experience performing other functions, somewhat mitigating this issue.

- LAFPPS does not have formal training programs established for indoctrinating and training new employees or employees who transfer to new positions within LAFPPS. Training consists of on the job "over the shoulder" training, review of documentation and manuals (e.g., OnPoint), review of the city charter and administrative code, and one on one interactions with experienced employees familiar with the job duties. LAFPPS may wish to explore developing more formal training in tandem with completing its process documentation. We note that the vacancy rate within Benefits Administration is currently 9.4%, which suggests the opportunity for efficiency gains if the training period can be reduced through improving effectiveness of training.

- **Web Site/Member Communications:** LAFPPS recently revamped its web site and now provides a wide variety of downloadable forms, plan information, contact information, and counseling information. The site also includes a self-service area for DROP participants. LAFPPS plans to make self service available to active and retired members in the future. The web site is easy to navigate and is an effective communications tool. LAFPPS notes that its members generally retire at younger ages than other retirement plans and are web savvy. We observed the following areas for possible review:

  - Counseling materials are generally informative and include worksheets and forms for members to use in planning. However visually they range from nicely designed PowerPoint presentations with information presented in a graphical, easily accessible way, to dense Word documents that are informative, but more difficult to wade through. LAFPPS should consider reviewing all materials for possible graphical re-design to make the information more visually appealing and accessible. In addition, LAFPPS should consider developing interactive online worksheets for select popular topics. We note that current technology is available to provide online PowerPoint presentations with audio tracks to replicate some of the group counseling sessions.

- The current web site contains FAQ (frequently asked question) lists with a link from the home page banner. LAFPPS should consider adding links to the FAQ lists to the individual area drop down menus.

- In the Medical Reimbursement/Subsidy area, LAFPPS should consider linking directly to health plan information at the plan administrator web sites rather than to their home pages, to make the information more easily accessible to members.

We observed a number of other conditions, some, not entirely within the control of Benefits Administration, that impact the ability of Benefits Administration to perform efficiently and effectively.

LAFPPS does not currently adhere to best practices for managing physical files, (other than perimeter facility security) or follow best practice principles for protecting sensitive information. Files are left out overnight on desktops (including medical records in the Disabilities Section), and stored in unlocked files cabinets. A physical data and file security plan do not exist, although leadership is aware of this issue. (This is one of the areas identified as a priority in the draft Strategic Plan.)

There is no formal tracking of backlogs or delays, leaving no visibility to executive leadership unless the impacted supervisor escalates the issue, except in the Disability Pension Section, which provides a monthly report on processing of claims to the AGM.

There are myriad concerns expressed within the Benefits Administration area regarding the selection, implementation, adequacy and future plans surrounding the OnPoint system. An assessment of the systems area and the OnPoint project are outside the scope of this review, so we are unable to independently assess the accuracy of these concerns. Our impressions are that some opinions expressed by supervisors and staff appear to be based on speculation rather than fact. Those sections interviewed where OnPoint has been fully implemented express satisfaction with the system and their interactions with it. Those sections where OnPoint has not yet been implemented do not appear to have a strong commitment to the OnPoint system and its implementation process.

LAFPPS does not have a formal program in place to mask or restrict access to social security and other "high value" information that could be used for identity theft.

In attempting to review the Benefits Administration area for operational efficiency, we were hampered by the lack of internal metrics or external comparative data. We observed that LAFPPS' system area has started to flow chart core procedures in preparation for the document management system project, and that this effort may help the organization identify inefficient

processes that that could be improved. In our interviews we noted a number of processes that appeared to be inefficient, but in the absence of process documentation, we could not formally assess them. As examples:

- One area has a computer supported system that is used to complete payroll change forms (43P). This system then prints out forms that are used to manually enter data into the RAP legacy retiree payroll system run by LA City, with the net effect that all data is entered twice. (LAFPPS notes that double entry was eliminated as of 1/1/07 by the DROP section through the use of OnPoint, however at the time of our on-site audit, the PC based system noted above was demonstrated to us as an active system still in regular use for preparation of Form 43P which was then re-entered into RAP.)

- There appears to be an issue where the OnPoint system (due to more modern technology) calculates benefits that are off by a penny or two compared with the legacy COBOL system. LAFPPS made a policy decision to calculate benefits using both old and new systems, and use the higher of the two calculations to set the benefit. This results in staff overriding OnPoint frequently, rather than relying on OnPoint. This is an inefficient practice, and the additional benefit to members appears to be minor. (A benefit difference of a penny per month over a 30-year retirement is less than $4.00 lifetime, and less than $2.00 in present value. We speculate that the cost in labor to perform dual calculations and to override OnPoint significantly exceeds this amount. We strongly encourage LAFPPS to have its actuaries review and certify that the OnPoint calculations are accurate and use OnPoint as the system of record in performing calculations once certified, especially considering that the legacy system is scheduled for possible sun setting. LAFPPS management is in agreement as to the de minimis calculation difference noted above.

Task Area 2c Recommendations 1-29
LAFPPS should develop an assessment tool for measuring the effectiveness of group, individual, and self-service counseling tools.
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.
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

Task Area 2c Recommendations 1-29
personnel understand roles, responsibilities, and current project status on systems projects that affect their area.
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.)
LAFPPS should establish internal and member based instruments for assessing quality of service delivery, and monitor and track trends over time.
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.
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.
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.
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.
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.
LAFPPS should establish metrics for measuring the cost effectiveness and quality of the health plans that are funded through subsidies.
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.
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.
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

Task Area 2c Recommendations 1-29
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.)
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.)
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.
LAFPPS should develop a physical and electronic data security plan for benefits administration and member data.
LAFPPS should develop a privacy protection plan and processes to ensure that LAFPPS complies with applicable HIPAA and other privacy regulations.
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.
LAFPPS should establish procedures to ensure that outgoing supervisors prepare interim performance review information for direct reports before their change in duty assignment/departure.
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.
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.
LAFPPS should consider developing processes and skills training to aid section heads and management in managing multiple projects and should

Task Area 2c Recommendations 1-29
consider establishing standard ways to assign and communicate responsibilities.
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 them, to reduce the amount of speculation and rumor present within the organization.
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.
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.)
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.
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 Documentum projects.
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.)

The draft Strategic Plan addresses a number of these recommendations, and its successful implementation will remediate a number of observed conditions.

2d. Staffing Adequacy

(Please see also Section 2f. on other staff related matters)

Principles

Staff levels should be adequate to ensure completion of the Department's mission and objectives in a timely, efficient manner. In order to provide adequate staffing, the Department must be able to attract, organize, and retain employees of sufficient quantity that possess the appropriate skills sets.

Risks

Inadequate staffing exposes an organization to a variety of otherwise controllable risks, including governance risk as well as implementation risks (both tactical and operational).

Observed Condition

LAFPPS has budgeted for '07/'08 eight full time positions that are related to its investment management function plus two administrative support positions. Two positions are unfilled; one is vacant and one position is occupied but the Investment Officer in that position is on emergency appointment at the Water & Power Pension Department.

The Investment Division is primarily responsible for implementation and oversight of the LAFPPS investment program.

At the time of our audit, the Benefits Administration Area (Communications, Active Member Services and Retirement Services) had an authorized employee count of 53 with five vacancies or a vacancy rate of 9.4%. (The Department shows an authorized count of 112, with 15 vacancies and a vacancy rate of 13.4%.)

No area reported difficulty processing current transaction volumes with current staffing levels, although some areas reported seasonal peaks and busy times. Possible conclusions suggest that LAFPPS can operate with a smaller number of employees than authorized, but needs a larger authorized employee count to ensure sufficient staffing is on hand at any time given the delays in filling open positions in a civil service environment, or alternately that the open positions may be a key contributor to the issues observed with LAFPPS' difficulty in successfully completing long term projects not directly related to daily processing. In the absence of backlog and performance metrics we were not able to statistically assess the adequacy of authorized or actual staffing levels.

All Benefits Administration supervisors interviewed had significant on-the-job experience and familiarity with LAFPPS and its core processes, with the exception of a supervisor in a newly expanded position who was learning the details of the additional processes in the combined section.

Most supervisors and many individuals interviewed identified at least one person who had the knowledge and experience to fill in for them as a temporary replacement, although in most cases there was not a formal cross-training process in place, and the backup might come from a different section. We could not assess the potential impact on the section donating an employee to cover a temporary vacancy.

As noted earlier, a number of Section Heads and other key personnel have expressed their intent to retire within the next 12 to 24 months. This may result in insufficient resource at this level, or in insufficiently seasoned personnel replacing incumbents with long tenures. We recommend that LAFPPS consider enhancing its succession planning process to include other senior staff in addition to the GM and CIO.

The Assistant Retirement Plan Manager Position for Retirement Services position was vacant at the time of our review, with an SMA II Section Head temporarily assuming some of the duties of the position. In the absence of an incumbent to interview, we were unable to assess the duties/role of this position, and the impact of its vacancy.

Most areas noted that they did not have sufficient capacity to focus on longer term strategic projects such as developing procedure and process documentation or developing and writing user requirements for the OnPoint conversion. We recommend that LAFPPS consider acquiring consulting assistance or the addition of two or three staff members to assist in this area.

Task Area 2d Recommendations 1-5
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.
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 documentation and improvement.
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.

Task Area 2d Recommendations 1-5
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.
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.)

2e. Use and Sufficiency of Resources

Principles

Resource allocation throughout an organization is one of the key tasks that management must carry out consistently. Ensuring that appropriate funds are allocated to the procurement and maintenance of systems, personnel, business unit operations, and communications are crucial to the ongoing success of a given enterprise. With particular regard to pension systems, some of the key considerations in this area relate to the resources allocated to items such as IT, staffing, training and development, as well as plan administration.

Risks

The lack of sufficient resources within an organization can detract from its ability to perform crucial tasks and deliver on commitments to its key stakeholders and constituents.

Observed Condition

Benefits administration staff interviewed identified three areas of insufficient resources including the OnPoint System, lack of formal training programs for new hires, and insufficient staffing to focus on non transaction related projects such as documenting procedures and providing user requirements to the OnPoint project.

In the absence of any type of performance metrics, we were unable to independently assess staffing adequacy. We note in the above section a recommendation that LAFPPS consider temporary or permanent staffing support on a department wide basis to support special projects such as process documentation.

Currently, training within the benefits administration area is handled section by section, primarily through shadowing and on-the-job training. Many interviewees reported additional self-training by reading the administrative code and other non LAFPPS materials such as the city charter that provide the basis for the transactions that they process. We did not review LAFPPS vacancy reports to assess annual turnover, but do note that departments report lead time of up to six months before a new employee is fully qualified to perform the functions of their job (e.g., DROP).

LAFPPS could benefit from establishing a more formalized training program aimed at reducing the time it takes for a new employee to become fully trained in his or her job duties. Most employees were aware of training programs on general skills offered by LA City.

LAFPPS should also consider whether selected incumbents in certain positions such as Retirement Benefits Specialists and Senior Clerk Typist positions should be identified for training in the processes of multiple sections so that they could be flexibly assigned based on seasonal staffing needs. LAFPPS would need to consider how to effectively conduct such training in evaluating this suggestion and ensure that its implementation complied with civil service requirements.

Where OnPoint has been fully implemented, sections report that it is an effective tool. We note that there is significant concern within the Benefits Administration Area over the adequacy of the OnPoint system, the system implementation process, and the system's overall effectiveness, primarily in areas where the OnPoint implementation has not yet been completed. In response to the issues raised within Benefits Administration, we interviewed the Acting Director of Systems and the head of ConSEPPS, which is responsible for the OnPoint project. We also note that LAFPPS management recognizes these issues and has engaged an IT consultant to review the OnPoint project and its current status, and to provide recommendations for completing the OnPoint implementation.

The current incumbent in charge of the OnPoint ConSEPPS area appears to be following sound project management processes and procedures, with adequate documentation, current phase plans, and testing and rollout strategies. The incumbent is aware of issues with the implementation and testing process, and is working to remediate these issues. The incumbent notes that recently she has been receiving more support from executive leadership. In addition, LAFPPS has hired an outside consultant to assist LAFPPS in addressing organizational issues that have impeded the speed and organization support for the OnPoint project, and to reassess current and future implementation plans.

Project management of implementation of the OnPoint system is hampered by dispersed responsibility within LAFPPS. Responsibilities appear to be split between the Chief Management Analyst, Acting Director of Systems, and the ConSEPPS group. (Note the same grade reporting issue identified under Organizational Structure.)

Several interviewees mentioned the attempted implementation of employee self service (which was withdrawn shortly after its initial "go live" date due to implementation problems) as a symptom of the current issues with the OnPoint implementation process, citing technical errors and poor communications as negatively impacting the process. (This project was managed outside the ConSEPPS group.)

ConSEPPS Project management also appears to be hampered by lack of participation of some sections, their supervisors, and staff in identifying user requirements, reviewing specifications and participating in testing. Interviewees offered inconsistent responses on their understanding of the priority of OnPoint implementation in their responsibilities.

A review of current ConSEPPS communications, testing, user documentation, and project plans suggests that within ConSEPPS the planning process is sound, and that many of the issues around OnPoint and its implementation are related to LAFPPS' organizational and communications issues outside the ConSEPPS group.

LAFPPS senior management has engaged an outside consultant who is in the initial stages of assessment to help LAFPPS remediate these issues. We note that the OnPoint project and issues surrounding its selection and implementation continue to distract the organization, and emphasize that those units where OnPoint has been fully implemented express satisfaction with its direct capabilities.

An independent audit of the Systems Area is outside the scope of this audit, so we provide the following observations for LAFPPS' future investigation and follow-up.

In our interviews with Systems personnel, we did not identify anyone with the responsibility for ensuring that LAFPPS had copies of current member data and key files in its possession to enable it to operate in the event of an OnPoint disruption or contract dispute, conduct analyses, or reestablish operations in the event of an un-recoverable or extended delay business continuity issue with OnPoint. Without this, the current provider essentially could hold LAFPPS hostage, as LAFPPS does not currently have an independent copy of the data that resides in OnPoint in its possession.

System personnel interviewed were not consistently aware of the significant details of their roles to ensure business continuity in the event that a disaster affected OnPoint and were only partially aware of the City of Los Angeles' disaster recovery plan for City hosted systems, how LAFPP would recover from a disruption at its location, or the procedures for reestablishing operations at an alternate location.

The Systems department does not appear to have standards or a formal replacement cycle for computer or other technology hardware.

LAFPPS does not appear to have a formal life cycle management plan for ad hoc database or legacy systems.

This suggests that the systems area is an area of high risk for LAFPPS due to the critical nature of the functions it performs. We do not believe that an assessment of the Systems area beyond the OnPoint implementation is a part of the IT consultant's engagement.

Task Area 2e Recommendations 1-3
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.
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.
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.

2f. Use of Investment Consultants and Provision of Contractual Services

1. Consultant's Functions

Principles

Most pension funds hire experienced professionals to assist them in fulfilling their investment oversight responsibility. Investment consultants provide a variety of information that helps Board members and staff make better investment decisions, although the level of reliance on the investment consultant varies from fund to fund. Best practices suggest that Board members or fund staff should employ an investment consultant that has the necessary experience, independence, objectivity and resources to provide a diversity of expertise. If there are gaps in that expertise, the fund's leaders may be unable to make effective and successful decisions.

An investment consultant's specific duties, responsibilities and reporting lines of authority should be clearly defined in writing. An essential component of good governance is an

understanding and clear articulation of the respective role and responsibilities of the investment consultant.

An investment consultant's contractual "scope of work" should establish its role and responsibilities to the fund. The investment consultant's functions typically revolve around the selection and monitoring of investment managers and their performance and the development of investment policy and guidelines. However, the investment consultant's role differs from fund to fund. Typically, the consultant's functions include:

- Asset allocation recommendations;
- Investment policy development;
- Investment structure and roles for particular investment managers;
- Manager search and selection;
- Drafting individual account guidelines;
- Calculating and reporting investment returns;
- Comparing those returns to benchmark returns and peer group performance;
- Calculating portfolio risk statistics; and
- On-going manager monitoring and compliance checks.

Consultants are also frequently called on to provide advice about custodial operations, trading and brokerage practices of investment managers, proxy voting, and the educational needs of Board members.

Risks

A Board's ability to prudently invest and monitor a fund's assets could be impaired if they do not have an objective expert to advise them. Absent a capable, objective consultant, a fund's investment program could be exposed to undue risk, undue costs or inferior returns.

The absence of a well-defined scope of services setting forth a detailed listing of the consultant's functions could expose a fund to unnecessary risk due to the potential for misunderstanding and/or lack of continuity, which could increase governance and fiduciary risk.

Observed Condition

As of last year, LAFPPS hired a nationally recognized general investment consulting firm, Pension Consulting Alliance ("PCA"), to advise the Board on a full-service retainer basis. Previously LAFPPS hired various consulting firms for specialty areas such as a manager search consultant and a performance analytics consultant. LAFPPS also currently employs The Townsend Group ("Townsend") to advise them on real estate, and the Board is in the process of hiring a private equity consultant (PCA was a specialist private equity consultant under

LAFPPS' previous consulting structure). The use of Townsend is discussed in a separate section below.

The following table lists typical general investment consulting services and compares them to:

- the responsibilities of the investment consultant specified in LAFPPS' IPS,
- the services required in the LAFPPS Contract for full service pension fund investment consulting services (the "contract") effective October 1, 2006 between LAFPPS and PCA, and
- the services actually provided in practice to LAFPPS by PCA (based on our interviews, survey data and documents provided by LAFPPS to IFS).

Table 2f-1: Analysis of General Consulting Services			
Typical General Consulting Services	Responsibility Stated in IPS	Service Required by the Contract	Service Provided in Practice by Consultant
FIDUCIARY STATUS			
• Consultant acknowledges fiduciary status			
ESSENTIAL SERVICES			
Asset Allocation and Asset/Liability Studies			
• Produce capital markets assumptions			✓
• Produce asset allocation study			✓
• Make asset allocation recommendations			✓
• Produce asset/liability report		✓	
Investment Policy and Structure			
• Prepare or review fund's Investment Policy Statement			✓
• Review and recommend Fund's investment structure			✓

Table 2f-1: Analysis of General Consulting Services			
Typical General Consulting Services	**Responsibility Stated in IPS**	**Service Required by the Contract**	**Service Provided in Practice by Consultant**
• Recommend performance benchmarks for asset classes and investment managers		✓	✓
Periodic investment performance reports			
• Produce investment performance reports	**✓(review reports, not produce)**	**✓(review reports, not produce) (review excludes real estate)**	**✓ (reviews report N. Trust produces with some text and data inserted by PCA)**
• Calculate investment rates of return for total Fund and asset classes		**Explicitly stated NOT to calculate performance**	
• Calculate investment rates of return for external investment managers			
• Rank Fund and managers against appropriate peer universes			
• Produce portfolio characteristics or risk analytics for each asset class			
• Produce portfolio characteristics or risk analytics for each investment portfolio			
• Reconcile return calculations with external managers			
• Monitor asset allocation rebalancing			
Selection and monitoring of external investment managers			
• Recommend external investment managers	*	✓	✓
• Prepare profiles or analysis of recommended external managers	*		✓

Table 2f-1: Analysis of General Consulting Services			
Typical General Consulting Services	Responsibility Stated in IPS	Service Required by the Contract	Service Provided in Practice by Consultant
• Prepare guidelines for managers hired by Fund		✓	Upon request to assist staff
• Check compliance of external managers with Fund guidelines			
• Monitor personnel, process and business issues at external managers			✓
Board Meetings, Education and Research			
• Attend Board Meetings		✓	✓
• Advise on other investment subjects		✓	✓**(as requested)**
• Conduct educational programs for Board and staff and provide ad hoc research on investment topics			
SECONDARY SERVICES			
Assist in Custodian search and selection		✓	
Custodial evaluation or monitoring			
Securities lending analysis			
Brokerage analysis			
Commission recapture or brokerage discount analysis			
Advice on transition management services			
Advice on proxy voting policies and monitoring			
Other (special projects)	✓	✓	✓

* Reference to consultant in Manager Retention Policy within the IPS

Overall, the scope of services listed in the contract are less detailed than those required in a typical general consulting contract, as evidenced in the chart above. The contract leaves many items on an "as requested" basis, which leaves many routine projects up to the Board to initiate. The contract also states that the consultant shall provide additional services upon request from

the Board if such services are "normally considered within the scope of a full service investment consulting mandate." Potential disagreements regarding the definition of services that are normally considered within the scope and those that are not normally considered within the scope could consume time and trigger hourly charges in addition to the retainer fee. We recommend that consultant contracts specify the range of expected services and identify the services without ambiguity. Standard template investment consultant contracts are available and are described in Task Area 2f.

Although the contract refers to a periodic "asset-liability asset allocation study", which could be interpreted to mean an asset-liability study, in practice the consultant prepares an asset allocation study (detailed in Task Area 3c (Asset Allocation)).

We understand that PCA is currently assisting LAFPPS in a private equity consultant search, and that PCA contributes analysis and policy advice when requested. LAFPPS would benefit from specifically requiring PCA to provide advice on several collateral issues related to compliance monitoring, custody, brokerage, transition management and proxy operations. These issues are not central to the structure of LAFPPS investment program (asset allocation, investment structure, manager selection, etc.), but PCA will have substantial experience with the ways in which its other pension fund clients organize their custodial, brokerage and proxy services. PCA may be able to help LAFPPS achieve greater efficiencies in investment operations (custody services) and compliance monitoring, reduce costs (brokerage and transition management) and strengthen performance of fiduciary duties (proxy voting).

Typically an investment consultant measures investment performance and prepares quarterly reports detailing investment performance, manager skill, and diversification. LAFPPS' contract specifically notes that PCA does not measure performance (the custodian processes performance). The contract specifies that the consultant will review performance, but the actual performance report for the Board is prepared by the custodian and PCA inserts some analytical text.

The standard of care required of the consultant is not specified in the IPS or the contract. See further discussion on standard of care in section below and in Task Area 1 (Governance).

The SEC requires that consulting firms offer their ADV annually to clients. The contract appropriately does require the consultant's ADV Part II be submitted whenever there are updates.

Task Area 2f Recommendation 1-3
The Board should specify in the contract that the consultant provide periodic review and recommendations regarding commission recapture, brokerage discount practices, proxy voting, etc.

Task Area 2f Recommendation 1-3
The Board should review the IPS and contract for consistency and solidify vague requirements as noted in our Report.
The Board should include an annual or bi-annual asset allocation study as a specific task in the consultant's contract.

2. Best Practices and Consultant Services

Principles

Good investment consulting advice requires consultants with broad and deep experience in the areas of capital markets behavior, asset allocation theory and practice, investment strategies, brokerage practices, custody services, investment performance measurement, pension fund governance, and presentation skills. Additionally, the consultant's reports must be accurate, comprehensive and clear.

A board must have a very high degree of confidence in the advice and analysis of the consultant to be effective.

Risks

If a board relies upon the advise and analysis of a substandard investment consultant, the board risks making imprudent decisions for the fund.

Observed Condition

As noted above, PCA was hired in 2006 as the first general consultant to advise LAFPPS on a full service retainer basis. PCA provided private equity investment specialist consulting services to LAFPPS for many years.

The consultant is well regarded by the Board which selected PCA as general consultant last year. Based on our interviews and survey results, staff considers PCA to be generally accessible and responsive.

The consultant appears to have sufficient knowledge and experience regarding investment management and pension plan management to provide satisfactory consulting services to LAFPPS.

Based on IFS' experience, PCA's consulting services are of appropriate quality to meet the needs of LAFPPS and are generally consistent with industry practices.

- We understand that on many projects, such as a manager search, PCA provides backup assistance or policy decisions to support staff's work.

- As discussed above, PCA could be explicitly required to provide more deliverables within the structure of this contract, such as a consultant-led review of the year's proxy voting or a routine review of brokerage practices, custodial services, etc.

The consultant's work that we reviewed is of good quality and the reports prepared by the consultant are clear. The investment consultant's latest asset allocation documentation and recommendations were satisfactory and the investment structure analysis was thorough and well executed. We found the content of and analysis provided within these documents to be generally consistent with industry best practices, although we did make a number of recommendations (see corresponding Task Areas), which we believe will improve LAFPPS' investment program in the above subject areas.

We understand that the Board is not actively requesting educational programs from PCA on a routine basis.

PCA's assigned consultant interacts with the Board and staff frequently and we understand that either the assigned consultant or chief consultant is generally available by telephone or email for questions upon staff or Board request, and the consultant attends most required Board meetings; otherwise the chief consultant attends.

As discussed above, the general consultant position is new, and is the result of restructuring in 2006. We found no reference in the IPS or elsewhere to a periodic consultant review by the Board. Periodic, generally annual, reviews of retainer consultant performance are an industry best practice.

Task Area 2f Recommendations 4-6
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.*
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

Task Area 2f Recommendations 4-6
include reviewing the consultants on their timeliness, depth of research, understandability of their material, and their overall availability.
The Board should amend the consultant contract to specifically provide periodic education to ensure LAFPPS' current practices remain valid.

3. Consultant Fiduciary Responsibility

Background

Under ERISA, pension fund board members are charged with managing a defined benefit pension plan with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims. This generally compels a board, which may lack the necessary investment skill and knowledge, to rely on qualified investment consultants and investment managers to assist it in fulfilling its responsibility.

Principles

Although a plan's investment consultant is not legally required to be a fiduciary, fiduciary status imposes on the consultant the ERISA fiduciary standard. This means that the investment consultant accepts fiduciary responsibility along with a plan's board for the advice it renders.

The inclusion of fiduciary responsibility in a consultant's contract reduces a fund's risk and conforms to best practices in the consulting industry.

Even if an investment consultant's contract does not expressly classify the consultant as an ERISA fiduciary, the consultant's conduct may cause it to be deemed a fiduciary.

Risks

If the investment consultant does not serve in the capacity of a fiduciary, a fund risks that the quality of advice it receives from its consultant may not be the highest.

If an investment consultant is not designated a fiduciary per se, it may not be subject to ERISA fiduciary standards, including the duties of prudence and loyalty.

The absence of a required duty of loyalty is particularly significant in terms of avoiding potential conflicts of interest, such as self-dealing, given the many forms of "pay to play" monies from investment managers that may compromise a plan's investment consultant's objectivity.

Observed Condition

PCA's contract with LAFPPS does not indicate that it serves as a fiduciary.

The inclusion of fiduciary responsibility in the PCA contract reduces risk for LAFPPS, and in this respect, the contract with PCA would conform to best practices in the consulting industry. See earlier discussion in Task Area 1 (Governance).

Task Area 2f Recommendation 7
The Board should specify the standard of care and fiduciary responsibility of the General Investment Consultant in their contract.

4. Conflicts of Interest

Background

Conflicts of interest are pervasive in the financial services business. The potential for conflicts, particularly at multi-service financial services firms that provide services to and receive revenues from several categories of sources, are substantial.

Some consulting firms derive a portion of their revenues from clients through security transactions (in the form of brokerage commissions), manager searches (for which additional payment is required from investment managers, e.g., some consultants may charge a fee to be in the consultant's manager database), asset management, or through the consulting firms' own direct services to the investment managers their clients employ, e.g., marketing guidance, performance measurement, receipt of brokerage commissions, educational conferences, and strategic advice. However, investment consulting firms often do not disclose in writing to their consulting clients the amount or source of the compensation they receive for services provided to investment managers.

These multiple lines of business have the potential to create significant conflicts of interest for consulting firms. The investment consultant plays an integral part in a pension system investment program. Board members and staff often rely extensively on the consultant for input in developing manager search criteria, narrowing the list of qualified candidates, identifying distinguishing characteristics and, after hiring, on-going monitoring and firing.

Given the level of reliance on the consultant and the degree of judgment inherent in the process, any bias (positive or negative) by the consultant toward an individual asset management firm can have, or be reasonably perceived to have, a significant impact on the quality and objectivity of the consultant's advice. For example, can the consultant objectively monitor

managers on behalf of a fund (or be perceived as being objective) when those same managers are also clients of the consultant? At the same time, however, these multiple lines of business can provide the consulting firm greater resources, e.g., more accessible working capital to pay for superior research departments, and advanced technology.

In recent years investment consulting firms have come under significant pressure to disclose such relationships. In 2002, the Investment Management Consultants' Association (IMCA) released final Standards of Practice for investment management consultants. One goal of the Standards is to ensure ethical behavior among investment consultants. To achieve this goal, the Standards require:

- Full disclosure of conflicts of interest; and

- Full disclosure to clients of all consulting services provided and all compensation received and compensation paid, in all forms, including all financial relationships, direct and indirect, between the consultant and investment managers, plan officials, beneficiaries, and sponsors, and third-party affiliations.[15]

The CFA Institute (formerly known as the Association for Investment Management and Research, or AIMR) also has disclosure requirements for consultants regarding conflicts and additional compensation arrangements.

In May, 2005, the Office of Compliance Inspections and Examinations of the Securities and Exchange Commission released a staff report concerning the SEC's examination of a number of investment consultants. The SEC described its analysis as follows:

> *Under the Investment Advisers Act of 1940 (Advisers Act), an investment adviser providing consulting services has a fiduciary duty to provide disinterested advice and disclose any material conflicts of interest to their clients. In this context, SEC staff examined the practices of advisers that provide pension consulting services to plan sponsors and trustees. These consulting services included assisting in determining the plan's investment objectives and restrictions, allocating plan assets, selecting money managers, choosing mutual fund options, tracking investment performance, and selecting other service providers. Many of the consultants also offered, directly or through an affiliate or subsidiary, products and services to money managers. Additionally, many of the consultants also offered,*

[15] Sample conflict of interest protocols for third party consultants, sample guidelines for internal review of conflicts and sample guidelines relating to provisions for inclusion in contracts and requests for proposals, and sample disclosure forms for third-party investment consultants and investment managers were provided by IFS to the General Manager following the interview phase.

> *directly or through an affiliate or subsidiary, brokerage and money management services, often marketed to plans as a package of "bundled" services. The SEC examination staff concluded in its report that the business alliances among pension consultants and money managers can give rise to serious potential conflicts of interest under the Advisers Act that need to be monitored and disclosed to plan fiduciaries.*

The SEC examined in detail the practices of 24 major pension consulting firms who are registered investment advisers. The SEC found that:

- More than half of the firms provided services to both pension funds and investment managers;

- A significant number hold conferences that involve the participation of both pension fund clients and investment managers;

- Many sell the consulting firm's performance evaluation software to investment managers;

- A majority are affiliated with broker-dealers, and they often receive payment for their consulting services based on the amount of client brokerage directed through the affiliated broker-dealer;

- Many consultants do not consider themselves to serve their pension fund clients in the capacity of a fiduciary; and

- Many do not maintain policies and procedures designed to prevent conflicts of interest and to disclose the nature of the consultants' other business relationships.

The SEC report reminded consultants that, under Rule 206(4)-7 of the Investment Advisers Act, consultants have an obligation to adopt policies and procedures to identify conflicts and compliance risks. The report suggested that consultants take action to insulate their advisory activities from other business activities, to disclose all business relationships to their consulting clients, and to prevent conflicts associated with brokerage activities or gifts and entertainment given to clients.

Principles

If an investment consultant receives revenue (e.g., commissions) or other payments from investment managers, the consultant has competing interests/loyalties and thus may not be totally independent and objective in its assessment of the investment manager's performance. In such cases, the consultant may be influenced in its recommendation of new investment managers to

the client (or to keep an underperforming manager) if the manager has (or will) generate commissions for the consultant or its affiliates or if the consultant identifies managers which will do very little trading.

Investors that rely on consulting firms for advice concerning service providers that are also sources of revenue for those consulting should install processes to effectively identify such conflicts and properly manage them.

By the same token, the consulting firms should install processes to identify and disclose conflicts to their clients as well as manage them to mitigate the conflict or eliminate them altogether. The latter is preferable.

<u>Risks</u>

Conflicts of interest create a risk that (i) the consultant's objectivity will be or has actually been compromised, and (ii) in appearance the consultant's objectivity will be or has been compromised. Both the fact and the appearance of an impairment of objectivity are appropriate matters of concern.

<u>Observed Condition</u>

Although many investment consultants are compromised by conflicts of interest, PCA does not appear to have any of the conflicts of interest outlined above.

Currently, the contract does require PCA to notify the Board whenever there are significant changes in its business, but the contract does not specifically require PCA to notify the Board if PCA develops any conflicts of interest. Best practices dictate that a consultant annually certify that they do not have any conflicts of interest and that a consultant be required to notify LAFPPS upon entering into a conflict of interest (see Task Area 2a and Task Area 2b – Investment-related Organizational Structure for discussion and recommendation regarding annual certification from service providers).

Task Area 2f Recommendation 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.

5. Role of the Real Estate Consultant

Principles

Like private equity, real estate is a complex asset class that involves unique risks and opportunities. The skills required to advise LAFPPS in this asset class typically go beyond those offered by most general investment consultants or in-house fund staff. Boards need specialist advice to set policy, select investments and monitor results. For a real estate program of any size or complexity, the absence of a real estate consultant increases the likelihood that LAFPPS will fail to achieve the investment returns it seeks from this asset class.

Many large institutional investors employ a specialist consultant to advise the Board on investment strategies and opportunities in real estate. These assignments can take a variety of forms, some with discretion to make investments on behalf of the client, while others may only provide advice to decision makers (Board or staff) at LAFPPS. The traditional distinction between investment consultant and investment manager seen in the worlds of publicly traded investments (like stocks and bonds) is often less clear in real estate because the consultant sometimes performs duties that more closely resemble those of a discretionary asset manager. The distinction is further blurred depending on the extent to which LAFPPS itself employs staff with significant skills in real estate acquisition and management. Some consultants work closely with LAFPPS' staff to implement a real estate plan. Others focus on advising the Board on the selection of discretionary real estate managers and calculation of investment rates of return.

Generally, the real estate consultant will advise the Board on:

- Market conditions;
- Strategy and investment policy;
- Investment structure and roles for managers;
- Manager or real estate Fund selection;
- Manager guidelines;
- Preparation of an investment performance report;
- Portfolio risks; and
- On-going manager monitoring and compliance.

To the extent that the consultant also has the discretion to select specific properties for purchase by LAFPPS, the consultant will take responsibility for:

- Sourcing potential investments;

- Evaluating the extent to which a specific investment meets LAFPPS' requirements or guidelines;
- Due diligence on the property under consideration, including review of financial data, evaluation of tenancy and leasing, and visits to the property;
- Negotiation with the seller;
- Closing the transaction;
- Selection of property manager, leasing agent, maintenance firms and other service providers;
- Preparation of regular reports on the property;
- Capital budgeting and improvements; and
- Disposition of properties when market circumstances or LAFPPS' needs so warrant.

To the extent that the real estate consultant recommends specific investments or vehicles for LAFPPS, it should serve as an investment fiduciary. If the consultant does not serve in the capacity of a fiduciary, a fund risks that its investment portfolio may not be managed to the highest standard of duty and care.

Observed Condition

The Townsend Group ("Townsend") has been LAFPPS' real estate consultant since 2005. Townsend is widely recognized as one of the most capable real estate consulting firms in the U.S. serving institutional investors. It is employed by a range of major pension funds, many with billions in real estate holdings, and by a number of large public pension funds. Townsend's staff is highly experienced, its organization is stable, its database of real estate investments is substantial, and its reports to clients are comprehensive.

Our review of Townsend's consulting advice to LAFPPS indicates that the services it provides are thorough and complete. Townsend produces a quarterly performance measurement report and presents it to the Board, reviews the Board's real estate investment policies, guidelines, and real estate investment portfolio on an ongoing basis, and makes recommendations on real estate strategy and investments. Townsend appears to provide the services that are specifically required in its contract with LAFPPS, and Townsend's services are consistent with a "full-service" specialist consultant (operating in this asset class).

Townsend's work for LAFPPS and the procedures it employs are well-documented. This work product creates a sound foundation on which the Board can make investment decisions.

Townsend does not make discretionary investments for LAFPPS. Townsend provides due diligence and hiring recommendations to the staff and Board for individually managed account investment managers (IMAs or separate accounts) and commingled funds. IMA managers are

required to get Board approval for each property investment, and the time-consuming process of Board clearance limits LAFPPS access to many deals that close quickly, thus LAFPPS has more access to commingled fund investment. See Task Area 3g (Investment Structure) for more discussion on the real estate program.

6. Role of the Private Equity Consultant

Principles

Private equity is an asset class that is often used by large institutional funds and one that differs markedly from publicly traded assets like stocks and bonds. Both private equity and real estate are relatively illiquid assets that are complicated to acquire and to sell. Once invested, an owner cannot exit easily, and when an asset fails to meet expectations, the investor may find it necessary to become more directly involved in management of the underlying business. Private equity, which includes venture capital and some private debt, offers the potential for substantial returns, but with the likelihood of greater risk. In any event, such investments are relatively labor-intensive from the investor's point of view.

Private equity consultants provide more in-depth knowledge of the workings of private markets, possess up to date information on managers and funds, and can deliver access to investment vehicles that would otherwise be unavailable to the investor. Although the content is different, the types of services and advice they offer to investors resemble that of general investment and real estate consultants.

Essential services by a private equity specialist include:

- Development of an overall strategy for investment in the asset class;
- Creation of an investment policy that guides the fund's efforts;
- Advice about how to structure an appropriate blend of leverage buy-outs, venture capital, mezzanine financings, secondary funds, distressed debt, private debt, and other private assets;
- Advice about the selection of limited partnerships, sector-specific funds, and fund-of-fund vehicles;
- Due diligence on the most appropriate candidates for investment;
- Identification and evaluation of specific managers and partnerships;
- Assistance in negotiating advantageous terms when making an investment;
- Monitoring the portfolios and operations of those managers selected by the fund;
- Construction of benchmarks or indexes for comparison to manager returns;
- Performance reporting and calculation of investment returns; and
- Documenting the procedures employed by the client in this asset class.

Other common services may include:

- Longer-range planning for the client's program;
- Accounting for cash flows into and out of the investment vehicles;
- Access to the consultant's database of manager and partnership returns;
- Research on general topics in the field;
- Preparation of educational materials and presentations for the Board;
- Participation on the advisory boards associated with many partnerships or managers;
- Arranging for background checks on managers; and
- Responsibility for "discretionary" management of investments or for provision of a fund-of-funds vehicle.

Depending on the role of a fund's own investment staff, the specialist consultant may provide some of these additional services.

Risks

For funds of virtually any size, to the extent that its private equity program extends beyond use of a few fund-of-fund vehicles, use of a private equity or alternatives specialist represents a best practice.

Observed Condition

As mentioned above, LAFPPS formerly employed specialist consultants and did not retain a general investment consultant. At that time PCA was one of two non discretionary private equity consultants. LAFPPS also retained two discretionary private equity consultants. Retaining four private equity consultants is an unusual practice, in part because a retainer relationship includes access to research and databases that could result in paying for duplicative services, and retaining so many firms is very expensive (see Task Area 5 (Costs) and 3g (Investment Structure)). The Department's desire to allocate a portion of the portfolio to specialized/ emerging private equity investments may justify retaining a specialist consultant to focus on that niche investment strategy separately from the mainstream private equity program.

The two discretionary consultants are no longer affiliated with the LAFPPS program. PCA resigned its private equity position upon becoming the general investment consultant. Currently PCA provides high level advice on the private equity program and, at the time of this review, PCA is assisting LAFPPS in a preliminary search for a non discretionary private equity consultant. The Board, Staff and PCA have yet to determine a final plan for structuring their private equity consulting.

2g. Use of Legal Counsel

1. Evaluate the Procedures in Place Relating to Legal Advice Provided to the Board and Staff

Principles

Boards and staff members of public pension systems should have access to expert legal advice, as needed. Laws are continuously changing which requires management and boards to assess how they affect their organization and operating environments. In many organizations, the role of a legal function is not only to keep an organization's board and management informed about such changes, but to help ensure that the organization is in compliance with applicable laws, rules and regulations. In addition, it is not uncommon for the legal function to serve as an advocate and represent organizational interests. In this context, the specific organization, rather than an external entity, determines how best to accomplish all of their legal needs, including, evaluating whether they have enough legal-related issues to warrant in-house legal expertise; to rely upon outside legal resources; and/or to use a combination of both options.

A public pension fund is different from other governmental agencies in that its governing body, the Board, has a specific fiduciary duty to the members of the System. Accordingly, a public fund is best served by an attorney whose duty runs exclusively to the fund's fiduciaries, unimpaired by a simultaneous duty to other public officials who do not have a fiduciary responsibility to the fund's participants and beneficiaries.

Granting the board the exclusive authority to contract for legal services is reflective of best practices for public pension funds.[16] In the Kroll Report, stemming from an investigation of the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure, the drafters echo this best practice, stating that to "*to enhance the likelihood that [the retirement system] will act for the sole benefit of the system's beneficiaries, independent of the City, [the retirement system] must be free to retain its own independent legal counsel.*"[17] We agree with the Kroll Report. To be consistent with best practices, the board must be empowered to independently select its legal advisor(s), which may be in-house legal counsel and/or external legal counsel (including using the state, county or city attorney's office or a private law firm). Indeed, a board given authority and discretion to select its legal counsel could and often does also choose to use the sponsoring government's attorney for certain issues when a combination of expertise, convenience and cost renders such a choice prudent.

[16] Uniform Management of Public Employee Retirement Systems Act, Sec. 5(a) (2).
[17] Report of the Audit Committee of the City of San Diego (Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure), August 8, 2006, Arthur Levitt, Jr., Lynn E. Turner, Troy A. Dahlberg; Kroll, Inc. & Willkie Farr & Gallagher, LLP. (commonly referred to as "The Kroll Report")

While granting pension funds the authority to independently retain its legal advisors is consistent with best practices, it is not necessarily the common practice. In a number of states and municipalities, the state, county or city attorney is the constitutional or statutorily designated legal advisor to the pension fund. Notwithstanding such designation, a number of the respective Boards have nevertheless been authorized to retain their own in-house legal counsel.

A myriad of arrangements exists where the applicable legal framework does not empower the pension fund to independently retain legal counsel. Where statutory provisions dictate that the attorney for the sponsoring government also serve as the fund's attorney, precise and enforceable procedures should be established for identifying situations in which conflicts of interest or lack of specific expertise require the engagement of separate counsel.

Risk

If a public fund attorney's loyalty and independence are compromised, the fund is at risk of being guided by legal advice colored by conflicting obligations and the attorney's need to accommodate interests other than the interests of the fund's participants and beneficiaries.

- The fund also risks violating applicable rules and regulations and entering into binding agreement(s) that do not represent the organization's best interest.

An attorney who represents the pension fund but is employed by the sponsoring governmental entity may be viewed as representing two clients with potentially conflicting interests without the consent of both clients, since the pension fund does not have the discretion to select the attorney.

a. Adequacy of Legal Resources

Managing pension fund assets requires expert legal advice. The trustees of a public pension fund need attorneys knowledgeable in the interpretation and application of the complicated laws governing their funds, experienced in reviewing and negotiating agreements with investment managers, consultants and service providers and familiar with the legal issues surrounding emerging investment issues such as private equity, venture capital, class action litigation and corporate governance. Given that a public pension board typically consists of trustees who, although appointed by various stakeholders, owe a duty to the fund's participants and beneficiaries, the attorney for the board should have undivided loyalty to the fund.

While fund attorneys are generally not considered "fiduciaries" in the same way that trustees are, they have a similar duty of loyalty derived from the professional canons of ethics which govern the legal profession. As the Official Comment to Rule 1.7 of the American Bar

Association's Rules of Professional Conduct states, "Loyalty and independent judgment are essential elements in the lawyer's relationship to a client." The California Rules of Professional Conduct require attorneys to avoid representing clients with potentially conflicting interests unless both clients consent.[18]

A number of California public retirement systems employ independent in-house counsel including CALPERS, CALSTRS, LACERA, San Diego, Orange County, San Bernardino, Alameda County, and Santa Barbara County.

General Observations

As part of our evaluation of the legal services provided to LAFPPS, IFS also conducted an anonymous survey of Board members and staff to obtain candid, objective feedback from each regarding the legal services they receive. On average, the survey results indicate that the Board and staff are generally satisfied with the quality of legal research and clarity of legal advice provided by the City Attorney's Office. Furthermore, they believe the City Attorneys assigned to LAFPPS are responsive to their legal needs.

Consistent with comments from Board members and staff during our interviews, the survey results also revealed that some respondents believe the City Attorneys have insufficient capacity to handle the LAFPPS' workload and that the Board needs a better process for selecting outside counsel.

In general, the Board members and staff appear to have a healthy respect for the legal work provided by the City Attorney's office to the pension fund, finding the assigned lawyers to be knowledgeable about fiduciary, investment, benefit, and municipal, issues in general. However, some expressed a desire for more proactive legal advice and expressed concerns regarding the ability of the City Attorney's Office to provide legal advice about more specialized pension fund matters (thus requiring more reliance on external legal counsel and having to absorb additional legal costs) and the timeliness of the services provided.

A number of interviewees felt the Board should have the autonomy to independently select counsel. Other Board members commented that the current arrangement whereby legal support is provided by the City Attorney works fine.

Attorneys from the City Attorney's office assigned to LAFPPS informed us that they attend every Board meeting and believe they have a good working relationship with staff and the Board.

[18] California Rules of Professional Conduct, Rule 3-310(C)(1)

Board members also indicated that they received some fiduciary training from outside attorneys, although there is no separate formalized education program regarding applicable laws and regulations.

As discussed above, LAFPPS is defined as a "*department*" of the City. However, unlike the Mayor's Office, the City Council, the Police Department and several City departments, the pension fund does not have its own legal counsel.

Observed Conditions

Legal services are provided to LAFPPS by the Los Angeles City Attorney's Office (the "City Attorney"). The City Attorney is a separately elected official whose powers and duties include, among other things, serving as "legal advisor to the City, and to all City boards, *departments*, officers and entities." (See Article II, Section 271 of the Los Angeles City Charter, emphasis added.) In addition, the City Attorney may engage outside counsel (at the fund's expense) when a particular matter before the Board (such as tax, private equity or securities litigation) requires specialized expertise that is not available within the City Attorney's Office.

Attorneys from the City Attorney's Office provide or obtain through the use of private external law firms a variety of legal services to LAFPPS, including:

- General legal counsel and advice;
- Legal advice on investments (private equity, hedge funds, real estate) – typically handled through the use of external legal counsel;
- Divorces/dissolutions;
- Charter changes, legal opinions (administrative forms, procedures);
- Litigation;
- Monitoring of procedural compliance related to Board meeting/minutes (governance, open meetings laws, ethics matters, public services/disclosure);
- Tax counsel;
- Power of attorneys; and
- Member inquiries/questions (coordinated with member attorneys to provide independent advice to the System).

The City Attorney determines which attorneys, the number of attorneys and the level of experience of those attorneys who are assigned to LAFPPS. Currently, the City Attorney's office assigned to LAFPPS consists of four attorneys, and one support person who are assigned to work primarily with LAFPPS, including one Assistant City Attorney, who is in charge of the legal team, one Deputy City Attorney and one staff attorney, all of whom report to the City Attorney – not to the LAFPPS Board.

The designated lawyers are located in the same office building as LAFPPS. Being in the same physical location represents a convenience and helps facilitate more face-to-face communications.

The fact that LAFPPS' attorneys are employees of and under the control of the City Attorney creates a potential inherent structural conflict of interest. The City Attorney's control over the attorneys from the City Attorney's Office is inconsistent with the Board's status as an independent decision-making body with a fiduciary responsibility to LAFPPS' participants and beneficiaries. In reality, the interests of the City Attorney are not necessarily always aligned with the interests of LAFPPS and its Board. This is not unique to LAFPPS. In fact, with respect to litigation, particularly litigation relating to benefits, it is quite likely that the City's interests may be at odds with those of the pension fund.

Task Area 2g Recommendations 1-4
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.
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.
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.
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.

The lawyers in the City Attorney's Office believe they represent both the interest of LAFPPS and the City. The designated lawyers believe the City Attorney's Office provides them

with sufficient latitude to carry out their LAFPPS responsibilities without any conflicts of interest. They believe their role is to serve as general counsel to the Board.

The City Attorney lawyers are assigned LAFPPS work on the basis of both availability and nature of the legal issue/matter. The City Attorney's Office has not designated areas of specialization for each lawyer.

LAFPPS wants to have input into which lawyer within the City Attorney's Office works on specific issues. LAFPPS' experience indicates that certain lawyers in the City Attorney's Office have greater subject matter expertise than others. LAFPPS does not have the ability to insure that their work is given priority or that the lawyer with the best expertise is assigned to a given matter.

In addition to serving LAFPPS, the designated lawyers in the City Attorney's Office are responsible for delivering legal services to the City's other pension systems (LACERS and Water & Power). The City Attorney's Office charges back the pension systems for the designated attorneys' time spent on the pension fund's business. In addition, the pension fund pays a proportionate share of the City's Attorney's expenses for rent, travel expenses, conferences, dues/subscriptions and publications (the "Shared Expenses"). The City Attorney allocates the Shared Expenses between LAFPPS and LACERS. LAFPPS' allocation is two-thirds of the basic cost, while LACERS pays one-third of the cost, and, the Department of Water and Power is billed on an hourly basis for actual time worked.

We requested the formal agreements between LAFPPS and the City Attorney for legal services and requested the underlying documentation supporting the allocation of costs and expenses between the funds. LAFPPS was not able to provide documentation relating to services provided by the City Attorney's Office. [19]

The City Attorney provides services to the pension fund and the Board has a fiduciary obligation to monitor those services and the costs associated with the provision of services. The Board has not documented the current allocation of legal expenses between the funds nor does the Board have procedures in place to monitor and oversee legal costs.

LAFPPS does not have any system or protocol in place to track the use of the lawyers within the City Attorney's Office. Any staff or Board Commissioner may contact lawyers directly for advice and counsel. As a result, LAFPPS has no way in which to evaluate the performance of the City Attorney's Office.

[19] LACERS also was not able to provide this documentation.

Task Area 2g Recommendations 5-6
LAFPPS 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.
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.

The City Attorney lawyers indicate their workload has dramatically increased over the years without any corresponding increase in staff size. To manage the workload, the Attorneys manage their workload based on deadlines established by LAFPPS. The current staffing level assigned to LAFPPS by the City Attorney prevents them from being more responsive to LAFPPS' needs.

Both staff and various Board members have expressed concerns about the City Attorney's ability to timely respond to the Board's matters. It is possible that this concern can be addressed at least in part by assigning additional attorneys to work with LAFPPS and its staff. Staff has indicated that they are currently reviewing the services provided to LAFPPS by the City Attorney to determine (1) is additional legal resources are needed; and (2) to evaluate the quality of the current legal services made available to LAFPPS and determine if a higher level of customer service from the City Attorney's Office is required. We believe this type of review of the legal services is absolutely necessary and should be a priority for LAFPPS.

Task Area 2g Recommendations 7-8
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.
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.

The City Attorney's lawyers conduct a competitive bid process to select outside legal counsel. The City Attorney has hired outside fiduciary, tax, securities litigation, real estate and

alternative investment, and securities litigation counsel to assist it in the provision of legal services to the Board. According to the City Attorney, the need for and process for selecting outside counsel rests solely with the City Attorney.

The City Attorney's Office compensates external legal counsel on the basis of time spent.

LAFPPS expressed an interest in dealing directly with outside legal counsel. Currently, the process is for LAFPPS to go through the City Attorney's Office to have outside legal counsel address specific issues/matters. The City Attorney's Office believes it is important for them to play a coordination role in dealing with outside legal counsel.

Task Area 2g Recommendations 9-11
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.
The LAFPPS Board and the City Attorney should execute a formal memorandum of understanding which specifically identifies the process for selecting and terminating outside counsel. This process should also be incorporated into the Board's Governance Manual.
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.

The role of the City Attorney, and more specifically the attorneys assigned to LAFPPS are not defined in the Governance Manual; consequently, Board members have divergent views on the appropriate role of the City Attorney and the attorneys assigned to LAFPPS.

Task Area 2g Recommendation 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.

With very few exceptions, the City Attorney must approve all draft contracts executed by the retirement system "as to form." (See Administrative Code, Section 370.) The Code does not define the scope of this "approval;" therefore, it is not clear whether or not this is a substantive review.

The pension fund does not have its own in-house legal counsel to draft contracts and other legal documentation. During the interview process, IFS was informed that in most cases LAFPPS' investment staff prepares the initial draft of investment manager contracts. We understand that LAFPPS uses outside counsel to draft documentation relating to private equity and real estate investments. Legal counsel assigned to LAFPPS then reviews the draft contract (1) "as to form" and (2) to insure that terms of the contract reflect the intent of the Board.

The use of a model contract containing the standard provisions that the Board, with advice from legal counsel, has determined are protective of the plan assets, the interests of the beneficiaries and participants, and LAFPPS is consistent with best practices. A model contract improves the effectiveness and efficiency of contract negotiations and minimizes organizational and implementation risk (e.g. the likelihood that critical contractual provisions will be omitted as a result of changes in staff or legal counsel). Following the interview phase, we were informed that LAFPPS had an investment contract template. LAFPPS contract template contains many of the standard provisions which should be included in a model investment contract.[20] Nevertheless, the contract template should be updated to address, including but not limited to, the following topics: (1) the definition of fiduciary, including the inclusion of a functional test;[21] (2) the applicable fiduciary standard of care; (3) incorporation by references of applicable performance guidelines and benchmarks; (4) designation of key persons, etc.

Task Area 2g Recommendations 13-14
The Board should request legal counsel to update the current standardized contract template.
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.

[20] See, for purposes of illustration only, the Investment Contract Checklist complied by National Association of Public Pension Attorney's Investment Contract workshop participants.

[21] The contract template (on or about page 2) provides that the "CONTRACTOR acknowledged that it is a fiduciary. However, there is no functional definition of the term fiduciary. Further, (on or about page 12 of the template), fiduciary is defined as a member of the Board, and executive and senior management staff.

2h. Appropriateness of Staffing Skill Sets and Review of Position Descriptions

Principles

Identifying and defining the skill sets required of its key executives, managers, and staff as accurately as possible is important. Identification of relevant skill sets is crucial to developing a well-trained workforce as well as to the ability of the organization to achieve its strategic goals.

From an organizational performance perspective, staffing skill sets serve several important purposes. In particular, they provide important indicators to guide the determination of overall staffing needs, recruiting requirements, training and development priorities, as well as offer the basis upon which to offer incentives to and evaluate the performance of individuals over a given time period . In this sense, the clear definition of staff skill sets plays a fundamental role in helping the organization meet its commitments to key stakeholders and constituents.

Risks

Poorly defined staffing skill sets and position descriptions can undermine organizational performance in several ways, especially by failing to identify and hire the managers and staff who possess the correct skills and experience to effectively perform the jobs required for operational and strategic success.

Observed Condition

Best practices for global investment organizations including public pension funds suggest that future hires at LAFPPS should be held to a higher standard set of educational and professional qualifications such as requiring business degrees in finance, math, and economics, etc, and even advanced degrees. In the same vein, qualifications for professional recognition should be required and sought by current staff, such as the Chartered Financial Analyst. These upgraded requirements which we believe are a necessity for the future may require a commensurate increase in salaries over the long-term.

LAFPPS uses both City Civil Service Classification minimum requirements bulletins and LAFPPS position descriptions to communicate work roles and tasks. These documents are generic by title, i.e., Investment Officer II, Investment Officer I, etc. Generic job descriptions by their very nature only go so far in their ability to describe the actual work performed.

We reviewed the classification minimum requirements and position description for one representative position for each job title within the Investments and Benefits Administration areas. For the selected positions, we asked the incumbent to identify whether they had seen the

job description for their position, and whether it accurately reflected the duties. For each selected position, the incumbent confirmed the accuracy of the job description and acknowledged they had previously received and reviewed the position description.

One incumbent not included in the sample noted that she had recently received a new assignment within LAFPPS, and had not yet seen the job description for her new position.

The position description gives a more detailed breakdown of duties and responsibilities, including physical requirements. LAFPPS uses it for many personnel actions, including, but not limited to designating new positions; requesting that positions be reallocated due to changes in duties; and assessing whether an employee may be unable to perform his or her duties as part of a Workers' Compensation filing.

The job description is used to designate the desk duties of a position. Same classifications may have different job descriptions based on the unit/section under which they fall.

We reviewed the LAFPPS manager job descriptions and background and skills of the incumbents for the two Benefits Administration positions identified as Manager and above, which included the Retirement System Manager and Assistant General Manager positions. The Assistant Retirement Plan Manager for Retirement Services position was vacant so we were unable to review the incumbent's skills.

The backgrounds of LAFPPS managers meet the qualifications contained in the class specification because the City's qualifications are generic and are not specific to the LAFPPS work functions. Given the City's hiring/selection process, LAFPPS position incumbents met the minimum class specifications to compete for their respective positions.

In addition, both managers have significant tenures within LAFPPS and have acquired significant on the job experience in the department's processes and procedures.

Task Area 2h Recommendations 1-3
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.
LAFPPS should require the CFA professional designation for senior investment officers and the CIO.
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

2i. Span of Control (Reporting Relationships)

Principles

Span of control and management layers are components of organizational structure. Span of control refers to the number of employees reporting to a supervisor. (Management layers refer to the number of layers in an organization excluding the bottom level of non-supervisory line workers.) The span of control and organizational structure of different entities is important because they affect communication, decision making, flexibility, employee morale, and resource allocation. While not uncommon, incremental changes to staffing arrangements without an overall strategy can be detrimental to the organization's overall performance. Lack of planning and flexibility may result in abrupt organizational changes, which may negatively affect employee morale and the organization's ability to respond to changing external conditions.

In addition to highlighting the reporting relationships within an organization, an analysis of the span of control addresses other issues:

- Appropriateness of coordination through direct supervision;
- Opportunities to leverage wider spans of control when possible (i.e., when other management tools are used to coordinate tasks or when subordinates' tasks are sufficiently similar or routine in nature); and
- Consideration of an organization's size that may require a wider span (i.e., larger ratio of supervisors to subordinates).

Risks

The absence of an appropriate span of control may undermine the performance of an organization in a number of ways, including increased work backlogs, marked declines in product or service quality due to insufficient management oversight, and lack of timely constructive performance feedback to subordinates.

Observed Condition

LAFPPS' manager/supervisor to staff ratios in the Benefits Administration area are as follows:

Table 2i-1: Area	Direct Report Counts (Excluding Admin Asst.)	Ratio	Note
General Manager	4	1:4	1
Assistant Retirement Plan Manager – Exec. Officer	3	1:3	2
Assistant Retirement Plan Manager – Retirement Services (Vacant)	4	1:4	3
Communications/Special Projects	2	1:3	4
Active Member Services	8	1:8	5
Retirement Services:			
- Medical and Dental Benefits Section	6	1:6	5
- Service Pensions Section	9	1:9	5
- DROP/Retired Member Services Section	11	1:11	5
- Disability Pensions Section	11	1:11	5

Notes:

1. Typically this position has the Assistant Retirement Plan Manager as a sole or one of few direct reports.
2. Typically this position has the main "Chief" level positions reporting to it, which is not the case at LAFPPS.
3. While this is below the 1:5 "standard" it is not atypical if the role requires significant approval or document review roles such as signing all outgoing member correspondence.
4. This position is a SMA I position, and a low ratio is not unusual at that level.
5. There is often a team leader relationship within the section, reducing the actual supervisor:staff ratio.

We note two unusual span of control conditions:

- Often roles that report to the General Manager at LAFPPS report to the Assistant General Manager – Executive Officer at similar organizations. The breadth of operational units that report directly to the General Manager includes Investments, Administration (including accounting) and Systems, as well as oversight for all projects assigned by the Board of Commissioners. We recommend that LAFPPS consider reducing the scope of direct reports. As noted earlier, one common model, currently used by LACERS, has these units as well as the Pension Division reporting into an Assistant General Manager position, freeing the General Manager to focus on Board, Strategic Planning, Policy and Long Term Planning issues.

- The direct report ratio of the Assistant General Manager – Executive Officer is low compared to similar organizations.

Within the Benefits Administration Section, the section with the highest supervisor-to-staff ratio is 1:11 (DROP/Retired Member Services), which is within the range of acceptable span of control ratios for administrative/transaction oriented sections.

Due to a current vacancy, the Assistant General Manager – Executive Officer has temporary additional oversight responsibilities in supporting the section heads and the SMA II that is temporarily handing some of the responsibilities of the vacant position require.

When Service Pensions is combined with the existing DROP/Retired Member Services unit, a team structure will need to be put in place within the unit to prevent a supervisor: staff ratio that otherwise would exceed reasonable standards.

In reviewing management levels we observed a maximum of three levels of supervision below the General Manager level. We did not observe any conditions of excessive levels of management.

Task Area 2i Recommendations 1-4
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.
LAFPPS should consider reducing the number of direct reports reporting to the General Manager.
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.
LAFPPS should consider establishing a formal or informal team structure within sections when their size approaches a 1:10 or greater supervisor: staff ratio.

The Internal Audit Function

LAFPPS is considering an Internal Audit function and has begun work to determine how best to establish it. We understand that the Internal Auditor has not been identified for the role, although someone has been designated to research it.

Internal auditing for public pension funds is consistent with the policies of the major statewide multi-employer retirement systems, and we consider it to be a best practice. The

Internal Audit function requires a professionally trained and experienced internal auditor to fulfill the role.

Principles

An Internal Auditor should be required to manage the internal audit function in accordance with the Standards for the Professional Practice of Internal Auditing of the Institute of Internal Auditors.

The Audit Committee of the Board should interface with the internal and external auditors regularly.

A Board should adopt formal audit committee and internal audit charters that set forth the authority granted to the Audit Committee and to the Internal Audit function, its roles and responsibilities and the responsibilities of the Board, Chief executive, and staff in interacting with Internal Audit.

The Internal Auditor should be independent of the functions being audited. This requirement typically plays out by establishing a direct report to the Audit Committee and an administrative report to the organization's chief executive.

We make the following recommendations to enhance the role of the internal auditor within LAFPPS:

Task Area 2i Recommendations 5-6
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.
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.

2j. Joint Opportunities with LACERS for Enhanced Efficiency and Effectiveness

Principles

There is a widely perceived obligation on local government to its taxpayers to provide effective government services in an efficient manner.

In periods of increasing cost to taxpayers for almost all services, it is the further obligation of government to explore means to reduce the effect of increased costs on taxpayers by increasing government efficiency, if not by reducing services.

In a public pension fund where many benefits are guaranteed by the local government or, at least extremely difficult to reduce, there is an enhanced emphasis on the obligation to find more efficient means to provide the services and benefits.

Years of increasing benefit provisions for retired employees and their beneficiaries granted by the legislative bodies of local governments are coming to bear in the form of tangible and substantially higher benefit payments and liabilities. Witness the recent disclosure under GASB Statement 45 of these liabilities for retiree health care and other post-employment benefit commitments.

Governments across the nation have found real and projected savings and efficiencies through economies of scale gained by consolidation of multiple groups responsible for providing the services.

Consolidation of service providers can often enhance the services and by no means needs to result in reduced services and benefits.

Risks

Opportunities for significant cost reduction may be missed.

Observed Condition

Los Angeles police, fire and general employees are served by two separate pension Departments: LACERS and LAFPPS. (Note: Los Angeles Department of Water and Power employees are served by a third city pension fund.)

The two Departments provide very similar services to their constituents.

Each Department has a General Manager and separate Investment and Benefits Administration units.

Each Department has a Chief Investment Officer (CIO).

Each Department separately hires a general investment consultant, a real estate consultant, a private equity consultant, a custody bank, an actuarial firm, an auditor, and uses the City Attorney for legal advice, among other services that are common to both Departments.

Each Department maintains a member and benefits database.

In several areas the professional services provided to the Departments are performed by the same entity, e.g., same general consultant, same custodian, some of the same managers, same legal counsel.

The most significant areas of cost, where services are provided by the same or overlapping entities are:

Table 2vix

Overlapping Area	Approximate LACERS Current Cost	Approximate LAFPPS Current Cost	Estimated Cost of Combined[22]	Estimated Savings
Audit	$96,000	$83,000	$72,000	$107,000
Investment Manager Fees (inc. R/E & Alt)	$24,354,000	$46,317,000	$65,760,000	$4,911,000
Legal services	$699,000	$517,733	$384,000	$832,700
Investment Consulting	$1,855,000	$852,000	$744,000	$1,963,000
Estimate of Annual Savings				**$7,800,000**

This estimate does not take into consideration additional revenues from securities lending or other investment opportunities due to increased negotiating leverage. We expect these would be significant.

Task Area 2j Recommendations 1-3

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.

[22] Estimated using RV Kuhns survey of public funds over $20 billion.

Task Area 2j Recommendations 1-3
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.
The City should consider the eventual creation of a combined benefits administration function as a second step in the consolidation process.

1. Implementation Issues

With the creation of a consolidated investment program and consistent with other recommendations contained in this report we note the following implementation issues:

a. Staffing

There would be one new Chief Investment Officer position over the consolidated investment program. The two current CIO positions could be eliminated at LACERS and LAFPPS.

All current investment staff in both Departments could be offered the opportunity to make a lateral move to the new Department.

Concurrent with the creation of a consolidated investment program, new job specifications should be created with upgraded requirements. Current investment staff could be 'grandfathered' into the new positions. New staff should be required to meet the new job descriptions and upgraded requirements.

At a minimum, the new CIO position should be an exempt position, serving at the pleasure of the fiduciaries. However, we believe, and strongly recommend, that the CIO and all *Senior* Investment Officer positions should be exempt from civil service in order to attract and retain the qualified staff that will be needed for the future of the consolidated investment program and the City's overall benefit.

New salary ranges should be set for the Investment staff of the consolidated investment program. The new salary ranges would be wide enough to pay current staff an amount that is equal to current salaries and consistent with a lateral transfer to the consolidated investment program, yet compensate new hires who meet the new job specs and upgraded requirements.

All fiduciaries to the consolidated investment program should have appropriate investment qualifications.

b. Transition

An advisory group should be formed to address issues required by or resulting from consolidation such as: Charter language changes, staffing levels, implementation schedules, location, management tools transfer and compatibility, and asset integration analysis. The asset migration analysis can be performed by the current investment consultant.

The advisory group should make recommendations to the mayor and city council, which will have the authority to implement through Charter amendment and appropriate legal process.

In the meantime, we recommend that neither Department change the current custodian or general consultant[23] until such time as the assets are consolidated.

2. The new consolidated investment program

The new consolidated investment program should operate under a state of the art governance model to be developed that is consistent with fiduciary responsibility to the members and beneficiaries of the pension funds, the City Charter, other applicable laws, and the other related observations and recommendations contained in this report. General counsel for the Board indicated that there could be some legal issues with consolidation in light of the provisions of Prop. 162. We encourage the City and the Board as they work through this to explore whether or not there are legal issues.

3. The existing Boards

Through appropriate legislative changes the existing pension boards could be relieved of their investment role.

Each existing Board should retain authority to hire actuaries.

4. Expected Benefits from Consolidation of the Investment Programs

We see numerous benefits from consolidation. Done properly, consolidation can:

- Create efficiencies that will improve investment management, reduce overall costs and enhance investment returns.

[23] Both Departments use the same general consultant and custodian.

- Over time, reduce the administrative costs resulting from operating two separate investment functions.

- Better coordinate investment management for all pension funds involved.

- Take advantage of economies of scale in implementing investment strategies; increased asset class allocations can result in:

    - Better bargaining power for investor rights and enhanced opportunities in portfolio construction; and
    - Fee schedules and break points that are more favorable to the fund.

- Take advantage of economies of scale in reducing cost of service providers:

    - Investment consultants;
    - Investment managers;
    - Custodian;
    - City Attorney and other legal services; and
    - Financial auditing.

- Poise the consolidated investment program to take certain asset management in-house; through the attractiveness of the combined investment pool and staff:

    - open opportunities to bring more management in-house in areas that do not require a lot of high priced fundamental research;

    - increase individual investment officer salaries while reducing overall cost ratio of staff to assets under management; and

    - be more attractive to the pool of qualified investment professionals in the industry.

- Enhance the current Boards' focus on their re-defined responsibilities by narrowing them to benefits. Creation of a consolidated investment program could bring additional skilled people on board as fiduciaries, thus increasing the number of 'hands' to do the work.

- Enhance the current Boards' ability to manage their re-defined responsibilities by benefiting from:

- A consolidated investment program with fiduciaries having appropriate experience and interest not distracted by benefits and disability issues, and

- A separate board or boards administering the benefit plans and granting pensions without the distraction of dealing with complex investment programs.

- Reduce overall retirement costs to the City and taxpayers.

- Enhance the national stature of the City as a leader in the public pension industry and increased 'clout' in the investment world – the combined fund would place in the top 50 public funds in the U.S. – larger than over 20 state-wide funds.

Task Area 3 – Investment Program

3a. Investment Performance

Principles

A pension fund board should measure and evaluate the performance of each major segment of the portfolio and the portfolio as a whole against objective market benchmarks and internally adopted benchmarks over various time periods.

Risks

Poor performance puts a fund at risk of not having sufficient assets to pay benefits and of having to increase contributions paid by the plan sponsor.

Observed Condition

IFS reviewed the cumulative investment performance history of the Total Fund and each underlying asset class investment over one, three, five, seven and ten year time periods. IFS also evaluated the returns on an annual basis for the past ten years as well. Investment performance data was computed by linking historical returns.

Presented below are summary investment performance tables for the Total Fund and each asset class along with their respective policy benchmarks through December 31, 2006. IFS compared the returns of the Total Fund against a universe of Public Sponsor Defined Benefit Plans (Wilshire Cooperative[1]). IFS also compared the segment returns of each asset class against a universe of Total Funds, compiled from Public, Taft-Hartley, Corporate, and other Plan Sponsors. IFS also provided risk-adjusted returns for LAFPPS over five and ten year time periods.

It is important to note that the returns provided by LAFPPS are slightly different than the returns that are used to create the asset class universes. The peer asset class universes are derived by taking the segment return of a total fund composite, which excludes the cash position. The data provided by LAFPPS is a composite return of each asset class which includes cash. This would most likely result in a lower ranking of LAFPPS' individual asset classes during periods

[1] The Wilshire Cooperative is a collaboration between Wilshire Associates and more than 60 independent investment consulting firms to provide performance measurement and analytical services to Wilshire's plan sponsor clients. The investment performance data for their universe comparisons are generally composed of gross-of-fee returns.

of positive performance, and an upward ranking in periods of negative performance, due to the contribution of the cash return on the composites.

1. Total Fund: Cumulative Performance

As can be seen in Table 3a-i, the Fund ranked between the 8th and 67th percentile of the Total Fund Public Sponsor Universe over the short, medium and long term time periods evaluated. LAFPPS outperformed its Policy Index over the three and five year periods. It appears that LAFPPS' asset allocation may have played a significant role in its historical returns, as its Policy Index ranked between the 5th and 58th percentile over the same time periods.

On a risk adjusted basis, the Fund earned a higher rate of return for a given level of risk, as measured by their Sharpe ratio[2], over the five year time period ended December 31, 2006. For the five year time period, LAFPPS' Sharpe ratio measured 0.70 compared to 0.63 for its Policy Index. The higher Sharpe ratio was due to a combination of excess returns and lower volatility relative to the Policy Index. Over the ten year time period, its Sharpe ratio was lower than that of its Policy Index measured at 0.42 compared to 0.51, respectively. The lower Sharpe ratio was a result of both lower relative returns and higher volatility for the Total Fund.

Table 3a-i: Total Fund Returns - Cumulative Performance - As of December 31, 2006

	1 Year	3 Year	5 Year	7 Year	10 Year	5 Year Sharpe	10 Year Sharpe
FPPS	**14.86%**	**12.13%**	**9.58%**	**4.97%**	**9.09%**	**0.70**	**0.42**
FPPS Percentile	*19*	*8*	*9*	*67*	*13*	--	--
Policy Index	15.43%	11.78%	9.16%	5.41%	9.73%	0.63	0.51
Policy Index Percentile	*9*	*12*	*15*	*58*	*5*	--	--
Universe Median	11.90%	9.28%	7.78%	5.79%	8.07%	--	--

Note: Performance for periods longer than one year is annualized
*Universe: Wilshire Cooperative Total Returns of Total Fund Public Sponsor Portfolios

2. Total Fund: Consecutive Performance

As can be seen in Table 3a-ii below, LAFPPS' Total Fund ranked in between the 3rd and 92nd percentiles on an annual basis over the last ten years. It appears that LAFPPS' worst three years on a relative basis were during the economic slowdown in 2000-2002. Conversely, during the economic rebound, LAFPPS ranked in the top quartile over the past four annual periods. This performance is consistent with a relatively aggressive asset allocation, where a fund will performance in the top quartile during positive economic periods and then rank in the bottom

[2] Sharpe Ratio a statistical measure developed by William F. Sharpe, calculated using the return of the portfolio minus the risk free asset (91 day T Bills) divided by standard deviation of the portfolio. The higher the Sharpe ratio, the better the fund's historical risk-adjusted performance.

quartile during economic slowdowns. Overall, LAFPPS ranked above the median for six of the ten annual time periods and underperformed its Policy Index on an annual basis for the six of the last ten years.

Table 3a-ii: Total Fund Returns - Consecutive Annual Performance					
	2006	2005	2004	2003	2002
FPPS	**14.86%**	**8.59%**	**13.02%**	**25.38%**	**-10.63%**
FPPS Percentile	*19*	*19*	*12*	*10*	*79*
Policy Index	15.43%	6.47%	13.64%	24.37%	-10.75%
Policy Index Percentile	*9*	*50*	*8*	*14*	*81*
Universe Median	11.90%	6.47%	10.00%	19.90%	-8.21%
*Universe: Wilshire Cooperative Total Returns of Total Fund Public Sponsor Portfolios					

Total Fund Returns - Consecutive Annual Performance					
	2001	2000	1999	1998	1997
FPPS	**-7.05%**	**-7.33%**	**25.53%**	**15.51%**	**17.19%**
FPPS Percentile	*89*	*92*	*3*	*38*	*61*
Policy Index	-6.58%	-0.15%	20.55%	20.87%	20.09%
Policy Index Percentile	*89*	*62*	*8*	*6*	*34*
Universe Median	-2.74%	1.25%	12.00%	14.62%	17.80%
*Universe: Wilshire Cooperative Total Returns of Total Fund Public Sponsor Portfolios					

3. Domestic Equity: Cumulative Performance

As can be seen in Table 3a-iii below, LAFPPS' domestic equity portfolio ranked between the 45th and 67th percentile over the short, medium and long term time periods measured. On a relative basis, LAFPPS outperformed its policy benchmark over the three, five and seven year time periods and underperformed over the one and ten year cumulative periods.

On a risk adjusted basis, LAFPPS outperformed its policy benchmark over the five year time period. LAFPPS' Sharpe ratio measured 0.30 compared to 0.25. This was primarily due to the excess return added relative to the benchmark. Over a ten year time period, the domestic equity portfolio had a lower Sharpe ratio compared to its policy benchmark. The ten year Sharpe ratio for LAFPPS' equity portfolio was 0.23 compared to 0.29. The lower Sharpe ratio was primarily due to excess volatility relative to the benchmark over ten years.

Table 3a-iii: Domestic Equity Returns - Cumulative Performance - As of December 31, 2006							
	1 Year	3 Year	5 Year	7 Year	10 Year	5 Year Sharpe	10 Year Sharpe
FPPS	**13.55%**	**10.80%**	**7.44%**	**1.59%**	**8.68%**	**0.30**	**0.23**
FPPS Percentile	*67*	*63*	*48*	*66*	*45*	--	--
Policy Benchmark	15.77%	10.43%	6.19%	1.33%	8.90%	0.25	0.29
Policy Benchmark Percentile	*35*	*68*	*68*	*71*	*42*	--	--
Universe Median	14.99%	11.50%	7.38%	2.90%	8.42%	--	--
Note: Performance for periods longer than one year is annualized							
*Universe: Wilshire Cooperative Equity Returns of Total Fund Portfolios							

4. Domestic Equity: Consecutive Performance

As can be seen in Table 3a-iv below, LAFPPS' domestic equity portfolio ranked between the 7th and 85th percentiles over the past ten year annual periods. LAFPPS ranked above the median fund for four of the ten years. On a relative basis, LAFPPS' equity portfolio outperformed its policy benchmark for four of the ten years as well.

Table 3a-iv: Domestic Equity Returns - Consecutive Annual Performance					
	2006	2005	2004	2003	2002
FPPS	**13.55%**	**5.96%**	**13.04%**	**35.70%**	**-22.43%**
FPPS Percentile	*67*	*65*	*49*	*21*	*62*
Policy Benchmark	15.77%	4.91%	10.87%	28.70%	-22.10%
Policy Benchmark Percentile	*35*	*77*	*75*	*71*	*58*
Universe Median	14.99%	6.99%	13.02%	31.47%	-21.41%
*Universe: Wilshire Cooperative Equity Returns of Total Fund Portfolios					

Domestic Equity Returns - Consecutive Annual Performance					
	2001	2000	1999	1998	1997
FPPS	**-13.09%**	**-10.25%**	**37.10%**	**21.30%**	**23.79%**
FPPS Percentile	*81*	*84*	*7*	*39*	*85*
Policy Benchmark	-11.89%	-7.76%	24.56%	28.75%	33.26%
Policy Benchmark Percentile	*72*	*71*	*24*	*13*	*21*
Universe Median	-8.81%	-3.44%	18.42%	19.09%	29.36%
*Universe: Wilshire Cooperative Equity Returns of Total Fund Portfolios					

5. Fixed Income: Cumulative Performance

As can be seen in Table 3a-v, LAFPPS' fixed income portfolio ranked between the 11th and 88th percentiles over the short, medium and long term time periods evaluated. On a relative basis, LAFPPS outperformed its benchmark over the three and five year time periods, but underperformed over the one, seven and ten year cumulative time periods.

On a risk adjusted basis, as measured by the Sharpe ratio, LAFPPS earned a higher level of return at a given level of risk over the five year time period. LAFPPS' fixed income Sharpe ratio over five years was 0.87 compared to 0.80 for the policy benchmark. The higher Sharpe ratio over five years was attributable to the excess performance relative to the policy benchmark. Over the ten year time period, LAFPPS' fixed income portfolio underperformed its policy benchmark on a risk adjusted basis, and had a Sharpe ratio of 0.50 compared to 0.72. The lower Sharpe ratio was due to a combination of lower returns and higher volatility compared to the policy benchmark.

Table 3a-v: Fixed Income Returns - Cumulative Performance - As of December 31, 2006							
	1 Year	3 Year	5 Year	7 Year	10 Year	5 Year Sharpe	10 Year Sharpe
FPPS	**4.57%**	**4.84%**	**6.29%**	**5.30%**	**5.84%**	**0.87**	**0.50**
FPPS Percentile	*42*	*11*	*11*	*88*	*76*	--	--
Policy Benchmark	4.96%	4.22%	5.36%	6.68%	6.39%	0.80	0.72
Policy Benchmark Percentile	*29*	*21*	*36*	*30*	*30*	--	--
Universe Median	4.42%	3.67%	5.03%	6.40%	6.18%	--	--
Note: Performance for periods longer than one year is annualized							
*Universe: Wilshire Cooperative Fixed Income Returns of Total Fund Portfolios							

6. Fixed Income: Consecutive Performance

As can be seen in Table 3a-vi below, LAFPPS' fixed income portfolio ranked between the 4th and 98th percentile. LAFPPS' fixed income portfolio ranked above the median Fund for six of the ten years. On a relative basis, LAFPPS outperformed its fixed income policy benchmark for five of the ten periods evaluated.

Table 3a-vi: Fixed Income Returns - Consecutive Annual Performance					
	2006	2005	2004	2003	2002
FPPS	**4.57%**	**3.16%**	**6.84%**	**12.26%**	**4.88%**
FPPS Percentile	*42*	*17*	*8*	*4*	*93*
Policy Benchmark	4.96%	2.74%	4.98%	4.19%	10.09%
Policy Benchmark Percentile	*29*	*33*	*28*	*62*	*35*
Universe Median	4.42%	2.37%	4.18%	4.61%	9.23%
*Universe: Wilshire Cooperative Fixed Income Returns of Total Fund Portfolios					

Fixed Income Returns - Consecutive Annual Performance					
	2001	2000	1999	1998	1997
FPPS	**4.73%**	**1.00%**	**3.92%**	**5.56%**	**12.05%**
FPPS Percentile	*95*	*98*	*4*	*96*	*3*
Policy Benchmark	8.52%	11.61%	-0.84%	8.72%	9.62%
Policy Benchmark Percentile	*46*	*28*	*57*	*45*	*37*
Universe Median	8.44%	10.67%	-0.52%	8.63%	9.27%
*Universe: Wilshire Cooperative Fixed Income Returns of Total Fund Portfolios					

7. International Equity: Cumulative Performance

As can be seen in Table 3a-vii, LAFPPS' international equity portfolio ranked between the 28th and 37th percentile for the time periods evaluated. LAFPPS' international equity portfolio consistently outperformed its policy index, with excess returns increasing over each time period.

On a risk adjusted basis, as measured by the Sharpe ratio, LAFPPS earned a slightly higher rate of return for a given level of risk over a five year time period (0.76 versus 0.73). Over a ten year time period, LAFPPS earned a significantly higher Sharpe Ratio compared to its policy benchmark (0.42 versus 0.22). Over the five and ten year periods, the higher Sharpe ratio was due to excess returns as the Fund had higher volatility than the policy benchmark for these time periods.

Table 3a-vii: International Equity Returns - Cumulative Performance - As of December 31, 2006							
	1 Year	3 Year	5 Year	7 Year	10 Year	5 Year Sharpe	10 Year Sharpe
FPPS	**27.33%**	**21.83%**	**17.49%**	**7.73%**	**12.23%**	**0.76**	**0.42**
FPPS Percentile	*37*	*35*	*25*	*28*	--	--	--
Policy Benchmark	26.78%	20.34%	15.39%	4.72%	7.91%	0.73	0.22
Policy Benchmark Percentile	*43*	*62*	*47*	*53*	--	--	--
Universe Median	26.43%	20.91%	15.18%	5.65%	--	--	--
Note: Performance for periods longer than one year is annualized							
*Universe: Wilshire Cooperative International Equity Returns of Total Fund Portfolios							

8. International Equity: Consecutive Performance

As shown in Table 3a-viii, LAFPPS' international equity portfolio ranked between the 5th and 68th percentiles on an annual basis over the past ten calendar years. LAFPPS ranked above median for seven of the ten periods as well and outperformed its policy benchmark for each of the ten annual periods.

Table 3a-viii: International Equity Returns - Consecutive Annual Performance					
	2006	2005	2004	2003	2002
FPPS	**27.33%**	**16.90%**	**21.49%**	**44.90%**	**-14.57%**
FPPS Percentile	*37*	*41*	*31*	*15*	*51*
Policy Benchmark	26.78%	13.91%	20.69%	39.16%	-15.64%
Policy Benchmark Percentile	*43*	*60*	*38*	*34*	*64*
Universe Median	26.43%	15.66%	19.77%	36.48%	-14.48%
*Universe: Wilshire Cooperative International Equity Returns of Total Fund Portfolios					

International Equity Returns - Consecutive Annual Performance					
	2001	2000	1999	1998	1997
FPPS	**-17.73%**	**-8.53%**	**41.99%**	**26.26%**	**4.95%**
FPPS Percentile	*55*	*34*	*39*	*5*	*68*
Policy Benchmark	-21.51%	-14.00%	26.97%	19.98%	1.76%
Policy Benchmark Percentile	*78*	*52*	*69*	*14*	*79*
Universe Median	-16.76%	-13.43%	35.07%	12.31%	7.31%
*Universe: Wilshire Cooperative International Equity Returns of Total Fund Portfolios					

9. Real Estate: Cumulative Performance

As can be seen in Table 3a-ix, LAFPPS' real estate portfolio ranked between the 10th and 25th percentile for the time periods evaluated. LAFPPS' real estate portfolio consistently added value above its policy benchmark for all the time periods evaluated.

On a risk adjusted basis, as measured by the Sharpe ratio, LAFPPS earned a lower rate of return for a given level of risk over a five and ten year time period than its policy benchmark. Over the five year time period, LAFPPS' Sharpe ratio was 1.23 versus 2.34 for the policy benchmark and over ten years, LAFPPS' Sharpe ratio measured 1.53 versus 2.57 for the policy benchmark. While LAFPPS returned a higher rate of return relative to the benchmark, the lower Sharpe ratio was a result of having a significantly higher level of volatility relative to the policy benchmark. This appears to be indicative of a policy benchmark that may not represent the actual risk exposure of the investment. This issue is discussed further in Section 3.b.4. (Appropriateness of Investment Performance Benchmarks: Real Estate).

Table 3a-ix: Real Estate Returns - Cumulative Performance - As of December 31, 2006							
	1 Year	3 Year	5 Year	7 Year	10 Year	5 Year Sharpe	10 Year Sharpe
FPPS	**28.52%**	**22.87%**	**14.19%**	**13.75%**	**14.30%**	**1.23**	**1.53**
FPPS Percentile	*16*	*14*	*25*	*10*	--	--	--
Policy Benchmark	17.62%	13.60%	11.28%	11.03%	11.13%	2.34	2.57
Policy Benchmark Percentile	*35*	*70*	*45*	*24*	--	--	--
Universe Median	15.22%	15.49%	10.93%	9.87%	--	--	--
Note: Performance for periods longer than one year is annualized							
*Universe: Wilshire Cooperative Real Estate Returns of Total Fund Portfolios							

10. Real Estate: Consecutive Performance

As shown in Table 3a-x below, LAFPPS' real estate portfolio ranked between the 8th and 83rd percentiles on an annual basis over the past ten calendar years. LAFPPS ranked above median for seven of the ten periods as well and outperformed its policy benchmark for eight of the ten annual periods.

Table 3a-x: Real Estate Returns - Consecutive Annual Performance					
	2006	2005	2004	2003	2002
FPPS	**28.52%**	**30.60%**	**10.53%**	**3.97%**	**0.67%**
FPPS Percentile	*16*	*8*	*61*	*83*	*83*
Policy Benchmark	17.62%	14.25%	9.11%	9.04%	6.75%
Policy Benchmark Percentile	*35*	*69*	*67*	*47*	*30*
Universe Median	15.22%	18.04%	12.00%	8.61%	4.84%
*Universe: Wilshire Cooperative Real Estate of Total Fund Portfolios					

Real Estate Returns - Consecutive Annual Performance					
	2001	2000	1999	1998	1997
FPPS	**10.91%**	**14.39%**	**14.30%**	**15.49%**	**17.99%**
FPPS Percentile	*13*	*31*	*11*	*30*	*20*
Policy Benchmark	6.98%	13.94%	9.99%	12.85%	11.29%
Policy Benchmark Percentile	*49*	*33*	*46*	*40*	*52*
Universe Median	6.91%	12.38%	9.00%	11.02%	12.84%
*Universe: Wilshire Cooperative Real Estate of Total Fund Portfolios					

11. Alternative Investments[3]: Cumulative Performance

As seen in Table 3a-xi below, LAFPPS' alternative investment portfolio both outperformed LAFPPS and underperformed its policy benchmark, depending on the specific time period evaluated. LAFPPS outperformed over the three, five and seven year time periods, but underperformed over the one and ten year time periods.

On a risk adjusted basis, as measured by the Sharpe ratio, LAFPPS outperformed its benchmark over the five and ten year time periods. LAFPPS' Sharpe ratio over the five and ten year periods was 0.93 and 0.23 compared to 0.53 and 0.29 for its policy benchmark.

IFS would like to point out one caveat in regards to the type of performance calculation being performed. IFS performance analysis uses time weighted returns. For assets such as Private Equity, an IRR (internal rate of return) is the industry standard in calculating the return of this asset class. Money weighted returns are more appropriate than time weighted returns since the investment manager maintains control over the timing and amount of the external cash flow. Therefore, money weighted returns allow the Board more insight into the value being added. The reporting provided to the Board is on an IRR basis.

Table 3a-xi: Alternative Investment Returns - Cumulative Performance - As of December 31, 2006

	1 Year	3 Year	5 Year	7 Year	10 Year	5 Year Sharpe	10 Year Sharpe
FPPS	**15.22%**	**23.27%**	**11.06%**	**9.98%**	**11.63%**	**0.93**	**0.23**
Policy Benchmark	20.34%	14.81%	10.45%	5.23%	12.75%	0.53	0.29

Note: Performance for periods longer than one year is annualized

12. Alternative Investments: Consecutive Performance

As can be seen in Table 3a-xii below, LAFPPS underperformed its policy benchmark for six of the ten annual periods evaluated. Given the significant deviation in returns, it appears the structure of the alternative portfolio has not had a high level of correlation with its benchmark on a calendar year basis, which is not unusual for a private equity portfolio.

Table 3a-xii: Alternative Investment Returns - Consecutive Annual Performance

	2006	2005	2004	2003	2002
FPPS	**15.22%**	**29.80%**	**25.24%**	**6.97%**	**-15.66%**
Policy Benchmark	20.34%	9.11%	15.26%	33.51%	-18.73%

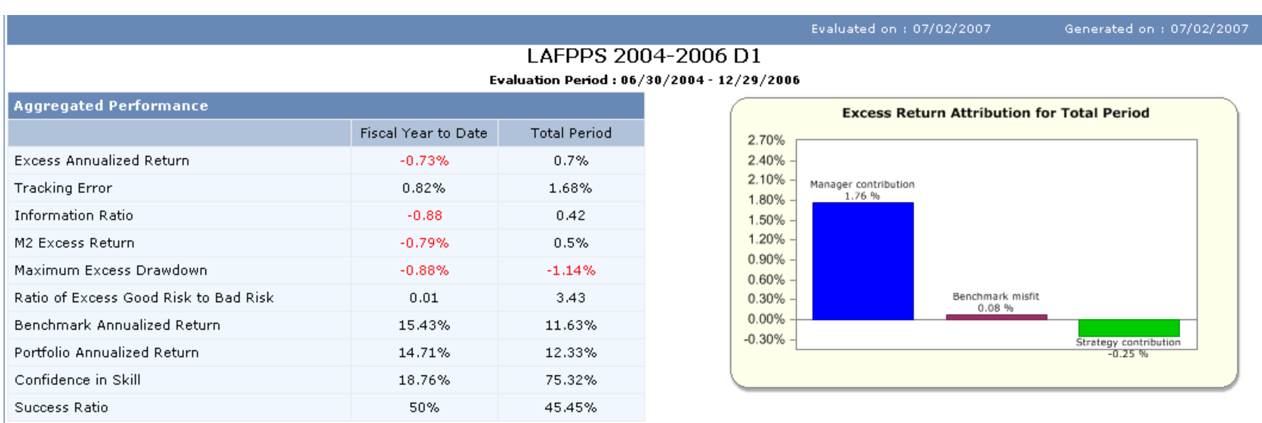
[3] Wilshire CO-OP does not have a comparable alternative investments universe, therefore this segment was not compared to a peer group.

Alternative Investment Returns - Consecutive Annual Performance					
	2001	2000	1999	1998	1997
FPPS	**-23.08%**	**49.74%**	**22.14%**	**10.17%**	**14.70%**
Policy Benchmark	-8.17%	-5.34%	25.68%	33.68%	38.30%

13. Performance Attribution and Risk Analysis: Total Fund

We used M^Cube's AlphaEngine® software to determine the value added by LAFPPS' actual allocation strategy and active managers on a Total Fund basis. Using aggregate sub-asset class data provided by the System, it appears that over the period analyzed (June 2004 through December 2006 – the most current period of time where the policy asset allocation did not change) the portfolio benefited from the one key source of return - manager alpha, whereas asset allocation detracted and benchmark misfit added a few basis points. In this portfolio there is benchmark misfit risk in many asset classes. Benchmark misfit risk is created when the asset class benchmark is different from the aggregate benchmarks of the sub-asset class, and this is the case in US Equity, International Equity and Fixed Income.

Table 3a-xiii



Evaluated on : 07/02/2007 Generated on : 07/02/2007

LAFPPS 2004-2006 D1

Evaluation Period : 06/30/2004 - 12/29/2006

Aggregated Performance	Fiscal Year to Date	Total Period
Excess Annualized Return	-0.73%	0.7%
Tracking Error	0.82%	1.68%
Information Ratio	-0.88	0.42
M2 Excess Return	-0.79%	0.5%
Maximum Excess Drawdown	-0.88%	-1.14%
Ratio of Excess Good Risk to Bad Risk	0.01	3.43
Benchmark Annualized Return	15.43%	11.63%
Portfolio Annualized Return	14.71%	12.33%
Confidence in Skill	18.76%	75.32%
Success Ratio	50%	45.45%

As can be seen in the above table, the annualized benchmark return for the static portfolio (e.g., a passively managed portfolio at policy benchmark weights) over the time period analyzed is 11.63%. Actual asset allocation strategy detracted 25 basis points annualized to the overall portfolio, whereas benchmark misfit added eight basis points and manager returns in excess of the benchmark contributed 176 basis points annualized for this period.

The table below shows that actual performance which includes manager returns (and the interaction between actual allocation strategy and manager returns[4]), added alpha (~70 bps annualized) for the evaluation period June 2004 through December 2006. Volatility increased slightly (from 5.8% to 6.0%), and the maximum drawdown and worst single negative performance deteriorated. On an M-square risk-adjusted basis, there is still positive out performance. However, this period was a relatively bullish period that does not capture the impact of the market downturn during which an alternative policy was in place. We describe the impact of only the actual allocation in the next section.

Table 3a-xiv

Performance Summary Aggregate

Total Period

		Annualized Return	Annualized Standard Deviation	Annualized Return-Risk Ratio	M2 Return	Maximum Drawdown	Average Return when Positive	Average Return when Negative	Worst 'Single' Negative Performance
Total	BMK	11.63%	5.83%	1.99	11.63%	-0.89%	3.58%	-0.57%	-0.89%
	Portfolio Decision	12.33%	6.01%	2.05	12.13%	-1.3%	3.83%	-0.8%	-1.3%
	Excess	0.7%	1.68%	0.42	0.5%	-1.14%	0.75%	-0.33%	-0.77%

Table 3a-xv below shows detailed performance of the asset allocation strategy (akin to an asset allocation benchmark, exclusive of actual manager results) versus the Policy Index for the Total Fund (where the benchmark for this analysis is the weighted sub-asset class benchmarks at the sub-asset class policy weights and not the asset class benchmarks). The result here (that actual allocation detracted performance) has to be viewed in the context that the Fund was underweight alternatives and real estate (two assets with strong benchmark performance that can take several years to fund) and hence this analysis may mis-state the quality of decisions made in the liquid asset classes, which appear to have favored equities (e.g., emerging markets and developed equities).

[4] The Actual Allocation is capturing the effect of changes to the allocations using benchmark data. In this portfolio, the manager contribution is significant. Therefore, there is an interaction effect that detracts value by 90 bps to the overall portfolio which is quite significant. The interaction effect occurs when the actual allocation strategy overweights asset classes with managers that are underperforming (for example US Large Cap Manager etc.) or underweights asset classes with managers that out perform (for example Alternatives Manager etc.). Thus in isolation, managers and actual allocation strategy produces its own excess, but these two actions can interact in overall portfolio to either detract or add value. In this portfolio, the former is the case.

Table 3a-xv

Performance Summary

Total Period

		Annualized Return	Annualized Standard Deviation	Annualized Return-Risk Ratio	M2 Return	Worst 'Single' Negative Performance	Longest Under-Performance	Recovery Period	Maximum Drawdown	Maximum Drawdown Occurred On
Total	BMK	11.72%	6%	1.95	11.72%	-1.37%	1	0	-1.37%	03/31/2005
	Strategy	11.47%	6.12%	1.87	11.35%	-1.46%	1	0	-1.46%	03/31/2005
	Excess	-0.25%	0.31%	-0.78	-0.37%	-0.31%	9	1	-0.94%	09/29/2006
		Correlation With BMK	**Ratio of Good/ Bad Risk**	**Down Side Risk - 1%**	**Down Side Risk - 5%**	**Confidence in Skill**	**Success Ratio**	**M3 Return**	**Average Return when Positive**	**Average Return when Negative**
Total	BMK	1	3.66	0%	0%	N/A	N/A	11.72%	3.67%	-0.86%
	Strategy	1	4.76	0%	0%	N/A	N/A	8.9%	3.65%	-1.06%
	Excess	0.36	0.82	0%	0%	9.13%	45.45%	-2.82%	0.09%	-0.17%

Based purely on the numbers, it appears that the Fund detracted 25 bps (assuming no transactions costs) with low tracking error (0.31%) by deviating from their asset allocation policy, but this analysis has to be seen in light of the comment made earlier regarding alternatives being underweight. The ratio of good-to-bad risk of the Fund is better than the benchmark. In addition, most of the other performance statistics like worst single performance, longest underperformance, recovery period, maximum drawdown, average return when benchmark positive and average return when negative are very similar to that of the benchmark.

14. Performance Attribution and Risk Analysis: Asset Class

We used M^{Cube}'s AlphaEngine® software to determine the value added by LAFPPS' active managers at the asset class level. The table below shows overall Manager Portfolio and benchmark performance for the April 2001 – December 2006 period. The analysis is conducted on a purely static basis assuming fixed weights to each asset class (using the 2004-2006 policy weights), and actual performance from external management compared to the benchmark for each asset class.

- The overall Fund annualized benchmark return is 7.99% with standard deviation of 11.42%. Maximum drawdown of the Fund is -16.96% and occurred on September 2002.

- Over this time frame, on a purely static basis, while the Fund outperformed the benchmark by 0.97% annualized, our analysis indicates that a good portion of the value added (0.67% annualized) was derived from benchmark misfit risk. The added value of the Fund came with lower volatility to the overall portfolio (10.6%

versus the benchmark of 11.42%). This analysis is not precise because of the static nature of the analysis, but suggests that adding external managers added some risk management by way of lowering overall volatility and drawdowns, even though within individual asset class segments risk management could be improved. The individual asset class segments are more relevant. In short, based on the assumptions made for the analysis, it appears that diversification is being provided by external management in total as some risks appear to be lowered at the full Fund level.

Table 3a-xvi

Portfolio : LAFFPS Fund : LAFFPS Fund — Evaluation Period (04/02/2001 - 12/29/2006) — Evaluated On: 06/26/2007

Reporting Period: *Calendar*

Performance Summary Aggregate

Total Period

		Annualized Return	Annualized Standard Deviation	Annualized Return-Risk Ratio	M2 Return	Worst 'Single' Negative Performance	Longest Under-Performance	Recovery Period	Maximum Drawdown	Maximum Drawdown Occurred On
Total	BMK	7.99%	11.42%	0.7	7.99%	-11.74%	9	4	-18.77%	09/30/2002
	Portfolio Decision	8.96%	10.6%	0.85	9.24%	-9.8%	9	4	-16.96%	09/30/2002
	Excess	0.97%	2.01%	0.48	1.26%	-1.18%	10	9	-1.13%	06/29/2001

		Correlation With BMK	Ratio of Good/ Bad Risk	Down Side Risk - 1%	Down Side Risk - 5%	Confidence in Skill	Success Ratio	M3 Return	Average Return when Positive	Average Return when Negative
Total	BMK	1	0.68	8.22%	5.62%	N/A	N/A	7.99%	4.67%	-5.2%
	Portfolio Decision	0.99	0.71	7.62%	3.31%	N/A	N/A	9.31%	4.46%	-5.47%
	Excess	-0.48	2.37	0.07%	0%	89.74%	52.17%	1.32%	0.92%	-0.58%

Detailed reports of each asset class are attached separately as Exhibit B. To summarize:

- Many of the sub-asset classes beat their benchmark on an annualized basis over this period (US Large Cap Equity, International Developed Equity, Emerging Markets, Core Bonds, Cash and Real Estate all have positive information ratios). Where the asset classes have underperformed (US Small Cap, High Yield and Alternatives), the underperformance is quite significant.

- On a calendar year basis, the asset classes that outperformed the benchmark have few negative excess years whereas US Small Cap, High Yield and Alternatives managers have a higher number of negative excess years. Among the outperforming sub-asset classes, only International Developed Equity has a success ratio less than 50% (i.e., less than 50% of the quarters performance was ahead of the benchmark). In addition, for the asset classes that outperformed their benchmarks, confidence in skill for International Developed and Emerging Markets Equity are less than 70%, implying that the returns that they have

generated are more likely luck based and not skill based. Correlation of excess returns with the benchmark for Emerging Markets, Core Bonds, Alternatives and Real Estate managers are negative (as was the case for the entire Fund), implying that these managers provide insurance when benchmark performance is negative.

- In most asset classes, the volatility of the managers in aggregate was greater than the benchmark. Therefore, an investor should expect to earn higher returns, but on a risk adjusted basis (M-square measure), Emerging Markets and Real Estate may not have compensated adequately.

- Maximum drawdown for US Small Cap Equity, International Developed Equity, Core Bonds, High Yield, Alternatives, Cash and Real Estate were all worse than the drawdown of the benchmark. The High Yield result was particularly meaningful – suggesting the portfolio should be reviewed. Overall, this suggests that risk management needs to be enhanced either in manager selection or manager allocation in these asset classes.

3b. Appropriateness of Investment Performance Benchmarks

Principles

Performance benchmarks are objective standards used to assist in evaluating a manager or fund's investment performance. A good benchmark should have the following characteristics:

- act as a representative opportunity set;
- transparent,
- objective,
- exhaustive, and
- composed of investable securities or assets.

Institutional investors typically use at least two types of performance benchmarks: "policy" benchmarks and "strategic" benchmarks.

Policy benchmarks should represent the broad asset class and are used as a reference point against which the investor can compare its total asset class returns. For example, a domestic equity investment structure designed to provide broad asset class exposure may use the Wilshire 5000 Index or the Russell 3000 Index (broad measures of the domestic stock market) as a policy benchmark as opposed to the S&P 500 Index, which is more concentrated in larger-capitalization stocks. Policy benchmarks also help define the types of investment managers that should be used to achieve the investment objectives for the asset class and the nature of the manager's investment mandate.

Strategic benchmarks are generally more narrowly defined and typically focus on a particular investment "style" within the asset class. They more clearly describe the expected range of investment opportunities for a given manager and more objectively measure the manager's value added, or the manager's return independent of its investment style.

For example, an investor setting a strategic benchmark for a domestic equity investment manager that seeks to purchase large capitalization stocks that it believes will grow their earnings above the average rate relative to the market (a "large cap growth" manager) may select a large cap growth benchmark such as the Russell 1000 Growth Index as an appropriate strategic benchmark.

Therefore, the manager's excess return above the "comparable style" strategic benchmark is generally due to its active decisions as opposed to its investment style being "in favor" relative to a style-neutral strategic benchmark.

As an additional measure, many funds also (as a matter of policy) establish an "Asset Allocation" index. This also is constructed using published market benchmarks.

In contrast to the Policy Index, the Asset Allocation Index's asset class weights change to reflect the actual asset allocation of the fund as it "drifts" or as tactical decisions are made to overweight or underweight an asset class.

Therefore, this benchmark adjusts for the asset allocation drift over time. A fund's excess or under-performance versus the Asset Allocation Index is mainly attributable to the performance of the underlying investment managers (internal or external).

Risks

An inappropriate benchmark may not provide an investor with an accurate and appropriate measurement with which to compare its investment performance and/ or volatility.

Observed Condition

LAFPPS currently works with the investment consultant, Pension Consulting Alliance (PCA), in determining appropriate benchmarks for the Total Fund, each asset class and each investment manager. LAFPPS reviews and sets their Total Fund Policy Index when addressing LAFPPS' asset allocation decisions. Asset class benchmarks are reviewed when new sub-asset class strategies are introduced to the portfolio. In reviewing LAFPPS' quarterly report, IFS discovered that when LAFPPS makes a change to the new asset class benchmark, they would replace the "old" benchmark returns with the historical returns of the "new" benchmark. LAFPPS should maintain the old benchmark data and link future performance to the "new"

benchmark. For example, LAFPPS decided to change its benchmark for its domestic equity portfolio in January 1, 2006 from the Standard and Poor's 500 Index (S&P500) to the Dow Jones Wilshire 5000 Index. Instead of replacing the returns of the S&P 500 with the historical returns of the DJ Wilshire 5000, LAFPPS should link the historical data of the S&P 500 to the DJ Wilshire 5000 Index.

Task Area 3b Recommendation 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.

1. Domestic Equity

LAFPPS currently uses the Dow Jones Wilshire 5000 Index to measure the overall domestic equity portfolio, as documented in Northern Trust's quarterly report and in the IPS. The DJ Wilshire 5000 Index measures the performance of 4,961 U.S. companies based on total market capitalization, representing approximately 100% of the investable U.S. equity market. We have found that the majority of pension funds use either the Russell 3000[5] or the DJ Wilshire 5000 as the benchmark to represent the broad domestic equity market. The DJ Wilshire 5000 Index is an appropriate policy benchmark for LAFPPS' equity allocation.

LAFPPS uses a combination of Standard and Poor's and subset indices from the Russell 3000 as strategic benchmarks for their nine equity style mandates. For example, LAFPPS uses the Russell 2000 Value Index to measure the performance of its small cap value managers. LAFPPS uses both the Standard and Poor's 500 and Russell 1000 Value as benchmarks for its passive equity investments.

While we did not analyze the investment strategies of the individual underlying investment managers, we did perform a holdings based analysis of LAFPPS' equity managers along with a review of the investment manager guidelines. Based on this analysis, it appears that LAFPPS is using the appropriate strategic benchmarks for their equity managers. (See Exhibit B – LA City Fire and Police Holding Analysis.)

[5] The Russell 3000 Index measures the performance of 3,000 U.S. companies based on total market capitalization, representing approximately 98% of the investable U.S. equity market.

2. International Equity

According to the "Board Investment Policies" and as documented in Northern's quarterly investment report, LAFPPS currently uses the MSCI EAFE Index[6] as the benchmark for the total international equity segment. The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is structured to measure the performance of the *developed* international equity markets, excluding the US & Canada. As of December 2006 the MSCI EAFE Index consisted of 21 developed market country indices.

The Board currently breaks down the international equity allocation into two mandates, "Total Developed Markets" and "Total Emerging Markets". LAFPPS compares these two sub-asset classes against the MSCI EAFE Index and MSCI Emerging Markets Index.

As of December 31, 2006, LAFPPS' international equity portfolio consisted of seven managers.

- The *Developed Markets* mandate consists of five managers benchmarked to the broad *developed* market index of the MSCI EAFE Index. Based on a review of the investment manager guidelines, it appears that only one manager (McKinley Capital Management) has a universe of investments that consists solely of securities in the MSCI EAFE Index. For example, Brandes Mid Cap International Equity is benchmarked to the MSCI EAFE Index, although for the most part guidelines are based on the FTSE World ex-US Medium Cap Index. The FTSE World ex-US Medium Cap Index may be more appropriate to measure this mandate, since it is more representative of the manager's opportunity set. The three other managers (Fisher, Julius Baer and Brandes Investment Partners) have the ability to invest a portion (10-20%) in the emerging markets. It would be more appropriate to measure these three managers against a broader index, such as the MSCI ACWI (All Country World Index) ex-US[7]. The MSCI ACWI ex-US is a free float-adjusted market capitalization index that is structured to measure equity market performance in both the *developed* and *emerging* markets.

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[6] The underlying countries that make up the MSCI EAFE Index are the following: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

[7] The underlying countries that make up the MSCI ACWI ex US are the following: Argentina, Australia, Austria, Belgium, Brazil, Canada, Chile, China, Colombia, Czech Republic, Denmark, Egypt, Finland, France, Germany, Greece, Hong Kong, Hungary, India, Indonesia, Ireland, Israel, Italy, Japan, Jordan, Korea, Malaysia, Mexico, Morocco, Netherlands, New Zealand, Norway, Pakistan, Peru, Philippines, Poland, Portugal, Russia, Singapore Free, South Africa, Spain, Sweden, Switzerland, Taiwan, Thailand, Turkey, the United Kingdom, and Venezuela. MSCI targets 85% of the free float-adjusted market capitalization in each industry, in each country for inclusion in the benchmark.

- The *Emerging Markets* mandate consists of two dedicated emerging market managers and is currently benchmarked to the MSCI Emerging Market Index. The MSCI Emerging Market Index consists of 25 *emerging* market country indices.

- IFS reviewed the investment manager guidelines and the quarterly report exhibits of the international equity managers as presented by Northern Trust. In reviewing these documents, it appears LAFPPS is using the appropriate strategic benchmarks for its underlying managers.

Given LAFPPS' current mix of both *developed* and *emerging* market managers, IFS believes the use of the MSCI ACWI (All Country World Index) ex-US would be a more appropriate policy benchmark for the total international equity allocation.

Task Area 3b Recommendations 2-3
The Board should consider measuring the international equity segment against the MSCI All Country World Index ex-US.
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.

3. Domestic Fixed Income

The current policy benchmark used in the quarterly report for the entire domestic fixed income portfolio is the Lehman Brothers Universal Index[8]. The Lehman Brothers Universal Index includes all of the securities that make up the Lehman Brothers Aggregate Index[9] (Treasury, Government Related, Corporate and Securitized Securities) along with other securities such as High Yield Corporate bonds, 144A securities[10] and dollar denominated Emerging Market bonds.

LAFPPS breaks down the fixed income allocation into two distinct mandates, "Core Fixed Income" and "High Yield".

[8] The Lehman U.S. Universal Index represents the union of the U.S. Aggregate Index, the U.S. High-Yield Corporate Index, the 144A Index, the Eurodollar Index, the Emerging Markets Index, the non-ERISA portion of the CMBS Index, and the CMBS High-Yield Index

[9] The **Lehman Brothers U.S. Aggregate Index** represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

[10] Securities for resale to qualified institutional buyers exempt from the registration requirements of Section 5 of the 1933 Act.

In reviewing the investment manager guidelines and reviewing the Northern Trust quarterly report, it appears that there is a contradiction of benchmarks for many of the fixed income portfolios. It appears that some of the guidelines may have not been updated when their respective benchmark was changed. For example, LM Capital and Reams Asset Management are benchmarked in the quarterly report to the Lehman Brothers US Aggregate Index +1%, but the Investment Manager Guidelines state a benchmark of the Salomon Brothers Broad Investment Grade Index +1%.

Core plus managers typically invest the majority of their assets in securities that are included in the Lehman Brothers Aggregate Index; however these managers are permitted to invest a portion of their holdings in "plus" sectors such as below investment grade securities, foreign denominated bonds, and emerging market securities. LAFPPS has two managers that can be considered core "plus" managers. Ideally, these managers will be benchmarked against an index with a representative opportunity set. In the case of LM Capital and Reams Asset Management, both managers are allowed to invest in securities outside their index. One approach to benchmarking would be to compare them against a broader index, such as the LB Universal Index. Another approach is to add a "skill" premium to the benchmark since the manager can invest in securities that may yield a higher return. LAFPPS' use of the LB Aggregate +1% is a reasonable benchmark. In reviewing the guidelines for Loomis Sayles Long Duration portfolio, it appears that the manager may invest in "high yield" securities, although their benchmark of the LB Long Government/Credit Index do not take into account these securities. LAFPPS may want to consider adding a "skill" premium to the benchmark to address the additional risk that the manager has the ability to take. In reviewing the fixed income managers, it appears that the Equitable CCMF is not benchmarked against an index. In order to assess the reasonableness of the investments performance, it should be measured against an appropriate index.

LAFPPS uses the CS Domestic High Yield Index for both the total High Yield allocation and each underlying manager. The use of this benchmark is appropriate. The benchmark is labeled as the First Boston High Yield Index in the investment manager guidelines, which is its former name.

LAFPPS' use of the Lehman Brothers Universal Index is an appropriate benchmark for its fixed income portfolio.

4. Real Estate

LAFPPS currently uses the NCREIF (National Council of Real Estate Investment Fiduciaries) Property Index (NPI) plus 1.0% to measure the private real estate portion of the portfolio as reported by the Fund. In reviewing the Northern Trust quarterly report, the NCREIF Index and DJ Wilshire REIT Index are reported.

- As of December 31, 2006, NPI contained over 5,333 properties in the Apartment, Industrial, Office or Retail sectors, with a total market value over $247 billion.

- In order to be included in NPI, these properties must have been acquired on behalf of tax-exempt institutions and held in a fiduciary environment.

- To date, NPI is the broadest most encompassing benchmark for the private real estate market.

- NPI is also widely accepted and utilized despite its few known “flaws,” such as the fact that it does include the use of leverage properties, is gross of fees, which tend to be substantial in this asset class, and the lag in appraisal valuations result in distortion of reported volatility of the asset class.

LAFPPS’ current investment in real estate is made up various funds that invest in Core and Value Add Strategies (Stable, Enhanced and High Return). LAFPPS invests in both commingled funds and various real estate partnership funds. LAFPPS also has equity real estate exposure by having a fifteen percent allocation to REIT securities.

Given the use of value add strategies it appears that the NPI + 1% appears to be a reasonable benchmark for the private real estate allocation. In interviews with LAFPPS’ staff, IFS learned that it was the staff’s opinion that the NPI +1% took into consideration both the value add strategies and the REIT allocation. IFS believes that the LAFPPS should consider using a blended benchmark to better represent the investable universe, such as 85% NCREIF +1% and 15% of the DJ Wilshire REIT Index. IFS believes the current policy benchmark of NPI +1% does not closely reflect the expected return or volatility level of the current real estate portfolio. This is demonstrated in Section 3.a.9 (Investment Performance: Real Estate Cumulative Performance) where the returns and volatility deviate significantly from its policy benchmark.

Task Area 3b Recommendation 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.

5. Alternative Investments

According to LAFPPS’ quarterly report, it currently uses the S&P 500 + 4% when evaluating the performance of their Alternative Investment portfolio.

There currently are no standard institutional benchmarks to evaluate private equity returns. A common approach to Private Equity investments has been to take a public equity

benchmark, such as the S&P 500 or Wilshire 5000 and add "liquidity" premium of three to five percent to the return. Alternative benchmarks used for private equity investments are those created by Cambridge Associates and Thomson Venture Economics. These benchmarks are composed of various private equity manager-reported returns weighted to create an "average" return for the asset class.

We understand that LAFPPS' consultant, PCA, recently recommended a benchmark of the Russell 3000 + 4%. IFS finds LAFPPS' use of either the S&P 500 or Russell 3000 plus 4% be a reasonable benchmark for its private equity allocation. IFS noticed that neither benchmarks are provided in LAFPPS' IPS. When LAFPPS decides which benchmark to use, it should update its IPS with the decision.

6. Total Fund

LAFPPS' current policy index is composed of 35% Wilshire 5000 Index, 18% MSCI EAFE, 27% Lehman Brothers Universal Index, 10% NCREIF Index + 1.0%, and 10% S&P 500 + 400 basis points.

This policy index is reasonable and representative of LAFPPS' investment universe, except for a few caveats. The Total Fund Policy Index should be constructed of the underlying asset class benchmarks as a target of the Total Fund. Therefore, if LAFPPS adopts our recommendation to use the MSCI ACWI ex-US (international equity) and a weighted average NCREIF/DJ Wilshire REIT Index (real estate), the same adjustments should be made to the Total Fund Policy Index.

3c. Asset Allocation, Diversification, Risk and Return

Overview

Asset allocation is the process of diversifying an investment portfolio among asset classes (stocks, bonds, real estate, etc.) in order to have a high probability of achieving a particular investment objective, such as consistently attaining a certain level of total return while controlling risk (e.g., volatility or standard deviation).

Asset allocation is generally considered to be the single most important determinant in minimizing risk and maximizing return over time. Empirical research[11] has shown that asset allocation generally has a far greater effect on investment performance than does the selection of investment managers or individual securities.

[11] See for example, Gary P. Brinson, L. Randolph Hood, and Gilbert L. Beebower, "Determinants of Portfolio Performance," *Financial Analysts Journal* (July/August 1986):39-44. "[T]otal return to a plan is dominated by investment policy decisions. Active management, while important, describes far less of a plan's returns than investment policy."

Determining the appropriate balance of asset classes is not an exact science. However, the use of computer modeling techniques (e.g., mean variance optimization or "MVO") and appropriate assumptions about the expected risk and return of various asset classes can increase the probability of achieving long-term investment objectives.

Establishing an appropriate asset allocation requires an examination of several key factors, including:

- The nature of the fund, e.g., a pension fund is typically considered to have a long-term investment horizon;
- The collective risk tolerance of the Board as expressed in the IPS, including expressed tolerance for various types of risk (e.g., liquidity risk, interest rate risks, etc.). Some Board members may be more or less aggressive and willing to accept more or less volatility in asset levels;
- Willingness to invest in "alternative" asset classes, e.g., private equity, hedge funds, etc.;
- Actuarial condition (such as its funded status and the demographic characteristics of a fund's participant population), cash flow projections and liquidity needs; and
- The current and expected future economic and market climate.

A pension fund is responsible for both investing pension fund assets as well as making benefit payments to participants. Therefore, an asset allocation study should take into account the liability structure of the pension funds – or even better – a full-blown asset liability study should be completed.

IFS reviewed the process the Board uses to set LAFPPS' asset allocation policy, specifically, IFS considered the following:

- Who is involved in setting the asset allocation?
- What methodology was used, e.g., was a quantitative model used?
- What is the risk level and does it match risk tolerance of the Board as expressed in the IPS?

- Does the process consider the nature of LAFPPS' liabilities and actuarial and funding conditions?

- What are the current asset classes used, how do their targets and ranges compare to peers and are they suitable for the System?

- What capital market assumptions were employed?

- What is LAFPPS' rebalancing process?

Principles

Given its fundamental importance, best practices dictate that asset allocation decisions be made at the Board level, where they can be coordinated with funding policies, actuarial condition and investment objectives. In our view, the ultimate fiduciary decision-maker should seek to understand the process used to develop the assumptions and to assure that the process is reasonable and fundamentally sound. The Board should also be made aware of the risks involved with various asset classes and asset allocations.

Overall, we believe a full Asset/Liability Model (ALM) is superior to the "plain vanilla" asset allocation used by many institutional investors and/or investment consultants, although it is not necessary to perform such a study as frequently as a simple asset allocation study. A pension plan should have a unique asset allocation study (or preferably an asset liability study) prepared due to its individual demographics, funding level and cash flow requirements. Changes in one or more of these areas can be analyzed through an asset liability study.

A more mature pension plan might desire a less volatile asset allocation and it would eventually need to consider the time horizon and liquidity of various asset classes (such as private equity and real estate), even while maintaining an overall total return approach to investing. Such a plan might also choose to make structural decisions in the portfolio in response to the shortening duration of the liabilities.

Asset allocation is distinguishable from portfolio structure, the former of which can be modeled using MVO, while the latter includes various policy judgments and some quantitative work (such as possible use of risk budgeting), but not full-blown MVO (portfolio structure is described more fully in Section 3.f (Investment Management Structure).

Risks

Not using any type of quantitative model to conduct the asset allocation analysis would put a board at risk of setting an inefficient asset allocation and not acting in accordance with both

best and common practices. An undisciplined asset allocation process could result in an inappropriate asset allocation made without proper authorizations.

In addition, not taking into account a fund's liabilities would put a board at risk of an unintended mismatch between assets and liabilities.

Observed Condition

LAFPPS' IPS requires that the Board adopt and implement an Asset Allocation Plan, "which provides adequate diversification and gives the expectation of the highest rate of return commensurate with an acceptable level of risk, or volatility." The IPS also requires that the asset allocation be reviewed quarterly to determine if rebalancing is necessary and that the Asset Allocation Plan be reviewed at least every five years. The Plan is supposed to include, or be based on:

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

We understand that the Board reviews the asset allocation every few years, as deemed necessary. The most recent study was conducted by its general investment consultant, PCA, in December 2006. The prior study was conducted by PCA in 2002.

PCA groups assets into two main categories – Equity Oriented (includes publicly traded domestic and international equity, real estate and alternatives) and Stable Investments (includes bonds and cash). They compared LAFPPS' allocation to other large California public plans and to other third party universe data. This comparison showed that on a *target* basis (20% for real estate and private equity combined), LAFPPS had a higher exposure to private market assets; however, only approximately 12% of the *actual* allocation was in private markets (5% alternatives and 7% real estate).

PCA properly notes that it is important to select the best portfolio given LAFPPS' own risk tolerance, time horizon and constraints. PCA also discusses their optimization model and how they develop their asset class assumptions, including the use of a building-block approach. Additionally, they show comparisons of their risk and return assumptions to those used by a few other national consulting firms.

PCA does not comment on the funded status of LAFFPS' defined benefit or healthcare trust funds or the required contribution levels. The latest actuarial valuation of LAFPPS, as of June 30, 2006, shows that based on the actuarial valuation of assets, the defined benefit plan had

a 94.6% funded ratio (versus 94.1% in 2005) and the healthcare fund had a 37.6% funded ratio (versus 47.5% in 2005), for a total of 88.2% funded ratio (versus 89.8% in 2005). The contribution rates for both retirement and health have gone up significantly over the last five years – from approximately 12.3% total in 2000 to 30.7% in 2006 as a percent of payroll (22.2% for retirement and 8.5% for health). The Board currently uses the same asset allocation for both the defined benefit and healthcare funds. Based on our experience, this is common practice, although some funds do develop distinct asset allocation policies for healthcare trust funds due to the disparities in the liability streams.

In the 2006 valuation, the actuary reduced the assumed actuarial rate downward from 8.5% to 8.0% (and lowered the inflation rate from 5.0% to 3.75%). This rate is in line with peer funds and is the median actuarial assumed interest rate according to the Wilshire Consulting 2006 Report on City & County Retirement Systems: Funding Levels and Asset Allocation. The RV Kuhns Public Fund Universe Analysis Report for June 30, 2006 shows 8.0% to be the most frequently reported actuarial rate assumption. Wilshire Consulting estimated the funding ratio of the pension plans in its survey was 87% in 2005. Of the 66 city and county retirement systems that provided actuarial data for 2005, 77% were underfunded, with the average underfunded plan at 81%.

PCA calculated the downside deviation, the downside probability (the probability of achieving a return less than 3.50%[12]) and the average downside deviation for the current policy and calculated efficient policies. However, the impact of the proposed asset allocation policies on the funding ratios and contribution levels were not discussed or quantified in the report. The asset allocation review should attempt to do this in future studies, even if only to a limited degree, and ultimately LAFPPS should consider doing a full blown asset liability study every 5-10 years.

PCA found that LAFPPS' then current policy resided on the efficient frontier. Although they also showed that adding "Absolute Return" as an asset class did not materially impact the return-risk characteristics, PCA recommended adopting an alternative portfolio close to the current policy that included a 5% allocation to absolute return to gain additional asset class diversification. After these recommendations were presented, the Board requested PCA model their Portfolio #9 (PCA's recommended option) as well as two alternate versions suggested by staff and the Board and compare them to the then current policy. All four portfolios had similar expected returns (8.2-8.3% or 5.7-5.8% after subtracting out PCA's 2.5% inflation assumption) and risk-return characteristics, with the Board recommended policy having a slightly higher one-year standard deviation, due to its slightly higher equity exposure. We understand that the Board -adjusted Asset Allocation Targets and Ranges were adopted. We evaluate them in more detail later in this section.

[12] 3.50% is the previous actuarially required real rate of return; this rate would now be 4.25% after the 2006 study.

Overall, we find that that Board used a reasonable process to determine the asset allocation policy.

Task Area 3c Recommendations 1-2
The Board should request that the consultant provide more discussion on how proposed asset allocation policies will likely impact funding ratios and contribution levels.
The Board should consider conducting a complete asset liability study every five to ten years.

1. Asset Classes Used and Peer Comparison

Principles

Major institutional investors, including pension funds, tend to diversify their investments across many asset classes, in an effort to maximize expected return at the lowest feasible levels of risk, and in light of their respective investment policies. The opportunity set of available asset classes has grown over the last 10 to 20 years, with increased investments in hedge funds (including new types of derivatives), private equity and other alternatives, inflation protected securities, etc. A recent survey of 76 corporate, public and nonprofit funds conducted by The Bank of New York[13] shows that "only about 15% of participants were investing in hedge funds five years ago, in the next five years, 45% expect to invest in hedge funds."

The appropriate asset allocation for any given fund depends on numerous factors, including, e.g., its investment policy, liability structure, cash flow needs, investment horizon, risk controls, organizational structure (including staffing and resources appropriate for managing certain types of assets and risks) and other matters. Even though the appropriate asset classes and asset allocation for a given investor depend on its individual circumstances, comparisons to peers may provide useful reference points.

In recent years, many pension plans have found it difficult to meet their actuarial assumed rate given the decreased return expectations for some of the typically employed asset classes (e.g., domestic equity). In addition, the volatility of funded ratios and need for increased contributions has caused pension plans to suffer increased scrutiny. These factors have helped to rekindle an interest in strategies that focus on matching liabilities (which is generally accomplished with fixed income instruments and, more recently, with synthetic securities), rather than focus only on maximizing returns. There is often a trade-off between seeking higher total return and optimizing a portfolio to better match liabilities, and it is generally more difficult to make up a funding deficit with a portfolio more heavily tilted towards bonds. Historically the

[13] "New Frontiers of Risk: The 360° Risk Manager for Pensions and Nonprofits," October 2005.

more volatile asset classes have also produced the highest returns over time, despite occasional periods of sharp decline.

Including less traditional asset classes and investment strategies, along with traditional publicly traded stocks and bonds, generally results in a total portfolio with a higher expected rate of return and a lower overall expected standard deviation or variability. Non-traditional investment strategies (i.e., investments in properties and appraised assets that are not traded on an exchange that provides objective, readily ascertainable prices and strategies using derivatives) generally exhibit two characteristics that are favorable to the total fund's investment characteristics: higher expected performance than traditional classes of investments and/or a correlation that generally reduces total portfolio variability.

Each additional asset class in a fund adds an incremental degree of return and risk to the total portfolio, which can be positive or negative. Return is additive; the return of the portfolio is the weighted average of the returns of its components. Risk, defined as variability of returns or the degree to which long term average returns fluctuate over short periods (e.g., standard deviation), is a complex concept because variability of two instruments can moderate one another or can amplify one another.

The degree to which two instruments move similarly to one another is measured by their correlation. When two instruments tend to move in the same direction in response to particular economic events, they tend to change value in the same direction at the same time, and so the combination of the two movements is additive (i.e., positive correlation). When they react differently to particular events, they tend to change value in opposite directions, so they tend to offset one another (i.e., negative correlation). Correlation is statistically measured between pairs of investments and can be used to calculate the variability of portfolios holding different mixes of investments. Correlations range from positive 1.0 to negative 1.0, with 1.0 signifying perfect correlation.

Risks

By not investing in all available (and advisable) asset classes, a board risks the pension fund not being appropriately diversified. Adding nontraditional asset classes and strategies should lower volatility of returns (risk), enhance risk adjusted returns and potentially increase absolute returns.

Observed Condition

The 2006 Greenwich Associates Market Dynamics Report shows there has been a slight shift in recent years away from domestic stocks and bonds and toward international stocks and alternatives. The average amount allocated to domestic stocks and bonds has decreased to 45% from 47% and to 23% from 28%, respectively; while the allocation to international stocks has

increased to 15% from 11%. Allocations to equity real estate, private equity and hedge funds all increased 1% from 2002 to 2006 to 4%, 4% and 2%, respectively, as shown in the table below.

In Table 3c-i below, we compare LAFPPS' current policy target asset allocation (adopted January 18, 2007) to various third parties. LAFPPS has a smaller target allocation to publicly-traded equity than the peer survey data shown below. This is due primarily to its greater allocation to alternatives – private equity and absolute return (which are not fully funded). LAFPPS' allocation to fixed income is also lower than most of the large fund peer groups. On the other hand, its target allocations to real estate (6.5% funded), private equity (3.4% funded) and absolute return (not yet funded) are higher than the survey averages.

Table 3c-i:		Third Party Asset Allocation Data				
Asset Class	**LAFPPS 2007 Target Allocation**	**Greenwich Associates 2006 Public Funds over $5 billion[14]**	**Greenwich Associates 2006 Total Fund**	**Wilshire City & County Average[15]**	**RV Kuhns 6/30/2006 All Funds**	**RV Kuhns 6/30/2006 $10-$20 B Funds**
U.S. Stocks	35.0%	42.1%	44.7%	46.5%	41.4%	43.0%
Large Cap	*31.5%*	-	-	-	-	-
Small Cap	*3.5%*	-	-	-	-	-
Non-U.S. Stocks	18.0%	18.8%	15.0%	14.4%	18.3%	16.3%
Developed Markets	*15.5%*	-	-	-	-	-
Emerging Markets	*2.5%*	-	-	-	-	-
Global Equity	-	-	-	-	1.5%	1.3%
Total Publicly-Traded Stocks	*53.0%*	*60.9%*	*59.7%*	*60.9%*	*61.2%*	*60.6%*
U.S. Fixed Income	22.0%%	27.1%	22.9%	29.3%	23.3%	25.8%
Core Fixed Income	*19.8%*	-	-	-	-	-
High Yield	2.2%	-	-	-	-	-
Global/Non-U.S. Fixed Income	-	-	-	1.2%	1.7%	2.3%
Total Fixed Income	*22.0%*	*27.1%*	*22.9%*	*30.5%*	*25.0%*	*28.1%*
Asset Class	**LAFPPS 2007 Target Allocation**	**Greenwich Associates 2006 Public Funds over $5 billion[16]**	**Greenwich Associates 2006 Total Fund**	**Wilshire City & County Average[17]**	**RV Kuhns 6/30/2006 All Funds**	**RV Kuhns 6/30/2006 $10-$20 B Funds**
Equity Real Estate	9.0%	5.9%	4.1%	4.7%	5.4%	4.8%
Alternatives/Private Equity	10.0%	4.5%	3.8%	1.3%	5.4%	4.3%
Hedge Funds	5.0%	0.4%	2.1%	-	-	-
Other	-	1.2%	7.4%	2.7%	1.2%	0.8%
Cash	1	-	-	-	1.7%	1.3%
	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

[14] Greenwich Associates data is as of late 2006 and is dollar-weighted. Public Funds universe included 296 plans, 194 Municipal Funds and 95 State Funds. Total Funds universe included 1950 funds.
[15] Survey of 107 city and county retirement systems, September 14, 2006. Fund data is primarily from 2005.

Despite the differences from the peer group data, overall, we believe that LAFPPS' asset allocation appears to be reasonable.

2. Capital Market Assumptions Used

Background

In formulating asset class assumptions for risk, return and correlation, asset classes may be defined broadly (e.g., stocks or bonds) or more narrowly with segregation into sub-asset classes (e.g., emerging markets equity versus developed international equity, large cap versus small cap domestic equity).

- When asset classes are defined more broadly, allocations to asset subsets are considered "policy" decisions, rather than being quantitatively modeled.
- When asset classes are defined very narrowly for purposes of modeling, it can be difficult to develop reliable risk, return and correlation statistics for some classes due to various factors, including:
  - Lack of historical data,
  - Lack or insufficiency of an index or benchmark,
  - Lack of public market valuations, e.g., some real estate data is appraisal based and is therefore subject to smoothing, which may artificially decrease its correlation with other asset classes, if judged in isolation.

Fund boards should consider the process an art, not a science. We believe there is a *range* of acceptable inputs, rather than a single, precise set of "correct" inputs for each asset class. Modeling techniques can use ranges as well as specific points to generate expected future results.

Principles

The following inputs need to be developed to perform an MVO analysis:

- Average expected return for each asset class;

[16] Greenwich Associates data is as of late 2006 and is dollar-weighted. Public Funds universe included 296 plans, 194 Municipal Funds and 95 State Funds. Total Funds universe included 1950 funds.
[17] Survey of 107 city and county retirement systems, September 14, 2006. Fund data is primarily from 2005.

- Expected asset class risk (or standard deviation); and
- Correlation between asset class returns.

Expected returns should be developed using both historical analysis and forward-looking observations, given various historical and current market valuation measures. The inputs into the model should generally be forward looking, rather than purely historical averages and should reflect expectations for the time horizon being considered i.e., they in effect project how each asset class may be expected to perform in the future. Thus, uncertainty exists and simple mechanistic extrapolations of past data may ignore changed environments and may fail to consider where various markets currently are within their cycles.

The combination of these three elements produces optimized portfolios. Asset allocation modeling is only as sound as the quality and objectivity of the inputs employed in the process. The assumed levels of risk, return and correlation for each asset class are critical to the process, both on an absolute basis and relative to other asset classes. Small adjustments to any of the assumptions can profoundly alter the conclusions as to which portfolios are efficient.

Risks

Using overly optimistic return assumptions would cause a pension fund to run the risk of the actual portfolio not generating the needed return and thus, risk eventual underfunding, the need for unexpectedly high contributions, and/or decreased benefits.

Conversely, using overly pessimistic return assumptions might cause a pension fund to take on a more aggressive asset allocation than actually necessary in order to achieve the actuarial return.

Observed Condition

In the following tables, we compare the return and risk assumptions used by LAFPPS' investment consultant (PCA) in the last study it conducted for LAFPPS in December 2006 versus the current assumptions used by IFS and other representative national consulting/investment management firms as well as the Greenwich Associates 2006 Survey (published in 2007).

In the December 2006 Asset Allocation Review, PCA used their 2007 projected risk, return and correlation assumptions. In their review, they compared their assumptions to a few other firms' 2006 assumptions and we compare them in Table 3c-ii below to IFS' and a few other firms' 2007 assumptions. As noted in their study, PCA's assumptions are fairly consistent with the peers. Their public and private equity returns are on the higher end of the range, but not unreasonable; the hedge fund/absolute return is slightly low, but the other asset class assumptions (e.g., fixed income and real estate) are generally in line with the third party assumptions.

Table 3c-ii: Comparison of Return Assumptions

Asset Class	PCA 2007P[18]	IFS 2007	Greenwich Associates Total Funds 2006	Ennis Knupp January 2007	Wilshire 2007[19]
Domestic Equity	9.00%	8.50%	8.2%	7.2%	8.25%
International Equity	9.00%	8.75%	9.7%	6.9%	8.25%
Emerging Markets	-	-	-	-	8.25%
Private Equity	13.00%	11.7%	11.7%	9.2%	11.75%
Hedge Funds	7.50%	8.0%	8.8%	-	-
Real Estate Equity	6.75%[20]	7.0%	8.8%	6.8%	6.75%
REITS	-	-	-	-	5.75%
Domestic Fixed Income - Core Bond	5.25%	5.50%	5.2%	5.4%	5.25%
High Yield	-	-	-	-	6.75%
TIPS	-	4.75%	-	-	5.00%
Cash (STIF)	4.00%	3.75%	-	-	3.00%
Inflation	2.50%	2.50%	-	2.4%	2.25%

In the next table we compare the risk assumptions (as measured by standard deviation) used by PCA to those used by IFS and a couple other nationally known consulting firms. While PCA's numbers do not appear unreasonable, they are on the high side when compared to peers for virtually all of the asset classes. While this may result in a slightly higher overall expected standard deviation for the Policy portfolio, as long as the proportion of the risk to each other stay the same, the MVO analyses will still be comparable.

Table 3c-iii: Comparison of Risk Assumptions (Standard Deviation)

Asset Class	PCA 2007	IFS 2007	Ennis Knupp January 2007	Wilshire 2007[21]
Domestic Equity	18.5%	16.75%	16.4%	16.00%
International Equity	20.0%	18.50%	18.5%	18.00%
Emerging Markets	-	-	-	24.00%
Private Equity	35.0%	30.00%	30.7%	29.00%
Hedge Funds	10.5%	8.50%	-	-
Real Estate Equity	13.0%	10.50%	11.1%	12.50%
REITS	-	-	-	15.00%
Domestic Fixed Income - Core Bond	7.0%	5.25%	6.6%	5.00%

[18] For modeling purposes, PCA used real returns, subtracting out its 2.5% inflation expectation.
[19] IFS subscribes to Wilshire Compass and Co-op and has access to Wilshire's capital market assumptions.
[20] Assumes a mix of core real estate and a variable mix of public real estate securities of between 5% and 20%.
[21] IFS subscribes to Wilshire Compass and Co-op and has access to Wilshire's capital market assumptions.

Table 3c-iii: Comparison of Risk Assumptions (Standard Deviation)				
Asset Class	**PCA 2007**	**IFS 2007**	**Ennis Knupp January 2007**	**Wilshire 2007[21]**
High Yield	-	-	-	10.00%
TIPS	-	5.75%	-	6.00%
Cash (STIF)	1.5%	1.00%	-	1.00%
Inflation	-	-	-	1.00%

Similar to PCA, IFS does not consider small, mid and large cap stocks to be distinct asset classes for modeling purposes (especially if divided further amongst core, value and growth) because, in our opinion, while these sub-sets of the total domestic equity market may perform differently over shorter time periods, the basic characteristics of risk, return and correlation among these three are not sufficiently distinct or fundamental to use different inputs in a long-term quantitative model. In addition, IFS' and PCA's assumptions for international equities cover both developed and emerging markets. While as a firm IFS does not develop assumptions for emerging market equities or high yield fixed income, it is not uncommon to do so and valid arguments are made for their being considered distinct asset classes.

IFS also has developed risk, return and correlation assumptions for hedge fund-of-funds, while many consultants do not. While we agree with the general argument that hedge funds are not a true separate asset class, we agree with PCA that it can be worthwhile to model them. Hedge funds are used primarily for either absolute return or portable alpha strategies.

3. MVO Analysis Performed by Independent Fiduciary Services

IFS performed a Mean Variance Optimization (MVO) analysis using our 2007 assumptions and produced sample efficient frontiers to evaluate the efficiency of LAFPPS' target asset allocation. We compared three portfolios to our model efficient frontiers (the newly approved 2007 target allocation (Portfolio A), the actual asset allocation as of January 1, 2007 (Portfolio B) and the previous asset allocation policy (Portfolio C)) and calculated the probability of these portfolios meeting the actuarial rate of return over various time periods. Our analysis is not intended to replace a full asset allocation study conducted by LAFPPS' consultant; it is provided primarily to demonstrate the sensitivity of MVO analysis in general and to raise issues for the Board to discuss.

We calculated three efficient frontiers using different constraints on our analysis (setting the minimum and maximum amounts allowed in a few asset classes). Efficient Frontier #1 has the loosest constraints (but does not add hedge funds), while Efficient Frontier #2 is arguably more realistic (still without hedge funds), and Efficient Frontier #3 adds hedge funds as an asset class into the mix. In Efficient Frontier #3 we set an additional constraint of no more than 25%

allocated to the total of real estate, hedge funds and private equity, due to liquidity concerns. Given the liquidity concerns associated with the private market assets, and as PCA did in their analysis, we used the current allocations to Alternatives and Real Estate as starting points. In Efficient Frontiers #2 and #3 we limited the amount allocated to Non-U.S. Equity to two-thirds of the amount allocated to U.S. Equity, which is in line with the current allocation. We show IFS' risk and return assumptions for 2007 along with the imposed constraints in the following table:

Table 3c-iv: IFS' Efficient Frontier Analysis Assumptions

			Eff. Frontier #1		Eff. Frontier #2		Eff. Frontier #3	
Asset Class	Expected Return	Expected Risk	Asset Min. %	Asset Max. %	Asset Min. %	Asset Max. %	Asset Min. %	Asset Max. %
U.S. Stocks	8.50%	16.75%	0%	100%	0%	100%	0%	100%
Int'l Stocks	8.75%	18.50%	0%	100%	0%	67% of US	0%	67% of US
Fixed Income	5.50%	5.25%	0%	100%	20%	100%	20%	100%
Real Estate	7.00%	10.50%	0%	15%	6.5%	12%	4%	12%
Private Equity	11.70%	30.00%	0%	15%	3.4%	12%	5%	12%
Hedge Funds	8.00%	8.50%	0%	0%	0%	0%	0%	10%
Cash	3.75%	1.00%	0%	5%	1%	3%	1%	3%

Using IFS' capital market assumptions, we calculate a projected nominal return of 8.53% for the new 2007 Target, with a risk of 11.88%, for a return/risk ratio of 0.72 (Portfolio A). This compares to the previous target where we calculate an 8.43% expected return, 11.73% standard deviation and 0.72 for return/risk (Portfolio C). The actual January 2007 asset allocation has an expected return of 8.13%, a standard deviation of 11.49% and a return/risk ratio of 0.71 (Portfolio B). LAFPPS should be able meet its actuarial return requirement of 8.0% on a nominal basis given our analysis, and on a real return basis after backing out the inflation assumption.

As can be seen in the graph below, the new target asset allocation (Portfolio A) lies on Efficient Frontier #2 and #3, while the previous target (Portfolio C) is also very close and both are closer than the actual asset allocation as of January 2007 (Portfolio B). The MVO model tends to favor asset classes such as real estate, private equity and hedge funds due to their lower correlation with publicly traded stocks and bonds and relatively high returns.

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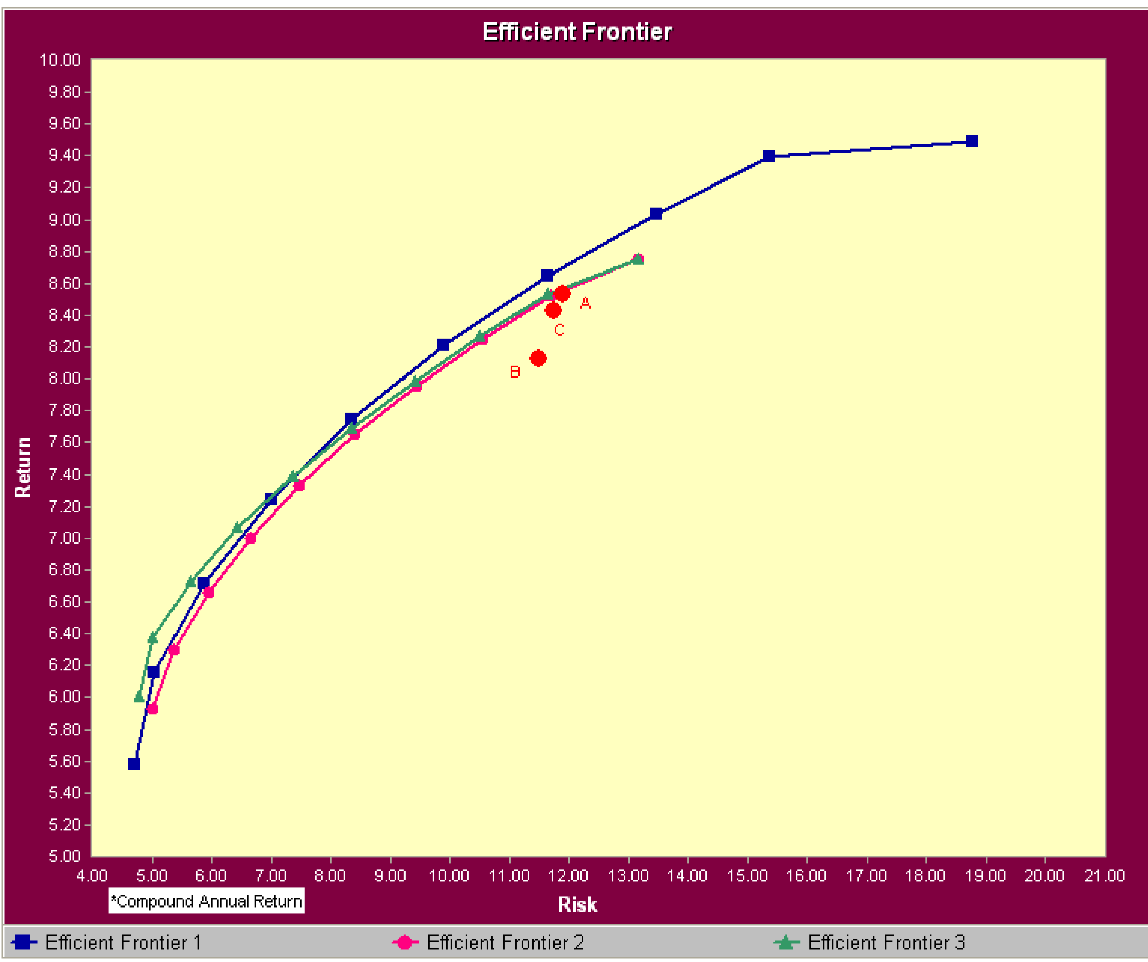


The tables below shows the return, risk (standard deviation) and the return/risk ratio for ten sample portfolios that lie on the three efficient frontiers in the above graph. Since the Target portfolios do not lie directly on the efficient frontier, other portfolios would offer a higher or equal rate of return at a lower risk level.

Similar to the analysis conducted by PCA, our analysis shows that the addition of hedge funds/absolute return strategies does not materially improve the potential return/risk ratio. For example, Portfolio 8 on Efficient Frontier #2 consists of 24% U.S. Equity, 16% International Equity, 12% Real Estate, 35% Fixed Income, 12% Private Equity and 1% Cash with an expected return of 8.25%, standard deviation of 10.5% and return/risk ratio of 0.78. This portfolio is markedly similar to Portfolio 8 on Efficient Frontier #3 with 23% U.S. Equity, 16% International Equity, 6.5% Real Estate, 35% Fixed Income, 12% Private Equity, 1% Cash and 6.5% Hedge Funds for an expected return of 8.27%, standard deviation of 10.5% and return/risk ratio of 0.79.

Table 3c-v: Efficient Frontier #1											
Asset Class	**2007 Target %**	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
Return	8.53	5.58	6.16	6.71	7.24	7.74	8.21	8.64	9.04	9.39	9.49
Risk	11.88	4.71	5.04	5.88	7.01	8.34	9.9	11.63	13.46	15.35	18.77
Return/Risk	0.72	1.18	1.22	1.14	1.03	0.93	0.83	0.74	0.67	0.61	0.51

Table 3c-vi: Efficient Frontier #2											
Asset Class	**2007 Target %**	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
Return	8.53	5.92	6.29	6.65	7.00	7.33	7.65	7.96	8.25	8.52	8.75
Risk	11.88	5.02	5.37	5.94	6.66	7.47	8.40	9.43	10.54	11.70	13.15
Return/Risk	0.72	1.18	1.17	1.12	1.05	0.98	0.91	0.84	0.78	0.73	0.67

Table 3c-vii: Efficient Frontier #3											
Asset Class	**2007 Target %**	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
Return	8.53	6.01	6.38	6.73	7.06	7.38	7.69	7.98	8.27	8.53	8.75
Risk	11.88	4.79	5.02	5.64	6.44	7.36	8.36	9.41	10.51	11.65	13.15
Return/Risk	0.72	1.25	1.27	1.19	1.10	1.00	0.92	0.85	0.79	0.73	0.67

Similar to the analysis performed by PCA, we believe that one useful way to look at the overall "risk" of LAFPPS' current asset allocation is to examine the probability of achieving (or not achieving) certain rates of expected return over short and longer-term periods.[22] As expected, the 2007 Target (Portfolio A below) has slightly better odds of achieving the desired actuarial return. As the table below shows, IFS' analysis indicates that LAFPPS' 2007 Target has a 77.4% probability of avoiding a negative return in any one year (or, conversely, a 22.6% probability of producing a negative return in any one year). Similarly, this analysis also indicates that LAFPPS' target asset allocation has a 55.2% probability of earning at least an 8.0% rate of return (the assumed actuarial rate of return) over ten years (or, conversely, a 44.8% probability of not earning the actuarial rate over ten years). The probabilities are set forth immediately below:

Table 3c-viii: Probabilities of Return						
	Portfolio A (2007 Target)		**Portfolio B (1/07 Allocation)**		**Portfolio C (Previous Target)**	
Consecutive Time Periods	**Probability of Return > 0.0%**	**Probability of Return > 8.00%**	**Probability of Return > 0.0%**	**Probability of Return > 8.00%**	**Probability of Return > 0.0%**	**Probability of Return > 8.00%**
1 Year	77.4%	51.2%	77.4%	49.7%	78.0%	50.9%
5 Years	95.8%	52.8%	95.7%	49.8%	96.0%	52.4%
10 Years	99.6%	55.2%	99.6%	50.8%	99.5%	54.1%

[22] This analysis uses Monte Carlo simulation to calculate the log normal median.

Therefore, the current target allocation does appear to be reasonable and as discussed above, LAFPPS appears to have used an appropriate process. It will take time, however, for LAFPPS to gain its target 10% exposure to private equity and real estates.

In addition, we used M[Cube]'s AlphaEngine® software to compare the historical performance and risks associated with the previous asset allocation policy (in place from 2004-2006) to the long-term policy target adopted in 2007. For the purpose of this analysis, the benchmark data for each of the sub-asset classes was used from 2001-2006, to evaluate the impact on performance and returns over the sample data period. We present a historical analysis of the two policy options, in order to highlight possible risks, but with no comment as to what may happen in the future.

Since the LAFPPS fund has benchmark misfit risk in many asset classes (as discussed previously, e.g., the U.S. Equity Benchmark is the Wilshire 5000, but the sub-asset class benchmarks are the S&P500 and Russell 2000; the same applies for International Equity and Fixed Income), we have conducted this analysis using the sub-asset class indices for the 2007 policy. Using the asset class benchmarks would give a different result and would require additional modeling of the Fund on an asset class basis for this comparison. A quick check suggests that the benchmark misfit risk for this period would have been on the order of 10 basis points (suggesting a higher return and lower volatility using the asset class data) so the general conclusions below are still validated.

Table 3c-ix

Performance Summary - Total Period

Name		Annualized Return	Annualized Standard Deviation	Annualized Return-Risk Ratio	Average Return when Positive	Average Return when Negative	Worst 'Single' Negative Performance	Longest Under-Performance	Recovery Period	Maximum Drawdown
Portfolio Decision										
LAFPPS 2007 Policy : LAFPPS 2007 Policy	BMK	8.41%	10.75%	0.78	4.59%	-4.66%	-10.35%	8	3	-15.94%
LAFFPS Fund : LAFFPS Fund	BMK	7.99%	11.42%	0.7	4.67%	-5.2%	-11.74%	9	4	-18.77%

Name		Maximum Drawdown Occurred On	Ratio of Good/ Bad Risk	Down Side Risk - 1%	Down Side Risk - 5%
Portfolio Decision					
LAFPPS 2007 Policy : LAFPPS 2007 Policy	BMK	09/30/2002	0.79	7.94%	4.96%
LAFFPS Fund : LAFFPS Fund	BMK	09/30/2002	0.68	8.22%	5.62%

Over the historical period, the 2007 benchmark portfolio (using the sub-asset class weights and indices) would have added about 42 basis points of additional returns relative to the policy portfolio implemented over the 2004-2006 period. Interestingly, the new 2007 portfolio has better risk characteristics across the board with lower volatility, lower drawdowns, single worst performance and even a better good risk/bad risk ratio. This helps to substantiate our belief that the 2007 policy asset allocation is reasonable.

4. Awareness of Risks

Principles

It is essential that a board understand the process used to develop the asset allocation recommendations and that the process is reasonable and fundamentally sound. A board should also be made aware of the risks involved with various asset classes and asset allocations and be comfortable with the capital market assumptions used. Education on the asset allocation process is especially necessary for lay board members. Ideally, investment programs seek a desired return objective while minimizing risk. Adding asset classes that are viewed as risky in isolation (e.g., private equity) can reduce the overall risk level of the total fund when combined with other low correlated asset classes. The appropriate level of risk varies by pension plan, asset class as well as investment strategy.

A board should also be aware of risks such as benchmark/style drift, standard deviation or volatility of returns, among others. There are also security specific types of risk for all securities such as illiquidity, often associated with appraised assets like private equity or real estate, and risks associated with derivatives. Individual manager guidelines are useful to articulate and manage the particular risks associated with each manager's unique investment process, strategy and risk characteristics. It is important to evaluate what kind of risk a fund has undertaken to take corrective action or to achieve maximized performance returns.

One of the most widely used methods to measure portfolio risk is calculating a fund's total standard deviation over a specific time frame or over rolling time periods. In essence, standard deviation measures the movement of returns over time, and it is one of the most common and easiest risk statistics to calculate.

As described above, asset allocation is the primary determinant of a fund's return (and risk) profile and deviation from the policy asset allocation results in tracking error risk. Once the asset allocation decision is determined and total expected absolute risk is quantified, the Board (with advice from its consultant and investment staff) makes portfolio structure decisions within each asset class, resulting in tracking error.

Risk budgeting is a tool to allocate tracking risk (sometimes referred to as the amount of active risk) effectively and efficiently across a fund's allowable asset classes and portfolios so that there is an increased probability of achieving positive relative returns compared to the given benchmark or policy index, and over the long-term, achieve the fund's investment policy investment objective of meeting or exceeding the fund's actuarial assumption within a prescribed level of total risk (the "risk budget"). The goal is to attempt to achieve the desired level of alpha (or excess return) at an appropriate level of volatility or risk.

Risks

If a board is unaware of the asset allocation process and the fund's risk, then they are less capable of approving an appropriate direction for the plan. A lack of understanding of the risks inherent in a portfolio increases the likelihood of mismanaging that risk and jeopardizing returns.

Observed Condition

It appears that in general the Board members are comfortable with the asset allocation and with the risks involved with their asset allocation. Investing in "alternative" strategies and financial instruments can be difficult for non-investment professionals to understand. Most Board members do not have an investment background, so it is important for them to receive regular investment related education.

In order to establish a risk (and return) framework around the Total Fund, LAFPPS' Policy Allocation has its associated Policy Benchmark. This benchmark is represented by a custom blend of indices which replicates total risk and return based on the allocation targets established in 2007. See also our recommendation regarding developing a risk management policy/procedure document to enhance LAFPPS' awareness of risks and how to deal with them in Section 3.e (Investment Policy).

The 2006 Asset Allocation Review looked at Total Fund risk primarily in terms of downside deviation and PCA's analysis showed an attempt to minimize downside risk versus achieving the required real return. As discussed above, LAFPPS' new Policy asset allocation has a fairly large allocation to "alternative" and private market assets which carry additional risks (e.g., illiquidity and sometimes higher volatility). While we acknowledge that asset allocation (MVO analysis) is part art versus science and the expected rate of return can not be targeted precisely, the Board has approved an asset allocation policy that targets an expected return slightly higher than is necessary to meet LAFPPS' actuarially assumed rate of return (which was reduced from 8.5% to 8.0% on a nominal basis and increased from 3.5% to 4.25% on a real return basis), and therefore taken on a slightly higher level of expected risk or volatility. In addition, see our analysis in Section C immediately above concerning the risk statistics associated with the previous and 2007 asset allocation policies.

The Board's quarterly performance report compares the actual asset allocation to the Target. The Total Fund Risk versus Return for the last five years is presented and compared to the Northern Trust Public Funds Universe and to core domestic equity and fixed income indices. For the period ending December 2006, LAFPPS had generated slightly more return than the median of its peers, but at a slightly higher level of risk. The quarterly report also shows a risk versus return graph and related risk statistics (standard deviation, downside risk, beta, etc.) for

each asset class and investment manager, where appropriate, e.g., domestic equity, international equity and fixed income.

See Task Area 3a (Performance) for IFS' calculation and discussion of LAFPPS' historical performance and risk over various time periods for the Total Fund and the various sub-asset classes.

Task Area 3c Recommendations 3-4
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.
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.

3d. Asset Allocation Process and Re-Balancing Process

Principles

Rebalancing is the process of re-adjusting the proportion of a portfolio invested in each of the major asset classes to within the permissible range around long-term targets. Over time, disciplined rebalancing can enhance performance and manage overall risk. A rebalancing program should be implemented and followed on a regular basis, e.g., monthly, quarterly, semi-annually, or annually.

Rebalancing ranges around long-term targets should be designed to ensure that asset allocation "drift" is controlled in a cost-effective way. The IPS should describe the process and timing for rebalancing. A fund may choose to rebalance only when an asset class exceeds its range, rebalance based on other market based hypotheses, or rebalance with a calendar based approach (e.g., rebalance to target every quarter, semi-annually or annually). Rebalancing more frequently can reduce tracking error to a fund's policy benchmark, but it will also create additional transaction costs.

The policy should also prescribe whether or not the asset class should be rebalanced to target, half-way to target or whether there is discretion. Rebalancing to the target, rather than half-way to the target, will also reduce tracking error but again the fund will likely incur slightly higher transaction costs during the rebalancing due to the additional amounts of security transactions.

Recent studies on rebalancing[23] have shown that the most important factor is having a rebalancing policy. Secondary to that decision is the policy itself. A more risk adverse board that wants to have minimal tracking error and is willing to incur slightly higher transaction costs might choose to rebalance at every month end. Alternatively, the Board might decide that it prefers to let an outperforming asset class run up to the outer bounds of its range and rebalance only when outside the range and perhaps rebalance only half-way to target.

Risks

The lack of an adequate documented rebalancing policy could lead to an improperly managed asset allocation and unrewarded risk. It could cause rebalancing to occur too frequently (incurring unnecessary transaction costs, especially in a very volatile market) or not frequently enough, which could lead to significant policy benchmark risk.

Overly frequent rebalancing may also occur if a policy range is too narrow or a target is set too close to the outer limit of a range. Therefore, a Board needs to consider its risk tolerance as well as the practical realities of implementing the rebalancing policy. Many retirement systems use cash flows to assist in their rebalancing to help minimize transaction costs.

Observed Condition

As mentioned previously, LAFPPS' IPS states, "Funds shall be rebalanced among asset classes when they are outside their target ranges or when they exceed the allocation target." As discussed in Section 3.e (IPS), the IPS does not outline what the rebalancing policy is. A memo from PCA to the Board on January 18, 2007 recommends a rebalancing policy and different ranges for the various asset allocation policy options are proposed. [We understand that this rebalancing was adopted by the Board on May 3, 2007.] LAFPPS staff performs rebalancing; staff worked out the ranges with PCA and acknowledge that they cannot rebalance alternative assets. Staff only takes action when an asset class/subclass is outside its range, and they will rebalance back to target depending on the dollar amounts involved. Staff looks at the asset balances weekly to determine if rebalancing is necessary.

PCA proposed the revised asset allocation policy targets and threshold ranges shown in the table below:

[23] See for example Nesbitt, Stephen, "Asset Mix Range and Rebalancing Policy," Wilshire Associates, May 31, 2001; and Masters, Seth J., "Is There a Better Way to Rebalance?" Alliance Bernstein, December 2003.

Table 3d-i: Asset Allocation Targets and Ranges			
	Targets	**Threshold Ranges**	
Asset Class	**2007 Allocation**	**Upper**	**Lower**
U.S. Stocks	35%	38.9%	31.2%
Non-U.S. Stocks	18%	19.8%	16.2%
Fixed Income	22%	23.7%	20.5%
Equity Real Estate	9%	10.1%	7.9%
Alternatives/Private Equity	10%	12.0%	8.0%
Absolute Return	5%	5.4%	4.6%
Cash	1%	3%	1.0%

The January 2007 rebalancing policy states that when actual allocations fall outside their target ranges, staff should rebalance "back to the mid-point between the end of the range that was exceeded and the target allocation. In no event will rebalancing occur more frequently than every three months." The policy goes on to address the priority for rebalancing:

1. Investing net contributions into asset classes that are below their range limitations;

2. Drawing cash flowing out of the portfolio (for benefit payments and expenses) from asset classes that are above their range limitations (using interest payments, rental revenues and dividends); and

3. Selling over weighted assets and/or buying underweighted assets.

In addition, managers are to be reallocated assets on an equal weighted basis, unless they are on probation. Staff is to report to the Board quarterly.

Overall, LAFPPS' rebalancing policy is reasonable and is in line with common practice among large public plans, although it could be potentially improved with SMART Rebalancing, as discussed below. In addition, in our opinion, some of the rebalancing ranges are fairly tight (e.g., a boundary of +/- 1.8% for international equity, +/- 1.65% for fixed income). Also real estate and alternatives are starting out well below the lower range of their rebalancing ranges and it will be some time before they could be in compliance with the policy, which contributes to the benchmark misfit risk discussed earlier in our Report. The addition of public REITs does add daily liquidity to the real estate portfolio and could be used for rebalancing needs. In addition, the Board should be aware of the potential risk that limiting rebalancing to no more than once every three months could cause the portfolio to be outside its policy ranges for a prolonged period and potentially exposing the assets to extreme market movements.

In order to test the effectiveness of the System's rebalancing policy quantitatively and retroactively, we used M[Cube]'s AlphaEngine® software to test a few scenarios. It should be noted that there are a couple elements of the LAFPPS portfolio that make it difficult to test rebalancing policies. For example, the asset class benchmark is different in many cases from the aggregate of the sub-asset class benchmarks and the sum of the maximums of the sub-asset class ranges exceeds the maximums of the asset class range. As a result, the rebalancing policy was tested on an asset class basis using the asset class benchmark indices for the 2007 Policy. Additionally, LAFPPS' current implementation policy is to rebalance portfolios back to the midpoint of the range if the range limit is breached. In a multi-asset portfolio, it is not possible to test such a policy as the implementation options are limitless. Therefore, to best approximate the actual rebalancing policy, the following rebalancing strategies were tested:

- Rebalance back to target using the following symmetric policy ranges:
  - 2007 Policy Ranges: USEQ +/-3.9%; NUSEQ = +/-1.8%; RE = +/-1.1%; Alternatives = +/-2%; Fixed Income = +/-1.7%; Hedge Funds = +/-0.4% and Cash +/-2%;
  - 2007 Volatility Based Ranges: Since the ranges for the asset classes are not currently related to the volatility of the asset class, we provide a simulation with the following volatility consistent ranges: USEQ +/-3.6%; NUSEQ = +/-3.6%; RE = +/-1.17%; Alternatives = +/-3.6%; Fixed Income = +/-0.8%; Hedge Funds = 1.65%, and Cash +/-0.36%. All ranges are calibrated based on the ratio of USEQ range to the asset class volatility or multiplying asset volatility by approximately 0.2.
- Annual rebalancing: Return assets to neutral at the end of every calendar year (since we are using quarterly data, it makes sense only to test policies with a lower frequency).

Table 3d-ii below provides a comparison of the performance and risks of the three rebalancing strategies using the historical benchmark returns data from 1997-2006 provided by the System[24], as well as a "SMART" strategy discussed in more detail below.

Of the three rebalancing strategies tested over the historical period, Volatility Based Rebalancing produces higher returns with higher turnover. However, the standard deviation of returns for all three rebalancing strategies are very similar to that of the benchmark volatility (10.7%). Worst single performance and Maximum Drawdown statistics are also very similar to

[24] Transactions costs assumed: 15 bps round trip for USEQ; 20 bps for NUSEQ and 10 bps for Fixed Income. All other assets assumed at 0.

that of the benchmark. The Success Ratio of the three rebalancing strategies is below 50% indicating that many quarters are negative.

What this suggests is that typical rebalancing policies do not improve the absolute risk profile of the Fund, but do keep tracking error low. The Maximum Drawdown measures the maximum decline in the percentage value of the Fund and what the analysis shows is that the Fund value declined by 15.55% in some period and rebalancing could not improve this risk.

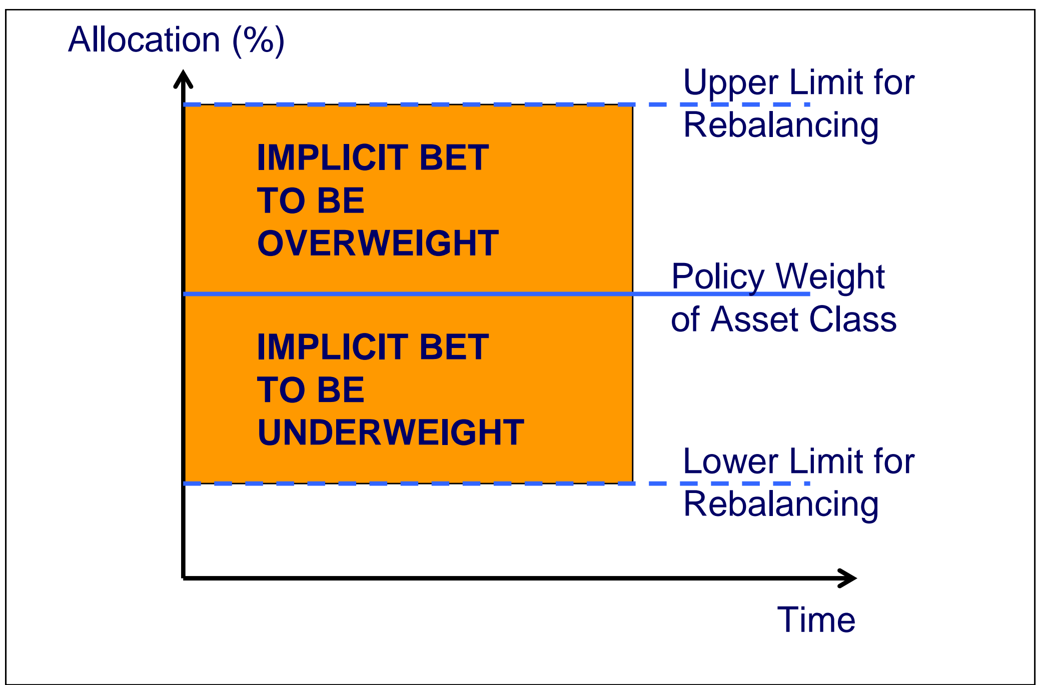
Table 3d-ii

Performance Summary - Total Period

Name		Annualized Return	Annualized Standard Deviation	Annualized Return-Risk Ratio	Worst 'Single' Negative Performance	Maximum Drawdown	Success Ratio	Annual Turnover
Strategy								
LAFPPS Range	BMK	10.29%	10.73%	0.96	-9.96%	-15.55%	N/A	N/A
	Strategy	10.25%	10.76%	0.95	-9.86%	-15.71%	N/A	N/A
	Excess	-0.04%	0.19%	-0.19	-0.36%	-1.43%	45%	3.94%
LAFPPS Yearly	BMK	10.29%	10.73%	0.96	-9.96%	-15.55%	N/A	N/A
	Strategy	10.24%	10.7%	0.96	-9.4%	-15.48%	N/A	N/A
	Excess	-0.05%	0.34%	-0.14	-0.52%	-1.79%	45%	3.15%
LAFPPS Vol Ranges	BMK	10.29%	10.73%	0.96	-9.96%	-15.55%	N/A	N/A
	Strategy	10.29%	10.71%	0.96	-9.96%	-15.51%	N/A	N/A
	Excess	0%	0.09%	0.02	-0.17%	-0.35%	35%	4.85%
LAFPPS Smart Rebal	BMK	10.29%	10.73%	0.96	-9.96%	-15.55%	N/A	N/A
	Strategy	10.47%	10.72%	0.98	-10.08%	-14.87%	N/A	N/A
	Excess	0.19%	0.32%	0.58	-0.31%	-0.55%	60%	7.38%

One of the reasons for this profile is that typical rebalancing policies often have an implicit bet embedded in them. As shown in the graphic below, when rebalancing policies are silent about what to do in the range, the Board or staff is effectively taking a bet to be overweight or underweight an asset class relative to a benchmark. Range based and calendar based rebalancing polices do not specify what do as long as the asset classes are within the ranges, resulting in "unmanaged" allocations or implicit bets. These bets are also not eliminated by rebalancing policies that suggest rebalancing back to the mid-point of the range.

Graph 3d-i



1. SMART Rebalancing Strategy

Under an approach termed SMART Rebalancing adopted by some other public pension plans in California, the policy ranges are set by the Board, and staff is delegated the responsibility to manage the allocations within the range using an analysis of current market factors. These market factors are converted into "Rules" to allow for a consistent application of economic analysis to evaluate the relative attractiveness of the assets in the portfolio – a process akin to the process used by LAFPPS' external managers. Hence, if the fund is overweight stocks in the range and a market analysis suggests that stocks are expensive, a rebalancing may be made prior to the range being hit. Many pension funds are often taking an implicit bet on markets when the portfolio is drifting within the range and the idea is to improve governance by managing the allocation decisions using a robust, repeatable and transparent process.

We tested SMART Rebalancing by using AlphaEngines® for a LAFPPS case study and used the typical valuation factors of price earnings ratios and dividend yields; macroeconomic factors such as the price of oil and slope of yield curves; as well as seasonality factors as to when markets do well or badly. These factors are used to make intelligent rebalancing decisions within the ranges across U.S. Stocks, Bonds, International Stocks and Cash. Therefore, SMART

Rebalancing can be compared to other rebalancing policies and typically results in better risk management and performance as other rebalancing policies have implicit bets embedded in them.

The last row in the Rebalancing Strategies performance table above shows performance statistics for SMART Rebalancing. Using the same historical data, this strategy added 19 basis points of annualized alpha, while keeping the tracking error (~0.3%) comparable to the other three more "traditional" rebalancing strategies. The volatility of this approach is similar to that of the benchmark, but the maximum drawdown is lower than that of the benchmark. The Information Ratio and Success ratio ("hit rate") are much higher in the SMART rebalancing case. Annual turnover is marginally higher, but this analysis incorporates transactions costs.

The charts below show that on a calendar basis, there are only two negative excess years with SMART rebalancing, whereas other rebalancing options have a higher number of negative excess years with greater volatility in excess during those years.

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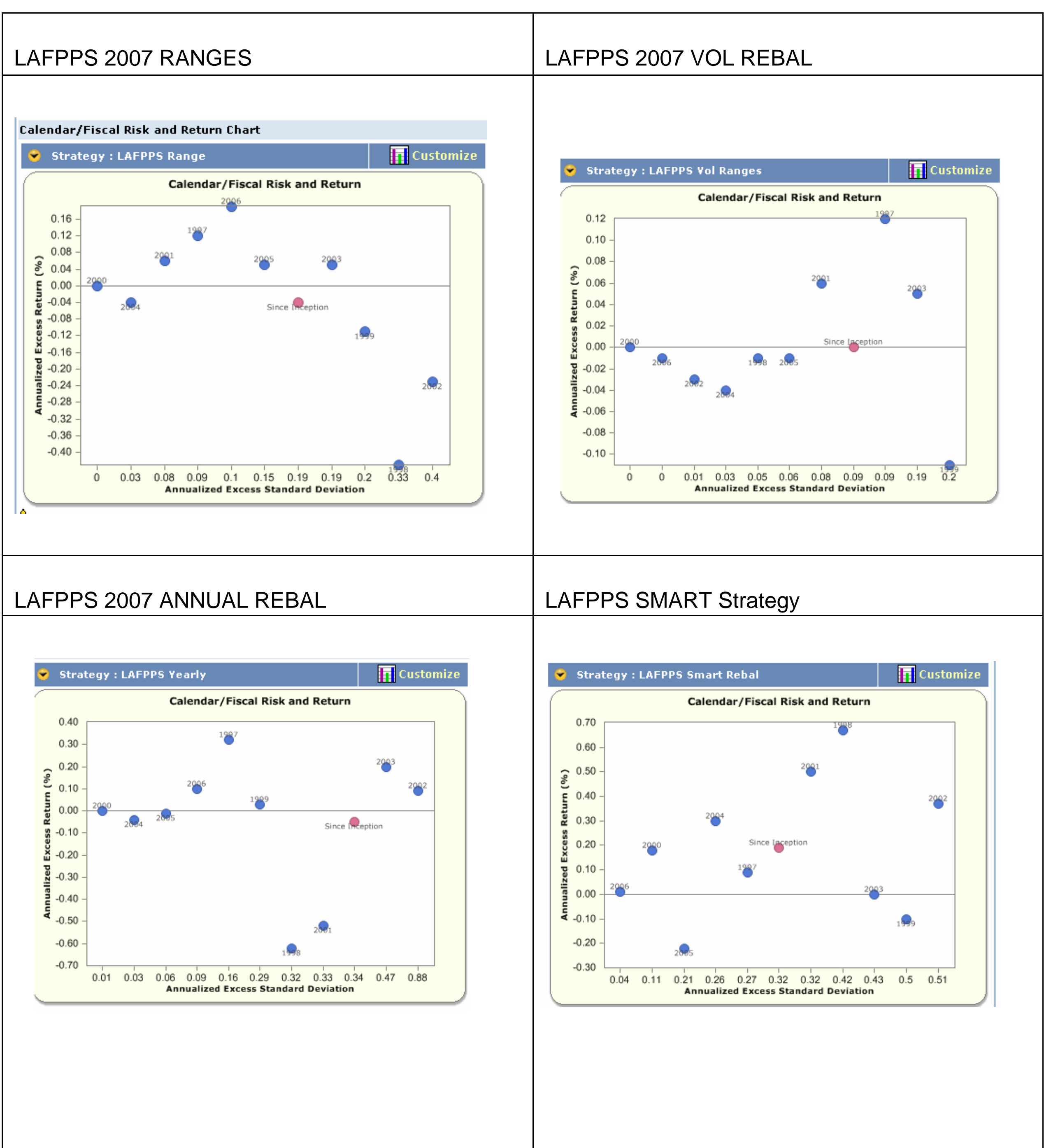
Graph 3d-ii



Overall, while we believe the rebalancing policy adopted by LAFPPS is reasonable and in line with current public fund common practices, as stated above; the Board and staff should consider adopting a SMART rebalancing strategy to add incremental value to the Fund and "convert implicit decisions into explicit decisions managing underweight and overweight positions of asset classes within the range (HOW MUCH) by evaluating the relative attractiveness of assets using market factors (WHY)."[25]

Task Area 3d Recommendation 1
The Board should consider adopting a SMART rebalancing strategy to rebalance the asset allocation.

3e. Investment Policy Statement (IPS) and Guidelines

1. LAFPPS Investment Policy Statement

Principles

A thorough and clear investment policy statement ("IPS") is an industry standard document that serves as a critical part of the foundation for the ongoing supervision and management of an investment program. The purpose of an IPS is to articulate the consensus view of the board regarding the overall investment program and to document policies and procedures regarding major issues (e.g., developing a long-term strategic asset allocation, selecting service providers and performing due diligence, monitoring performance and investing assets consistent with appropriate fiduciary standard).

An IPS formalizes the board's agreement on the framework from which to direct the investment program. The IPS should address the following elements:

- A fund's mission and purpose;
- A fund's investment objectives;
- A fund's risk tolerance, including the liquidity needs of the fund;
- The roles and responsibilities of essential parties, e.g., Board of Commissioners, staff, the investment consultant(s), investment managers, custodian and the decision-making process;

[25] Mcube Rules – April '07. Beta vs. Alpha Separation – The Beta Management Discussion.

- The long-term strategic asset allocation, including:
  - Specific targets and ranges for each asset class, and
  - The rebalancing process;
- Standards and measures of investment performance, including:
  - Benchmarks for each asset class and the fund as a whole;
  - The process for monitoring and evaluating performance of a fund and individual managers;
- Process for selection of external investment managers;
- Broad fund and asset class investment guidelines, including:
  - Permissible and impermissible asset classes, investment strategies and instruments;
  - Reasons and general parameters for each major asset class;
- Criteria and policies (or reference to separate policies and procedures) regarding specific miscellaneous subjects, including:
  - Securities lending,
  - Proxy voting, and
  - Brokerage practices; and
- A statement regarding the process for periodic review of the IPS.

Risks

The absence of a clear and complete IPS could cause a board, staff and service providers to act outside the determined policies of the board, which in turn could cause the fund to incur too much (or too little) investment risk or to not follow the board's policies in areas such as manager search, performance evaluation, etc.

Observed Condition

The City Charter Section 1106(d)(1) requires an Investment Policy Statement and specifies many of its component parts. LAFPPS' IPS is a compilation of individual Board investment policies specific to major topics and presented in the Governance Manual as Part III. Board Investment Policies. Although the format of the IPS is atypical due to its construction as a collection of underlying policies, we found the IPS to be fairly complete and to contain most of the essential elements described above. The IPS contains several unclear or inconsistent elements, perhaps due to its construction from an assortment of documents. We understand that the General Consultant and staff are in the process of reviewing the IPS to make revision recommendations to the Board.

The individual investment policies are collated into sections comprising the IPS and they are: the general IPS titled "investment guidelines," private equity investments, real estate strategic plan, real estate emerging manager, emerging manager, fund of hedge fund program investments, proxy guidelines, manager retention, marketing cessation, and securities litigation. We discuss the essential elements below and highlight any areas where we believe the IPS could be enhanced.

Task Area 3e Recommendation 1
The Board should perform a comprehensive review and edit of the IPS for consistency and clarity.

2. LAFPPS Mission and Purpose Statement

Principles

An IPS should discuss the mission and purpose of the fund (e.g., to accumulate funds exclusively for the benefit of its members and beneficiaries and to provide professional plan administration and sound investment practices). The IPS should also state the fiduciary standard of care to which the Board must adhere. (Please see earlier extensive discussion on fiduciary standards.)

Risk

It is important for a board to have a clear understanding of the fund's mission and purpose to avoid breaching their fiduciary duty.

Observed Condition

The IPS does not state the mission and purpose of LAFPPS. The City Charter Section 1106(a) states that the Board shall administer its "system for the following purposes:

1. to provide benefits to system participants and their beneficiaries and to assure prompt delivery of those benefits and related services;

2. to minimize City contributions; and

3. to defray the reasonable expenses of administering the system."

The IPS should include the City Charter description of LAFPPS' purpose, and in addition, we suggest that the mission and purpose section clarify that the LAFPPS includes two plans: the Pension Plan and the Health Benefits Subsidy Plan.

The IPS does not state the Board's fiduciary responsibility. According to the City Charter Section 1106(c) the Board is held to the prudent person standard. We believe that inserting an initial brief paragraph to document LAFPPS' mission and purpose and the Board's fiduciary responsibility would help frame the IPS.

The IPS does appropriately describe the purpose of the IPS itself as to establish:

1. Objectives for the investments of the LAFPPS;

2. Minimum diversification requirements; and

3. Criteria for investment performance evaluation.

Section 1.1 of the IPS references Sections 2.0-10.0 (covering emerging managers, manager retention, proxy, etc.) which are attached as sub-policies.

We understand that the General Consultant and staff are currently recommending revisions to this area of the IPS.

Task Area 3e Recommendation 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.

3. Total Fund Investment Objectives

Principle

It is necessary to establish clear Total Fund performance objectives, (e.g., earn a rate of return in excess of inflation, which meets or exceeds the fund's assumed actuarial rate and is consistent with the fund's long-term Policy Index), to help shape the entire investment program. Establishing objectives for each asset class and strategy likewise can help shape their nature and structure. Investment objectives should grow out of – and conform to – the investment horizon of the fund, its current and expected future cash flow needs and take into account liability considerations (namely, funded ratio and employer contributions).

Risk

Not designating the most appropriate investment objectives for a fund in the IPS could put a board at risk for not achieving the assumed actuarial rate of return, which could lead to under funding over the long-term. Investment objectives that are impractical and unachievable can lead to a misinformed evaluation of a fund's performance.

Observed Condition

The City Charter Section 1106(d)(1) states that the IPS "shall include at least the desired rate of return…" The LAFPPS IPS Section 1.2, Investment Objectives, states the following objectives for the Total Fund: (1) over a full market cycle (usually five to seven years), to earn a return on investments matching or exceeding the required actuarial rate of return and investment performance above the median of a sampling of public funds, (2) active managers should provide value added net of fees; active management returns should exceed the corresponding index net of fees by an amount commensurate with the risk incurred as well as the other standards set out in the IPS, Section 8.0 Manager Retention Policy; and (3) passive managers should produce index-like returns at low cost.

We believe that these overall goals are reasonable. Most funds seek to meet or exceed a nominal actuarial rate of return (e.g., 8%), and often cite beating the CPI by a certain percent as an additional goal. LAFPPS' return objective is not only established relative to the actuarial valuation (and therefore dependent upon the accuracy of that valuation), but also to the return of its peer group, which is a practical counterpoint. We note that comparing performance to that of a peer universe is imprecise, because other public funds will each have different asset allocations, although many funds do compare themselves to their peers. The IPS also does not address the intention to achieve total returns in excess of a specified policy index, which we believe is important to add.

In addition to the specific objectives concerning active and passive manager value added, we believe a sentence could be added regarding monitoring and controlling LAFPPS' investment costs in general.

As discussed below, the investment objectives should also be tied to a discussion on the risk tolerance of the Board, including liquidity needs and time horizon.

Task Area 3e Recommendations 3-4
The Board should include in the IPS the additional investment objective to achieve total returns in excess of the Policy Index.
The Board should include overall cost control as an objective in the IPS.

4. Risk Tolerance and Liquidity Needs

Principle

Risk measures attempt to quantify the likelihood of investment loss given an expected or desired level of return. Some risks can be quantified in a straightforward manner, e.g., a fixed income portfolio's sensitivity to changes in interest rates through measures such as duration; while other risks are more difficult to quantify, e.g., the impact of external shocks to the economy that could cause economic sector meltdowns, etc.

A fund's ultimate decision makers (i.e., the Board) should determine and specify what types and level of risk are acceptable and have an awareness of the risk level of the fund's asset allocation. Risk tolerance is also affected by the funded status of a plan, i.e., if a plan is underfunded and is willing to take greater risk to increase the funded level or if a plan's benefit payments exceed its contributions and it needs greater liquidity.

The decision should be based on the fund's:

- Demographics: average age and years of experience, active/inactive ratio, retiree liability to plan assets (i.e., duration of liabilities);
- Funded status: funded ratios, actuarial assumptions, etc.;
- Time horizon;
- Cash flow: positive or negative, timing of contributions, benefits schedule;
- Investment objectives;

- System tolerance for short-term losses versus the chance of long-term gains or tolerance for unpredictable returns;
- Board member's comfort with fund performance volatility; and
- Other concerns and ancillary goals such as a campaign to increase benefits.

Risk

Without a good understanding of the appropriate risk level of the fund, the Board risks setting an inefficient or overly risky policy in order to meet its return objectives.

Observed Condition

Although some of the asset class specific policies, such as Section 6.0 Fund of Hedge Fund Program Investments, include some description of risk parameters, other asset class risk parameters are not discussed. Additionally, Total Fund level risk and risk tolerance are not examined and discussed in the IPS. The IPS Section 1.5, Asset Allocation Plan, specifies an asset allocation with "an acceptable level of risk," without further discussion while Section 1.3 Diversification Requirements cites minimum and maximum percentages of investment allowed in specified asset classes, securities and investment managers. Diversification is one of many risk management tools, although we understand that some of the diversification requirements are language from the previous version of the City Charter, such as "a minimum of 20% of LAFPPS' assets shall be invested in fixed income assets." The City Charter Section 1106(d)(1) states that the IPS "shall include … acceptable levels of risk for each asset class."

We believe that a discussion on risk should be developed and included in the IPS to examine and document the Total Fund risk levels and the Board's risk tolerance, i.e., whether the Board is willing to accept above average market risk given its time horizon, or something similar. In developing its risk tolerance, the Board should take into account current and future cash flow needs for LAFPPS. Demographics, funded ratios and contribution rates are all discussed in LAFPPS' Annual Actuarial Valuation, but they are not discussed in the IPS. As LAFPPS continues to mature and the ratio of active participants to retirees continues to decline the need to use a greater portion of investment income to make benefit payments is likely to increase. The IPS should address the situation and how liquidity needs will change over time. The risk discussion should also address situations such as how a sustained period of negative returns could force LAFPPS to deviate from its asset allocation policy.

We believe that it would be helpful to expand or supplement LAFPPS' risk discussion with a more detailed practical policy/procedure document outlining exactly how "risk management" will be performed. This policy could include, for example:

- What metrics will be used to measure risk and how often they will be calculated;
- Table that compares/contrasts different risk metrics;
- Permitted financial instruments/strategies;
- How risk goals will be communicated to investment managers;
- Events that could trigger a review of risk management policies and procedures;
- Job description of staff member(s) assigned to risk management process;
- Risk management link to any incentive compensation plans; and
- How to benchmark against other public pension funds with respect to risk management best practices.

Task Area 3e Recommendations 5-7
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.
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.
The Board should consider developing a detailed practical risk management policy/procedure document.

5. Identification of Roles and Responsibilities

Principle

An IPS should outline the assignment of responsibilities and clearly distinguish the roles and responsibilities of the essential parties, i.e., the Board, investment staff, consultant and any other service providers.

Risk

Not delineating the roles and responsibilities of the Board and various staff members could create confusion. It is important to note what staff is permitted to do without Board approval versus Board approval being required, as well as the role of the consultant in the overall process.

Observed Condition

Some individual sections of the LAFPPS IPS address the roles of the parties relative to a particular asset class. For example, Section 6.0, Fund of Hedge Fund Program, includes Appendix 1 Designated Responsibilities and Tasks which thoroughly details the specific responsibilities of the Board, staff, manager selection consultant and performance consultant

relative to the hedge fund of funds program. (We note that Section 6.0 of the IPS requires revision to reflect the restructuring last year whereby LAFPPS now utilizes a general consultant, not a specialist manager selection consultant and a performance consultant.)

The IPS as a whole does not define the responsibilities of all of the distinct groups of individuals relative to all investment categories in detail and the standard of care applicable to each party is unclear. For example, we note that responsibility for investment manager compliance monitoring is not explicitly delegated. The City Charter Section 1106(d)(1) states that the IPS "shall include … guidelines for the delegation of authority." We believe that it can be useful to delineate specific roles and responsibilities of each party relative to each and all aspects of LAFPPS investment program, and such detail could be located in a distinct section of the IPS.

We understand that the General Consultant and staff are currently recommending revisions to this area of the IPS.

Task Area 3e Recommendations 8-9
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.
The Board should review and update all stated roles and responsibilities to reflect the restructuring of consultant responsibilities done last year.

6. Asset Allocation

Principle

Another fundamental purpose of an IPS is to establish a fund's long-term asset allocation policy. The targets for each asset class should be based on and generally consistent with the results of the most recent asset allocation and/or asset liability study. It should reflect the balance between the Board's risk tolerance (willingness to accept short-term volatility of returns and the possibility of negative total return over short periods) and the desire to achieve the fund's long-term investment objectives. To further control risk, a fund should also diversify within each asset class by style, capitalization, sector, etc.

Risk

Not stating the asset allocation targets or the requirements as to how often and how asset allocation studies should be conducted, could put a board at risk of giving up part of its control over the fund's asset allocation, which is known to be the primary determinant in a fund's performance.

Observed Condition

The IPS includes Section 1.5, Asset Allocation Plan, which specifies that the Board must adopt and implement an asset allocation plan (commonly called an asset allocation study) and that it be "reviewed" at least every five years. We suggest the language be changed so that the wording is explicit that the asset allocation plan be performed (not only reviewed) at least every five years. Section 1.5 also specifies that the asset allocation plan include or be based on an analysis of the actuarial liabilities of LAFPPS, and we discuss this in more detail in Task Area 3c (Asset Allocation).

The section also states that "conformance with the asset allocation shall be reviewed quarterly." Although reviewing actual asset allocation versus target weights on a quarterly basis is common practice as part of reviewing investment performance, Boards more commonly review the target asset allocation on an annual basis to decide if revisions are necessary.

The IPS acknowledges the importance of asset allocation in achieving LAFPPS' investment objectives; however the IPS does not directly state what the target asset allocation is and does not identify the selected asset classes. Ordinarily, an IPS outlines the target allocation and range for each of the asset classes (and sometimes sub-classes) or the IPS references the document as an attachment to the IPS.

See IFS' more detailed discussion on asset allocation in Task Area 3c (Asset Allocation).

Task Area 3e Recommendations 10-11
The Board should clarify the asset allocation review and monitoring process as distinct from performing the analysis and executing a new study.
The Board should require an annual review of the asset allocation and a complete asset allocation study at least every five years.

7. Rebalancing

Principle

An IPS should also define the rebalancing process. Rebalancing ranges around the long-term targets should be set up to ensure that asset allocation "drift" is minimized. When an asset class exceeds the range around the long-term target, the IPS should describe the process and timing for rebalancing and whether it is to the target or half-way. Over time, disciplined rebalancing may enhance performance and manage overall risk.

Risk

The lack of a rebalancing policy could cause rebalancing to occur too frequently (incurring unnecessary transition costs) or not frequently enough, which could lead to significant policy benchmark risk.

Observed Condition

The LAFPPS IPS states in Section 1.5, "Conformance with the asset allocation shall be reviewed quarterly. Funds shall be rebalanced among asset classes when they are outside their target ranges or when they exceed the allocation target." Otherwise, the IPS does not reference or identify a rebalancing policy, but a policy is outlined in a Pension Consulting Alliance memo to the Board dated January 18, 2007. The memo documents the permissible ranges around the major asset class policy weights and sub-asset class weights. The memo recommends that rebalancing be executed to a mid-point between the target allocation and range limit, be done no more than quarterly, and that staff report the activities to the Board on a quarterly basis. Additionally the policy prescribes a process to decide the order by which to pare and adjust assets.

We understand that the General Consultant and staff are currently recommending revisions to this area of the IPS. See additional discussion on rebalancing in Task Area 3d (Rebalancing).

8. Evaluation of Investment Performance

Principles

In addition to the overall investment objectives, an IPS should also establish the standards and measures of investment performance, including designating benchmarks which reflect performance expectations for each asset class and for the fund as a whole.

For the Total Fund, "best practices" suggest employing a Total Fund Policy Index and an Asset Allocation Index. Published market indices are weighted to create a "Policy Index" that matches a fund's long-term target asset allocation and the weights remain fixed over time, until those targets are changed. The Policy Index serves as an objective measure of Total Fund performance. Differences in performance between a fund's actual return and the Policy Index can be attributed to:

- asset allocation "drifts" from the long-term target,
- over or under-performance by LAFPPS' investment managers, and
- tactical decisions to overweight or underweight an asset class.

As an additional measure, many funds also (as a matter of policy) establish an "Asset Allocation" index. This also is constructed using published market benchmarks. In contrast to the Policy Index, the Asset Allocation Index's asset class weights change to reflect the actual asset allocation of a fund as it "drifts" or as tactical decisions are made to overweight or underweight an asset class. Therefore, this benchmark adjusts for the asset allocation drift over time. A fund's excess or under-performance versus the Asset Allocation Index is mainly attributable to the performance of the underlying investment managers (internal or external).

Risk

Not establishing appropriate standards and measures of investment performance for a fund in the IPS could put a Board at risk for not evaluating the performance correctly, and not structuring portfolios optimally.

Observed Condition

The LAFPPS IPS includes Section 1.12, Performance Monitoring, which requires that the Board compare its Total Fund return to that of other pension funds and the LAFPPS actuarial rate of return. The IPS also designates that an outside performance measurement firm provide a quarterly investment performance report.

The IPS designates a Policy Benchmark for each asset and sub-asset class, but does not establish a Total Fund level Policy Index or Asset Allocation Index, which we believe can serve as useful Total Fund benchmarks. We note that the quarterly performance report does include return comparison with a total fund Target Allocation Index (which we understand to be a Total Fund Policy Index). As described in the Principles section above, a policy benchmark and asset allocation index provide yardsticks from which to evaluate the Board's policy decisions (including strategy decisions and implementation decisions). Strategy decisions (e.g., deviations from the asset allocation targets) are evaluated by measuring the difference between the Asset Allocation Index and the Policy Index, while implementation decisions (manager selection) are evaluated by measuring the difference between the fund's actual return and the Asset Allocation Index. We note that reviewing performance attribution analytics can also help determine whether or not asset allocation or individual portfolio managers add value.

We find that the LAFPPS IPS does not specify reporting of performance metrics or characteristics for most asset classes, such as bond portfolio duration, quality and diversification. IPS Sections 2.6, Private Equity Investments Program Monitoring Evaluation, and 3.4.C., Performance Measurement Report, do provide satisfactory performance reporting requirements specifically for the private equity and real estate programs, including asset class benchmarks (but we note that the quarterly performance report provided by the general consultant and custodian

reports a different real estate benchmark than what is stated in the IPS, see Task Area 3b (Benchmarks) for further discussion).

Task Area 3e Recommendation 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.

9. Selection and Termination of Investment Managers

Principle

An IPS should designate who has primary and ultimate responsibility for the selection and subsequent termination of investment managers. The process for selection of investment managers is one of the fundamental decisions a Board must make in their fiduciary capacity. Therefore, it is important that a Board establish thorough and well documented procedures for implementation of the manager selection process.

Risk

The lack of an established policy on the selection (and termination) of investment managers could put the Board at risk of being inconsistent in its approach and not considering all of the best available managers for the strategy in question.

Observed Condition

We understand that the general investment consultant and the investment staff work together in conducting searches for investment advisors that they recommend to the Board. The IPS does not address the manager search process and due diligence. The IPS provides direction for the ongoing investment manager monitoring and termination process in Part 8.0, Manager Retention.

The IPS could be enhanced by providing detail on the process to be followed and/or referring to separate manager search policy documents.

We understand that the General Consultant and staff are currently recommending revisions to this area of the IPS.

Task Area 3e Recommendation 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.

10. Guidelines

Principles

Many institutional investors distinguish between investment policy provisions applicable to the fund as a whole from more particularized investment guidelines for individual portfolios and investment managers (internal and/or external). Consistent with those institutional investors, we believe investment manager guidelines should be separate and distinct from the IPS. The IPS should reflect broad policy provisions that apply to all managers for the portfolio as a whole and for broad asset classes. Examples of broad policy provisions would include minimum levels of diversification and securities or strategies that are prohibited across all accounts (e.g., non-dollar denominated stocks or bonds, hedging, below investment grade fixed income, derivatives, etc.).

By contrast, customized guidelines should be developed for each manager or account to articulate and manage the particular risks and performance expectations associated with the unique investment process, strategy and risk characteristics of each. These documents should be tailored to and agreed upon by the manager and the investment fiduciary (typically the Board or staff to whom they have delegated this function). (We discuss the individual investment guidelines in Task Area 3e and 3f.)

Risk

Constraints intended to apply to the entire pension fund or investment pool should be included in the IPS. The absence of individually tailored investment guidelines for the various investment managers would put the Board at risk of having investment managers who may take on undue risk and/or have style drift.

Observed Condition

LAFPPS IPS Section 1.4, Manager Account Restrictions, specifies that each stock and bond manager should have specific manager guidelines developed upon hire. IPS Sections 1.6 to 1.10 address asset class level guidelines, and Sections 2.0 through 6.0 address asset class level guidelines for private equity, real estate and hedge fund of funds investments. Each asset class guideline, including private equity, appropriately specifies the investment objective which includes a published benchmark and the authorized and prohibited securities.

We review individual manager guidelines in Task Area 3f (Compliance Monitoring).

11. Other Investment Related Policies

a. Proxy Voting Policy

Principles

Shareholders have the right and responsibility to vote proxies. Institutional shareholders and pension fund trustees were put on notice of the importance of proxy voting in February 1988 when the U.S. Department of Labor published a letter to Helmuth Fandl, Chairman of the Retirement Board of Avon Products. Known subsequently as the "Avon Letter," the DOL stated that proxies were plan assets that should be managed with the same care and prudence as other plan assets. Proxies could not be ignored and how they were voted mattered.

Public pension funds fulfill their proxy voting responsibilities in various ways. Most assign the responsibility to collect, evaluate, and vote proxies to their equity investment managers (with each manager responsible for the proxies associated with the holdings in the manager's portfolio). Some funds delegate proxy voting tasks to internal staff of the fund and provide their staff with sufficient resources to accomplish the job. An increasing number hire a "third party" specialist firm to collect, evaluate, and vote proxies, and they transfer that responsibility from the investment managers to the specialist firm. Regardless of how this responsibility is assigned, a Board must determine which party is responsible for setting the policies that will guide the fund's proxy voting program.

No matter what approach is employed to undertake the mechanics of proxy voting, board members retain the responsibility to set a policy that:

- Is motivated by an informed perspective on how shareholders can contribute to the governance of corporations;
- Anticipates many of the complex issues that populate the proxies of major corporations today; and
- Recognizes the differences between the accounting and corporate governance regimes in the United States and other countries.

Specifically, a comprehensive proxy voting policy should articulate the fund's philosophy on issues including:

- Election of directors and the balance between insiders and independent directors;
- Methods of shareholder voting, such as cumulative voting, confidential voting, and super-majority requirements;
- Opportunities for shareholder initiatives;
- Composition of the board and compensation of directors;
- Anti-takeover provisions;
- The role of the CEO on a company's board;
- Executive compensation, use of stock options, and performance standards;
- Expensing of stock options;
- Increases in the amount of common stock issued; and
- Reincorporation.

Among public pension funds, it is not uncommon for a fund's proxy voting policy to include positions on social issues such as:

- Corporate environmental practices, CERES Principles[26], and climate change;
- Production of tobacco products;
- Affirmative action in the workplace;
- Investment and business operations in Northern Ireland; and
- International labor standards.

The IPS should indicate who has responsibility for voting proxies. If investment managers are delegated the responsibility, the fund should establish a process by which voting can be monitored. The IPS should require periodic reporting of proxy voting (no less than annually) and it should indicate whether or not managers are permitted to "abstain" from voting on any issue or whether votes should be either "for" or "against." Manager voting reports to the board members should summarize each proxy issue and indicate whether the manager's vote was for or against management's recommendation. The Board needs to make sure that managers receive written guidelines established by the Board, if any, and adhere to them.

Best practices indicate that a fund's proxy voting policy should be written, specific with respect to the most frequent types of corporate governance resolutions, and regularly reviewed by the Board. To the extent that a fund has equity holdings in companies located outside of the United States, the fund should have a proxy voting policy that is tailored to the different issues that are presented to shareholders who invest in foreign companies.

[26] Created in 1989 by the Coalition for Environmentally Responsible Economies, the CERES Principles (formerly known as the Valdez Principles) are broad standards for evaluating corporate activity and useful for investors seeking to measure a corporation's commitment to sustainable environmental practices.

Risk

If a fund does not have a proxy voting policy, the Board may not be fully availing itself of its rights as shareholder and the Board risks inconsistent proxy votes. Relying on investment managers to vote proxies is an inexpensive and operationally easy approach for an institutional investor, although it does carry certain governance risks. First, each manager may have different policies on a given issue (like executive compensation, classified boards, and anti-takeover provisions) and these policies may be inconsistent with one another. Second, if two managers hold shares in the same company, the client's proxies may be voted differently on a resolution before that company's shareholders. Third, the managers are likely to report their proxy votes in different formats and time periods, making it difficult for the fund to consolidate, compare and review the totality of the fund's proxy votes. The evolution of institutional practices with respect to proxy voting has gone beyond reliance on investment managers.

Observed Condition

The IPS Section 7.0, Proxy Guidelines, provides detailed proxy voting instructions. The Proxy Guidelines specify that the Board delegates the voting of normally routine proxy solicitation matters to the General Manager. The General Manager is expected to bring exceptions to the attention of the Board.

We understand that LAFPPS has engaged ISS to vote proxies according to the Board's guidelines.

Task Area 3e Recommendation 14
The Board should update its IPS to reflect that a third-party specialist administers the proxy process in accordance with Board policy.

b. Securities Lending Policy

Principle

The IPS should indicate whether a pension fund is allowed to participate in a securities lending program, as well as the broad parameters of the program, e.g., collateral should have a market value of 102% for U.S. securities (105% for international securities) and be marked to market daily. The IPS should reference separate guidelines for the investment of securities lending collateral.

Risk

The absence of criteria for securities lending increases the risk of the Board's either not employing a lending program, allowing participation in a sub-optimal securities lending program, or not adequately structuring or monitoring whatever they do adopt in that regard. Inadequate structure or monitoring in turn may produce undue risk or sacrifice available returns.

Observed Condition

The IPS addresses securities lending in Section 1.11 and provides appropriate collateral parameters. A more detailed IFS discussion of the securities lending policy can be found in Task Area 3h (Custody).

c. Brokerage Policy

Principle

The IPS should acknowledge that brokerage commissions are a plan expense and that, as such, the Board will monitor them, if necessary, with the assistance of an outside investment consultant. The IPS should indicate external managers are obligated to seek best execution (i.e., best trade based on share price, commission, available research, etc.) on all trades.

Ideally, the IPS should also specify policies on soft-dollar, directed brokerage and/or commission recapture arrangements, which constitute plan assets, if any, and it should establish a process by which the board members will monitor the fund's investment manager brokerage commission activity and practices.[27]

Risk

By not documenting any brokerage policies in the IPS, the Board risks incurring unnecessary trading costs or managers not operating in accordance with their wishes.

Observed Condition

LAFPPS' IPS addresses trading and brokerage practices in Section 1.13. The policy specifies that all trading should be done on a best execution basis and includes the general guideline on brokerage commissions as "9 cents per share, or less," which is a very high limit for

[27] "Soft dollars and commission rebates generated by investment managers through trading activities are plan assets, and both plan sponsors and investment managers have fiduciary responsibilities regarding their prudent management and oversight as they do with other plan assets." U.S. Department of Labor Employee Benefits Security Administration *Report of the Working Group on Soft Dollars/Commission Recapture*, November 13, 1997.

domestic equities (as discussed further in Task Area 3e (Transaction Costs)). Selection of brokerage firms is delegated to the investment managers provided they "use a variety of, and subject to best execution, shall use Los Angeles based brokers when feasible."

We advise that the IPS require investment managers to submit an annual report on brokerage activity to staff, in particular a report on brokerage commissions. Additionally, we suggest that the Policy include discussion of directed commissions/brokerage and soft dollar usage.

We discuss how LAFPPS measures transaction costs in Task Area 5 (Investment Transaction Costs).

Task Area 3e Recommendations 15-16
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.
The Board should require managers to submit an annual report on brokerage activity to staff.

d. Securities Litigation Policy

Principles

Securities class action litigation affects investment returns and an organized approach to securities class action litigation can potentially recoup material value by affording the opportunity to recover losses resulting from the wrongful actions of a company in which pension fund assets are or were invested. An IPS should also specify whether or not the system considers legal claims to be plan assets; the Department of Labor (DOL) views securities class action claims as plan assets. Since the claims are plan assets, DOL has advised ERISA funds that trustees have *an affirmative duty to determine whether it would be in the best interest of plan participants to become actively involved* in securities litigation, and a duty to take reasonable steps to realize on claims.[28] DOL's reasoning was based on common law trust principles. The trustees' duties extend to actively monitoring situations where "the activities of the plan alone, or together with other shareholders, are likely to enhance the value of the plan's investment, after taking into account the costs involved."[29] This analysis is critical because pursuing securities litigation as an active plaintiff, either by separate lawsuit or by serving as a lead plaintiff, imposes fiduciary responsibility to other class members (in the case of lead plaintiff status) and requires significant resources in terms of time, expenses, and effort.

[28] DOL *amicus* brief submitted in *Bragdon* v. *Telxon Corp.* 98 Civ. 2876 (N.D. Ohio April 28, 1999).
[29] Interpretive Bulletins Relating to ERISA, 59 Fed. Reg. 38,860, 38,860-61(1994).

Although public pension funds are not subject to ERISA, most are governed by fiduciary standards that are similar, if not identical, to ERISA principles. It is probable that courts will take ERISA principles into account when construing whether public pension fund board members have an affirmative duty regarding securities class action claims. Consequently, it is advisable for public pension fund board members to address how they are going to meet their fiduciary responsibility in this area.

To address its fiduciary responsibility, and to take reasonable steps to identify and recover securities class action claims, a Board should adopt a formal securities class action litigation policy. The policy should (a) acknowledge that securities class action claims, arising out of misdeeds which caused losses to the pension fund, are plan assets and therefore the board members have a fiduciary duty to take reasonable, cost-effective, steps to identify, analyze, pursue, and collect securities class action claims; (b) identify the objectives of the board in pursuing securities litigation; (c) set forth the evaluation and monitoring process that will be used; (d) identify a minimum loss threshold; and (e) define the roles and authority of the key parties in the process.

Risk

Not documenting any securities class action litigation policies in the IPS would put the Board at risk of not participating in class action law suits and receiving compensation owed to it.

Observed Condition

IPS Section 10.0 describes the LAFPPS policy regarding securities litigation. This policy discusses in general terms the reasons for securities class action litigation, the need for a lead plaintiff and the financial risks associated with being a lead plaintiff. For further discussion of securities litigation see Task Area 2a.

e. Private Equity and Real Estate Policies

Principles

Assets that are relatively illiquid and not traded on an exchange that provides objective, readily ascertainable prices are often known as "appraised assets." Such assets – including real estate and private equity – pose special risks, distinct from publicly traded securities.

Risk

Because of these special risks, investors in appraised assets should adopt distinct investment policies and procedures to help structure and manage their portfolios of real estate and private equity.

Observed Condition

As noted above, the LAFPPS IPS includes distinct and detailed policies for Private Equity (Section 2.0), real estate (Section 3.0) and Hedge Fund of Funds (Section 6.0), which is an appropriate practice. We note that the real estate (Section 3.0) policy states an asset class benchmark of the NCREIF Property Index (NPI) plus 250 basis points, but LAFPPS currently uses the NPI plus 1.0% according to the Fund.

f. Investment Policy Review Policy and Process

Principles

To ensure that the Board and staff are aware of the IPS and to ensure that an IPS remains current, the industry standard requires a periodic (at least annual) review of the IPS.

Risk

Over time, the IPS may not reflect the Board's actual policies and goals. Out-of-date language could lead to confusion regarding the investment policy.

Observed Condition

The City Charter Section 1160(d)(1) states "At least annually, the board shall review the IPS and change or reaffirm it. After the annual review, the board shall forward the statement to the Mayor and Council for informational purposes." The LAFPPS IPS is a collection of underlying policies, and most of the component policies include a requirement for annual Board review, although each policy has a different date trigger. We understand from our interviews that the IPS was reviewed by the Board during January and February this year, and further revision currently is underway by the General Consultant and staff, and their initial recommendations are being considered by the Board. Some of the underlying policies require review "as necessary." These are Sections 4.0, Real Estate Emerging Manager; 5.0, Emerging Manager; 7.0, Proxy Guidelines; 8.0, Manager Retention; and 10.0, Securities Litigation.

3f. Compliance with Investment Guidelines and Monitoring

Principles

New information continuously enters the financial markets and a market somewhere in the world is always open. Security prices can fluctuate rapidly and significant amounts of volatility or "noise" cloud our ability to determine true or "intrinsic" investment value. Faced with this uncertainty, it is by no means an easy matter to separate the contribution made by an investment manager's style, skill and luck. Institutional investors must employ sophisticated techniques to control and monitor the performance of their investment managers to unravel the interplay of risk, returns, and costs in the portfolios they hold.

Regardless of the size or complexity of a fund's investment program, thorough and comprehensive monitoring of investment managers is widely considered to be essential. Many institutional investors rely on their general investment consultant to perform much of this task, with the Board receiving periodic reports on manager performance. Others have fund staff deeply involved in the process. Some combination of staff and consultant review is the approach most commonly pursued by major funds. No matter who performs the monitoring function, these are the fundamentals:

- **Investment performance**: Track holdings; account for cash flows and transactions; calculate periodic investment rates of return; compare returns to appropriate benchmarks, and rank in a universe of peer managers.

- **Investment risks**: Based on portfolio holdings, evaluate portfolio characteristics such as price/earnings, price/book, dividend yield, earnings growth ratios (for equity) and maturity, duration, yield, convexity (for fixed income); observe how portfolio holdings are distributed among sectors and industries; calculate measures of volatility for the portfolio; compare characteristics, diversification and volatility to that of an appropriate benchmark and manager peer group. Estimate the role of investment style in the manager's returns (if relevant to the investment structure of the fund). Apply sophisticated portfolio analytic systems to estimate the risk of the portfolio on a forward looking basis (such as estimated tracking error).

- **Compliance**: Compare individual holdings within a portfolio to the guidelines set for the manager to determine if there are any holdings that lie outside of the permitted securities for the account. Confirm that the account is consistent with any portfolio-wide requirements established by the guidelines. Identify any variances and investigate further. Transactions and portfolios should be analyzed

to determine whether pre- or post-trade compliance is preferred. Managers should have tools to provide the preferred method.

- **Periodic, in-depth review of managers**: Review long-term performance in light of the risks incurred by the manager; estimate the sources of return in a manager's portfolio and compare to the fund's expectations (attribution). Meet with the manager's key personnel to discuss results and strategy; make site visit if possible. Confirm organizational details, such as key investment personnel, sufficiency of resources, growth of business, trading and proxy practices.

Best practices require investment performance reporting to be done by someone that is independent of the investment managers. The regular quarterly performance report (routinely provided by the consultant) should clearly and concisely summarize the essential factors, which should be analyzed and interpreted for the Board (by a combination of the consultant and fund staff), culminating in a recommendation about whether to retain or replace a manager. Effective monitoring has two benefits: it helps the fund fiduciary make good decisions, and it also signals to the manager that the fund is serious about performance and compliance.

Best practices also include regular checks of the extent to which investment managers comply with the guidelines given to the managers.

Risks

Regular, comprehensive portfolio and investment manager monitoring is essential to prudent management of a fund's assets. The absence of clear reports that provide sufficient information to monitor managers can put a Board at risk for not making sound decisions about investment performance, manager skill and diversification.

Insufficient guidelines and infrequent guideline monitoring opens the possibility of excessive portfolio risk, prohibited investment positions, and inadequate performance.

Observed Condition

Monitoring Policies

LAFPPS IPS Section 8.0, Manager Retention, clearly spells out many key requirements for monitoring and maintaining investment managers, such as requiring an annual review of each manager. IPS Section 1.12 specifies quarterly performance monitoring metrics, which focus on return targets (risk metrics and policy are discussed in Task Area 3e (Investment Policy Statement)). IPS Section 8.0 specifies a "watch list" process and includes factors to analyze before deciding to terminate a manager, such as additional performance analytics, reviews of the

investment management staff who establish investment strategy and a review of the loss of clients and the addition of new business at the investment management firm.

The policy does not spell out the investment manager guideline compliance monitoring process, does not identify the parties responsible for monitoring guideline compliance, and does not provide for a method of documenting the ongoing monitoring activity. We believe that these activities need to be documented and included in the IPS.

Monitoring Practices

The Board receives a quarterly performance report prepared by the custodian with input from the General Consultant, based upon performance measurement data supplied by the Custodian and the Real Estate Consultant. The Real Estate Consultant also provides a quarterly report for the Board. The General Consultant and staff review LAFPPS' quarterly performance with the Board.

We understand that, in practice, staff has responsibility for monitoring each investment manager's adherence to their investment guidelines. Recently, LAFPPS has engaged the custodian bank's "Compliance Analyst" portfolio monitoring software to flag guideline violations. The system emails a daily report which flags any violations to four staff members. Some reported "violations" are false alarms: often a security out on loan will trigger a "short" violation. Someone on staff will check the violation reports every few weeks, but who does it varies because no one individual is specifically responsible.

Task Area 3f Recommendation 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.

1. Investment Manager Guidelines

Principle

Pension fund "best practices" generally indicate that to manage investment risk properly at the individual manager level separate customized investment guidelines should be developed and provided to each investment manager. Guidelines are essential for monitoring, measuring and analyzing portfolio performance, risk, and structure relative to the objectives.

Such guidelines are typically drafted by a fund's investment consultant and/or staff and incorporated into the manager's contract, in order to hold the manager legally responsible to comply. Investment managers should be allowed to provide input into the draft guidelines to assure they are appropriate without unduly limiting the manager's ability to manage according to its style and earn a rate of return at or above the appropriate benchmark.

Guidelines should define the style of investment management employed by the manager and identify specific metrics (such as performance expectations as well as other portfolio characteristics) by which the fiduciaries (staff and/or Board) can determine whether the manager is doing what the manager was hired to do. Overall equity and fixed income guidelines should generally include, among other items:

- Investment strategy of the portfolio;
- Investment objectives, including the style specific performance benchmark and other expectations regarding performance (e.g., perform in the top half of a designated universe);
- Limits on the amount that any manager can hold of the securities of a single corporate issuer (typically 5% for other than activist investors);
- Limits on the percentage portfolio weight in any one security (again, other than for activist investors);
- A requirement that the portfolio's holdings within industry sectors be limited to an amount specified in writing, pursuant to a system of industry classification to be agreed upon between the fund and each equity manager;
- Expectations regarding certain portfolio characteristics (e.g., capitalization);
- Maximum amount allowed in cash and/or whether the manager can equitize cash;
- Whether, and the extent to which, hedging is allowed in international portfolios;
- Prohibitions on use of certain securities, such as certain types of derivatives;
- Prohibitions on margin transactions or any borrowing of money;
- Any trading directions, including requirement for best execution;
- Fiduciary standard of care;

- Proxy voting directions (e.g., whether the investment manager should vote them, reporting requirements, etc.);

- Action required for breach of guidelines;

- Requirement to maintain fiduciary liability insurance (often in the contract); and

- Communication and reporting requirements (including requirement to report organizational changes at the firm or material changes in investment philosophy or strategy).

In most cases, these principles apply equally to internal investment managers.

Risk

Inadequate guidelines could potentially allow an investment manager to invest assets in accordance with a strategy other than that it was engaged to pursue, possibly causing the portfolio to take on different risk and structural characteristics than desired by a fund and result in misunderstanding by the Board, staff, investment consultant and investment manager.

Observed Condition

The LAFPPS IPS includes high level guidelines per asset class and also requires that each manager have individually tailored guidelines. We understand that staff drafts the guidelines with input from the investment manager, and upon request the General Consultant may provide input. As per the scope of work, we reviewed a set of representative investment manager guidelines to determine whether they contain all the necessary elements. In general, we found that the guidelines contained many of the essential elements listed above. The individual guidelines that we reviewed appropriately contain each of the following sections:

- Authorized investments;
- Limitations on percentage held in any one issuer; and
- Short sales or margin restrictions.

In addition we reviewed the Alliance Capital, Marvin & Palmer, and LM Capital contracts. We found that the contracts included several items that are sometimes included in guidelines:

- A direct statement of the applicable fiduciary standard of care;

- Insurance requirements;
- Proxy direction (e.g., whether the investment manager should vote them; included in the active manager's contract);
- The requirement to report on "significant events," but not including guideline violations; and
- Requirement to reconcile with the custodian bank.

We believe that the guidelines would be improved with the addition of:

- Reporting requirements: A description of the standardized reporting and including the required reporting for guideline violations;
- Consistently specifying a performance objective benchmark;
- Performance objectives could also address volatility: e.g., in terms of tracking error or in terms of standard deviation of returns compared to that of the index; and
- Contact information for manager disclosures.

We believe several items should be included in each manager's guidelines, even if such items are also outlined in the manager's contract; such items include: the fiduciary standard of care, proxy voting direction and the required action for guideline violations.

Some of the individual guidelines contain an introduction summarizing the manager's mandate, but some guidelines only specify the investment mandate in the title (e.g., the Magten Asset Management guidelines do not provide an introductory description of the mandate).

Most of the guidelines specify a maximum limit on cash from 10-15% after the initial funding of a mandate has been completed. This is a high level of permitted cash for most manager styles. The more typical cash maximum is 5% of the account after the initial funding of a mandate has been completed, unless the manager's style requires more cash flexibility.

A performance objective is not specified in every guideline. For example, Attucks guidelines specify the Russell 2000 as a performance standard, but the Frontier Capital, Marvin & Palmer and Magten guidelines do not specify any performance objectives.

Another area where we believe the guidelines could be enhanced is in their monitoring of certain investment risks. This would require setting standards for and evaluating portfolio characteristics such as price/earnings, price/book and beta (for equity) or duration (for fixed income) and comparing them to the stated benchmark's characteristics.

- We note that the LM Capital guidelines specify a weighted average portfolio duration to be maintained between two and eight years with no limit on

individual securities durations. In this case we recommend that the duration bands be relative to the benchmark, not absolute.

We note that LM Capital guidelines state one benchmark, yet the performance reports detail a different benchmark.

The FIS and Attucks guidelines each specify investing in emerging managers and define such managers as "a firm with less than $2 billion under management." The Emerging Manager Policy within the IPS defines emerging managers as firms with less than $500 million under management. See Task Area 3e (Investment Policy Statement) for further discussion and recommendation regarding consistency of documentation.

Task Area 3f Recommendations 2-3
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.
Staff should reconcile the emerging manager program managers' guidelines with the Emerging Manager Policy.

3g. Investment Management Structure

Overview

"Investment management structure" relates to the following:

- The allocation of fund assets to various styles within an asset class and any biases that may exist (e.g., in terms of capitalization or value vs. growth); thus, it is separate and distinct from asset allocation;

- The number of managers used and whether they are invested in separate or pooled/commingled accounts;

- The use of active and passive strategies; and

- The use of internal versus external asset management.

Principles

Generally, the proper allocation to various investment managers is guided by the Policy Benchmark for the asset class in question.

- For example, if a fund's equity policy benchmark is the Wilshire 5000 Index, a fund's manager allocations would typically be done in such a way that the overall exposure to different "styles" would be roughly similar to the Wilshire 5000 Index.
  - Thus, if the Wilshire 5000 Index consisted of 80% large cap stocks and 20% small to mid cap stocks, a benchmark driven investment structure would have roughly those same percentage allocations.
  - Similarly, if the Wilshire 5000 Index consisted of 60% growth stocks and 40% value stocks, a benchmark driven investment structure would have roughly those same percentage allocations.

"Best practices" suggest that a fund should use enough investment managers to achieve proper diversification in the asset classes in which it has chosen to invest. Generally, a fund should seek a mix of equity, fixed income and other managers, (separate accounts and/or commingled funds) with complementary styles (as opposed to duplicative styles):

- Complementary styles increase overall diversification.
- Duplicative styles can create administrative burdens, increase investment management costs and potentially detract from overall diversification.
- The number of managers required should be tied to the asset allocation.

Generally, a fund should have the number and variety of investment managers necessary to achieve the fund's stated investment objective and to control risk while incurring reasonable costs.

Risks

An investment structure which is significantly different from the policy benchmark introduces the risk of a "bias" or "bet" both to and away from another style within that benchmark.

Too few or too many managers can be problematic. Having too few managers can cause a fund to bear unnecessary risks, such as lack of diversification and organizational risk (i.e., if a fund has a large amount of assets invested with one organization and that manager has problems). On the other hand, too many managers can result in higher overall investment management fees; multiple managers with similar styles can actually cause a fund to lose the benefits of active management by becoming too index like overall; and a large number of managers increases the complexity of due diligence and monitoring. Using too many managers also may unnecessarily increase custody fees and transaction costs.

Observed Condition

Total Fund

We compare the number of managers used by LAFPPS for publicly traded asset classes to the average number of managers used by public funds over $5 billion and by all funds, as reported in the 2006 Greenwich Associates survey, in Table 3g-i below. Given this survey information, the number of managers employed by LAFPPS appears to be on the high side for each class. We discuss each asset class separately in the narrative below.

Table 3g-i: Number of Investment Managers

Asset Class	LAFPPS	2006 Greenwich Associates Survey Public Funds over $5 billion	2006 Greenwich Associates Survey All Funds
U.S. Stocks	9	7.7	5.3
International Stocks	7	6.0	3.0
Fixed Income	8	5.1	2.9
Total	**24**	**18.9**	**11.2**

1. Domestic Equity Structure

Background

Most large institutional investors seek to structure and maintain a broadly diversified domestic equity portfolio. The Wilshire 5000 Index and the Russell 3000 Index are the two most commonly used broad market policy indices for domestic equity. The Wilshire 5000 and Russell 3000 Indices represent approximately 100% and 98% of the entire U.S. equity market capitalization. S&P also publishes the S&P 1500 Index which is not quite as inclusive as the Wilshire and Russell Indices. More broadly diversified equity portfolios generally offer less volatility of returns than portfolios "concentrated" in one style or capitalization.

Principle

Institutional investors should seek to structure a broadly diversified domestic equity portfolio in an effort to maximize expected return while lowering risk.

Risk

An investment structure which is significantly different from the equity policy benchmark introduces the risk of a "bias" or "bet" both to and away from another style within that benchmark:

- An "overweight" to any one style (e.g., overweight to large-cap or growth) must also include an "underweight" in another style (e.g., underweight to small cap or to value) relative to the overall equity benchmark.

- The result of the above is a "bet" that the overweight style will outperform the underweight styles.

Historical analysis suggests that styles come into and out of favor over time, with no one style consistently outperforming others.

- Therefore, a bias to any style can introduce added "risk" (i.e., likelihood of performance that varies significantly from the policy benchmark).

- Thus, a "style neutral" approach is often sought.

Observed Condition

LAFPPS has a diversified domestic equity program. On a manager allocation basis, the portfolio has a slight bias toward small cap managers when compared to the broad market and does not appear to have any mid-cap managers, although some small cap and large cap managers have the tendency to "drift" into the mid-cap space. The large cap portion of the portfolio appears to have a bias to value managers while the small cap portion has a growth bias. As of December 31, 2006, LAFPPS was slightly overweight its policy targets to both large cap (30.1% vs. 28.0%) and small cap (7.9% vs. 7.0%); this is due primarily to the fact that the allocations to private equity and real estate have not yet been fully funded. The domestic equity structure is outlined in the table below.

Table 3g-ii: Domestic Equity Structure as of December 31, 2006			
Manager	**Product Style**	**% of Total Fund**	**% of Asset Class**
Alliance Capital	S&P 500 Index	19.1%	50.2%
Boston Partners	Large Cap Value	2.8%	7.4%
Delta Asset Mgmt	Large Cap Core/Growth	2.9%	7.7%
FIS Group Mgr of Mgrs	All Cap	0.9%	2.3%
TCW – Value	Large Cap Value	2.4%	6.4%
TCW - Growth	Large Cap Growth	2.0%	5.2%
Total Large Cap		***30.1%%***	***79.2%***
Daruma Asset Mgmt	Small Cap Value	2.8%	7.3%
Frontier Capital Mgmt	Small Cap Growth	4.8%	12.5%
Attucks Mgr of Mgrs	Small Cap	0.4%	1.1%
Total Small Cap		***7.9%***	***20.8%***
Total Domestic Equity		**38.0%**	**100.0%**

Within the domestic equity structure, IFS analyzed each equity manager's holdings in order to verify the true equity investment style of each manager. The analytical tool we used is a "holdings-based" style analysis that assigns a range of growth-value and large-small metric scores to each stock held in each portfolio and for the portfolio as a whole based on the specific characteristics of each stock (see Exhibit C for our analysis as of December 31, 2006). As can be seen in the style map, the total domestic equity composite plots fairly close to the Wilshire 5000 Index (LAFPPS' domestic equity policy benchmark), with a slight growth and small cap bias. This is likely due in part to the fact that a couple of the value managers plot in the growth quadrants (both TCW Large Cap Value and Daruma Asset Management).

To analyze this asset class further, using LAFPPS' equity holdings as of December 31, 2006, we compared the total combined equity portfolio to the Wilshire 5000 Index (the Policy benchmark) in terms of style and capitalization and show them in the bar graphs and tables below:

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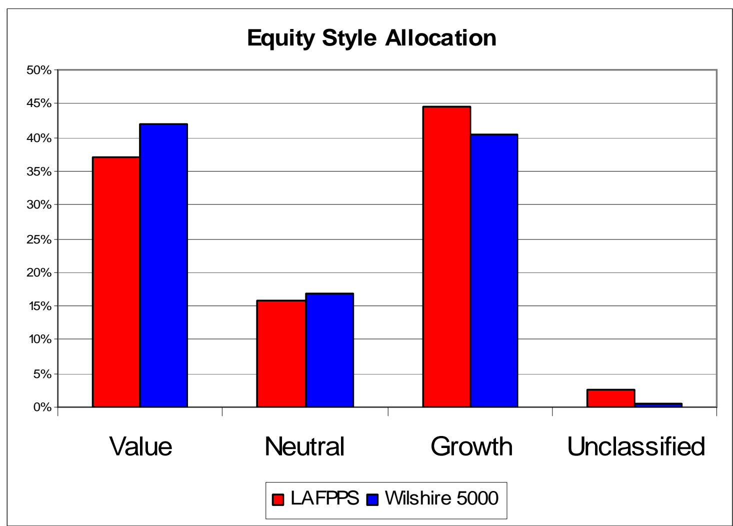

Table 3g-iii: Domestic Equity Style Comparison		
	LAFPPS	**Wilshire 5000**
Value	37.1%	42.1%
Neutral	15.9%	16.8%
Growth	44.6%	40.5%
Unclassified	2.5%	0.6%

As shown in the graph and table above, from a value-growth perspective, the total domestic equity portfolio has a slight growth bias (or conversely it is underweight value) when compared to the Wilshire 5000. In addition, as shown in the graphs and table below, on a holdings basis, the domestic equity composite is slightly underweight large and mid-cap stocks and has a small cap bias versus the Wilshire 5000. Versus the Wilshire 5000, LAFPPS is overweight small cap growth (9.6% vs. 4.7%) and neutral (2.4% vs. 1.8%), but slightly underweight small cap value (3.3% vs. 4.1%). This is in line with the manager allocations shown above. On the large cap side, LAFPPS' large cap growth allocation is in line with the benchmark, while the large value (30.2% vs. 32.6%) and large neutral (11.3% vs. 12.8%) are slightly underweight as are all segments of the mid-cap market.

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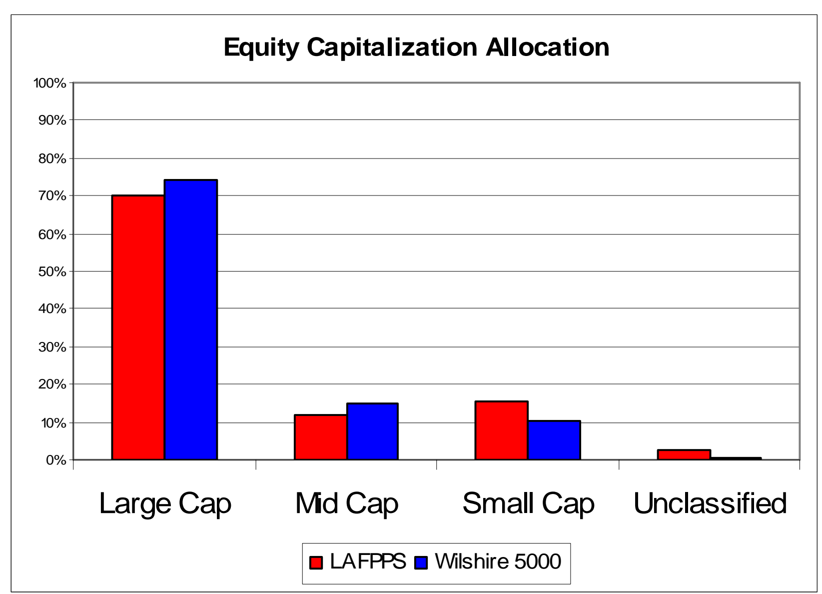

Table 3g-iv: Domestic Equity Capitalization Comparison		
	LAFPPS	**Wilshire 3000**
Large Cap	70.0%	74.0%
Mid Cap	12.1%	14.9%
Small Cap	15.3%	10.6%
Unclassified	2.5%	0.5%

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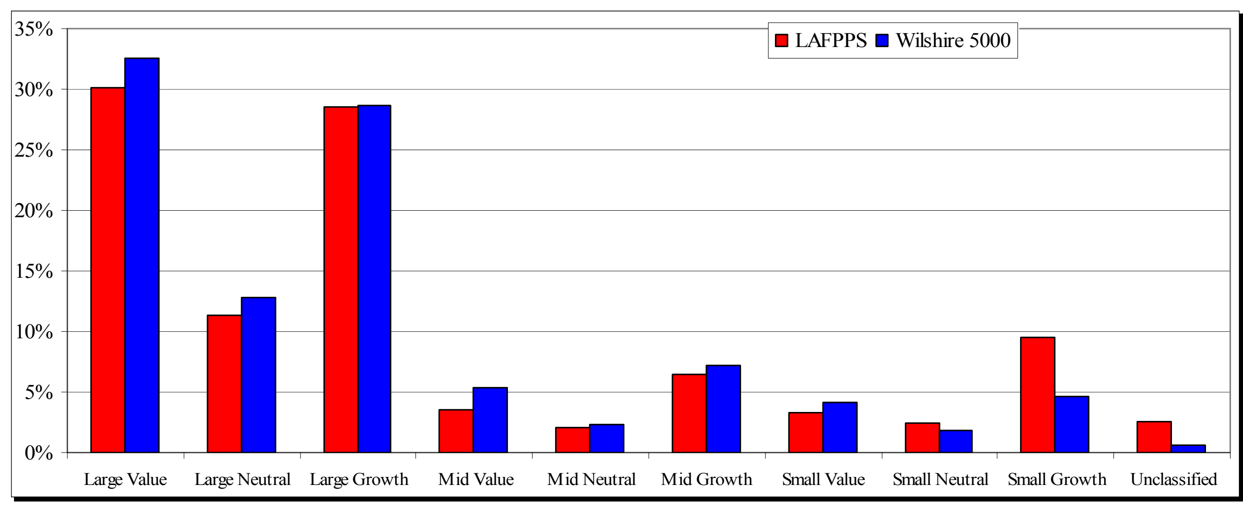
Total Equity Allocation



We believe that it is useful to perform this type of analysis as a "reality check" to confirm that the managers and investment structure are doing what they are supposed to be doing. The Northern Trust quarterly reports to the Board present a similar style map analysis.

We also reviewed the Domestic Equity Structure Review prepared by PCA in August 2003. In PCA's report, they discussed how large vs. small and value vs. growth factors could have a significant impact on performance and that historical style bias had been a major "risk driver."

We believe that it can be reasonable to take style and/or capitalization "bets" as long as the Board is kept informed of any potential risks and is aware that their portfolio looks different from the broad market. Despite the fact that the small cap managers as a group have lagged their benchmark over the trailing five years, the small cap overweight has likely helped the overall performance of the domestic equity composite. The Board should be aware that this is a "trend" that may not continue and active managers should be judged versus their peers as well as their benchmark (see also our discussion on Performance in Task Area 3a).

With regard to the number of domestic equity managers, as shown in Table 3g-i in the earlier section, LAFPPS has slightly more managers than the average large public fund (9 vs. 7.7); however, over 50% of the portfolio is allocated to one index manager so that LAFPPS may be able to trim redundant strategies, resulting in possible fee savings (see our discussion on fees in Task Area 5). Given LAFPPS' use of fund-of-fund managers (FIS and Attucks) to gain exposure to emerging managers, in addition to the normal diversified "slate" of managers, it will have a larger number of domestic equity managers than other comparable public funds.

In addition, given the number of underperforming managers in the large cap arena and the Board's approval of the foray into absolute return strategies, LAFPPS may want to consider using additional passive/index management for large cap equity with a portable alpha overlay of absolute return strategies. PCA's 2006 Asset Allocation Review recommended allocating a minimum of 5% to absolute return strategies and stated they should "gather information on Portable Alpha approaches before making a final decision." As discussed in Section 3b on asset allocation, absolute return/hedge fund strategies do not materially change the return/risk expectations so that the Board may want to consider a portable alpha overlay program in large cap domestic equity rather than a specific allocation to hedge funds as an asset class. The concept is based on the belief that the domestic, large-cap equity market is too efficient to generate attractive net returns above the index.

Portable alpha strategies have become widely available and fairly straightforward to implement using S&P 500 futures or swaps and hedge fund-of-funds with very low betas. This strategy, although innovative, is quickly gaining significant popularity. According to a recent JPMorgan Asset Management survey of 118 pension funds, 24% have implemented at least one portable alpha portfolio and 31% are considering using the strategy. According to the 2005-2006 Russell Investment Group Survey on Alternative Investing by institutional investors, 23% currently use portable alpha and 44% are considering using it.[30]

Task Area 3g Recommendations 1-3
The Board should continue to monitor its style and capitalization biases.
The Board should work with its consultant to determine if it can reduce the number of domestic equity managers.
The Board should consider implementing its absolute return allocation through a portable alpha program in the large cap equity area.

2. International Equity Structure

Principle

International equity exposure provides increased return opportunities and reduces total risk by diversifying the equity program. Additionally, investing beyond developed international equity markets into emerging markets expands the opportunity set even further. Although emerging markets have historically been more volatile, their addition to a pension fund can improve its overall risk/return prospects.

[30] Pensions & Investments, "Slaking the thirst for portable alpha" Crain Communications: November 14, 2005.

Risk

Funds that exclude international equity exposure risk missing certain return opportunities and the benefits of risk reduction through diversification.

Observed Condition

In the table below, we outline LAFPPS' international equity structure as of December 31, 2006.

Table 3g-v: International Equity Structure as of December 31, 2006

Manager	Product Style	% of Total Fund	% of Asset Class
Brandes Midcap	EAFE Midcap	1.0%	4.2%
Fisher Foreign Equity	EAFE	3.4%	14.1%
Julius Baer	EAFE	3.8%	16.0%
McKinley Capital Mgmt	EAFE	3.6%	15.1%
Brandes Invest Partners	EAFE	9.1%	37.8%
Total Developed Markets		***21.0%***	***87.2%***
Marvin & Palmer	Emerging Markets	1.6%	6.6%
Principal Capital Mgmt	Emerging Markets	1.5%	6.1%
Total Emerging		***3.1%***	***12.8%***
Total International Equity		**24.1%**	**100.0%**

LAFPPS appears to have a fairly neutral weighting to emerging markets when compared to the broad international equity market (as represented by the MSCI ACWI ex-U.S.) on a manager allocation basis. LAFPPS' weight of 12.8% to emerging markets managers is fairly equal to that of the MSCI ACWI ex-U.S. weight of approximately 13%, which includes most, but not all, emerging markets. However, the amount actually allocated to emerging markets is greater than this in total due to the broad mandates of most of the EAFE managers[31] and this aggregate number does not appear to be tracked on an ongoing basis.

PCA conducted a review of the International Equity asset class in December 2003. At that time, the allocation was 12% to Broad International and 2% to Emerging Markets (86% and 15% of the non-U.S. equity allocation, respectively). While the total amount invested in international equity has increased since then, the proportion invested in emerging markets has been slightly reduced. In addition, emerging markets now make up slightly more of the total international equity market than they did a few years ago.

[31] For example, Brandes is allowed to invest up to 20% in Emerging Market countries in both of its portfolios, Fisher is allowed up to 10% and Julius Baer up to 20%.

When compared to other large public funds, LAFPPS has slightly more accounts (seven versus six, as reported by Greenwich Associates – one manager (Brandes) manages two different strategies). LAFPPS does have four managers with similar EAFE mandates, however, so there may be the opportunity for consolidation and possible fee savings. We acknowledge that the number of emerging markets managers was reduced from three to two after the 2003 Review, but the number of broad market managers was increased in 2004.

Task Area 3g Recommendation 4
The Board should continue to work with its consultant to determine if it can reduce the number of international equity managers over time.

3. Fixed Income Structure

Principle

A well formulated fixed income structure includes diversified exposure by sector, credit, and maturity. Increasingly, pension funds have expanded their investments beyond the domestic core fixed income market to include dollar denominated international fixed income, high yield debt as well as other types of securities (e.g., bank loans).

Risk

An undiversified fixed income portfolio could expose a pension fund to unnecessary risks.

Observed Condition

In Table 3g-vi below, we outline LAFPPS' fixed income structure as of December 31, 2006.

Table 3g-vi: Fixed Income Structure as of December 31, 2006

Manager	Product Style	% of Total Fund	% of Asset Class
Northern Trust	Core Bond Index	4.6%	18.2%
LM Capital Mgmt	Core Plus	1.4%	5.5%
Reams Asset Mgmt	Core Plus	3.7%	14.9%
Bridgewater	TIPS	1.4%	5.5%
Western Asset Mgmt	TIPS	2.6%	10.4%

Table 3g-vi: Fixed Income Structure as of December 31, 2006

Manager	Product Style	% of Total Fund	% of Asset Class
Loomis Sayles	Long Duration	6.9%	27.7%
Equitable CCMF	California Mortgages	0.1%	0.4%
Total Core/Core plus		***20.7%***	***82.6%***
Mackay Shields (Magten)[32]	High Yield	0.2%	0.6%
Mackay Shields	High Yield	4.2%	16.8%
Total High Yield		***4.4%***	***17.4%***
Total Fixed Income		**25.0%**	**100.0%**

As can be seen in the above table, the majority of LAFPPS' fixed income exposure is to a combination of core (passive) and core plus (benchmarked to the Lehman Aggregate + 1%) mandates, with additional sizable mandates to TIPS, long duration and high yield and a very small allocation to a California mortgage fund. The resulting fixed income structure is quite different from the broad indices, such as the Lehman Universal, leading to "benchmark risk." For example, high yield makes up only 6.32% of the Universal as of the end of 2006. TIPS are not included in the Universal, and are treated by many as a separate asset class due to their unique characteristics and the fact that they respond differently to economic phenomena than nominal bonds. Although TIPS did not perform well in 2006, they act as a diversifier to other forms of fixed income and provide a hedge against inflation. The additional high yield exposure should increase the return potential of the portfolio and the long duration component should help the fixed income portfolio better match the liabilities of LAFPPS. Therefore, while the portfolio appears sound and well diversified, it will likely not track the broad market indices closely over all time periods.

PCA conducted a review of the fixed income program in March 2004. This review provided background on the asset class, including TIPS, which were added to the portfolio in 2005. PCA recommended changing the asset class benchmark to the Lehman Universal and also commented on the large number of core managers. Since that study, the number of core and high yield managers has been reduced, although two new TIPS managers have been added. Overall, LAFPPS still has a relatively large number of fixed income managers when compared to other large public funds (8 versus 5+, according to Greenwich Associates) although we do not believe the number of managers used is unreasonable, given the structure of the program. However, there may be some opportunity for consolidation of mandates and fee savings since there are multiple managers in a couple categories (TIPS and Core plus) and Equitable CCMF has such a small allocation that it will not have a material impact on the performance of the portfolio.

[32] This is a legacy account formerly managed by Magten, which is being liquidated.

Task Area 3g Recommendation 5

The Board should continue to work with its consultant to determine if it can reduce the number of fixed income managers over time.

4. Real Estate

Principle

There are several different investment vehicles available for investment in equity real estate:

- publicly traded REITs,
- limited partnerships (open-end as well as closed-end funds) and
- direct investment through separate accounts.

A well diversified real estate structure includes diversified exposure by geographic region and property type. A real estate program can also pursue different strategies such as:

- *Core:* a more conservative strategy generally invested in fully developed, fully leased properties that provide a bond-like return and a degree of inflation protection.
- *Value-add:* a slightly riskier strategy where the properties tend to be those that can significantly benefit from upgrading, such as combinations of physical renovation and improvement as well as aggressive leasing activities. Increased value is generated through capitalization of the higher rent rolls.
- *Opportunistic:* these investments tend to be more developmentally oriented and thus riskier than core or than value-add. Typical investments include land development or redevelopment, conversion to different use, major rebuilding and similar investments that add value to a property prior to achieving a capitalized rent roll.

Risk

Real estate investments are much more illiquid (except in the form of REITs) than the publicly traded asset classes. Non-core real estate funds often have multi-year lock-ups so are more illiquid than core funds. Open-end real estate funds may also not be immediately liquid.

Real estate valuation data is generally appraisal based (appraisals are generally performed annually or bi-annually with quarterly updates) so that current true market values are not readily available.

Observed Condition

As of December 31, 2006, real estate made up approximately 6.8% of the Total Fund. LAFPPS has a long-term target of 9.0% (by 2009) to this asset class. As of the time of our due diligence, portfolio structure information was available as of September 30, 2006 and is shown in the table below (as per The Townsend Group):

Table 3g-vii: Real Estate Portfolio Structure			
	Allocation Guidelines	Funded Investments 9/30/2006	Funded Investments & Unfunded Commitments 9/30/2006
Core			
Stable	**≥ 35%**	**29%**	**25%**
Public Equities	**≤15%**	**25%**	**20%**
Non-Core	**≤50%**	**45%**	**54%**
Enhanced		*31%*	*30%*
High Return		*13%*	*19%*
International		*2%*	*5%*
		100%	**100%**

LAFPPS' 2006 Investment Plan prepared by The Townsend Group states that they will temporarily over allocate toward the Non-Core portfolio until pricing of Stable properties becomes more attractive. The REIT portion of the portfolio was funded in 2006 up to the maximum of the target level in dollar terms so it is now over its policy threshold in percentage terms since the pace of funding for stable and non-core commingled funds did not meet the initial expectations. REITS tend to be more highly correlated with publicly traded equities and do not offer as significant diversification benefits, although they can be useful to gain exposure quickly to the asset class with lower transaction costs and higher liquidity. On a property type and property location level, the LAFPPS portfolio is well diversified with strategic over/ underweights versus the NCREIF Property Index.

LAFPPS is invested in three different types of real estate investments: separate accounts (or IMAs), pooled funds and public REITs. Townsend became the consultant for this asset class in 2005 and has been restructuring the program away from IMAs, so that they will only use

separate accounts for core investments and commingled vehicles for non-core investments. Separate accounts, especially non-discretionary accounts, require an increased amount of administrative time with the additional monitoring and due diligence required on the part of staff and the Board. In addition, there is added risk for a program the size of LAFPPS since single property investments can have a large impact on the total portfolio. Since the Board is restricted in granting discretionary investment authority to the IMAs, we believe that the Board should consider focusing the real estate program on commingled funds/limited partnerships going forward. Given the current market environment, it makes sense for LAFPPS to maintain its separate account exposure to core investments; however, as they slowly phase out, they could be replaced with pooled funds in lieu of future investments through the IMAs.

Task Area 3g Recommendation 6
The Board should consider focusing the real estate program on commingled fund/limited partnership investment vehicles going forward.

5. Alternative Investments – Private Equity

Principle

Alternative investments (e.g., private equity) have become a common component of diversified institutional portfolios and are typically structured as limited partnerships. The fund is a limited partner and the organizer/manager is a general partner, who typically has a stake in the investment.

Alternative investments can also be pursued through fund-of-funds managers, who create portfolios of different partnerships on behalf of investors. This reduces the extent of investor research and due diligence, but adds an additional layer of fees.

Risk

Innovative or non-traditional investment strategies may have higher individual variability, liquidity, and investment risks than traditional publicly traded stocks and bonds, and therefore need a higher level of scrutiny and should be monitored regularly.

Observed Condition

As of December 31, 2006, 3.4% of the Total Fund was invested in alternative investments through four different portfolios (note: PCA has resigned as a consultant for private equity, Portfolio Advisors has left the business, and Hamilton Lane's contract has expired).

Table 3g-viii: Alternative Investment Managers		
	% of Asset Class	**% of Total Fund**
Abbott Capital	31.6%	1.1%
Hamilton Lane	33.4%	1.1%
Portfolio Advisors	18.8%	0.6%
PCA	16.2%	0.6%
Total	**100%**	**3.4%**

Despite the fact that LAFPPS is underweight its Policy target of 10%, it has a fairly mature private equity program. PCA did a review of the entire program in January 2007, which showed the following structure:

Allocation by Market Value:

- 57% Buyouts
- 27% Venture capital
- 11% Special situation
- 2% Mezzanine
- 3% Diversified

For comparison, the 2006 Greenwich Associates survey provides the average style specific private equity asset mix for endowments only:

- 23.1% Venture Capital
- 32.7% Buyout funds
- 1.2% Mezzanine funds
- 4.3% Distressed debt
- 15.7% Natural resources
- 0.9% Secondary private equity
- 12.9% International private equity
- 0.6% Multi-strategy funds
- 2.1% Other
- 6.5% Fund-of-funds

The combined portfolio also has broad industry diversification and a sizable non-U.S. position at 18%. At the time of this report, LAFPPS was invested in 145 partnerships across 76 firms with commitments ranging in size from $1.25 million to $25 million for an average of $7.5 million per partnership. In our experience, this is a large number of partnerships with a relatively small average commitment level for a fund the size of LAFPPS. A large number of partnerships

also increases monitoring responsibilities. In order to increase its funding to the Policy allocation target of 10%, LAFPPS will need to increase the pace of its commitments and should consider increasing the average size of commitments.

The future structure of the private equity program was uncertain as of the writing of this report, since the Board had not decided how many private equity managers/consultants to retain and whether to do so on a discretionary or non-discretionary basis. The use of multiple consultants in the core area could result in duplicative investments and higher fees (see also our discussion on fees in Task Area 5). If more than one consultant is ultimately retained, we believe that it is important for one entity to oversee, and report on the performance of, the entire program to ensure it is meeting the goals and desires of the Board and that there is not unnecessary overlap. In addition, using multiple consultants or managers to invest in more limited partnerships at a smaller average commitment level would likely stretch staff resources with the required ongoing monitoring and due diligence for a large number of partnerships. Allowing the consultant(s) full discretion or "discretion-in-a-box" alleviates the administrative burden somewhat and allows the consultant to proceed with deals more quickly, lessening the likelihood that LAFPPS would be excluded from a partnership due to timing reasons.

Task Area 3g Recommendation 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.

As noted earlier in this section, LAFPPS has also made the decision to invest in absolute return strategies, but this had not been funded at the time we did our interviews.

6. Use of Active vs. Passive

Background

The debate among investment academics, practitioners and investors regarding whether active or passive portfolio investing is more effective has raged unsettled since the concept first arose. It is unlikely that a provable conclusion will ever be reached, but the question, when juxtaposed against particular portfolio objectives and risk preferences, is a valid one. The concept of passive investing was created as a result of the development of indexes – sets of securities assembled for the purpose of generating a standard measure of market performance. Passive investing is the practice of creating and maintaining a portfolio that duplicates or replicates a given index. Changes in mix and relative weights of securities in the portfolio are made only when the same changes are made in the index. Active investing is any investment

strategy in which securities are selected in an attempt to achieve a higher investment return than the benchmark/index.

The debate centers on whether active management can achieve a more attractive long term net return after costs than passive management. Passive management is clearly capable of achieving a return very close to the return of an index, with a very small degree of deviation (tracking error) from the index, as long as the index is investable. Also, because security selection in an index is achieved by the manager at essentially no cost, and because management of the portfolio can be largely automated, fees on index investing are significantly lower than fees on active investing in the same market.

Principle

Empirical research suggests that for developed, "efficient" markets, passive investing makes sense. Efficiency is the concept that market information disseminates so quickly that, in the absence of illegal insider information, no investor can achieve a greater than market return consistently over time. This leads to the premise that investing in such markets is a "zero-sum" game wherein for every winner, who beats the market, there must also be a loser. Research suggests that, over the long term, after investment-related fees and transaction costs are paid, the majority of investment managers are unlikely to provide added value over a passive portfolio. Nevertheless, many institutional investors still believe they can identify investment managers, or develop a team internally, with the active management skills necessary to provide above-benchmark performance.

The case for passive management includes the following arguments:

- Markets are inherently efficient. In an efficient market, prices adjust to their fair value almost immediately, so it is nearly impossible to invest in mispriced securities.

- While active managers can outperform the market at some times, no active manager consistently outperforms the market forever. Active management requires vigilance to replace managers before they turn bad and lose whatever gains they have achieved, which is an impossible task.

- Even where managers can achieve a rate of return higher than the market, the higher fees and trading costs of active management can consume the over performance.

The case for active management includes the following arguments:

- Markets are irrational, not efficient. Astute research can identify securities that are mispriced due to investors in the market who act emotionally.

- Discipline in identifying, buying and selling securities unemotionally can lead to higher returns than can be achieved by merely duplicating the index.

- Passive management can not reduce the volatility of returns, since by definition it matches the volatility of the market. Active management offers the opportunity to reduce risk as well as increase it in pursuit of higher return.

- Passive management may not achieve the index return, since trading costs and frictional cash in the portfolio (that are not in the index) diminish the results. Additional activity such as securities lending or derivative use, which increase costs, is needed to make up for the shortfall.

- Indexes are restructured either periodically (e.g., Russell) or continually (S&P) to reflect changes in security characteristics or existence. The process for recomposing indexes creates trading costs. More critically, the coordinated demand to buy securities being put into an index and to sell securities being taken out of an index affects prices adversely, while disguising the effect within the index return.

Risk

As discussed above, additional cost and investment management risk is inherent with active management strategies over passive strategies. Using all passive management, however, would not allow an investor to achieve above market returns.

Observed Condition

As can be seen in the table below, use of passive management for a portion of domestic equities is common (suggesting that many funds believe that the domestic equity markets are fairly efficient), whereas it is less widespread for international equities.

Table 3g-ix: Active vs. Passive Equity Management

	% of Domestic Equities			% of International Equities		
	LAFPPS	Greenwich 2006 Survey		LAFPPS	Greenwich 2006 Survey	
	12/31/2006	Public Over $5 Billion	Total Funds	12/31/2006	Public Over $5 Billion	Total Funds
Passive	50.2%	55.3%	41.1%	0%	26.6%	20.3%
Active	49.8%	44.7%	58.9%	100%	73.4%	79.7%

LAFPPS manages approximately 50% of its domestic equity passively, which is in line with other large public funds and appears reasonable.

LAFPPS does not use any passive management in its international equity portfolio. While we generally agree that active management is more likely to add value in international equity than in some areas of domestic equity, passive management is a cost effective method of managing a core portion of the portfolio, especially for a large fund. LAFPPS' international equity composite has outperformed its benchmark over the five years ended December 31, 2006, although many of the managers were funded in 2004, a passive portion would offer consistent benchmark returns for a core portion of the portfolio.

While survey data was not available for passive fixed income management, we believe that it can be a reasonable method of attaining exposure to the core U.S. bond market at a low cost. However, we believe that at least the majority of a fixed income portfolio should be actively managed. LAFPPS currently uses passive management for approximately 18% of its fixed income portfolio and we believe that this is reasonable.

There is no one correct amount of assets that should be actively or passively managed. However, passive exposure can be achieved at very low cost (in many cases, less than five basis points). Incorporating the use of some passive management can help reduce overall fees and the total costs of LAFPPS' investment program.

Task Area 3g Recommendation 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 underperforming active managers and/or to serve as a core exposure to developed markets.

7. Internal vs. External Management

Principle

In determining whether and to what extent a public fund's assets are better managed internally (hiring employees to operate an investment operation) or externally (hiring professional investment management companies), several general considerations are essential. These include legal, cost, continuity and investment performance. We discuss each of these below as well as other advantages and disadvantages of internal management.

- **Legal** – does applicable law prohibit hiring external managers, prohibit managing assets in house, or prohibit certain essential structures such as incentive compensation?

- **Cost** – what is the relative cost for the particular asset class and overall, given the size of the portfolios? For example, passive management is less expensive to manage both internally and externally, the costs should be weighed.

- **Continuity** – is the System able to retain experienced investment managers in-house? High turnover creates substantial investment risk for an internally managed portfolio.

- **Value achieved** – what is the relative return? Have the internal portfolio managers beaten their benchmarks? How does their performance compare to their peers?

a. Advantages of Internal Management

There are several advantages to managing assets internally. These include:

- Internal management can be less costly. External managers must compensate well to attract and retain highly qualified professionals. In addition, they must cover overhead costs for facilities as well as earn a profit. As a result management fees are relatively high when compared to internal management costs. Although public pension funds are not usually able to compensate their investment staff as well as external managers, many employees choose a career in state government deliberately for lifestyle or other reasons. In addition, public pension funds do not have marketing expenses and are not profit driven.

- There can be greater control over the investment process and compliance with guidelines. Monitoring compliance with external manager guidelines may be

complex, and often can be done only after the fact, sometimes weeks after. Understanding the investment process may also be difficult.

- There can be greater control over trading and brokerage usage.

- At least for certain types of assets and strategies, the performance of external managers (net of all fees and expenses) is often disappointing relative to index returns. Internal management can reasonably be expected to do as well for these strategies, at least if properly structured and administered.

In addition, cost considerations may differ for a very large fund versus a smaller fund. As the value of fund assets increases, the possibilities of enjoying substantial economies of scale from internal management also increase. These economies may include:

- greater clout in negotiating and controlling transactions costs;

- lower unit costs for acquiring and maintaining investment hardware and software; and

- staffing costs and related matters.

b. Advantages of External Management

On the other hand, external management also has its advantages. Given the limited resources often faced by many public pension funds, their ability to attract and retain qualified professional investment staff with the skills necessary to manage assets is typically frustrated. These include:

- Lower compensation at public funds may lead to higher turnover, especially among the most qualified professionals. Proven investment managers can command large compensation packages in the private sector and be lured away from public funds.

- The pension fund must still pay the many costs of investment management firms that are fixed or largely fixed, requiring a sizable asset base to maintain cost competitiveness. These include salaries, travel costs and support systems: successful internal asset management requires sufficient securities processing (which is both costly and sophisticated), order management/routing systems, trade entry systems and overall investment accounting systems. At external firms, these costs are generally offset by the economy of scales successful firms enjoy through

growing their book of business and attracting large amounts of assets under management.

- Staff needs are significant to manage portfolios and to operate the above mentioned systems, particularly for asset classes requiring considerable hands on management such as directly owned real estate and/or hedge funds.

- Greater direct control by the Board over the internal investment process may expose the Board to greater fiduciary risk as well as create the potential for political interference. Effectively controlling an internal asset management department requires significant internal discipline and organization, including proper separation of functions and internal controls, e.g., portfolio management versus measurement and evaluation, and portfolio management (front office) versus accounting and settlement (back office). Each of these functions requires specialized skill sets that may be difficult to attract given current restrictions in some states on hiring practices. Tighter ethical controls may also be needed for concerns such as personal trading policies.

- All asset classes, sub classes, types of securities, and geographic locations can be covered by external management.

- Replacement of a poorly performing external manager, or one whose firm structure, focus or staffing has changed, is relatively easy, and bears little risk of wrongful discharge suits, whereas it can be difficult to terminate an internal investment manager.

- Most investment managers are subject to regulation and oversight by the SEC and various security exchanges.

- An external manager relationship can be clearly and precisely crafted through a commercial contract with the manager.

The vast majority of assets managed internally by public pension funds appear to be publicly traded domestic stocks and bonds – relatively traditional and straightforward assets, traded in relatively efficient markets. By contrast, strategies or assets that require more esoteric expertise or research, with substantial prospects of materially outperforming (or under-performing) the relevant benchmarks often are better managed externally. One example would be a portfolio of equities of companies in emerging international markets, which may require unusual research, including foreign travel. Another example would be a portfolio of equities of fast-growing, newly formed companies with low capitalization, where very prompt, specialized information and delicate trading strategies may be essential to success.

Risk

The cost of a capable, in-house staff may be prohibitive, especially in instances requiring an expensive research process or costly external services such as market pricing and statistical systems. Another possible hazard of internal management is homogenization, i.e., the dominance of a single investment discipline running across all parts of the fund. By contrast, outside management by distinct firms may help diversify a fund's overall investment program through a true diversity of investment disciplines.

Observed Condition

LAFPPS does not manage any assets internally. Given the current staff size and skill sets we believe that this is reasonable. Despite the fact that LAFPPS has enough assets to consider the use of internal management, starting up an internal management program would mean added cost in (deciding on the asset class and style in question) terms of staffing and technology requirements and difficult to implement and add value.

3h. Custody Relationships and Fees

Principles

A fundamental function of the banking system for many years has been the custody of securities. Often this is combined with a trust responsibility, which is a legal and fiduciary relationship. Regardless of whether trusteeship is involved, custody is an operational and financial function.

The custodian's basic responsibility is to effect receipt and delivery of securities traded by the investment managers, to collect income on those securities, and to maintain accounting records of all holdings and activities.

Large, complex institutional investors actively invest in a variety of financial instruments in many markets around the world. They need to custody their portfolios in banks providing global master trust and custody services. Investment activities cannot be accomplished within legally required time limits without maintaining an institutional trustee or custodian. The distinction is legal, not just operational.

Master trust and custody banks provide a wide range of operational and recordkeeping services in addition to the basics. They can manage multiple investment entities (for example separate related pension plans) through a combined set of investment accounts without violating the legal separation between the entities. Such master trust and custody banks become global

when they have the direct and/or indirect capability of providing custody services in many countries linked electronically and consolidated into a single reporting system.

Pension master trust and custody is a service business provided by a limited number of banks, which requires highly complex and developed systems, and thus significant continual investments in hardware, software, communications systems and personnel. As the need to automate the process has increased, dozens of major regional banks have stopped offering pension master trust and custody services and have limited themselves to the low volume, limited reporting needs of local personal and corporate trust clients.

Modern global markets consist of many types of securities, electronic depositories, straight-through and near straight-through processing (essentially same day). The need for real-time, trade date portfolio information and a wide range of sophisticated analytics demand that custody banks to have very complex, sophisticated systems to support the custody operation.

Master trust and custody banks that have the capabilities to provide the comprehensive range of functions and services necessitated by large sophisticated institutional investors are referred to in the industry as the “top tier” custodians. Only about six U.S. banks are alluded to as the “top tier” global custodians[33] because they have made the strategic decision and investment of capital to develop and maintain a competitive position in pension master trust and custody market and attract the volume necessary to support it. There may be an equal number of foreign banks in this category.

Custody is largely a network of highly automated, tightly controlled communications and reporting systems. The custody relationship involves not only electronic links, but interpersonal operating relationships among the fund, the investment managers, the brokers, and the governmental and private agencies that hold securities. These operational relationships must be working flawlessly to avoid trade fails and other loss of value.

Changing custodians requires a transition that is an enormously complex task. Even moving from one top tier custody bank to another, where both have highly sophisticated recordkeeping systems, is a daunting task. Additionally, the visible and hidden costs of transitioning from one custodian to another are easily hundreds of thousands of dollars. For these reasons, most institutional investors change custodians very infrequently unless there is a material reason that compels change.

[33] March 2007 survey of R&M Consulting rated Global and North American custody banks based on client and asset manager satisfaction. The six U.S. banks providing full custody to pension fund clients ranked as follows: Mellon (#2 Global, #1 North America), Northern Trust (#7, #4), JPMorganChase (#11, #6), Citigroup (#12, #8), State Street (#13, #7), and Bank of New York (#14, #9).

The custodian possesses an incomparable amount of detailed information regarding a fund's assets and investments. In an appropriate control environment this information is verified, reconciled, and audited. As such the custodian's files are an excellent source of a wide range of portfolio controls and analytics that can assist investment staff to manage their activities efficiently.

Risks

Timely and accurate completion of the fundamental tasks of securities clearance, income collection, valuation and reporting is absolutely essential to managing the investment operation of a complex portfolio and understanding the dynamics of risk and return that affect it over time.

If the fundamental custody functions are not timely and accurate, not only is financial value reduced, but elements of control are lost. Through various regulatory requirements, funds need to measure and report their assets, income, and other results. Timely and accurate valuation, measurement, and reporting are essential to meeting these requirements.

The secondary or supplemental services now available from or through custody banks offer additional means to add value and reduce operational and portfolio risk. The common thread of these services is their basis in the portfolio data fundamental to the custody function.

These secondary services tend to reflect opportunity costs. While not every available product and service is cost effective for every fund, most funds can add some degree of additional financial value by using certain processes.

Not having such services available, having inadequate or ineffective services, and/or not evaluating and where beneficial using them may lead to foregone income or acceptance of excess risk.

Certain data resident in the custody records may be critical. Information on securities held and traded over a many year historical period may be necessary to make claims under class action lawsuits brought on behalf of investors. Systems within custody to identify and retrieve such records in precise detail are needed to enable LAFPPS to maximize the value of such claims. This becomes particularly complex when a prior custodian held assets during the claim period. Commonly such data is not available to successor custody banks and is no longer available through any automated mechanism.

Observed Condition

LAFPPS has a contract with Northern Trust for basic custody services effective October 2004 with a termination date of the end of September 2007. Custody agreement is a standard

basic bare-bones document. It contains additional clauses and exhibits largely addressing local procurement and contracting requirements, not operational or business aspects of the contract.

The agreement provides the option for a securities lending program under separate agreement. That agreement exists. There are no explicit provisions for LAFPPS to receive other services.

Such contracts are effectively limited to three year terms by provisions of the City Charter that make the process for approval of longer term contracts onerous. However, the cost of conducting a search for a custody bank is significant and the cost and disruption in changing custody banks is even more so.

The operative policy at LAFPPS is for staff to recommend to the Board that they negotiate a new contract with the incumbent custody bank at the end of the first three year term, if all services are satisfactory, without undergoing an RFP. Once a bank has been in place for six years an RFP is issued and a full search is conducted. This provides assurance that LAFPPS continues to be able to obtain competitive services at a competitive price while limiting the disruption of changing custodian banks.

We understand staff is recommending to the Board that the contract should be renewed in September without an RFP.

Custody agreement addresses basic operations in general terms only, and in some areas provides a degree of discretion. For example, the agreement leaves it to the Bank whether to pay income on contractual payable date or on actual receipt. It does not specify any conditions under which the bank can take one route or another, and specifies only the bank's recovery of value if the funds are credited prior to actual receipt. There is no provision specified for compensating LAFPPS for any loss of value.

The agreement provides that those specifics may be designated in writing. We did not see any comprehensive document spelling out those procedures, and so cannot evaluate whether they are in a manner most favorable to LAFPPS.

Pricing of the custody services is particularly favorable. There is no explicit charge for custody services as long as LAFPPS uses Northern Trust for securities lending.

The Fund has been particularly aggressive and successful obtaining additional services from Northern without any additional explicit cost. These additional services are not defined in the custody contract. Among these are performance measurement, Alerts guideline compliance, and use of Burgiss Private i alternative investments tracking data base.

Basis for obtaining additional services appears to be the ability to obtain without cost and/or the ability to use the service with minimal staff effort, rather than value, usefulness, or effectiveness. Staff mentioned, for example, a preference for the Venture Economics alternatives data base were it not for the additional cost.

LAFPPS has issued detailed, explicit guidelines on voting of proxies. Previously, LAFPPS physically voted every proxy itself. LAFPPS has now engaged ISS to vote proxies according to Board's guidelines at a nominal cost of $5,000. Under this arrangement Northern Trust has no involvement in voting proxies.

LAFPPS uses a combination of two Northern Trust collective trust funds for investment of cash. The investment objectives, portfolio characteristics and rates of return are reported on a two page flyer issued by the bank. There is also an annual report listing the investments as of the trust's year end. We requested a more detailed prospectus or offering memorandum, but have not received one.

Among other details, the documentation we received on the STIF does not disclose what fee Northern receives from the funds, though it states that datum is available on request. The STEP flyer discloses a 20 basis point fee. The custody agreement specifies that the fee on a dedicated STIF fund shall be 6.5 basis points. We were told that the regular 15 basis point fee is credited back to LAFPPS and the 6.5 basis point fee is charged. The contract does not mention any adjustment to the STEP fund. Northern's short term fund fees are generally competitive with other custody banks of its caliber.

LAFPPS has advised that it does not use certain other common custody related measurement and control tools that are available through the custody bank or through unrelated third parties. For example, LAFPPS does not use any means for measuring the quality of execution of its managers trading because the information is not sufficiently useful and because trading alone is not a reason to fire a good manager or to retain a poor manager.

We understand LAFPPS specified certain operational requirements and procedures into the RFP for custody bank services and considers that to be a contractual guideline for the bank. While incorporating an RFP into a contract is legally sufficient, as a best practice it is awkward to implement. An RFP contains many provisions that apply to the search process and various procurement requirements rather than to ongoing operations. It is more efficient to set forth detailed operational procedures in a separate document that is appended to or incorporated into the basic custody and related services agreement.

Detailed procedures and policies for basic custody services such as crediting income, handling proxies, and investigating and compensating for delivery fails are not specified in the custody agreement. This absence and the resultant discretion afforded the custody bank enables the bank to apply the process most in their favor.

Task Area 3h Recommendations 1-2
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.
LAFPPS staff should develop a detailed set of operational procedures and standards for custody operations and incorporate it into the custody agreement.

LAFPPS is obtaining certain supporting services from the custody bank, such as Alerts and Private. Even though there is no explicit incremental cost for these, they constitute a change in the contract. There appear to be no legally binding documents memorializing this arrangement.

Task Area 3h Recommendation 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.

In discussing the various tools available for monitoring and controlling various aspects of the investment program, the overriding concern seemed to be the avoidance of cost or at least a direct financial benefit as a return on that cost. A number of these may benefit LAFPPS in less than explicit ways and serve as a risk control by either directly spotting risks or generally alerting service providers that they are being monitored and so inducing a higher level of control.

Task Area 3h Recommendation 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.

3i. Securities Lending Program and Fees

<u>Principles</u>

Lending securities held in a long term portfolio has become a common practice among large institutional funds to generate incremental income at close to zero risk. Brokers and investors need securities to facilitate trading, to undertake short sales, and for various other purposes.

A security loan involves three primary parties: the investor who owns the portfolio from which the securities are loaned acting as lender, the broker or investment manager who borrows the securities on behalf of itself or its customers as borrower, and an intermediary institution matching borrower and lender and negotiating and enforcing terms, as agent for the lender.

Borrowers pay for the right to use the securities. In this aspect, the agent and the lender are a team. They split the revenue according to an agreed upon ratio that does not affect the terms of the loan itself.

The intermediary is most often an agent for the lenders arranging loans with unaffiliated borrowers. Certain of these firms also borrow securities for their own account and will enter an arrangement with a lender on a principal basis, in which all loans are to the intermediary. In many agency arrangements, the agent can lend to itself, but does not do so exclusively.

The market for lending securities has become reasonably standard, especially between the borrower and the lender's agent. There are standard agreements available that cover the majority of the terms of the loan. All such loans are collateralized, and most of the conditions regarding collateral fall within standard limits, including the types of collateral acceptable (principally cash or government securities) and the ratio of collateral value to value of the loaned securities.

In all securities lending arrangements collateral has to be posted against the loaned securities. Standard terms in the industry are for the borrower to post collateral against domestic securities worth 102% of the value of the borrowed securities and against foreign securities of 105%. This collateral ratio is marked to market daily and maintained through adjustments in the amount of collateral.

Borrowers pay for loaned securities in one of two ways, depending on the type of collateral posted.

When collateral is securities, the borrower pays an agreed upon fee to the agent and keeps the earnings on the collateral. In these situations the revenue rate is known and the risk of collateral loss of value is borne by the borrower.

When collateral is cash the agent invests the cash and keeps the earnings, paying the borrower a rebate at an agreed upon rate. In these situations the borrower's cost is known, the revenue is affected by the rate earned on the collateral, and the risk of collateral loss of value is borne by the lender.

The net revenue from each loan after it is closed is split between the agent and the borrower.

Aspects of securities lending arrangements that vary fall into two categories: terms of each loan and terms of the agency agreement between the lender and the agent.

Loan terms vary security by security, driven by supply and demand, as to the rate paid directly or indirectly by the borrower. Securities in high demand and with limited supply earn a higher fee (securities collateral) or pay a lower rebate (cash collateral) than securities in ample supply. Thus this aspect varies loan by loan and is driven by the composition of the portfolio and the market reach and skill of the agent.

Terms of the agency agreement apply to the program as a whole, and largely are driven by the composition of the portfolio, the resulting expected volume of loans, and the negotiating ability of the partners. The most important terms in this regard are the split of revenue between the lender and the agent and the degree the agent takes financial responsibility for whatever might go wrong.

Terms of any securities lending agency agreement are a matter of negotiation. Typically achievable terms provide that the agent is responsible for covering any loss resulting from a borrower default, because the agent is fully in control of the credit process and the setting of credit limits. Typically the lender and the agent share the risk of a collateral shortfall resulting from collateral investments in the same ratio as they share revenues.

Most lending agents are trust and custody banks. Often the lender's custody bank acts as agent on these programs. A number of other financial firms, including commercial banks, brokers, and investment managers will also serve as agent in third party securities lending programs. These are called third party programs because there are three parties involved in the lender side of the transaction. Rather than the custody bank managing a lending program directly, feeding off its real time portfolio accounting system, an outside bank or other financial institution acts as agent managing the program.

The chief disadvantage of a third party program is complexity, with resulting increased costs and risk of transactional problems. The custody bank has to facilitate the loan by supplying portfolio information to the agent and by communicating with the agent on delivery and receipt of securities going on and off loan. The custody bank incurs additional costs not offset by reductions in cost the agent incurs. The extra step in communicating can lead to errors, especially when a loan has to be called because the manager sold the security.

Risks

The chief financial risk to the lender of securities lies in the separate processes of maintaining and reinvesting collateral.

Maintaining collateral is the process of keeping collateral at the ratio specified in the Securities Lending Agreement between the borrower and the agent. The typical ratio is 102% for domestic securities and 105% for foreign securities, but sometimes this varies.

If the borrower defaults on the loan and fails to return the borrowed securities, the agent uses the collateral to replace the security or otherwise return the security's value to the lender. The risk is that the collateral is insufficient to cover this. Securities Lending Agreements specify not just the initial and ongoing ratio the borrower has to maintain, but the timing and process to maintain it. This is an area where risks occur.

Trigger Point: The ratio is permitted to fluctuate before a call for more collateral is made. A common structure sets the ratio at 102%, but does not call for the 102% ratio to be restored until the ratio drops below 100%.

Timing of Collateral Call: Valuation is normally close of business exercise. The collateral ratio is typically checked at the open of business using the prior day's close and only then is the borrower given notice to post additional collateral. Given that markets are evolving into 24 hour a day systems, the values may have incurred additional changes in either direction in the interim.

Timing of Replenishment: The borrower is given a period of time after notice to deliver additional collateral. The standard time is one business day. Again, values may have incurred additional changes in either direction in the interim.

These factors are set in and controlled by automated mark to market systems and monitored by lending agent management through exception reports.

While it is possible to demand different loan terms on a program, they can affect the volume of securities loaned, because most borrowers prefer the standard terms. This risk is mitigated to a large extent by imposing credit standards and volume limits on borrowers, to reduce the likelihood the borrower will default.

The process for maintaining the collateral's value depends on the type of collateral. If the collateral is securities, both the collateral security and the borrowed security are marked to market, and the borrower is responsible for posting additional collateral if changes in value of either result in a shortfall. If the collateral is cash invested by the agent, the borrower is not

responsible if the investments made with the cash collateral lose value, and only marks to market changes in value of the borrowed security.

When collateral is securities, the borrower receives the income on the securities and rebates a fixed amount to the agent/lender. The agent/lender income in this arrangement is known, and the risk of changes in the rate earned on the collateral is borne by the borrower.

When the collateral is cash, the agent bank or other investment manager invests the cash to earn a return. The agent pays the borrower an agreed rate, and the agent/lender keep whatever the cash earns in excess of that amount. If the cash earns less than the amount paid the borrower, the loan loses money. If the cash investments drop in value, the loan loses that amount as well.

This risk is best controlled by investing conservatively, such that the collateral portfolio does not take too much duration (i.e. interest rate) or default risk. While doing so is tempting to try to increase securities lending income, the downside can be considerable. In these situations, the loss is not contingent on borrower default.

This risk can also be controlled from the lender's position by negotiating responsibility for losses between the lender and the agent. Standard terms put the risk of loss of collateral value on the lender, even if the agent invests the funds according to its own guidelines. In such situations it is possible to negotiate agent responsibility, but that may result in a less favorable split of the net income. Large lenders often select the commingled collateral investment vehicle or require collateral to be separately invested according to the lender's own guidelines. This latter structure is common among large public fund lenders.

There are a few other areas of what might be better described as operating concerns than risks. Default on trades selling securities on loan: Securities lending is transparent to investment managers, so they often sell securities on loan. Such securities must be recalled in time to complete delivery. Major securities lending banks have sophisticated processes in place to handle this common occurrence. In most cases the agent is able to substitute a loan of the same securities from another lender, so the borrower's position is not disrupted. When this is not possible the agent terminates the loan. Fails can and occasionally do occur, but they are rare.

Treatment of securities over record date for proxy voting: Investors may have a significant interest in the subjects being voted on at a shareholders' meeting. When a security is on loan, the lender is not the holder of record, so the lender does not have the proxy vote. The borrower does. Lenders will recall securities in order to vote the proxy. At best this cuts off securities lending revenue; if the interest in the subject is particularly critical and widespread (such as a dissident slate of directors) many lenders may recall loans at the same time, affecting the market for that security. On the other side of the ledger, investors will sometimes seek to borrow securities over record date for the purpose of voting those shares. This situation can

result in a cost to those for whom the vote is important and an opportunity to make a loan at very large spreads for those who own the security but do not have a compelling desire to vote it.

Observed Condition

LAFPPS signed a contract with Northern Trust for securities lending coincident with the contract for custody effective October 1, 2004. The contracts are linked, in that there is no fee for custody services, but LAFPPS must use Northern for securities lending.

The process for selecting the custody services provider in 2004 involved an RFP that allowed bids on either or both of custody and securities lending. Staff reported that Northern provided the best estimate of securities lending volume and revenue among all bidders including stand-alone third party lending agents.

Staff was skeptical that Northern could achieve the volumes predicted, but was equally skeptical of other bidders. To date Northern's actual volumes have been better than predicted though.

The fee split is attractive, particularly given that the program pays for basic custody and for certain other normally additional cost support services. The split is 90%/10% on all except loans of U.S. Corporate Equity, which is 80%/20%. Since U.S. Corporate Equity tends to lend in lower volumes than bonds and foreign stocks, this should work out to an average split in the high 80s for LAFPPS, which is attractive.

Securities Lending Authorization Agreement is a basic, standard document. Our copy is unsigned and is missing the specific attachments, including a list of borrowers and guidelines for cash collateral investment accounts.

The agreement provides that cash collateral on short term loans (i.e. not term loans) is to be invested in a mix of the two basic short term collective funds: STIF and STEP. Also it provides that the cash collateral investment is to be maintained at a $1.00 constant net value per share. This is one of Northern's standard "custom" cash collateral options. Term loan collateral and non-cash collateral is invested in Northern's Global Core Collateral Section.

Collateral is pooled both for lenders and for borrowers, not specifically linked to individual loans. This is a common practice for active borrowers and lenders who use commingled cash collateral investment accounts. This practice is beneficial both operationally and financially. Mark to market is done for all a borrower's loans as a group, enabling netting to be done only as needed in aggregate. This lessens collateral shortfall risk as well as transactions.

Risk of loss in the collateral account is borne by the lender or lenders collectively, except for the agent bank's negligence or intentional misconduct. This is common practice among agent banks, even though the agent bank is the investment manager for the cash collateral.

Also common practice in securities lending is for the agent bank to indemnify the lenders against borrower default. While this is a rare occurrence and while the amount at risk is small in most situations, the agent is solely in control of the initial and ongoing credit limits and the monitoring of activity under those limits. This agreement does not provide for that type of indemnification.

At least one other top tier custody and securities lending bank has sometimes offered to improve the revenue split in exchange for dropping the agent's default indemnification. We are not aware whether such an arrangement was a part of the original fee negotiations. Evaluating whether trading the indemnification for additional revenue requires understanding the risks that would be covered by the indemnification, the probability of a covered default occurring, the likely amount lost as a result, and the additional income over time LAFPPS would earn in exchange.

A borrower default occurs when the borrower fails to return the securities and the agent bank is unable to replace them by selling the collateral and buying replacement securities. Given that the lender is primarily at risk for collateral shortfalls resulting from insufficient collateral income and from loss of collateral value through investment activity, an indemnification situation would generally require a combination of failure to return the securities and a shortfall between the security value and the collateral mark to market. The amount so indemnified would be only the difference, and only at the time the default occurred.

Reporting of securities lending results to LAFPPS is minimal. Northern provides reports of primarily accounting data: assets loaned by manager and security type, collateral type and value, earnings, net income and income split. Management reports such as percent of each pool of lendable securities on loan, spread rates, and similar data with comparison to Northern's program as a whole and charted over time may be available through Northern's internet based Passport reporting system. If so, LAFPPS staff apparently does not obtain and analyze them.

LAFPPS previously obtained Astec Consulting's standard securities lending analysis reports. Astec collects securities lending data from a large group of securities lending programs, including many large public funds, and publishes data on each fund's volumes and rates compared to the universe of participating funds generally. Staff advised they discontinued participating because they felt it was not useful information.

Astec Consulting is an independent data collection and analysis firm that has created a niche in measuring the performance of securities lending programs at various levels of detail for lenders, agent banks, and other participants in this market. At the most sophisticated levels,

Astec securities lending data can provide very useful insight into the results of a securities lending program. The process is centered on a cooperative effort in which participants supply data to Astec, who then reports relative results in a number of areas back to the coop participants.

LAFPPS participates currently at the lowest level. They provide loan data and receive back relative rankings of the program against the overall universe. At this level LAFPPS incurs no cost. We understand the reason for electing this level of participation includes the belief that knowing more detailed results would nevertheless not enable LAFPPS to increase the participation level or pricing of the program. In the short term that is likely to be true. Over the long term, and in particular when negotiating a new contract or even hiring a new service provider, having detailed comparative information may be very valuable. In addition, with detailed information on the lender's program results and the agent bank's overall results relative to other agents, LAFPPS may be in a better position to negotiate with custodian and third party agents to obtain a more attractive mix of custody costs and lending revenues.

The securities lending program was described as extra revenue, not a primary investment function, despite its generating a reported $11 million plus paying for custody services.

Overall the LAFPPS securities lending program is well structured and generates meaningful value. Monitoring the level of activity compared to agent and industry results may not necessarily generate more income, but it provides a level of prudent oversight that is important, especially in the event a problem arises. Measuring the results in other than dollars of revenues and discussing the quality of the program with the agent bank reminds the bank that they are being monitored and the results of the program are important. While loans are allocated by an equitable allocation algorithm, active communication and awareness may still have value in service and attentiveness.

Task Area 3i Recommendation 1
LAFPPS should resume active participation in Astec, obtain program activity information from Northern Trust, and thoroughly analyze the results of the program against peers and expectations on a regular basis.

Task Area 4 – Benefits Administration

4a. Reasonableness of Actuarial Methods

Principles

A review of the adequacy of an actuary's Actuarial Assumptions and Methods is an important activity for public pension systems in helping management to explain and clarify complex technical concepts. It enables management to better understand the used actuarial principles and, when appropriate, justify and suggest changes to the current actuary's work. The review determines whether a public pension fund's actuary performed the valuation in compliance with the American Academy of Actuaries (AAA) professional standards.

The AAA professional standards guide an actuary to develop reasonable liability and contribution amounts to adequately fund a public pension plan. The prescribed standards vary based on several factors, including selection of interest rates, cost methods and asset allocation techniques. An actuary also takes into consideration a public pension fund's market conditions, employee demographics and funded status in determining the appropriate assumptions and methods to use in the valuation process.

The AAA professional standards require an actuary to document the rationale for the selection of the actuarial assumptions and methods used in the valuation process. The documentation provides a useful record to show how changing assumptions/methods will affect the valuation results. It also enables a public pension fund to easily validate the work performed by the current actuary.

The AAA professional standards also require an actuary to compare actual plan experience to expected experience based on the assumptions used each year. An actuary is also required to develop a gain or loss analysis to quantify the effect of actual experience versus the expectation used.

Finally, the professional standards require an actuary to determine the funded status of a public pension plan. The actuary determines the ratio of assets of the plan to the liabilities of the plan. The ratio also impacts the actuarial assumptions and methods used.

Risks

Failure on the part of the actuary to use sound actuarial principles on the setting of assumptions and actuarial methods can have dire consequences on public pension plans. In some cases, it can lead to dissolving the pension plan and a resulting loss of retirement benefits to

existing retirees and promised future retirees (actives). In most public pension plans it is more likely that the sponsoring government would bear the cost of funding a severely underfunded plan. This bailout out can result in higher taxes or diminished services as monies may need to be diverted from critical service areas to be put into the pension plan. Numerous public pension plans across the country are critically underfunded and are putting a burden on cities to pay for the shortfall in the pension plans.

Many legislatures increased pension benefits during periods of rising markets. During the ensuing economic downshift, many sponsors have ended up on the watch list of underfunded plans. Even plans that were at one time adequately funded can become underfunded in a short period of time.

Average employees who work over 30 years in a lifetime have a reasonable concern that their retirement benefits may not be available or could be severely reduced when they are ready to retire.

Observed Conditions

The actuary for the LA Fire and Police Pension System ("the Plan") has performed annual valuations each year as per statutory and accounting requirements. The actuary has also performed experience studies that measured the actual economic and demographic experience of the plan every three years, with the most recent study dated June 30, 2004. The studies measure the experience for the prior three years and make recommendations based on that study to adjust, as needed, the assumptions and methods for the annual valuation.

- The last study was performed by Gabriel Roeder and Smith, the prior actuary for the Plan. As of the July 1, 2006 valuation, the Segal Company was installed as the new actuary for the Plan. Both firms are well known national actuarial firms with excellent reputations, especially in the governmental plan sector.

- As a result of the last study, various changes were recommended for both economic and demographic assumptions. At that time, the Board adopted the demographic changes but chose to keep the economic assumptions unchanged for the July 1, 2004 valuation. The previous actuary also made some additional assumption changes for the July 1, 2005 valuation in an attempt to improve the pricing of the Deferred Retirement Option Plan (DROP) provisions.

- Subsequent to installing the Segal Company as the new actuary, more changes were made in the actuarial assumptions based on their analysis. These changes included some of the economic assumptions the previous actuary recommended

(including reducing the investment rate of return assumption to 8% from 8.5%) and modifying some of the other demographic assumptions.

Experience losses continue for LAFPPS:

- Over the last three annual valuations, the Plan has generated actuarial losses in each year, but the levels of those losses have sometimes been less than the prior study.

- In particular, the experience loss for the last valuation was less than 1% of the total actuarial liability which is well within normal tolerances.

- The actuary's analysis indicated that the majority of the variation in the losses in the past has been due to investment experience, with other economic and all demographic experience playing a lesser role. The investment experience in this case is due to market value of asset losses occurring during the 2000-2002 period, which works its way through the chosen actuarial value of assets method over a five-year period. Those losses have been fully recognized as of the July 1, 2006 valuation.

- Due to the nature of the valuation process, a contribution rate is calculated in a particular year, but is only applied the following fiscal year. This can create an experience gain or loss in a succeeding year if there is a significant difference in the contribution rates from one year to the next. Such a jump in contribution rates occurred from 2004 to 2005, where the contribution rate moved from 12.86% of payroll to 20.56% of payroll. This, in turn, generated an experience loss for the July 1, 2006 valuation due to the one year lag in contributions.

Review of the assumptions used indicates they are reasonable.

- All of the demographic assumptions appear to be reasonable for the type of plan being valued. The meaningful provisions of the Plan (mortality, withdrawal, disability or retirement) appear to be valued with appropriate assumptions. No meaningful provisions of the Plan appear to have been excluded from valuation. (Due to the newness of the Plan provisions, the DROP provisions were not being explicitly valued at the time of the last experience study. This methodology has since been changed. See the discussion below.)

- The economic assumptions also appear reasonable. For example, the salary increase assumption is closely monitored and has been adjusted over the last few years.

- In each of the last three valuations the actuary has fine tuned the assumptions, in response to either the experience study or other issues that the actuary and the Board felt needed to be addressed. This is a proactive practice to attempt to stay on top of potential trends that may affect the funding of the Plan and is a reasonable step for a plan of this size.

The Board's policy of doing experience studies on a three-year cycle is in keeping with best practices.

- The recommendations from the study tend to be weighted choices, striking a balance between simply moving the assumptions to fit the data exactly and leaving the assumptions unchanged. This is a prudent policy, because some data variations may simply be random and not the establishment of a new trend.

- Assumptions with smaller probability, such as disability or mortality for non-duty personnel, were measured but not changed.

- The next full experience study would be due to be performed as of June 30, 2007, using data for the preceding three years from July 1, 2004 through June 30, 2007. We strongly encourage LAFPPS to continue this cycle to continuously monitor the Plan.

The reduction in the investment return assumption to 8% from 8.5% as of the July 1, 2006 valuation appears to be an appropriate move given the investment losses of earlier years. The previous actuary recommended this change in their last experience study, but the Board did not accept the recommendation at that time.

The DROP has particular issues with respect to the retirement assumption.

- The change in DROP provisions have clearly affected Plan demographics, as the reduction in retirements and the large increases in the average age of the active population indicate.

- In the last few years, this change created some uncertainty in setting retirement assumptions and the related method of valuing the DROP provisions. A decision was made to value the DROP benefits directly and return to higher (and more normal) retirement levels for each assumed potential year of retirement. We concur that this explicit approach is the best choice.

- This assumptions surrounding DROP are likely to be further refined as more data is received over the next few years. As current active participants in the DROP

program begin retiring, the potential changes in this assumption alone strongly suggest continuing to conduct experience studies regularly.

The primary actuarial methods chosen by the actuary would be considered reasonable.

- The entry age normal cost method is a conservative one that projects anticipated pay and service increases and attempts to fund the Plan with level percentage of pay contributions over the participant's working lifetime. As such, it will put more money into a plan earlier for any participant than other cost methods, such as traditional or projected unit credit. The entry age method is still chosen fairly often for government plans.

- The actuarial value of assets method does not immediately recognize the entire aspect of gains and losses in any one year, but spreads each year's impact over the next five valuations in a process referred to as "smoothing." The use of such a method is intended to smooth out the fluctuations in asset values that in turn can create gyrations in contribution levels from year to year that become difficult to plan for and budget. The method chosen by the actuary is a reasonable one and one that is chosen for many similar plans. While some actuaries do not smooth the assets at all, instead choosing to use the market value of assets directly, a five year smoothing of the assets is the most typical period chosen by actuaries when they utilize a smoothing method. Occasionally other periods, such as three or four years are chosen, but five years is by far the most popular choice. It is extremely rare to choose a smoothing period beyond five years, since the method is designed to delay and smooth but not eliminate contribution level changes. In particular, Statement 27 of the Governmental Accounting Standards Board notes in paragraph 102 that, "The Board believes that smoothing changes in market value over, for example, three to five years is appropriate for calculating the ARC (Annual Required Contribution)." The Board further notes that use of other smoothing periods could be warranted for particular investments, ". . . based on the judgment of those familiar with the circumstances." In any case, the choice of whether to smooth or not to smooth has no influence on the ultimate cost of the plan over the years. That cost is always described by the statement that Benefits Paid plus Administrative Expenses will always be the total cost of the Plan over the Plan's lifetime. The smoothing technique only affects the timing and volatility of the contributions to the Plan, as noted above.

Based upon our analysis, the rules set forth in Statements 25 and 27 of the Governmental Accounting Standards Board (GASB) appear to have been adhered to.

We would consider the overall funded status of the Plan as good.

- The Plan has a funded ratio of 94.6% as of July 1, 2006, the same ratio at the prior valuation date of July 1, 2005. This ratio is based on the actuarial value of assets divided by the actuarial liability.

- For private sector plans with ERISA mandated funding requirements, a funded ratio of 80% of the actuarial value of assets over the present value of accrued benefits would be considered the minimum acceptable funded ratio, because a ratio below 80% would require additional mandated contributions into the plan. Therefore, on a comparative basis, 94.6% is considered good.

- The actuarial value of assets is a smoothed version of the asset values over the last few years, and is lower than the current market value of assets, due to deferred investment gains on a market value basis in the last three years. Therefore, the funded ratio will tend to improve modestly over the next few years due to this factor alone.

- LAFPPS' actuarial liability is based on the entry age normal cost method. As mentioned in the previous section, this method funds ahead for anticipated increases in pay and anticipated future service to pay for the entire active lifetime of a participant in a more level manner as a percentage of compensation. The liability under this method is a larger number than the present value of benefits only accrued to date for participants.

- The net result is that the Plan is currently 94.6% funded on a conservative actuarial basis, with the asset value used for this measure having an upward trend due to unrealized gains in past years that will be realized during the next five years. (This ignores any investment experience gains or losses that may come about in the next few years.)

Contribution levels spiked in the last two valuations, primarily due to delayed effects of the market value of asset losses in earlier years.

- The losses have now worked their way through the asset method, so they will not create any additional spikes in contribution in future years.

- If assumptions were to be met perfectly over the next few years, the contribution level for the plan would probably stay about the same on a dollar basis and tick downward slightly on a percentage of pay basis, based on the cost and asset methods employed and the deferred asset gains from the last several years yet to be fully recognized.

Contribution policies for each Tier also seem reasonable.

- Tier 1 contains only inactive (retired) participants, and as such the dollar amount of unfunded liability is to be paid off over 31 years and counting as of July 1, 2006. This appears to be a decision to pay off the unfunded participants in a time frame similar to the expected average lifetime of the covered participants, which is a fair choice. The size of the Tier 1 group is very small relative to the entire plan, so liability gains or losses within the group should be relatively stable and not have a large overall impact.

- Tier 2 has both active and inactive participants, but due to prior experience currently has a surplus (i.e., a negative unfunded liability). The normal costs for active participants are being paid as part of the annual contribution, as is true for all active participants in every tier. In 2006 the actuary chose to amortize the surplus over 31 years, which means that some of the surplus is being used to draw down contributions in other tiers. Because it is our understanding that there has been migration out of Tier 2 into other tiers (and the size of this tier is still relatively small, especially relative to Tier 5), the use of the small surplus to draw down overall contributions makes sense. Again, because of the size of Tier 2 relative to the entire plan, the overall effect is minor.

- Tiers 3, 4 and 5 have active and inactive participants and unfunded actuarial liabilities. Active participants have their normal cost paid for each year as part of the annual contribution. The unfunded liabilities are determined as they occur and are amortized from the date of determination over 15 years for experience gains and losses and 30 years for assumption changes. These are typical amortization periods for governmental plans, and they fit well within the guidelines in GASB Statements 25 and 27 for accounting for these plans.

Task Area 4a Recommendation 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.

1. Contract Review of Actuarial Services

Principles

A contract of services between a consultant and public entity is a binding document. A defined process involved in awarding a contract to a vendor includes the following activities:

- Issuing a request for Proposal (RFP) to the various consultants;
- Reviewing the proposals submitted;
- Selecting the vendor that best suits the entity's needs; and
- Issuing a contract for services to the selected vendor.

Once the contract is accepted and both parties agree on the services, then the public entity has a legal expectation that all services in the contract will be performed. A review of the services proposed in the contract versus what is actually delivered to the public entity, will clarify whether the consultant fulfilled the contract requirements.

Risks

A breach of contract exposes an organization to a potential loss of resources that may be important for the public entity to make an informed decision.

Observed Conditions

The review covers the contract for Actuarial Consulting Services between the Segal Company and the Board of Fire and Police Commissioners of the City of Los Angeles, California. Our review identifies the individual retirement services the actuary is to complete and determines where in the final report document the identified service is referenced, if at all:

- Contractor agrees to perform an actuarial valuation, and to submit a report each year showing the cost of maintaining, upon a reserve basis, the funds of the Los Angeles Fire and Police Pensions (LAFPP), Tiers 1, 2, 3, 4 and 5. Said reports are to be computed as of June 30 of each year, 2004, 2005 and 2006, and must be delivered in final report form no later than October 1 of each year or sixty (60) days after the Contractor receives all final data necessary to prepare the report, unless mutually otherwise agreed between both parties.

  - Our review indicates that the Contractor (Segal) has prepared the initial final actuarial report for the period 2006 completed timely on December 12, 2006.

- Contractor agrees to perform a gains and loss analysis.

  - This was supplied by the actuary for 2006. See Section 2 page 7 of the Actuarial report.

- Contractor agrees to provide an Actuarial Certification Letter.

- This was supplied by the actuary for 2006. See Section 1 page IV of report.

- Contractor agrees to provide a Summary of Significant Valuation Results.
    - This was supplied by the actuary for 2006. See Exhibit of the Actuarial report.
- Contractor agrees to provide a Detail of Unfunded Actuarial Accrued Liability.
    - This was supplied by the actuary for 2006. See Section 3 page 34 of the Actuarial report.
- Contractor agrees to provide an Actuarial Methods and Assumptions section.
    - This was supplied by the actuary for 2006. See Section 4 page 47 of the Actuarial report.
- Contractor agrees to provide Contribution Rates by Tier.
- This was supplied by the actuary for 2006. See Section 2 page 13 of the Actuarial report.

- Contractor agrees to provide a GASB Analysis.

This was supplied by the actuary for 2006. See Section 2 page 17, Section 4 Exhibits II, III and IV of the Actuarial report.

Recommendation
No recommendations.

4b. Benefit Payment Testing

1. Analysis of Timeliness and Correctness of Benefit Payments

Principles

The expectation of a timely benefit payment is common to most newly retired employees. In retirement, they are migrating from a salary to a pension, and it is critical that the transition is seamless so that they can continue to pay their bills. It is optimum that public retirement systems

provide a retirement benefit that is payable to new retirees within 30-45 days of the initial payment request.

Risks

Failure to provide a retirement benefit in a timely manner can result in the retiree being unable to meet their financial obligations. In most instances, the retirement benefit is their primary source of income and is relied upon to uphold their standard of living.

Observed Conditions

The average number of days between the effective date for retirement and date of first payment is 25. The median amount of days was 23 (i.e., half of the cases took longer than 23 days and half took less than 23 days). The minimum number of days to receive a payment was three, and the maximum number of days was 299. Eighty six percent (86%) of retirement requests were completed within the optimum 45-day period. Of the remaining cases one took 97 days and the remaining three cases took the better part of eight – ten months to be paid (263 – 299 days).

Table 4b-i below shows the count of the number of days between an effective retirement date and date of actual receipt as well as the percentage completion rate of the total:

Days	Count	Percentage
Less than 30	22	73.3%
30-44	4	13.3%
90-104	1	3.3%
Greater than 104	3	10.0%
Grand Total	30	100.0%

LAFPPS' payment process is consistent with those typically found within other public pension systems. The majority of payments occur within the 45 day period. While there are always mitigating circumstances that may result in a minority of the payments being delayed, the expectation is that the majority of retirement requests are processed in a timely manner. LAFPPS is generally accomplishing this task.

Task Area 4b Recommendation 1
LAFPPS should consider ways to identify and prevent processing times in excess of 90 days.

2. Review of Retirement Calculations for Accuracy and Compliance with Plan Provisions

Principles

For most public employees, a retirement benefit represents the majority of their income after retirement. Employees expect to receive a benefit around which they plan their future. A public pension plan must provide an accurate benefit.

If applicable, the public plan benefits must continue to use the correct cost of living adjustments (COLA) adjustments so that the retirees can keep up with inflation. Most systems use a combination of automated calculations and manual calculations. The trend has been to automate the calculation process. Many times in migrating to a fully automated system there are differences in how the calculation was performed in the past and how it is calculated under the current automated system. The most important issue is that benefit calculations are correct. A sample of the old calculation method and the new calculation method needs to be selected, and differences in the correctness of the calculated benefits need to be examined.

Risks

If a fund incorrectly calculates a larger than required benefit, then the plan has the option of making the retiree pay back the excess benefit, which may prove to be a burden on the employee. Conversely if the benefit is smaller than required, then the plan must refund the underpayments to all affected employees.

If a retirement calculation error results in an underpayment or overpayment, the retirees and public entity are affected. Thus it is critical that the benefits calculations are done correctly.

Observed Conditions

LAFPPS provides a retirement benefit based upon final pay and years of service. LAFPPS uses a Tier system to calculate benefits. Historically, whenever changes are made to benefits in the pension system, a new tier (plan) is usually created. Currently there are Six Tiers. Tiers 1 through 4 plan provisions are contained in the Los Angeles Charter, Tier 5's plan provisions are contained in the Los Angeles Administrative Code, and the Tier 1 splits under Article 11.5 of the Old Charter. The basis provisions of the Tiers are:

- Tier 1 (Section 1304) – Sworn employees of the Fire and Police Departments of the City of Los Angeles hires prior to January 29, 1967. Eligible to retire after completing 20 years of service. Their retirement formula is:

Table 4b-ii Years of Service	Benefit
20	40% of Final Monthly Salary Rate
20 - 25	Additional 2% of Final Monthly Salary Rate for each year over 20 and under 25 years of service
25	50% of Final Monthly Salary Rate
25 - 35	Additional 1 2/3% of Final Monthly Salary Rate for each year over 25 and under 35 years of service
35+	66 2/3% of Final Monthly Salary Rate

- Tier 2 (Section1408) – Sworn employees of the Fire and Police Departments of the City of Los Angeles hires from January 29, 1967 through December 7, 1980 who are eligible to retire after completing 20 years of service. The retirement formula is:

Table 4b-iii	
Years of Service	**Benefit**
Less than 25	2% of Final Monthly Salary Rate for each year of service
25+	55% plus 3% per year over 25 to a maximum of 70% of Final Monthly Salary Rate

- Tier 3 (Section 1504) – Sworn employees of the Fire and Police Departments of the City of Los Angeles hires from December 8, 1980 through June 30, 1997 who are eligible to retire after attaining age 50 and completing 10 years of service. Their retirement formula is:

Table 4b-iv	
Years of Service	**Benefit**
Less than 20	2% of Final Average Salary for each year of service
20+	40% plus 3% per year over 20 to a maximum of 70% of Final Average Salary

- Tier 4 (Section1604) – Sworn employees of the Fire and Police Departments of the City of Los Angeles hires from July 1, 1997 through December 31, 2002 who are eligible to retire after completing 20 years of service. Their retirement formula is:

Table 4b-v	
Years of Service	**Benefit**
Less than 20	2% of Final Average Salary for each year of service
20+	40% plus 3% per year over 20 to a maximum of 70% of Final Average Salary

- Tier 5 (Section 4.2004) – Sworn employees of the Fire and Police Departments of the City of Los Angeles hires after January 1, 2002 who are eligible to retire after attaining age 50 and completing 20 years of service. The retirement formula is:

Table 4b-vi	
Years of Service	**Benefit**
Less than 20	50% of Final Average Salary
20+	50% plus 3% per year except in the 30th year when it is 4% up to a maximum of 90% of Final Average Salary

Upon retirement an employee requests a retirement benefit. The employee falls into one of the above Tiers and his or her benefit is calculated accordingly. The retirement benefit is payable for the employee's lifetime, and if married at least one year prior to retirement, for the

lifetime of the spouse and if married for the lifetime of the spouse. LAFPPS also provides a cost of living adjustment, which increases the retirement benefits annually. The provisions of the COLA are:

- Tier 1 (Section 1328) – Based on changes to the Los Angeles Consumer Price Index.
- Tier 2 (Section 1422) – Based on changes to the Los Angeles Consumer Price Index.
- Tier 3 (Section 1516) – Based on changes to the Los Angeles Consumer Price Index to a maximum of 3% per year.
- Tier 4 (Section 1616) – Based on changes to the Los Angeles Consumer Price Index to a maximum of 3% per year.
- Tier 5 (Section 4.2016) – Based on changes to the Los Angeles Consumer Price Index to a maximum of 3% per year. Excess above the 3% is banked and can be used in the future.

LAFPPS uses a member database system called OnPoint, which calculates the retirement benefit for their retirees. We looked at a cross section of 61 sample calculations to determine the accuracy of the calculations. We determined that a calculation was correct if it came within ± $0.03 within our calculation.

In the course of our review of the sample calculations, we observed the following:

- The Summary Plan Descriptions were well written and contained all the necessary information to perform the review.
- Ancillary Administrative materials were also available from LAFPPS and also contained the information needed.
- The files containing the data to perform the calculations were well documented and contained the necessary information to perform the calculations.
- Pre OnPoint calculations for our sample group were done correctly and complied with the plan provisions.
- The OnPoint calculation system accurately calculated the retirement benefits for the sample employees. The calculations followed the plan document for each

Tier, as well as the employee data and the administrative (COLA) and court imposed rules (QDROs).

- The employee data is contained mainly in a paper format and can be easily lost if there is a fire, flood or earthquake.

- The current actuarial conversion interest rates and mortality table used to convert the various elected forms of benefits available to the employees were not readily available. However, our review showed that benefits are being valued correctly. Not having the conversion factors readily available may make it difficult on a go forward basis for LAFPPS to determine if the OnPoint system is strictly adhering to the future plan provisions.

Task Area 4b Recommendations 2-3
LAFPPS should make a major attempt to scan member data to get closer to a paperless environment.
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 continue to calculate the correct benefit.

4c. Disability Pension Application, Review, Approval and Appeal Procedures

Principles

Assessing the adequacy of a public pension system's disability application review procedures helps to ensure prompt and accurate delivery of participant benefits. The assessment should take into account a fund's applicable rules and regulations that govern determination of disability applicants' retirement benefits. A public pension system's members must believe that the review procedures are fair and objective when they apply for retirement disability. In addition, pension systems want to ensure that applicants are actually unable to work, while at the same time, they do not want to overburden applicants with administrative paperwork dependent upon their medical conditions/impairments at the time.

A public pension system's disability review procedures need to include the gathering of as much relevant medical-related information as possible in order to provide decision makers with the necessary information to render an impartial retirement decision based upon available

medical evidence. Not having procedures in place to gather comprehensive medical records to validate an applicant's disability claim would be considered inadequate for disability retirement benefit determination purposes. Also, public pension systems need to gather medical evidence to help protect and safeguard the fund's assets from unwarranted claims.

To help ensure disability claims are processed appropriately, public pension systems need to train all parties involved in the disability application review process to understand their roles and responsibilities. First, staff members who administer the disability application review process must be trained to understand applicable government mandated rules and regulations. Training staff on disability is usually on-the-job training because there are no formal courses available in the subject area. In addition, board members or hearing officials must be familiar with applicable disability rules and requirements.

The rules and procedures for disability staff to follow in order to help mitigate errors and misjudgments need to be documented in writing. The documentation of rules is usually contained in city codes and charters, whereas, public pension systems typically develop step-by-step procedures for staff to follow when processing disability applications.

In addition, a quality assurance process is essential to help ensure disability applicants receive every benefit to which they are entitled. An effective quality assurance process involves checking both the basis of the disability retirement benefit determination as well as the accuracy of benefit calculations. The process also entails validating the medical evidence used in making disability determination decisions.

Further, an effective disability review process must be responsive to disability applicants' needs. The process must include tracking and reporting systems so applicants know the processing status of their disability claims. Not only should the process be responsive to disability applicants, it should help to keep management and board members informed about each disability applicant through on-going communications and reporting systems.

Risks

An inadequate disability application review procedure may not adequately protect the fund's assets, opens up the possibility for fraud and exposes an organization to bias and discrimination charges from those disability applicants whose claims are denied. An inadequate review procedure may also create morale problems for participants and result in higher benefit expenses for an organization if unwarranted claims are routinely approved.

Observed Conditions

The City Charter requires the LAFPPS Board of Commissioners to render a disability retirement benefit decision based upon medical reports from at least three regularly licensed, practicing physicians and such other evidence concerning the disability it may have before it (Section 1310 – Disability Pension – Service Connected).

LAFPPS has a Disability Section that consists of 12 authorized staff who are directly involved in processing disability applications. The Section is headed by a Pension Claims Officer (PCO) who reports to the Assistant General Manager. Processing applications is assigned to five Management Analysts, and there are two Senior Management Analysts who oversee their work products. There are four Clerk Typists who perform such administrative tasks as filing supporting document records, coordinating appointments and entering applicant data into the computers.

During the course of a typical year, the LAFPPS Disability Section processes between 1,200 and 1,500 applications. The monthly case load is approximately 100 applications, which are divided equally among the Management Analyst staff. Each Analyst processes between 20 and 25 disability applications per month.

The disability retirement benefit determination process is more complicated and complex than those typically found in the market because the City Charter requires disability benefits to be provided to fire and police officers based upon a tiering approach. Currently, the City Charter has defined five tiers applicable to fire and police for disability retirement benefit determination. Processing disability applications requires the staff to become familiar with the pension benefits available to applicants based upon their assigned tiers.

The Disability Section maintains a Disability Procedure Manual (DPM) issued to each staff member at the time of hire in hard copy is also maintained electronically. The DPM includes references to applicable provisions in the City Charter and contains step-by-step procedures along with examples of completed forms for staff use in processing disability applications. Our review indicates the DPM is comprehensive and serves as an excellent reference resource for the Disability Section staff. There are more than 80 different forms and 80 types of correspondence included in the DPM as reference resource materials. Although there are procedures in place and the staff indicates the DPM is continuously updated, the dates contained on most of the materials specify the mid- to late-1980s.

In addition to the DPM resource, the Disability Section has a peer review quality assurance process in place to help ensure that the initial Management Analysts' disability retirement benefit determination recommendations put forth by the Management Analysts are in compliance with members' impairment levels, years of service and charter case law. To aid in making the disability retirement benefit determination, the Disability Section uses a Disability

Rating Sheet that LAFPPS established in collaboration with both the fire and police unions. Senior Management Analysts are responsible for reviewing the Analyst's initial recommendation and making changes, if needed. Then, the recommendations are submitted to the PCO and the Assistant General Manager, as well as the General Manager for their review and input. Once the peer review is completed, recommendations are reviewed with disability applicants and/or their designated representatives.

The Disability Section categorizes all disability retirement benefit recommendations as either an Alternative One or Two for purposes of scheduling Board hearings. In the case of Alternative One, disability applicants agree with the Disability Section's recommendations and no board hearing is required. Whereas, a hearing is required under Alternative Two – applicants disagree with the Disability Section's recommendations.

LAFPPS has a thorough review process for determining disability retirement benefit recommendations for the Board. The process includes (1) collecting Workers' Compensation and medical records to determine the level of an applicant's impairment; (2) interacting with medical liaisons within the fire and police departments to identify job availability for applicants based on their diagnosed impairment level; (3) determining a Disability Rating Score to recommend the pension benefit, if any, and (4) coordinating with LAFPPS Service Pension Section to calculate actual pension benefits for applicants.

The typical timeframe for processing a disability application is 10–12 months:

Table 4c-i	
Processing Activity	**Typical Timeframe (in months)**
Receiving Completed Application	2 – 4
Collecting Medical/Workers' Compensation Records	2 – 3
Scheduling Medical Exams	2 – 3
Scheduling of Board Hearing	2 – 3

The Disability staff waits to receive information approximately 60% of the timeframe because most of the processing activities depend on other people over whom they do not have any control. The collection of medical and Workers' Compensation records is time consuming and paper intensive. The average administrative file developed in processing a disability application contains approximately 400 pages, while files range in size between 200 and 1,000 pages.

LAFPPS has a policy and procedures contained in the DPM, which address the confidentiality of administrative files for disability applicants. The policy is in accordance with California Government Code, Chapter 3, and Section 6254, which deals with records exempt from disclosure requirements. The procedure primarily identifies what information may be shared with individuals outside LAFPPS.

However, LAFPPS does not have any established policy and/or procedures to protect the privacy of medical records in the Disability Section. The medical records of applicants are not securely locked in file cabinets or offices when they are not in use. Also, there is no specific individual designated in LAFPPS' Administrative Section to handle disability applicants' medical records. Regardless of whether LAFPPS is required under the Health Insurance Portability and Accountability Act (HIPAA) to protect the privacy of medical information, it is "best practice" to safeguard personnel information, especially medical records.

The LAFPPS Board frequently modifies staff's Alternative Two disability recommendations. Specifically, our review indicates the Board has revised approximately 42% of the Disability Section's recommendations during the past three years.

Table 4c-ii	**Year**			
Alternative Two	**2005**	**2006**	**2007**	**Total**
Total Disability Cases	69	61	51	181
No. of Cases Board Changed Staff Recommended Disability Percentage	27	27	22	76
No. of Cases Board and Staff Agree on Disability Percentage	42	34	29	105
Percentage of Cases Board Increased Staff Recommended Percentage	39.1%	44.3%	43.1%	42.0%

Table 4c-iii	**Year**			
	2005	**2006**	**2007**	**Total**
Board Recommended Average Disability Percentage	46.8%	43.0%	49.0%	46.1%
Staff Recommended Average Disability Percentage*	36.8%	36.2%	41.4%	37.9%

* Disability retirement benefit expressed as percentage of applicant's pay.

The Board's decisions mostly increase the amount of the approved disability applicant's retirement benefits.

Table 4c-iv: Estimate of the Impact of Board Disability Case Decisions

	Year			
	2005	**2006**	**2007**	**Total**
Total Cost of Board Disability Cases	$1,613,490	$1,310,129	$1,248,686	$4,172,306
Total Cost of Staff Disability Recommendations	$1,270,871	$1,104,763	$1,056,652	$3,432,286
Increased Disability Cost Based on Board Recommendations	$342,619	$205,366	$192,034	$740,020
Impact	**27.0%**	**18.6%**	**18.2%**	**21.6%**

Note: The disability cost is the number of disabilities cases times the average pay times the average disability percentage suggested by the Board and by the staff. The increased disability cost is an annual expense as long as retirees are eligible to receive disability retirement payments.

Assumptions:
Average pay is assumed to be $50,000.

Factors that may affect the frequency with which the Board changes staff recommendations include: (1) the absence of a specific Board orientation to familiarize them with the basis and criteria for making disability retirement benefit determination decisions with Commissioners possibly not as familiar with medical terminology that is provided to them as part of reviewing Administrative files; (2) although Board Commissioners receive the disability package at the same time as other Board materials, there still may not be sufficient time to completely review the provided administrative files to render disability retirement benefit determination decision based on the medical records/evidence.

The Disability Section shares the results of applicants' medical examinations with the appropriate units within LAFD and LAPD so they can determine if there is a suitable job available, given their impairment levels. Concerns were expressed about LAPD raising job availability standards to essential job functions, i.e., performing all of the basic duties of an assigned police officer, for disability applicants. Staff indicated that this standard has not been adopted as policy, yet as a rule, no positions will be available for police officers who can only perform light duty. The Disability Section then needs to recommend a pension benefit even if their disability impairments are rated "minimum."

LAFPPS Service Pension Section calculates applicants' pension benefits. The Disability Section gathers applicant information from LAFD and LAPD and then requests the Pension Section compute pension benefits based on their assigned applicant Disability Rating. When completed, the pension disability calculation is returned to and reviewed by the Disability

Section before distributing the completed packages to Section management for their review prior to submission to the Board of Commissioners for approval.

Task Area 4c Recommendations 1-6
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.
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.
LAFPPS should adopt and implement safeguards to protect the privacy of applicants' medical records.
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.
The Board should evaluate whether to delegate responsibility for disability cases to hearing officers given their time constraints.
The Board should request written clarification on LAPD's policy regarding essential job functions required for disabled officers.

4d. Reasonableness of Calculations and Actuarial Methods Used for Projecting Future Retiree Health Benefits

Background

This section of our report was prepared by our actuarial sub-contractor, Cheiron, Inc. (Cheiron) Use of the terms "we" and "our" within this section refer to Cheiron.

Our understanding of the plan provisions is based on information in the summary information on the LAFPP website and the Summary of Plan Provisions in the 2006 Actuarial Valuation Report. Our understanding is that the claims experience we requested is not available since the contracts are insured contracts. We would like to obtain additional detail with regard to the contractual provisions. However, it is common for the detailed claims data history to not be available for insured contracts.

We reviewed all of the other documents, reports, and other information provided. These form the basis, in conjunction with Cheiron's H-scan projection model, of our conclusions in this section of the report.

Principles

An actuarial valuation of Other Post-employment Benefits (OPEB), or of a retirement plan, is based on four major factors:

1. the actuarial assumptions used to project future benefit payments under the plan,

2. the actuarial cost method used to allocate required costs or contributions to different periods,

3. the plan provisions, i.e., the specific eligibility and benefit provisions that give rise to future benefit payments, and

4. the participant data for all active employees, retirees and survivors, and terminated employees not yet receiving benefits.

The actuarial assumptions can be divided into two segments, demographic assumptions and health-specific assumptions. Demographic assumptions are those relating to turnover (how many employees will terminate employment each year), disability (how many will become disabled and leave employment and, possibly, become eligible for benefits by virtue of their disablement), retirement (how many and at what ages will employees retire), mortality (how many employees will die before retirement and, after retirement, how long will they live and receive benefits under the plan). Typically, demographic assumptions are the same for a retirement plan and a retiree medical plan covering the same population, and experience studies analyzing demographic assumptions are done for the retirement plan.

That is the case at LAFPPS, and we have received and reviewed the most recent Actuarial Experience Study for the period July 1, 2001 through June 30, 2004 prepared by Gabriel, Roeder, Smith & Company (GRS), the plan actuary at that time. This experience study "covers the time from July 1, 2001 through June 30, 2004…[and uses] the same data employed for our annual valuations." The GRS experience study also covers economic assumptions (inflation, investment return) and medical inflation (trend) assumptions.

1. Summary of Experience Study

The report states that "the investigation was made for the purpose of analyzing financial risk areas related to mortality, withdrawal, disability, retirement, and economic factors…[and] was based upon the statistical data furnished for the annual actuarial valuations…" The guidelines of the actuarial profession for studying and setting assumptions for OPEB valuations are Actuarial Standard of Practice (ASOP) No. 27, 'Selection of Economic Assumptions for

Measuring Pension Obligations' and ASOP No. 35, 'Selection of Demographic and Other Non-economic Assumptions for Measuring Pension Obligations.' We reviewed the experience study in light of those Standards of Practice. The experience study also addresses health-related assumptions.

The Board adopted the recommendations for changes in demographic assumptions, but did not adopt the recommendations for changes in economic assumptions. Economic assumptions were subsequently changed for the June 30, 2006 actuarial valuation. Changes in assumptions that were recommended by GRS include the following:

- **Inflation** – GRS recommended that assumed future inflation, as measured by the cost-of-living index (CPI) be reduced from 5.00% to 4.50%. It was not changed for 2005, but was changed to 3.75% for the 2006 valuation.

- **Investment return** – GRS recommended that the assumed net investment return on plan assets be reduced from 8.50% to 8.25%. The assumption was not changed for 2005, but was changed to 8.00% for the 2006 valuation.

- **Salary increases** – the assumption being used was a general inflation rate of 5.0% plus an age-related merit/longevity increase ranging from 5.0% at age 20 to 0.5% at age 60. No change was recommended. The assumption was changed for the 2006 valuation to the following:

  - general inflation – 3.75%
  - productivity – 0.50%
  - merit/longevity – age-related rates ranging from 5.25% at age 20 to 0.75% at age 60

  The salary increase assumption is an integral part of the retirement plan valuation, but only impacts the OPEB valuation as far as the payroll growth assumed for amortizing the Unfunded Actuarial Accrued Liability.

- **Retirement rates** – separate rates are used for Police and for Fire, each graded by age. Experience showed retirements at earlier ages (under age 60) to be "far less than expected". Reduced rates were recommended and adopted – a 50% reduction at age 50 and over for Fire, and a 50% reduction from age 50 to 60 for Police.

- **Mortality** – For retirees the experience showed significantly fewer deaths than expected, and modifications were recommended and adopted to reflect the longer life expectancy. Mortality among beneficiaries was in accordance with the assumption, and no change was recommended. A modification was also

recommended and adopted for lower duty-related mortality for active Fire and Police.

- **Turnover (termination rates)** – Experience showed terminations to be greater than expected, for both Fire and Police. For Fire, the higher number of terminations was mainly among those with less than five years of service. The recommended change was to introduce a withdrawal rate of 5.5% per year for those with less than five years of service, and to leave the rates the same for those with five years or more. For Police, the recommended change was to increase rates for those with five or more years of service, based on the experience during the period.

- **Disability rates** – Duty-related disabilities for both Fire and Police were significantly lower than projected by the assumption, and the recommended change was to reduce the assumed rates for both Fire and Police by one-third. Non-duty-related disabilities were also lower than assumed but, because of the relatively low number of assumed disabilities overall, no change was recommended.

Observed Conditions

In general, the changes in demographic assumptions appear reasonable based on the experience during the three-year period July 1, 2001 through June 30, 2004. We have the following comments on the recommended assumptions and the justification presented in the experience study report:

- **Inflation and investment return** – in general these are areas where there is considerable room for judgment, and for a range of expert opinions. Economists, investment managers, and investment consultants generally come to somewhat different conclusions as to future inflation, future real returns by asset class, and the risk inherent in various asset classes. For example, in 2005 a quarterly Survey of Professional Forecasters published by the Federal Reserve Bank of Philadelphia predicted that inflation over the next 10 years would average 2.5% per year, with the forecasts ranging from a low of 2% to a high of 6%. Forecasts of investment returns probably have even a wider range. With regard to inflation, as measured by the CPI, the prior 5% assumption is significantly higher than inflation has been for the last 15 years or so, and higher than economists' expectations. Therefore, a reduction is reasonable. The recommended change to 4.5% is a modest reduction. As mentioned above, this change was not adopted for 2005, but a reduction to 3.75% was adopted for 2006. The then-current assumption and the recommended change are as follows:

	Current	Recommended
Inflation	5.00%	4.50%
Real rate of return	3.50%	3.75%
Net assumed return	8.50%	8.25%

The change for the 2006 valuation was as follows:

Inflation	3.75%
Real rate of return	4.25%
Net assumed return	8.00%

The resulting 3.75% inflation assumption and 8.00% net investment return assumption do not appear to be unreasonable; however we note that the 4.25% real return is significantly less conservative than the prior 3.50%.

- **Salary increases** – this is generally not applicable to the OPEB valuation, except with regard to amortization of the Unfunded Actuarial Accrued Liability. The salary increase assumption is composed of three parts, inflation, real growth, and merit/longevity. The experience study stated that salary increase experience was higher than assumed, but no change was recommended for 2005 in anticipation that "future pay increases will be moderated due to existing and potential tight budgets." For the 2006 valuation, the salary scale assumption was changed to include the following components - 3.75% inflation, 0.50% productivity, and an age-related merit/longevity increase ranging from 5.25% at age 20 to 0.75% at age 60. The sum of the inflation and productivity components equal to 4.25%, is used for the "payroll growth" assumption to amortize the OPEB unfunded liability as a level percent of increasing payroll.

- **Retirement rates** – Experience during the three-year period showed substantially fewer retirements, especially at younger ages, than expected. The report states retirements were about 40% less than assumed for Fire and about 50% less than assumed for Police. Substantial reductions in assumed rates were recommended based on this experience.

- **Marriage and election of coverage** – Experience data for the three-year period showed that about 88% of retirees were married at retirement. The assumption is 86% and no change was recommended. With regard to coverage, 70% of eligible spouses are assumed to elect coverage after the retiree's death. No experience

data is provided with regard to election of coverage. The liability for a married retiree where the spouse is covered can be twice the liability for a single retiree; thus, it merits additional review. In the 2006 valuation, an assumption that female spouses are three years younger than their husband is included; this assumption is not mentioned in the 2005 actuarial valuation report, nor is any experience included in the report. Although these are not unreasonable assumptions when compared to other public sector valuations, data should be obtained and examined.

Task Area 4d Recommendation 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.

- **Mortality** – For healthy lives experience indicates that retirees are living longer than the assumed life expectancy on the assumed 1994 Group Annuity Mortality Table. GRS's recommendation was to continue to use the 1994 Group Annuity Mortality Table, but with a two-year age set-back. It would be appropriate to consider a table which includes future expected improvement, or even a generational table which automatically incorporates expected improvements in life expectancy.

  The change for disabled lives is to the 1994 Group Annuity Mortality Table but with ages set forward two years. For beneficiaries experience was fairly close to the assumed mortality which is the same table with a four-year age set-back, and the recommendation was to maintain that assumption without change.

Task Area 4d Recommendation 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.

- **Termination rates** – Experience during the three year period generally showed more terminations than projected by the assumed rates. The assumption for Fire was an age-related scale, and the assumption for Police was a select and ultimate assumption, with rates varying by years of service for the first five years and then varying by age. The recommendation, based on experience, was to change to a select and ultimate assumption for Fire, reflecting the higher turnover during the first five years, and to increase the turnover for Police with five or more years of service. The proposed assumption brings the expected number of terminations closer to the actual experience, and is a reasonable change.

- **Disability rates** – Experience during the three-year period showed duty-related disabilities for both Fire and Police to be about 35% to 40% of the number projected by the prior assumption. The recommended reduction by one-third is a reasonable step, with the further monitoring of experience.

As stated above, we believe that the experience study generally reflects an appropriate analysis in accordance with guidelines of ASOP No. 27 and ASOP No. 35. The recommended assumptions appear to be generally reasonable in the aggregate. Two areas that should be considered or where further data would be beneficial to additional analysis are mentioned above.

2. Analysis of Health-Specific Assumptions

Background

Demographic and economic (non-health-specific) assumptions were reviewed in the plan actuary's three-year experience study report and in the preceding section of this Report. These assumptions will generally be the same for a given population that is covered by both a retirement plan and a retiree medical plan. We now move to health-specific assumptions. These are generally medical claim costs, medical inflation (trend), and plan coverage and elections.

Medical claim cost assumptions are related to the specific plan of benefits provided and the providers that are contracted to provide those benefits under the plan. Medical inflation (trend) assumptions are related to these factors, but are also related to national and regional trends on medical inflation.

a. Summary of Experience Study with Regard to Health-Specific Assumptions

The Actuarial Experience Study report prepared by GRS, the plan actuary at the time, included recommendations as to health-specific assumptions. Three areas are covered. With regard to healthcare trend assumptions, GRS recommended a significant increase in the assumed trend, which was not adopted for the 2005 valuation. The assumption being used started at 6.50% and graded down over eight years to 5.0%. The recommended change was to a three-pronged assumption, pre-65 medical, post-65 medical, and dental. Pre-65 medical started at 9.0% and graded down over nine years to 4.50%. Post-65 medical started at 11.0% and graded down over nine years to 4.50%. Dental trend was a flat 4.5% per year.

Second, with regard to per capita healthcare costs, commentary in the GRS report was minimal. It appears that the per capita healthcare costs were based on the actual maximum

subsidy under the Plan. There is no information provided as to how the maximum subsidy was set, or the premiums for the various available medical plans.

Third, experience as to participation rates is summarized. The current assumption is 85% of eligible retirees, surviving spouses, and disability retirees will elect coverage. Experience during the three-year period showed that for pre-65 coverage, among all three groups, participation was significantly lower than 85%. For post-65 coverage, among all three groups participation was higher, about 92% among retirees, 67% among surviving spouses, and 84% among disability retirees. The recommended change was to maintain the 85% assumption post-age 65 and reduce it to 75% pre-age 65.

Other demographic and economic assumptions are the same as used for the retirement plan.

Observation Conditions

As mentioned above, some of the recommended changes in assumptions were implemented for the 2005 actuarial valuation, and certain changes in economic assumptions were implemented for the 2006 actuarial valuation. Our comments in this section relate to the assumptions used for the 2006 actuarial valuation.

In general the assumptions used for the 2006 actuarial valuation do not appear unreasonable. However, while the starting point of the health care trend assumption appears reasonable, we believe that the grading of health trends down by 1.0% per year to an ultimate rate of 5.0% is toward the more optimistic range of reasonable.

Task Area 4d Recommendation 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.

However, one item which is partially methodology and partially assumptions bears comment. Based on the description in the June 30, 2006 OPEB actuarial valuation report (page 28) the application of the trend rates to the subsidy amounts appears to be a half-year off. The application of the trend rates is described as follows, “For example, the proposed medical subsidy for a male retiree age 65 in the year July 1, 2007 through June 30, 2008 would be determined with the following formula: [$5,964 x (1 + 12%)] = $6,680. Since our understanding is that $5,964 represents the subsidy for calendar 2006, trend would need to be applied from the mid-point of 2006 to the mid-point of the 2007-2008 valuation year or, on average, from July 1, 2006 to January 1, 2008, or approximately (1+ .5 x 12%) x (1 + 12%) = 1.187. This would result,

in this example, with $7,080 rather than $6,680, about a 6% understatement. For the entire plan, this would result in an understatement of the Actuarial Accrued Liability of approximately $92 million.

Task Area 4d 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.

With regard to other assumptions, specifically marital status, coverage, and participation, there appear to be some inconsistencies in the description of these assumptions in the 2006 valuation report. The actuarial valuation report (page 20) states that 80% of retirees are assumed to receive a subsidy for an approved health carrier and that 90% of retirees are assumed to elect Medicare Parts A and B. However, on page 21 under Per Capita Claim Cost Development, utilization, which is defined as "the proportion of all retirees that elect to receive a subsidy," utilization rates of 75% for those without Medicare Part A and B and 85% with Medicare Part A and B are reflected. This appears to be inconsistent with the assumption of 80% on page 20.

With regard to spousal coverage, page 20 of the report states that "with regard to Members who are currently alive, 70% of eligible spouses…are assumed to elect coverage after the Member's death." It goes on to say that "with regard to deceased Members, 70% of the current eligible spouses are assumed to have elected benefits." It is not clear what that implies with regard to the valuation. Presumably, with regard to deceased members, an assumption as to whether the spouse has elected coverage is not needed.

Last, the assumed age difference of retiree and spouse (which is that wives are three years younger than their husbands) is not mentioned in the Experience Study, and no data is provided.

Task Area 4d Recommendation 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.

b. Review of June 30, 2006 Actuarial Valuation Report

Background

An actuarial valuation of the FPPS Retirement Plan and Other Post-employment Benefits (OPEB) is done annually as of June 30. We received and reviewed the valuation reports as of

June 30, 2004, 2005, and 2006. The 2004 and 2005 reports were prepared by GRS and the 2006 report was prepared by The Segal Company (Segal). Our review concentrated on the June 30, 2006 OPEB actuarial valuation report, although we did review the preceding two years and the retirement plan reports for context. Our comments, however, are solely with regard to the 2006 OPEB valuation.

As stated in the report, the valuation was prepared in accordance with the requirements of the Governmental Accounting Standards Board (GASB), specifically GASB No. 43, Financial Reporting for Post-employment Benefit Plans Other Than Pension Plans, and GASB No. 45, Accounting and Financial Reporting by Employers for Post-employment Benefits Other Than Pensions. Essentially, GASB No. 43 covers requirements for OPEB accounting by plans and GASB No. 45 covers requirements for OPEB accounting by employers sponsoring those plans. In addition, the report states that the valuation has been prepared in accordance with generally accepted actuarial principles and practices.

c. Summary of the Actuarial Valuation Report

The highlights of the report can be summarized as follows:

- The recommended contribution increased from the prior year from $52.2 million to $92.7 million (both adjusted for interest for contributions at the end of each pay period). As a percentage of payroll, the contribution increased from 5.03% to 8.48%. Note that the prior year saw an increase from 2.83% of payroll to 5.03%. The increase was primarily the result of actuarial losses from 2004 to 2005 (primarily investment losses), the revised actuarial assumptions in 2006, including the discount rate and medical trend, and the revised amortization schedule in 2006.

- LAFPPS will comply with GASB No. 43 effective with the June 30, 2006 actuarial valuation. The city must report in accordance with GASB No. 45 for its fiscal year beginning July 1, 2007.

- The Board has adopted a policy of amortizing the entire Unfunded Actuarial Accrued Liability (UAAL) as of June 30, 2006 over a fixed 30 year period as a level percentage of payroll, with an assumed payroll growth of 4.25% per year.

- Return on assets for the prior year (2005-2006) measured approximately 12.4% based on market value and approximately 7.4% on actuarial value of assets. (Actuarial value is a five year average of gains/losses compared to expected return at the valuation assumption. The valuation assumption was reduced from of 8.5% to 8.0% for the 2006 valuation.)

- Participant data showed relatively small increases from the prior year, about 1% for retirees and surviving spouses and about 2% for active employees.

- The significant increase in health contribution requirement from the 2005 to the 2006 valuation is being phased in over 3 years.

In general, the actuarial valuation appears to be completed in accordance with generally accepted actuarial principles and procedures, and in accordance with the requirements of GASB No. 43 and 45. However, there are a number of areas where additional information is needed to confirm the methodology. These are covered in the next section.

Observed Conditions

As mentioned above, the actuarial valuation appears to be prepared using methods and assumptions that are reasonable and meet the applicable requirements. However, there are certain areas where the actual description of the methodology is unclear, and additional information is required. In addition, there are some suggestions with regard to the clarity and completeness of the report that we suggest. Our comments are as follows:

- With regard to plan assets, several exhibits in the report are prepared based on total FPPS assets, i.e., including assets for the retirement benefits as well as OPEB. These include the Table of Financial Information (which is a summary statement of assets), the Summary Statement of Income and Expenses, and the Determination of Actuarial Value of Assets.

Task Area 4d Recommendation 6
If assets are tracked separately, it would provide useful information to include these exhibits for OPEB separately.

- **Implicit Rate Subsidy** - GASB 45 provides that in situations where retirees participate in a plan that covers active employees as well as retirees, or more to the point, if premiums or subsidies are determined on a "combined" basis, an implicit rate subsidy could result. In that situation, the use of the premium determined on a combined basis could understate the true cost of the retiree benefits. The 2005 actuarial valuation report prepared by GRS stated that "the health subsidy rates do not reflect the expensing in a manner consistent with forthcoming GASB disclosures…due to the 'implicit rate subsidy' considerations. This is not mentioned in Segal's 2006 valuation report. Since we do not have information relating to the determination of premiums for the various carriers and the maximum subsidy under the FPPS OPEB Plan, we cannot make

a judgment as to whether any implicit rate subsidy issue exists. If there is an implicit rate subsidy and if it is not reflected in the valuation, the Plan's Actuarial Accrued Liability and Normal Cost could be materially understated.

Task Area 4d Recommendation 7

Segal should be asked to describe whether an implicit rate subsidy exists, and to document their analysis by which they made their determination.

- The report states that contribution rates are developed in two ways, assuming that contributions will be paid either (i) at the beginning of the year, or (ii) throughout the year at the end of each pay period. The use of two different measures of cost and two different contribution rate percentages can be confusing.

Task Area 4d Recommendation 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.

- It appears from the benefits descriptions provided that FPPS is receiving a subsidy from the Federal government for retirees who have declined Medicare Part D coverage (prescription drug coverage) and are obtaining that coverage from the FPPS Plan. GASB has stated that, unlike accounting for corporate plans as promulgated by the Financial Accounting Standards Board, the subsidy should not be reflected in the determination of contributions under GASB accounting. Therefore, the fact that this is not included in the valuation is appropriate. However, since this can be a significant amount, it would provide relevant and useful information.

Task Area 4d Recommendation 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 report.

3. Cheiron's Proprietary H-Scan Projections Under Alternative Scenarios

An actuarial valuation typically presents results for one year. Although inherent in the valuation is a projection of the population and benefit payouts for 75 years or more, the basic results (annual required contribution and funded ratio) are shown for the valuation year. It is useful to examine projected results for a number of years under different economic scenarios.

This provides valuable information as to the future results, and how experience better or worse than assumed can affect those results.

We have projected valuation results using our H-scan projection model for 15 years. In addition to a baseline projection using the valuation assumptions, we have projected results using the following scenarios:

- discount rate and investment return of 7.5%
- discount rate and investment return of 8.5%
- medical inflation parameters equal to the baseline assumption, except declining to 5% over 14 years instead of seven years

These results, depicted graphically below, present experience under both positive and negative scenarios.

a. Baseline

The Baseline graph below, depict the assumptions used for the June 30, 2006 actuarial valuation of the plan, including an investment return assumption of 8%. The first year shows the 2006 valuation results, a funded ratio of 57% and Annual Required Contribution (ARC, equal to service cost plus amortization of the Unfunded Actuarial Accrued Liability) as a percent of payroll equal to 7.3%, based on the one-year timing lag. Over the 15 year period the funded ratio is projected to improve to 84% and the ARC is stable, declining and stabilizing at about 6.5% of payroll.

[space intentionally left blank]

H-scan OPEB

Stress Testing

CHEIRON

Assets and Liabilities

40% 41% 44% 48% 51% 55% 58% 62%

Millions

$5,000
$4,500
$4,000
$3,500
$3,000
$2,500
$2,000
$1,500
$1,000
$500
$0

2006 2008 2010 2012 2014 2016 2018 2020

Plan Funding

Perecent of Payroll

9.0%
8.0%
7.0%
6.0%
5.0%
4.0%
3.0%
2.0%
1.0%
0.0%

2007 2009 2011 2013 2015 2017 2019 2021

PAYGo Cost SVC Cost UAL Amort Actual Contrib

b. Discount Rate/Investment Return = 7.5%

Using a discount rate and investment return of 7.5% instead of the assumed 8.0%, the funded ratio improves to 83% after 15 years, but the annual required contribution increases to about 7.3% of payroll.

H-scan OPEB Stress Testing CHEIRON

Assets and Liabilities

37% 37% 41% 45% 49% 52% 56% 60%

Millions

$5,000 $4,500 $4,000 $3,500 $3,000 $2,500 $2,000 $1,500 $1,000 $500 $0

2006 2008 2010 2012 2014 2016 2018 2020

Plan Funding

Perecent of Payroll

10.0% 9.0% 8.0% 7.0% 6.0% 5.0% 4.0% 3.0% 2.0% 1.0% 0.0%

2007 2009 2011 2013 2015 2017 2019 2021

PAYGo Cost SVC Cost UAL Amort Actual Contrib

c. Discount Rate/Investment Return = 8.5%

Based on a more favorable discount rate/investment return of 8.5%, the funded ratio improves to 87% after 15 years and the annual required contribution is at 5.8%.

H-scan OPEB Stress Testing CHEIRON

Assets and Liabilities

43% 44% 48% 51% 54% 58% 61% 64%

Millions

$5,000
$4,500
$4,000
$3,500
$3,000
$2,500
$2,000
$1,500
$1,000
$500
$0

2006 2008 2010 2012 2014 2016 2018 2020

Plan Funding

Perecent of Payroll

9.0%
8.0%
7.0%
6.0%
5.0%
4.0%
3.0%
2.0%
1.0%
0.0%

2007 2009 2011 2013 2015 2017 2019 2021

PAYGo Cost SVC Cost UAL Amort Actual Contrib

d. Medical Inflation Grades to Ultimate Over 14 Years

Using the assumed discount rate and investment return of 8.0%, but based on medical inflation at 12% the first year, but staying at a higher level for a longer period of time than the valuation assumption, the funded ratio improves to only 82% and the annual required contribution is at a higher 8.7% of payroll.

H-scan OPEB
Stress Testing
CHEIRON

Assets and Liabilities

34% 34% 38% 43% 47% 51% 55% 59%

Millions
$5,000
$4,500
$4,000
$3,500
$3,000
$2,500
$2,000
$1,500
$1,000
$500
$0

2006 2008 2010 2012 2014 2016 2018 2020

Plan Funding

Perecent of Payroll
12.0%
10.0%
8.0%
6.0%
4.0%
2.0%
0.0%

2007 2009 2011 2013 2015 2017 2019 2021

PAYGo Cost SVC Cost UAL Amort Actual Contrib

Task Area 5 – Administration

(Please see related discussion on Board travel and education policies and procedures in Task Area 2.)

5a. Significant Expense Analysis

1. Investment Costs

a. Costs to Manage the Total Fund

Principles

An investment fund's gross return is a combination of the income the investments generate and net realized and unrealized gains and losses in investment value. The net return that flows to the "bottom line" and is available to pay benefits is the gross return reduced by the costs of achieving that return. The three main categories of costs that affect investment return are:

- Costs of investment management, generally being amounts paid to entities or persons for selecting and managing the investments.
- Costs of professional advice supporting the effort of managing the fund, including various consultants and other professionals who assist in selecting, monitoring, and measuring the investment managers and their activities, as well as custodians, record keepers and others supporting the control of the process.
- Costs of transactions within the portfolio, principally the cost of executing trades in the portfolio.

Some of these costs are separately invoiced and some are charged directly to the fund's investment accounts. Some are variable costs tied to the amount of assets, transactions, or other activity and some are fixed costs per period. Some are easily measured and others are difficult to quantify. All are to some extent negotiable. Some cost savings are relatively easy to negotiate and put in place; others are either financially or administratively difficult to achieve.

Risk

Making decisions regarding fund management is hampered without knowing the impact of such decisions on the total cost of managing a fund.

Observed Condition

The RV Kuhns Public Universe Analysis dated June 30, 2006 calculates an average plan total investment expense of 35.13 basis points for LAFPPS versus 25.27 basis points for their universe of public funds with $10-$20 billion in assets.

b. Costs for Investment Managers

Principles

Investment manager fees are determined as a part of the search and hiring process. Most investment managers maintain set fee schedules, typically with break points applying lower fee rates to assets above particular levels. This results in lower average fees for larger accounts. While the explicit fee tables may be negotiable, often they are not if only because other clients may have negotiated fee provisions providing for parity with similar clients (e.g., a "most favored nation" clause). In addition, fees can vary significantly by the capitalization size (e.g., small cap accounts are generally more expensive than large cap accounts) or the style of the account.

Competitiveness of fee schedules is a complex matter. Data is predominately available only from surveys or inquiries of other managers either obtained directly or through an investment consultant who maintains such data. This research can generate a range in which similar managers set their fees, but cannot identify the one "right" fee. At best it can identify outliers and give comfort that the fee is competitive. Ultimately, though, the goal is to achieve a net return, so a savings from lower fees could be more than offset by poorer returns.

Partnership fees for private equity, real estate, oil and gas and hedge fund limited partnerships are generally not negotiable for a fund, unless the fund is able to negotiate some sort of side letter agreement. Certain strategies are more labor intensive than others and private equity is typically considered to be very labor intensive. It is not unusual for the fee schedule to be reduced in the later years of the partnership. Most partnerships also have some form of carried interest where the General Partner will receive a certain percentage of profits (typically 20%) after some agreed to preferred return is earned by the Limited Partners.

i. A Note on Performance Fees

Performance fees are common, perhaps universal, in alternative asset structures such as hedge funds, private equity and private real estate. They are less common for managers following strategies investing in long-only positions in publicly traded securities. There are several reasons why performance fees are not commonly used in these strategies. Among the common criticisms are:

- Performance fees do not succeed in "incenting" managers to generate better returns (and may only encourage greater risk-taking on the manager's part);

- Managers are already motivated to earn superior returns under a traditional percentage of assets fee because as the market value of an account grows, the manager's total revenue from the account increases;

- Performance fees are more complicated to negotiate, to calculate and to monitor;

- Performance fee structures in practice prove not to be robust or sustainable (generally because either party may prefer to "drop out" during the term of the agreement if its effect is perceived to be adverse);

- The structure of these fees is rarely symmetrical (managers are typically rewarded for producing an excess return, but not as often penalized for underperformance and rarely to the same degree); and

- The appropriate reward for strong performance is the continuation of the business relationship, while the ultimate penalty for weak performance is the termination of the manager's services.

An effective performance fee should carefully define the period over which returns are calculated. The formula should link performance over multiple periods (as opposed to individual years) so that the investor is not paying a performance bonus for one good year when a manager's returns in other years failed to meet expectations. Techniques to accomplish this requirement include the use of a "high water mark" whereby a manager is rewarded only if performance over the entire life of the contract exceeds expectations (and not for temporary bursts of outperformance followed by periods of underperformance). Alternatively, payment of a performance bonus could be made contingent on the manager meeting expectations over rolling periods, requiring sustained success, rather than episodic or short lived success.

The question as to whether performance fees for traditional investment approaches are financially beneficial remains open. Consideration of such a structure should be undertaken not only when a manager is hired, but periodically during the manager's tenure to reconfirm that the fee structure – whether or not the performance component was triggered – is on a net basis beneficial.

Risk

A system that does not monitor its asset management fees risks paying higher than necessary investment management program costs and reducing its overall net return.

Observed Condition

We reviewed many LAFPPS manager fee schedules, LAFPPS quarterly performance reports, which report fees, and LAFPPS fees reported to RV Kuhns. We chart these LAFPPS fees against broad market surveys (below) and find LAFPPS pays a wide range of fees, most are reasonable and a few are above normal. Note that hiring fewer managers and placing more assets with them will generally result in lower fees, although fee alone should not be the only determinate for the number of managers to employ (see Task Area 3g (Investment Structure)).

Table 5a-i	LAFPPS External Management (cost in basis points)	Third Party Survey: Median Published Fees* (cost in basis points)	2006 Greenwich Associates Survey Public Funds over $5 billion
Domestic Equity: Large Cap Passive	.8	6.0	2.4**
Domestic Equity: Large Cap Active	11-36 FIS an outlier at 65	42.0	33.4
Domestic Equity: Small Cap Active	16-33 Attucks an outlier at 86	63.0	#
International Equity: Active	37-46 Brandes midcap an outlier at 84	70.0	40.8
Emerging Market Equity: Active	52-62	100.0	60.6
Domestic Fixed Income: Passive	2	8.0	#
Domestic Fixed Income: Active	7-22	21.0	18.2
Domestic Fixed Income: High Yield	45		
Active Real Estate	72	55 ##	#
Private Equity	123^	139##	#

* "Casey , Quirk & Acito Institutional Product Review", December 31, 2003
** 2005 data
# data points not surveyed
RV Kuhns Public Funds Universe Analysis Report 2006:
basis points per asset class extrapolated from total fund assets basis.
^For consistency calculated on committed assets.

As detailed above, LAFPPS generally paid lower or equivalent fees for external management than its peer group average as reported by the third party surveys. The Casey, Quirk & Acito survey reports published fees, which are frequently higher than actual, negotiated fees, but the Greenwich Associates and RV Kuhns survey reports are based upon actual account data.

Of the 24 investment managers that LAFPPS employs, only three are major exceptions where LAFPPS paid notably more than their peer group as shown on the table above. These are two emerging manager program fund-of-funds (FIS and Attucks) and Brandes midcap international equity. It should be noted that fees remain reasonable when rolled up to total for each asset class program as a whole.

Specialized programs, such as the emerging manager program, often cost more than traditional investment programs and often involve smaller mandates, and smaller portfolios usually have higher relative fees. In addition, FIS and Attucks manage a fund of funds structure, which generally costs more. Nonetheless, FIS is charging LAFPPS their published fee schedule and FIS publicly identifies LAFPPS as its fourth largest client for their investment product.[1] We think that both of those factors could be the basis for LAFPPS to attempt to negotiate a fee reduction.

Brandes is charging LAFPPS its published fee for its international midcap product. Given that the current account balance approximates $150 million, that Brandes lists this account as its second largest with the midcap product and that LAFPPS has an additional $1.3 billion in another Brandes product, Brandes could be open to negotiation for a lower fee. Additionally international midcap should be less expensive than international small cap, but the median published international small cap fee for a $150 million account is 82 basis points[2].

It is difficult to compare real estate fees since they include many different types of fees such as asset management fees, property acquisition fees, incentive fees and property management fees. Here too, fees will vary by fund strategy type and stage.

Some fee reductions may be possible by placing a larger amount of assets with individual managers. As discussed in Task Area 3g (Investment Structure), manager reduction may be possible in some asset classes. LAFPPS has split $1.6 billion between three international core managers: Fisher, Julius Baer and McKinley. Julius Baer charges 58 basis points for the first $100 million and drops the fee to 35 basis points for the amount over $100 million, while Fisher charges 43.5 basis points for the first $400 million and drops the fee to 25 basis points for the amount over $400 million. By combining those two international core accounts, for example, LAFPPS would only be paying the initial breakpoint high fee once, instead of twice, and may also be able to negotiate a lower total fee schedule. Additional asset classes to consider consolidating include the core plus and TIPS fixed income managers. See our recommendations on possible manager consolidation in Task Area 3g (Investment Structure).

[1] FIS lists LAFPPS as its fourth largest client in the FIS-supplied data in the Wilshire Compass database of investment managers.
[2] Data based on Wilshire Compass database of investment managers.

Overall, LAFPPS fees paid to investment managers are normal, and in many cases lower than its peers paid. Manager fees could be reviewed and in a couple of cases an attempt to renegotiate could be made.

Task Area 5a Recommendation 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.

c. Cost for the General Investment Consultant

Principles

The majority of public pension funds and public investment entities utilize an investment consultant. Although the investment consultant's role varies from fund to fund, the role typically includes advising on investment policy and guidelines, assistance with asset allocation, evaluating additional investment strategies and types of assets, selection and monitoring of investment managers and measuring and evaluating risk and return for the overall portfolio, each asset class and each investment account.

The level of reliance on the investment consultant also varies from fund to fund. The consultant's role, responsibilities and reporting lines of authority should be defined contractually.

Consultants provide a variety of information that helps directors, Board members, and staff make better investment decisions. If there are gaps in that information, the fund's leaders may be unable to make effective and successful decisions. Good investment consulting advice requires consultants with broad and deep experience in the areas of capital markets behavior; asset allocation theory and practice; investment strategies, processes and techniques; brokerage practices; custody services; investment performance measurement; pension fund governance; and presentation skills.

Risk

A fund without a consultant operates in an isolated environment without the third party vetting provided by a consultant or their competitive intelligence from direct experience with other funds. A fund without a consultant must develop its own research and services and does not access the cost savings that a consultant provides for services developed for and supplied to its many customers (performance reports, research on investment issues, etc.).

Observed Condition

LAFPPS changed its consultant structure last year from multiple specialist consultants to a general investment consultant, Pension Consulting Alliance ("PCA"); a real estate specialty consultant, The Townsend Group ("Townsend"); and an as yet unknown number of private equity consultants (assignment in transition, as discussed in Task Area 2f (Consultants)). Services to be provided and fee levels are specified in the contracts, with fees fixed in dollar terms and covering all services.

Per each contract, annual fees paid for these consultants are:

- PCA (general consulting) - $400,000
- Real estate: $240,000
- Private equity assignment in transition, contracting new consultant(s) – previously paid $1,632,830 for four consultants (PCA, Abbott Capital, Portfolio Advisors, and Hamilton Lane).

Greenwich Associates 2006 survey indicates that public pension funds with over $5 billion in assets used an average of 1.6 consultants. In our experience many funds involved with real estate and private equity use specialized consultants in addition to a general investment consultant.

The 2006 Greenwich Associates report shows investment consulting fees for public funds with over $5 billion in assets averaged $344,000 in 2006 or .3 basis points on total assets for each general consultant. In our experience PCA's fee is on the high side relative to their scope of services which is more limited than most general consulting contracts, (e.g., PCA does not calculate performance) as discussed in Task Area 2f (Consultants). The real estate consulting fee of $240,000 is moderate in our experience.

Previously LAFPPS retained four private equity consultants simultaneously, which resulted in multiple fees for some overlapping services, and thus was expensive at $1.7 million per year. In our experience private equity consulting is commonly handled by one consultant and the annual fee for this service costs approximately $900,000, depending somewhat upon the size of the program, investment targets and level of consultant discretion. The current decision regarding the size of the Fund's investment per deal could impact the cost of the private equity consultant hired by creating more administrative costs and fees (see Task Area 3g (Investment Structure) and Task Area 2f (Consultants) for more discussion). Additionally LAFPPS is developing a specialized private equity program, and hiring a separate consultant to handle this piece may be reasonable.

Consulting services, even more than investment management services, are sufficiently unique for each provider and each client such that there is no feasible means to determine their

reasonableness in absolute terms. All current consulting contracts are for terms not exceeding three years. This is a reasonable interval for revisiting the quality and cost of investment consultants.

d. Costs of Investment Transactions

Principles

Achieving total investment returns involves costs. Certain of those costs are explicitly stated fees for asset management, custody, accounting and reporting, and the like. Being charged separately from investment activity, these can be easily measured. They can be included or excluded from various rate of return calculations. Thus returns for managers and portfolios can be stated as gross or net of costs and both are used for various purposes.

Other costs are inherent in the process of buying and selling securities. These trading costs are incorporated into the price paid to acquire a security or the amount received on selling it.

Such costs can be perceived as having two components.

- The explicit trading cost is that amount by which the net price paid and received by the two principals trading simultaneously through separate brokers differs. Thus includes commissions charged plus the spread or difference in price passed through by the separate entities.

- The delay and opportunity cost of trading represents the difference between the price that could be achieved in an ideal trade, given the parameters of the trade, and the price actually achieved. These arise largely through timing and efforts in working the trade to effect it at an opportune time.

Other than commissions, which are separately stated on trade tickets, all other trading costs are subsumed within the trade price. Measuring these costs is complex, because they have to be measured against a somewhat arbitrary standard. The price of any security is constantly changing throughout the day. Various methods have been developed to measure trading costs implicit in securities prices against various measures of those securities prices over defined time periods relative to the time of the trade. For example, the price at which a security traded might be compared to the volume weighted average price at which the security traded during that day. This common standard is called VWAP. There are other, often more complex methods of making this measurement, and companies selling services to do so. Any such measurement system must be evaluated as broad averages over time, not individual trade by individual trade.

Trading costs can be substantial.

- Institutional commissions typically are about two cents per share for pure agency trades in widely held stocks. Total commissions charged including research, difficult trades, and principal trades frequently run five to six cents. On a $40 stock, this is 12.5 basis points.

- Market impact, encompassing spreads and other factors through which the trade itself affects the stock price, can range from 15 to as much as 75 basis points, with the median around 40 basis points.

- Combined, the cost of a trade can easily be one-half of one percent. A round trip costs twice that.

- The total effect on a manager's or a portfolio's rate of return from direct transactions costs is further affected by turnover. A turnover of 100, meaning the average security is held for one year, the return lost to trading would on average be one percent per year.

Delay and opportunity costs can add substantially to the reduction in total return that trading causes. These costs are difficult to measure, largely because they must be measured against a unique and arbitrary standard.

- Portfolio managers make decisions at particular times, affected in part by the price at that time.

- The degree the manager is sensitive to the price depends on the type of investment strategy, reasons for ordering the trade, volatility of the security, impending news, and multiple other factors. Managers will often specify urgency of execution and tolerance of price movement based on these factors.

- The delay between the manager placing the order and the executing of the order has a cost in the sense the price will move during that period. The movement may be favorable or unfavorable. The effect of delay can be affected on average over many trades by capable traders who understand the manager's objectives and degree of flexibility.

- Opportunity cost is an extreme degree of delay cost, in which the trade cannot be effected within the acceptable price range, and so is never done. There are tools that can measure the average delay and opportunity effects.

Because they are identifiable and measured, efforts are often made to control the amount and use of commissions. These include programs to recover a portion of the commission dollars, to use them to acquire investment information and tools, to direct them to various providers for

various financial and social purposes, and similar activities. The argument is that the commissions have to be paid anyway, so the extra benefit is "free".

Commissions in excess of pure trading costs fall into the area generically known as soft dollars. This subject has been of continuing interest to regulatory authorities, principally the Securities and Exchange Commission, but also other agencies regulating institutional investing such as the Department of Labor.

A typical agency trade commission on a liquid stock is five or six cents, of which two cents covers the pure trade cost. Absent any specific arrangement, the additional three or four cents goes to the broker collecting the commission.

Alternate arrangements for these dollars include:

- Commission recapture, in which the excess commissions are returned to the investor.
- Directed brokerage, in which the excess commissions are held as credits by the broker and used against the delivery of research from that broker to the investment manager.
- Soft dollars in which the excess commissions are held in an account and paid pursuant to the investor's instructions for the purchase of qualified investment information from a supplier other than the broker.

The SEC has issued regulations and other guidance under Section 28(e) of the Securities Exchange Act of 1934 on what constitutes qualified "research". These regulations change from time to time.

Investment managers are responsible for complying with these regulations, for assuring that the "research and brokerage services" they obtain with client commissions are within current regulations, and that they obtain "best execution" on all trades.

The Funds whose money the managers invest are also responsible under their fiduciary duty to monitor the managers' compliance with these requirements.

Risks

Trading costs are incorporated into the net price paid and received on securities trades. Thus they are hidden within the gross return from investments. Only the commission portion can even be identified. Other costs, including trading spreads, are thus hidden except from specialized measurement programs.

Due to the hidden nature of these costs, they are often not measured except as an indistinguishable part of investment return.

This approach is valid only to the extent that the standard for manager evaluation is total return only. However, this can result in reaching an expensive erroneous conclusion.

Transactions costs that are higher than they need to be may still not be sufficient to degrade a manager's return enough to cause the Fund to take action. Yet those excess costs compounded over a number of years can cost the Fund a substantial amount.

To the extent commission or non-commission transaction costs benefit the manager through directed brokerage, not only might the Fund be overpaying for trading, they may be overcompensating the manager. While the financial result may be the same, the fiduciary implications are different.

Observed Conditions

LAFPPS does not consider transactions costs to be a primary concern. Managers are evaluated based on total return only. Their approach was described as based on a good manager would not be terminated for being a poor trader and a good trader would not be retained despite poor performance.

Given this philosophy, LAFPPS considers measuring quality of execution a waste of money, other than for certain manager transition efforts. LAFPPS previously used a well known performance measurement firm, but deemed the information not to be useful and dropped the service.

LAFPPS has established an absolute limit of nine cents per share on commissions. They occasionally have the need to enforce this, but there is no similar limit on total execution cost.

LAFPPS uses a commission recapture arrangement. Managers were asked to designate the commission recapture programs they preferred, based on the assumption the managers would be better able to achieve best execution and would flow more volume than if the fund designated brokers.

Commission recapture direction to managers is limited to large cap domestic and international managers. Small cap and index fund managers are excluded based on difficulty of small cap trades and typical already low volume and price on index funds. Limit of direction is ten percent, but the managers are not pressured to meet this.

Managers are contractually limited to using no more than 20 percent of trading costs for obtaining research and other qualified soft dollar benefits. Managers are required to disclose what they obtain annually. Staff reviews the disclosure.

LAFPPS encourages managers to use minority and women-owned brokers up to ten percent. Current California law does not allow this to be a mandate. Many such trade credits are thought of as step-out transactions. LAFPPS indicated they have no need for any specialized research, initial public offering availability, or other credits in exchange for these trades. This activity is reported twice a year to the Board.

We do not fully agree that analysis to break down total return into such components as trading effectiveness, attribution to various portfolio characteristics and the like does not add to the management of an investment program. The effect of poor trading can be meaningful, but not of such magnitude that is pushes the manager below the threshold of acceptable total return.

At least occasional sophisticated analysis of transactions costs can provide material information for discussion with the manager. Certain methods such as simple VWAP can be done after the fact, so the manager does not have to be aware trades will be measured until after they are completed. Other methods require more detailed data such as time of order, and must be done with the cooperation of the manager.

Managers who know they are or may be monitored may make a better effort to see that their internal traders thoroughly work the trades.

Task Area 5a Recommendation 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.

On manager trades that involve directed brokerage or soft dollars it is particularly important to measure the cost-effectiveness of the programs. Commission recapture, for example, benefits from a lower net commission only. If other trading costs more than offset that refund, the net benefit is negative.

Task Area 5a Recommendation 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.

The SEC is in the process of tightening the definition of the type of "research" managers may obtain using customer soft dollar credits. While the manager is primarily responsible to comply with these regulations, the Fund has a fiduciary obligation to thoroughly monitor that activity as well. This should involve due diligence over the manager's process for generating the credits, obtaining the research within allowable constraints, and documenting how the research

benefits the Fund. We understand that management reports on soft dollars are required by contract and that the CIO reviews these reports.

Recommendation
No recommendation necessary.

5b. Appropriateness of Administrative Costs

Our focus in analyzing other costs is on the reasonableness of the cost compared to other public funds with similar characteristics. In particular, we think it makes sense to compare LAFPPS to LACERS because of the many similarities between the Departments.

Analysis of expenses cannot be done in a vacuum and we discourage the readers of this report from taking liberties with the figures in Table 5b-ii, below. For example, Line 23, Custody, shows $0 cost. Custody is typically a significant cost for a public fund. Our detailed analysis in Task Area 3h above of the LAFPPS custody relationship with Northern Trust explains the general nature of custody costs in relation to the specifics of the LAFPPS custody arrangement where custody is paid through income from the LAFPPS securities lending program.

Another example where comparison to LACERS is not an apples-to-apples comparison is in administrative costs and benefits paid. The two Departments have very different benefit plans and membership, i.e., safety personnel versus general employees. For example, LAFPPS has a multi-tiered structure and administers a DROP plan. The more complex structure can also explain why Total Administrative Cost per member is greater than LACERS, but because its assets are greater its Total Administrative Costs in basis points is very favorable when compared to the average of its peer group (please see Table 5b-ii below.) The more complex structure and larger asset pool can also explain why other costs are higher than LACERS such as personnel and legal. On a per retiree/beneficiary basis, LAFPPS benefits paid are about 58% higher than LACERS. This is not atypical of a safety personnel type fund which compensates safety personnel and to encourage employment in dangerous jobs. Over time a more expensive benefit structure can be more difficult to fund, yet LAFPPS has done a very admirable job in maintaining a strong funded status.

Further, while attempts are made by many analytical measurement firms to create an objective cost driver or relationship base, e.g., Average Assets or Number of Members, the application of these drivers and interpretation of their relationship to cost and, ultimately, their usefulness, is subjective. Also, many of these administrative costs are so small relative to the asset pool that the rule of thumb commonly applied is that they are less than one basis point of average assets. Legal, Audit, and Actuarial costs are all under one basis point of average assets.

Line	Table 5b-i: Administrative and Other Costs Analysis	June 30, 2004	June 30, 2005	June 30, 2006	LAFPPS Average	LACERS Average
1	**Beginning Assets($mil.)**	10,204.96	11577.37	12390.61	**11,390.98**	8,201.10
2	**Ending Assets($mil.)**	11,577.37	12390.61	13519.3	**12,495.76**	9,293.48
3	**Average Assets($mil.)**	10,891.17	11,983.99	12,954.96	**11,943.37**	8,747.29
4	**Investment Earnings($mil.)**	862.22	1174	1533.07	**1,189.76**	1,042.39
5	**Simple Return on Avg. Assets***	7.92%	9.80%	11.83%	**9.96%**	11.92%
6	**Investment Management Cost ($mil.)***	28.25	33.08	41.52	**34.28**	18.66
7	**External Investment Management Cost**	25.94	27.60	32.05	**28.53 bps**	21.66 bps
8	**Ratio of Inv Earnings to Benefits Paid**	1.53:1	1.94:1	2.36:1	**1.96:1**	2.23:1
9	**Number of Pensioners and Beneficiaries**	11,782	11746	11815	**11,781**	14,343
10	**Active Members**	12,649	12656	12903	**12,736**	27,755
11	**Total Members**	24,431	24,402	24,718	**24,517**	42,098
12	**Benefits Paid ($mil.)**	563.73	605.886	649.728	**606.45**	467.11
13	**Benefit Paid Per P/B**	$47,847	$51,582	$54,992	**$51,474**	$32,553
14	**Admin. Cost ($mil.)**	9.13	9.55	9.62	**9.43**	11.36
15	**Tot Admin. Cost in Bps**	8.38	7.97	7.42	**7.93**	13.05
16	**Tot Admin. Cost/Member**	$374	$391	$389	**$385**	$270
17	**Personnel Cost per Member**	$274	$277	$257	**$269**	$182
18	**Department Positions Filled (varies during the year)**	84	76	94	**85**	111
19	**Personnel Cost per Position**	$79,557	$88,850	$67,470	**$78,626**	$69,270
20	**Personnel % of Total Admin. Cost**	73.2%	70.7%	65.9%	**69.9%**	67.6%
21	**Legal Cost per Member**	$19.20	$20.11	$20.95	**$20.09**	$14.49
	One Basis Point Equivalent on Avg. Assets	$1,089,100	$1,198,400	$1,295,500	**$1,194,300**	$874,700
	Administrative Cost Breakdown (rounded)	**2004**	**2005**	**2006**	**LAFPPS Average**	**LACERS Average**
22	**Legal***	469,018	490,805	517,733	**492,519**	611,000
23	**Custody***	0	0	0	**0**	0
24	**Audit**	77,000	80,000	83,000	**80,000**	85,333
25	**Actuarial***	58,750	100,800	81,650	**80,400**	148,333
26	**Personnel related***	6,682,754	6,752,628	6,342,189	**6,592,524**	7,680,667
27	**All other admin. costs**	1,843,141	2,128,760	2,592,780	**2,188,227**	2,832,830
28	**Total**	9,130,663	9,552,993	9,617,352	**9,433,669**	11,358,163

Observed Conditions

Taken at face value alone, in several areas LAFPPS costs compare unfavorably to LACERS, most notably in Lines 6, 7, 16, 17, 19 and 21. These are highlighted in orange shading in the table and discussed above, while LAFPPS compares very favorably to LACERS and its peer funds, most notably in Line 15, highlighted in green shading. However, because of the differences and complexities of the Departments' programs as explained above, face value comparisons are not a basis for drawing conclusions.

A commonly used measure of the reasonableness of Total Administrative Costs for a public fund is the cost at comparable sized funds relative to assets managed as measured in basis points.

Using the latest published financial information at year end (2006), Table 5b-ii provides the comparison:

Table 5b-ii

Fund	Admin. Exp. ($Mil)	Assets ($Bil)	Basis Points
KPERS	7.719	15.916	4.85
OK TRS	4.425	8.797	5.03
Ark TRS	5.992	10.112	5.93
ID PERS	7.308	10.809	6.76
LAFPPS	**9.617**	**13.946**	**6.90**
IN TRF	6.726	9.093	7.40
NMPERA	10.207	12.875	7.93
ME ERS	9.535	9.582	9.95
LACERS	**12.207**	**9.074**	**13.45**
OH School	18.900	11.176	16.91
OH P&F	15.029	8.560	17.56
LASERS	16.042	8.130	19.73
Average	**10.309**	**10.673**	**9.66**

While LAFPPS is favorably below the average for the group, LAFPPS and LACERS occupy neither the low nor high positions in a group of 14 similar sized funds. Certainly this tells us that there may be justification to increase LAFPPS' overall administrative cost structure, the question of 'where' to increase is relative to the Department's programs, mission and objectives and cannot be determined in a vacuum.

It is assumed generally that administrative cost expenditures usually translate directly to the level and quality of service provided to members. The overall level of cost almost certainly derives from a pension fund's philosophy on the delivery of services and on the economic

environment and constraints within which it operates. Perhaps LAFPPS needs to increase its staffing level to provide service enhancements to its members, although it has only about 58% of the number of members in LACERS. Likewise, perhaps LAFPPS should reduce its external investment management expenses and revisit its asset management strategies because it is spending significantly more than LACERS but it earned about 200 basis points less than LACERS on average.

There's no simple answer when it comes to determining the appropriate level of administrative costs and the cost structure; and mathematical averages of what other comparable funds spend serve only as benchmarks. Given that personnel costs comprise about two-thirds of both LACERS and LAFPPS total administrative expenses, one can deduce that the LACERS and LAFPPS are comparable in the deployment of staff relative to their overall expense philosophy and budget, yet there may not be much that the Departments can do to control those personnel costs. The salary structure is virtually entirely outside the Department's control.

In conclusion, while we observe that there may be some justification for LAFPPS to increase expenses, and this should be explored in keeping with several other related areas of discussion and recommendations in our report, increased costs of services must be evaluated in terms of the expected increase in the level and quality of services and investment risk and returns. The current cost of LAFPPS' administrative expense in raw dollars is favorably below the average for similar sized funds but is still within a reasonable range.

* * * *

Section IV – Exhibits

Exhibit A – Summary of Recommendations

Set forth below are summaries of all recommendations from the preceding report. They are listed in the order they appear in the report with corresponding page number. The Task Area of each recommendation or related series of recommendations is set forth for ease of reference.

Section	Recommendation	Page
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.*	24
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.*	25
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.*	27
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.*	35
2	*The Board should direct staff to develop, in conjunction with the Board's general investment consultant, additional educational*	36

Section	Recommendation	Page
	seminars on investment strategies and products 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.*	37
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.)*	37
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.*	38
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.*	39
7	*The Board should consider enhancing its succession plan to include other senior staffing in addition to the GM and CIO.*	39
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.*	41

Section	Recommendation	Page
9	*The Board should incorporate its mission statement into the Board's Governance Documents and into the Strategic Plan.*	41
10	*The Board should amend its Governance Documents to include a general reservation of authority provision.*	42
11	*The LAFPPS Board should amend its Governance 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.).*	42
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.*	45
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.*	46
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.*	46
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.*	48
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.*	49
17	*The LAFPPS Real Estate Strategic Plan should be cross-referenced in the overall LAFPPS Strategic Plan and reviewed during the*	50

Section	Recommendation	Page
	strategic planning process described in the LAFPPS Strategic Planning Policy to ensure consistency.	
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.*	52
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 clarity in this policy whether the City's lobbying laws apply to service providers.*	52
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 non-monetary recovery, and the overall costs to LAFPPS to participate in the litigation.*	54
21	*The Board should determine a specific periodic review timeframe for the Securities Litigation Policy as it has done with other written policies.*	54
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.*	54
23	*The Board's Securities Litigation Policy should be amended to incorporate Claims Filing & Monitoring Procedures.*	55
24	*The Board's Investment Policies should acknowledge that the System's investment consultants and investment managers are fiduciaries.*	56

Section	Recommendation	Page
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.*	58
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.*	69
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.*	69
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.)*	69
4	*The Department should consider establishing a Call Center as a single contact point for members.*	69
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.*	69
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.*	70
7	*The Department should continue to evolve the web site as a source of benefit, counseling, and self-service resources.*	70

Section	Recommendation	Page
2c. Organizational Efficiency and Effectiveness		
1	*LAFPPS should develop an assessment tool for measuring the effectiveness of group, individual, and self-service counseling tools.*	81
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.*	81
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.*	81
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.)*	82
5	*LAFPPS should establish internal and member based instruments for assessing quality of service delivery, and monitor and track trends over time.*	82
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.*	82
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.*	82
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.*	82
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.*	82
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.*	82

Section	Recommendation	Page
11	*LAFPPS should establish metrics for measuring the cost effectiveness and quality of the health plans that are funded through subsidies.*	82
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.*	82
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.*	82
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.)*	82
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.)*	83
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.*	83
17	*LAFPPS should develop a physical and electronic data security plan for benefits administration and member data.*	83

Section	Recommendation	Page
18	*LAFPPS should develop a privacy protection plan and processes to ensure that LAFPPS complies with applicable HIPAA and other privacy regulations.*	83
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.*	83
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.*	83
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.*	83
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.*	83
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.*	83
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 them, to reduce the amount of speculation and rumor present within the organization.*	84
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.*	84
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*	84

Section	Recommendation	Page
	any life cycle plan for the replacement, a target date for OnPoint to fully replace RA, or a life cycle plan for RAP retirement.)	
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.*	84
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 Documentum projects.*	84
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.)*	84
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.*	86
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 documentation and improvement.*	86
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.*	86
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.*	87
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.)*	87

Section	Recommendation	Page
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.*	90
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.*	90
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.*	90
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.*	95
2	*The Board should review the IPS and contract for consistency and solidify vague requirements as noted in our Report.*	96
3	*The Board should include an annual or bi-annual asset allocation study as a specific task in the consultant's contract.*	96
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.*	97
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.*	97
6	*The Board should amend the consultant contract to specifically provide periodic education to ensure LAFPPS' current practices remain valid.*	98
7	*The Board should specify the standard of care and fiduciary responsibility of the General Investment Consultant in their contract.*	99

Section	Recommendation	Page
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.*	102
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.*	111
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.*	111
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.*	111
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.*	111
5	*LAFPPS 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.*	113
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.*	113
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.*	113

Section	Recommendation	Page
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.*	113
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.*	114
10	*The LAFPPS Board and the City Attorney should execute a formal memorandum of understanding which specifically identifies the process for selecting and terminating outside counsel. This process should also be incorporated into the Board's Governance Manual.*	114
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.*	114
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.*	114
13	*The Board should request legal counsel to update the current standardized contract template.*	115
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.*	115
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.*	117
2	*LAFPPS should require the CFA professional designation for senior investment officers and the CIO.*	117
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*	117

Section	Recommendation	Page
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.*	120
2	*LAFPPS should consider reducing the number of direct reports reporting to the General Manager.*	120
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.*	120
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.*	120
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.*	121
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.*	121
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.*	123

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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.*	124
3	*The City should consider the eventual creation of a combined benefits administration function as a second step in the consolidation process.*	124
Task Area 3 – Investment Program		
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.*	143
2	*The Board should consider measuring the international equity segment against the MSCI All Country World Index ex-US.*	145
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.*	145
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.*	147
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.*	153
2	*The Board should consider conducting a complete asset liability study every five to ten years.*	153
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.*	166
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.*	166
3d. Asset Allocation Process and Re-Balancing Process		
1	*The Board should consider adopting a SMART rebalancing strategy to rebalance the asset allocation.*	174
3e. Investment Policy Statement (IPS) and Guidelines		
1	*The Board should perform a comprehensive review and edit of the IPS for consistency and clarity.*	176

Section	Recommendation	Page
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.*	177
3	*The Board should include in the IPS the additional investment objective to achieve total returns in excess of the Policy Index.*	179
4	*The Board should include overall cost control as an objective in the IPS.*	179
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.*	181
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.*	181
7	*The Board should consider developing a detailed practical risk management policy/procedure document.*	181
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.*	182
9	*The Board should review and update all stated roles and responsibilities to reflect the restructuring of consultant responsibilities done last year.*	182
10	*The Board should clarify the asset allocation review and monitoring process as distinct from performing the analysis and executing a new study.*	183
11	*The Board should require an annual review of the asset allocation and a complete asset allocation study at least every five years.*	183
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.*	186
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.*	187
14	*The Board should update its IPS to reflect that a third-party specialist administers the proxy process in accordance with Board policy.*	190
15	*The Board should expand the IPS to define clearly how brokerage commissions should be monitored and what types of arrangements*	192

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	(e.g., commission recapture) are permissible or include reference to a separate brokerage policy document.	
16	*The Board should require managers to submit an annual report on brokerage activity to staff.*	192
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.*	197
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.*	201
3	*Staff should reconcile the emerging manager program managers' guidelines with the Emerging Manager Policy.*	201
3g. Investment Management Structure		
1	*The Board should continue to monitor its style and capitalization biases.*	209
2	*The Board should work with its consultant to determine if it can reduce the number of domestic equity managers.*	209
3	*The Board should consider implementing its absolute return allocation through a portable alpha program in the large cap equity area.*	209
4	*The Board should continue to work with its consultant to determine if it can reduce the number of international equity managers over time.*	211
5	*The Board should continue to work with its consultant to determine if it can reduce the number of fixed income managers over time.*	213
6	*The Board should consider focusing the real estate program on commingled fund/limited partnership investment vehicles going forward.*	215
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.*	217
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-*	220

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	performing active managers and/or to serve as a core exposure to developed markets.	
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.*	229
2	*LAFPPS staff should develop a detailed set of operational procedures and standards for custody operations and incorporate it into the custody agreement.*	229
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.*	229
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.*	229
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 of the program against peers and expectations on a regular basis.*	236
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.*	243
4b. Benefit Payment Testing		
1	*LAFPPS should consider ways to identify and prevent processing times in excess of 90 days.*	246
2	*LAFPPS should make a major attempt to scan member data to get closer to a paperless environment.*	251
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*	251

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	benefit election. This will allow LAFPPS to continue to verify that the Onpoint system continue to calculate the correct benefit.	
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.*	257
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.*	257
3	*LAFPPS should adopt and implement safeguards to protect the privacy of applicants' medical records.*	257
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.*	257
5	*The Board should evaluate whether to delegate responsibility for disability cases to hearing officers given their time constraints.*	257
6	*The Board should request written clarification on LAPD's policy regarding essential job functions required for disabled officers.*	257
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.*	262
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.*	262
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.*	264
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.*	265

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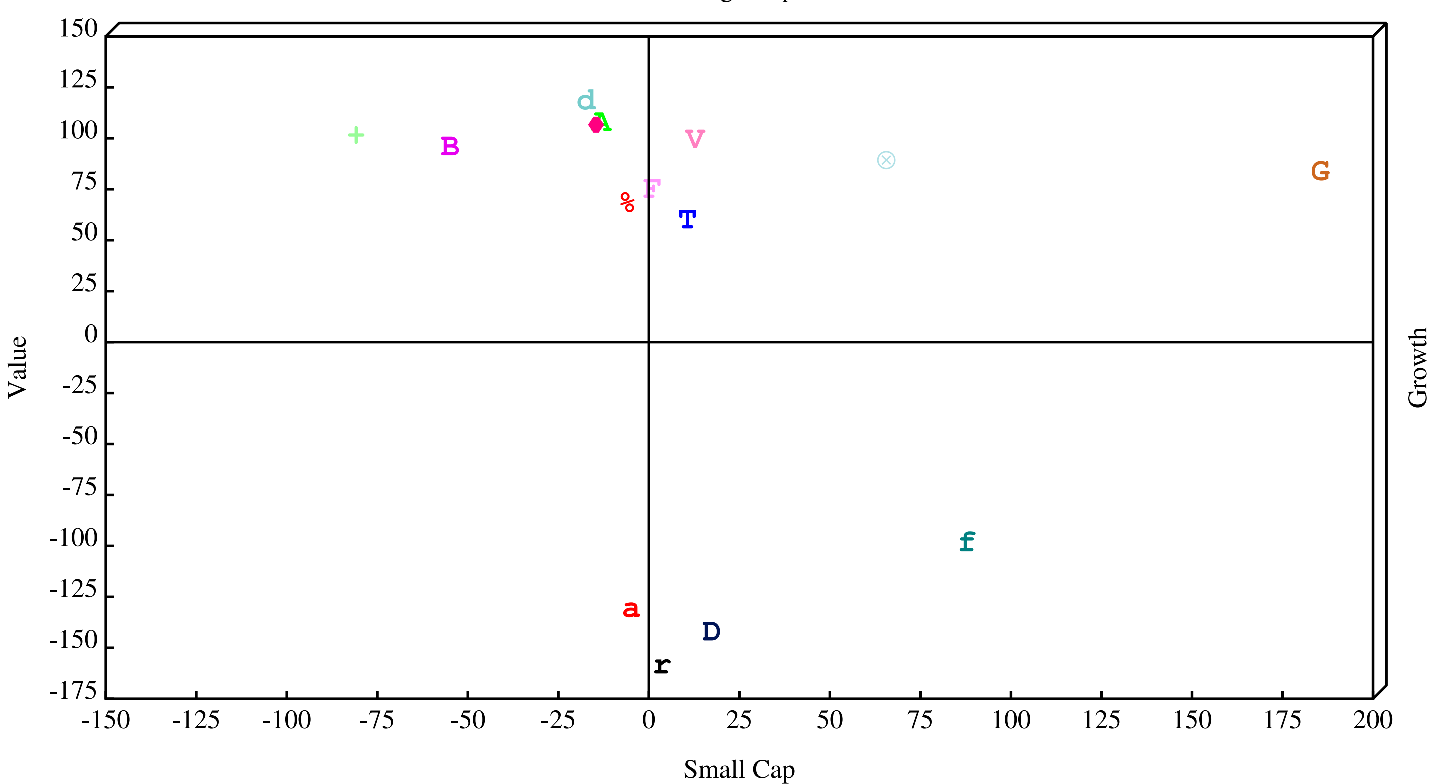
5	*Additional analysis of experience should be undertaken by LAFPPS in the election of medical coverage, the percentage of spouses, who will be covered, and the age difference of retirees and their spouses.*	265
6	*If assets are tracked separately, it would provide useful information to include these exhibits for OPEB separately.*	267
7	*Segal should be asked to describe whether an implicit rate subsidy exists, and to document their analysis by which they made their determination.*	268
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.*	268
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 report.*	268
Task Area 5 – Administration		
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.*	279
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.*	285
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.*	285

LA City Fire and Police Holdings Analysis
Equity Style Map
Quarter Ended 12/31/06



		Growth-Value	Size
T	Total Fund	12.08	59.22
A	Alliance Capital	-11.68	106.99
a	Attucks Group	-3.42	-131.34
B	Boston Partners	-53.45	95.10
D	Daruma Asset Management	18.82	-142.95
d	Delta Asset Management	-15.95	117.66
F	FIS Group	2.43	74.25
f	Frontier Capital Management	89.25	-99.21
G	TCW Large Growth	186.88	82.93
V	TCW Large Value	14.20	98.55
⬢	Standard & Poors 500	-12.75	106.13
%	DJ Wilshire 5000	-4.52	67.37
⊗	Russell 1000 Growth	66.78	88.21
+	Russell 1000 Value	-79.44	100.65
r	Russell 2000	5.05	-159.13

Analysis of the LAFP Managers from 04/2001 - 12/2006: Custom Reports - Comparative Report

Generated on: 06/26/2007

Reporting Period: ***Calendar***

LAFPPS - Detailed Manager Analysis (04/2001 - 12/2006)

Performance Summary - Total Period

Name		Annualized Return	Annualized Standard Deviation	Annualized Return-Risk Ratio	M2 Return	Worst 'Single' Negative Performance	Longest Under-Performance	Recovery Period
Portfolio Decision Aggregate								
LAFFPS Fund : LAFFPS Fund	BMK	7.99	11.42	0.7	7.99	-11.74	9	4
	Portfolio Decision	8.96	10.6	0.85	9.24	-9.8	9	4
	Excess	0.97	2.01	0.48	1.26	-1.18	10	9
LAFFPS Fund : US Large Cap	BMK	5.36	16.34	0.33	5.36	-17.28	13	8
	Portfolio Decision	5.96	16.85%	0.35	5.94	-17.91	11	6
	Excess	0.6	1.08	0.56	0.58	-1	5	2
LAFFPS Fund : US Small Cap	BMK	11.6	22.85	0.51	11.6	-21.4	9	4
	Portfolio Decision	10.47	29.3%	0.36	9.32	-33.44	9	4
	Excess	-1.13	10.82	-0.1	-2.28	-12.65	22	0
LAFFPS Fund : Intl Developed	BMK	11.35	18.36	0.62	11.35	-19.67	10	2
	Portfolio Decision	12.12	20.34%	0.6	11.46	-20.27	9	2
	Excess	0.77	2.95	0.26	0.11	-2.06	7	3
LAFFPS Fund : Emerging	BMK	23.74	24.96	0.95	23.74	-21.61	5	3
	Portfolio Decision	23.9	25.21%	0.95	23.71	-21.93	5	3
	Excess	0.16	3.99	0.04	-0.03	-3.65	12	3
LAFFPS Fund : Core Bonds	BMK	5.32	3.77	1.41	5.32	-2.44	4	3
	Portfolio Decision	6.01	4.12%	1.46	5.94	-3.16	2	1
	Excess	0.69	1.8	0.38	0.62	-2.21	5	2
LAFFPS Fund : High Yield	BMK	9.78	6.89	1.42	9.78	-3.98	2	0
	Portfolio Decision	5.46	11.97%	0.46	5.37	-11.67	10	4
	Excess	-4.32	6.8	-0.64	-4.41	-9.37	23	0
LAFFPS Fund : Alternatives	BMK	9.59	16.34	0.59	9.59	-16.28	9	4
	Portfolio Decision	5.32	11.39	0.47	5.35	-10.32	16	7
	Excess	-4.27	18.08	-0.24	-4.24	-21.21	23	12
LAFFPS Fund : Cash	BMK	2.54	0.72	3.51	2.54	0.23	0	0
	Portfolio Decision	4.32	2.07%	2.09	4.93	-1.97	3	2
	Excess	1.78	1.76	1.02	2.39	-2.39	10	9
LAFFPS Fund : Real Estate	BMK	10.61	3.64	2.92	10.61	-1.5	1	0
	Portfolio Decision	13.8	8.9%	1.55	8.75	-5.5	3	2
	Excess	3.19	8.18	0.39	-1.87	-7.2	12	3

Name		Maximum Drawdown	Maximum Drawdown Occurred On	Correlation With BMK	Ratio of Good/ Bad Risk	Down Side Risk - 1%	Down Side Risk - 5%	Confidence in Skill
Portfolio Decision Aggregate								
LAFFPS Fund : LAFFPS Fund	BMK	-18.77	09/30/2002	1	0.68	8.22	5.62	N/A
	Portfolio Decision	-16.96	09/30/2002	0.99	0.71	7.62	3.31	N/A
	Excess	-1.13	06/29/2001	-0.48	2.37	0.07	0	89.74
LAFFPS Fund : US Large Cap	BMK	-32.16	09/30/2002	1	0.63	14.09	3.95	N/A
	Portfolio Decision	-31.4	09/30/2002	1	0.63	14.4	4.5	N/A
	Excess	-1.39	09/29/2006	0.44	1.28	0	0	87.53
LAFFPS Fund : US Small Cap	BMK	-28.16	09/30/2002	1	0.89	15.84	16.49	N/A
	Portfolio Decision	-38.41	09/30/2002	0.94	0.83	21.76	21.87	N/A
	Excess	-16.58	12/29/2006	0.44	1.36	6.09	0	26.65
LAFFPS Fund : Intl Developed	BMK	-29.54	03/31/2003	1	0.8	15.78	11.54	N/A
	Portfolio Decision	-30.06	03/31/2003	0.99	0.85	15.91	10.09	N/A
	Excess	-4.19	03/31/2003	0.63	1.31	0.76	0	62.48
LAFFPS Fund : Emerging	BMK	-23.32	09/30/2002	1	1.06	13.3	12.91	N/A
	Portfolio Decision	-22.65	09/30/2002	0.99	1.04	14.11	11.73	N/A
	Excess	-14.72%	03/31/2006	-0.02	1.28	1.71	0	52.21
LAFFPS Fund : Core Bonds	BMK	-2.44	06/30/2004	1	1.82	0	0	N/A
	Portfolio Decision	-3.16	06/30/2004	0.9	1.27	2.25	0	N/A
	Excess	-3.34	09/30/2002	-0.03	0.78	0	0	81.53
LAFFPS Fund : High Yield	BMK	-5.32	09/30/2002	1	1.68	2.43	0	N/A
	Portfolio Decision	-29.78%	09/30/2002	0.88	0.86	8.08	5.07	N/A
	Excess	-35.26%	12/29/2006	0.53	0.57	5.32	3.65	4.53
LAFFPS Fund : Alternatives	BMK	-28.4	09/30/2002	1	0.63	13.96	3.95	N/A
	Portfolio Decision	-35.02%	06/30/2003	0.19	0.71	6.41	5.3	N/A
	Excess	-39.94%	12/31/2003	-0.79	0.46	14.53	11.95	31.73
LAFFPS Fund : Cash	BMK	0	06/29/2001	1	0	0	0	N/A
	Portfolio Decision	-1.97	09/30/2002	0.58	0	0	0	N/A
	Excess	-2.46	09/30/2002	0.27	0.48	0	0	99.2
LAFFPS Fund : Real Estate	BMK	-1.5	03/31/2005	1	4.03	0	0	N/A
	Portfolio Decision	-5.5	06/28/2002	0.39	1.86	4.24	0	N/A
	Excess	-16.78%	06/30/2004	-0.02	1.53	4.44	0	79.9

Name		Success Ratio	M3 Return	Average Return when Positive	Average Return when Negative
Portfolio Decision Aggregate					
LAFFPS Fund : LAFFPS Fund	BMK	N/A	7.99	4.67%	-5.2%
	Portfolio Decision	N/A	9.31	4.46%	-5.47%
	Excess	52.17	1.32	0.92	-0.58
LAFFPS Fund : US Large Cap	BMK	N/A	5.36	5.74%	-7.71%
	Portfolio Decision	N/A	6.59	6.04%	-7.86%

	Excess	60.87	1.24	0.49	-0.34			
LAFFPS Fund : US Small Cap	BMK	N/A	11.6	*9.17%*	*-9.75%*			
	Portfolio Decision	N/A	11.06	11.49	-11.26			
	Excess	*47.83*	*-0.53*	4.36	-3.68			
LAFFPS Fund : Intl Developed	BMK	N/A	11.35	7.87	-5.75			
	Portfolio Decision	N/A	11.45	8.8	-6.72			
	Excess	*47.83*	0.1	1.56	-0.92			
LAFFPS Fund : Emerging	BMK	N/A	23.74	12.29	-11			
	Portfolio Decision	N/A	23.79	12.32	-10.9			
	Excess	56.52	0.04	*1.42%*	*-1.74%*			
LAFFPS Fund : Core Bonds	BMK	N/A	5.32	2.05	-0.75			
	Portfolio Decision	N/A	6.04	2.37	-0.99			
	Excess	65.22	0.73	*0.68%*	*-0.79%*			
LAFFPS Fund : High Yield	BMK	N/A	9.78	3.93	-1.89			
	Portfolio Decision	N/A	7.3	4.88	-4.81			
	Excess	*43.48*	*-2.49*	*1.84%*	*-3.02%*			
LAFFPS Fund : Alternatives	BMK	N/A	9.59	6.74	-6.71			
	Portfolio Decision	N/A	9.47	5.37	-4.62			
	Excess	52.17	*-0.12*	*5.44%*	*-8.41%*			
LAFFPS Fund : Cash	BMK	N/A	2.54	0.63	0			
	Portfolio Decision	N/A	12.87	*1.21%*	*-1.97%*			
	Excess	86.96	10.33	*0.64%*	*-0.89%*			
LAFFPS Fund : Real Estate	BMK	N/A	10.61	2.93	-1.25			
	Portfolio Decision	N/A	10.6	4.08	-4			
	Excess	56.52	*-0.01*	3.05	-2.11			

Performance in Up and Down Markets (%)

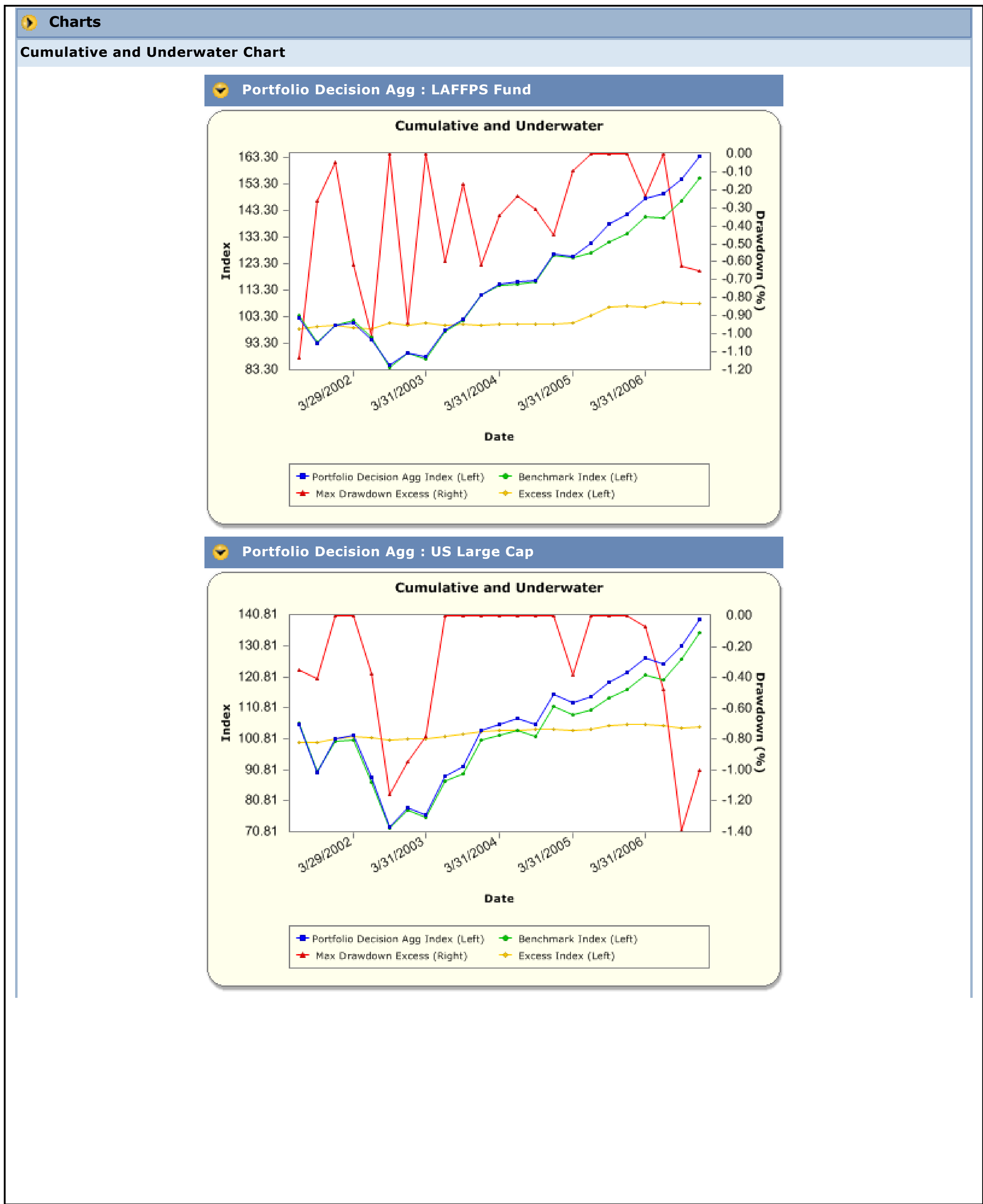
Portfolio Decision Aggregate

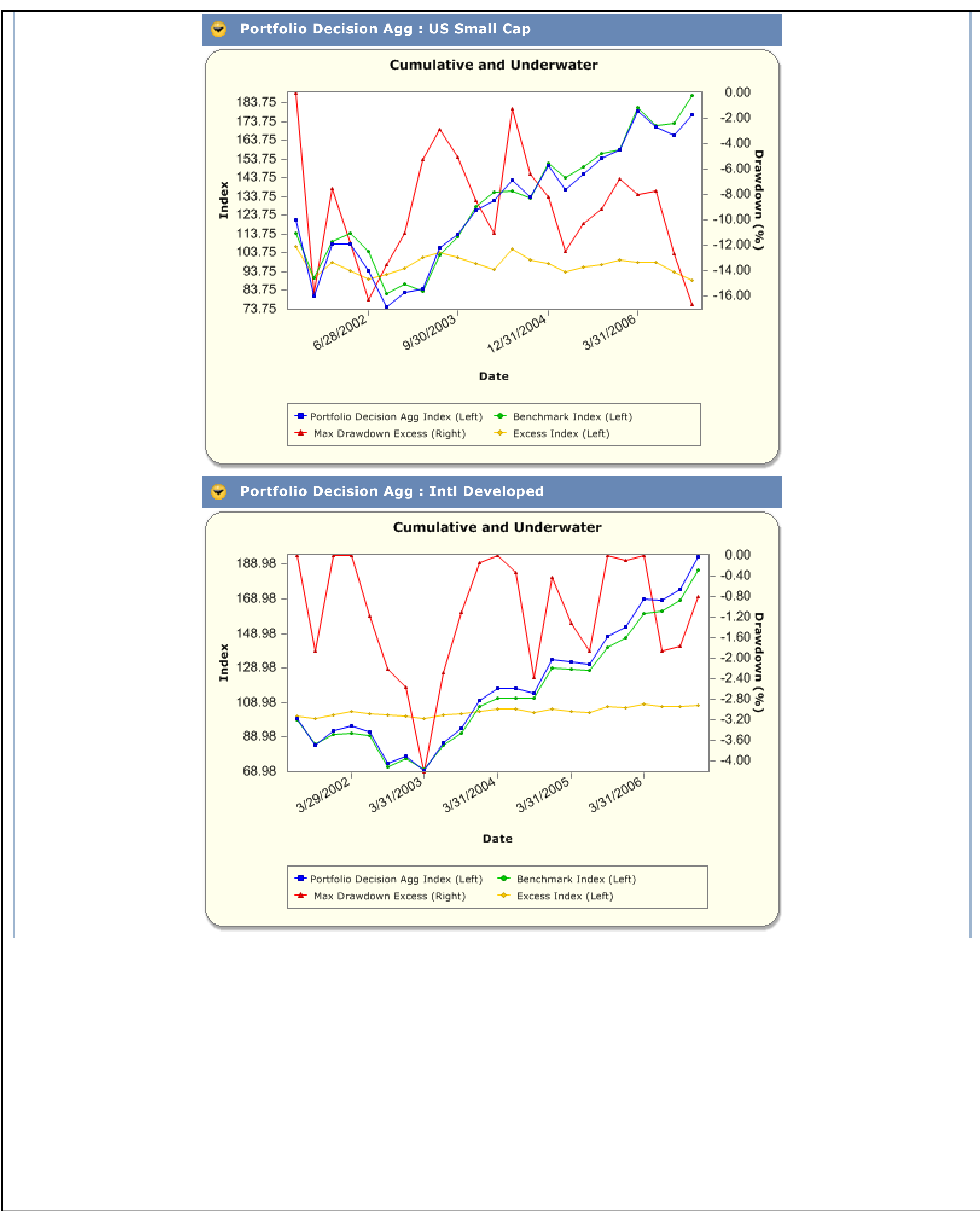
		Portfolio Positive	Portfolio Negative	Total	Average Excess	Standard Deviation
LAFFPS Fund : LAFFPS Fund	Benchmark Positive	73.91	0	73.91	-0.01	0.99
	Benchmark Negative	4.35	21.74	26.09	0.82	0.83
	Total	78.26	21.74	100	0.21	
	Average Excess	0.06	0.72	0.21		
	Standard Deviation	1.01	0.88			
		Portfolio Positive	**Portfolio Negative**	**Total**	**Average Excess**	**Standard Deviation**
LAFFPS Fund : US Large Cap	Benchmark Positive	69.57	0	69.57	0.3	0.57
	Benchmark Negative	0	30.43	30.43	-0.15	0.29
	Total	69.57	30.43	100	0.17	
	Average Excess	0.3	-0.15	0.17		
	Standard Deviation	0.57	0.29			

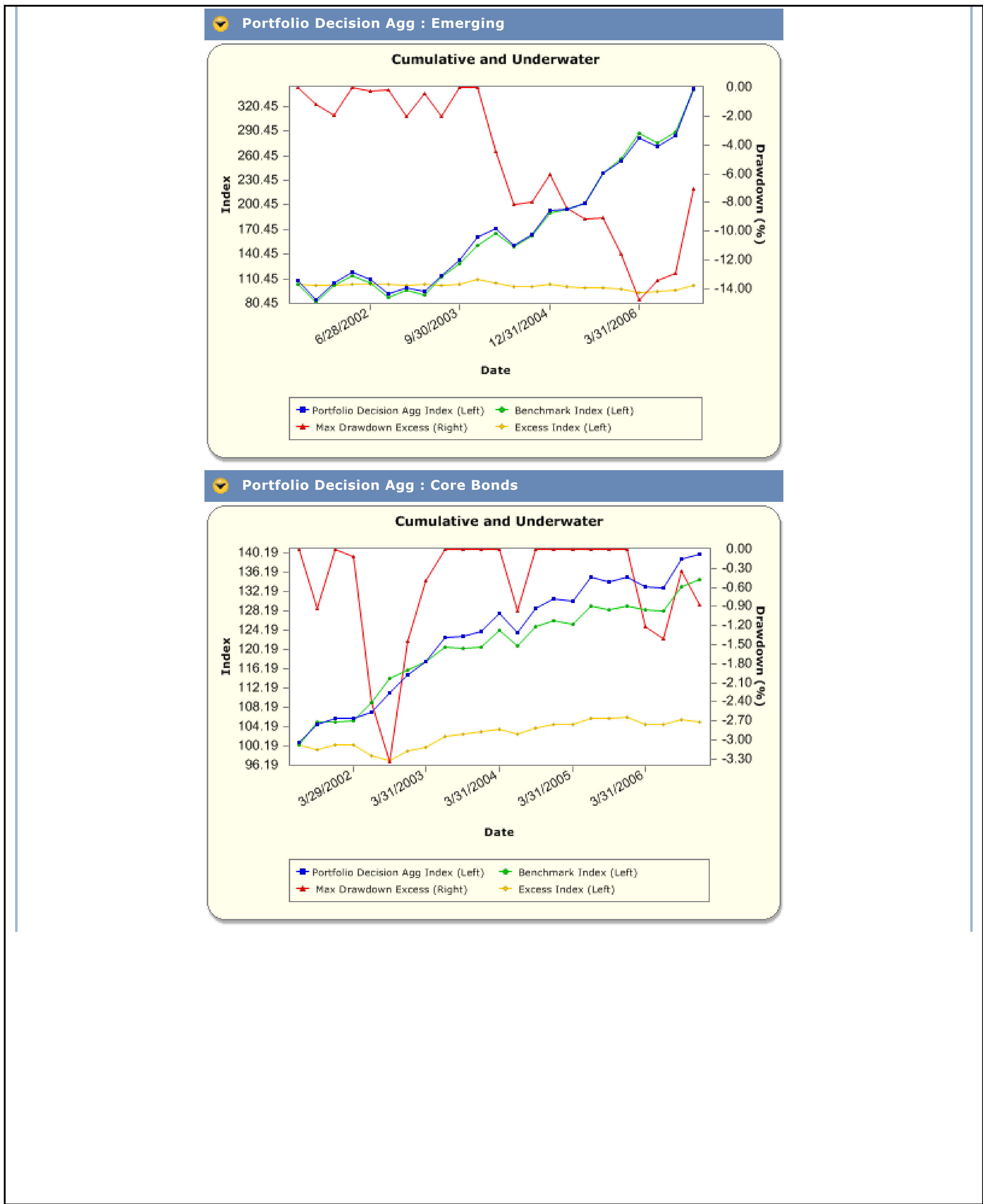
Fund		Portfolio Positive	Portfolio Negative	Total	Average Excess	Standard Deviation
LAFFPS Fund : US Small Cap	Benchmark Positive	60.87	8.7	69.57	1.25	4.9
	Benchmark Negative	4.35	26.09	30.43	-2.31	6.08
	Total	65.22	34.78	100	0.17	
	Average Excess	2.3	-3.84	0.17		
	Standard Deviation	4.86	4.09			
LAFFPS Fund : Intl Developed		Portfolio Positive	Portfolio Negative	Total	Average Excess	Standard Deviation
	Benchmark Positive	60.87	4.35	65.22	0.89	1.28
	Benchmark Negative	4.35	30.43	34.78	-0.9	1.08
	Total	65.22	34.78	100	0.27	
	Average Excess	1.06	-1.22	0.27		
	Standard Deviation	1.14	0.62			
LAFFPS Fund : Emerging		Portfolio Positive	Portfolio Negative	Total	Average Excess	Standard Deviation
	Benchmark Positive	73.91	0	73.91	0.03	2.23
	Benchmark Negative	0	26.09	26.09	0.1	1.3
	Total	73.91	26.09	100	0.05	
	Average Excess	0.03	0.1	0.05		
	Standard Deviation	2.23	1.3			
LAFFPS Fund : Core Bonds		Portfolio Positive	Portfolio Negative	Total	Average Excess	Standard Deviation
	Benchmark Positive	69.57	4.35	73.91	0.3	0.98
	Benchmark Negative	4.35	21.74	26.09	-0.19	0.52
	Total	73.91	26.09	100	0.17	
	Average Excess	0.33	-0.29	0.17		
	Standard Deviation	0.98	0.43			
LAFFPS Fund : High Yield		Portfolio Positive	Portfolio Negative	Total	Average Excess	Standard Deviation
	Benchmark Positive	65.22	8.7	73.91	0.16	2.82
	Benchmark Negative	0	26.09	26.09	-3.91	3.28
	Total	65.22	34.78	100	-0.91	
	Average Excess	0.63	-3.78	-0.91		
	Standard Deviation	2.48	3.09			
LAFFPS Fund : Alternatives		Portfolio Positive	Portfolio Negative	Total	Average Excess	Standard Deviation
	Benchmark Positive	47.83	21.74	69.57	-4.51	8.56
	Benchmark Negative	13.04	17.39	30.43	6.44	4.4
	Total	60.87	39.13	100	-1.18	
	Average Excess	1.11	-4.75	-1.18		
	Standard Deviation	4.46	12.99			
		Portfolio Positive	Portfolio Negative	Total	Average Excess	Standard Deviation

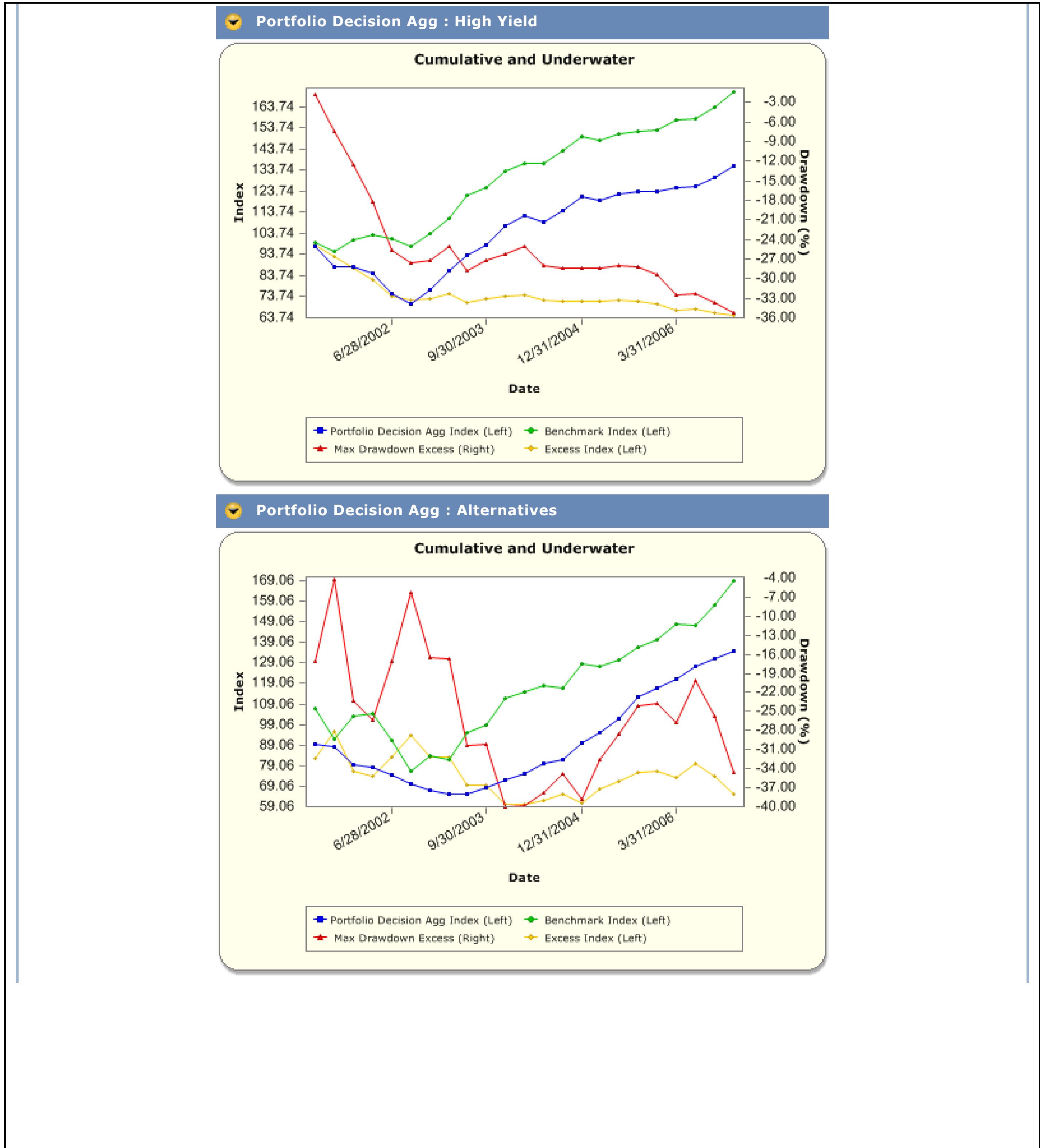
LAFFPS Fund : Cash	Benchmark Positive	95.65	4.35	100	0.44	0.88
	Benchmark Negative	0	0	0	0	0
	Total	95.65	4.35	100	0	
	Average Excess	0.57	-2.39	0.44		
	Standard Deviation	0.64	0			

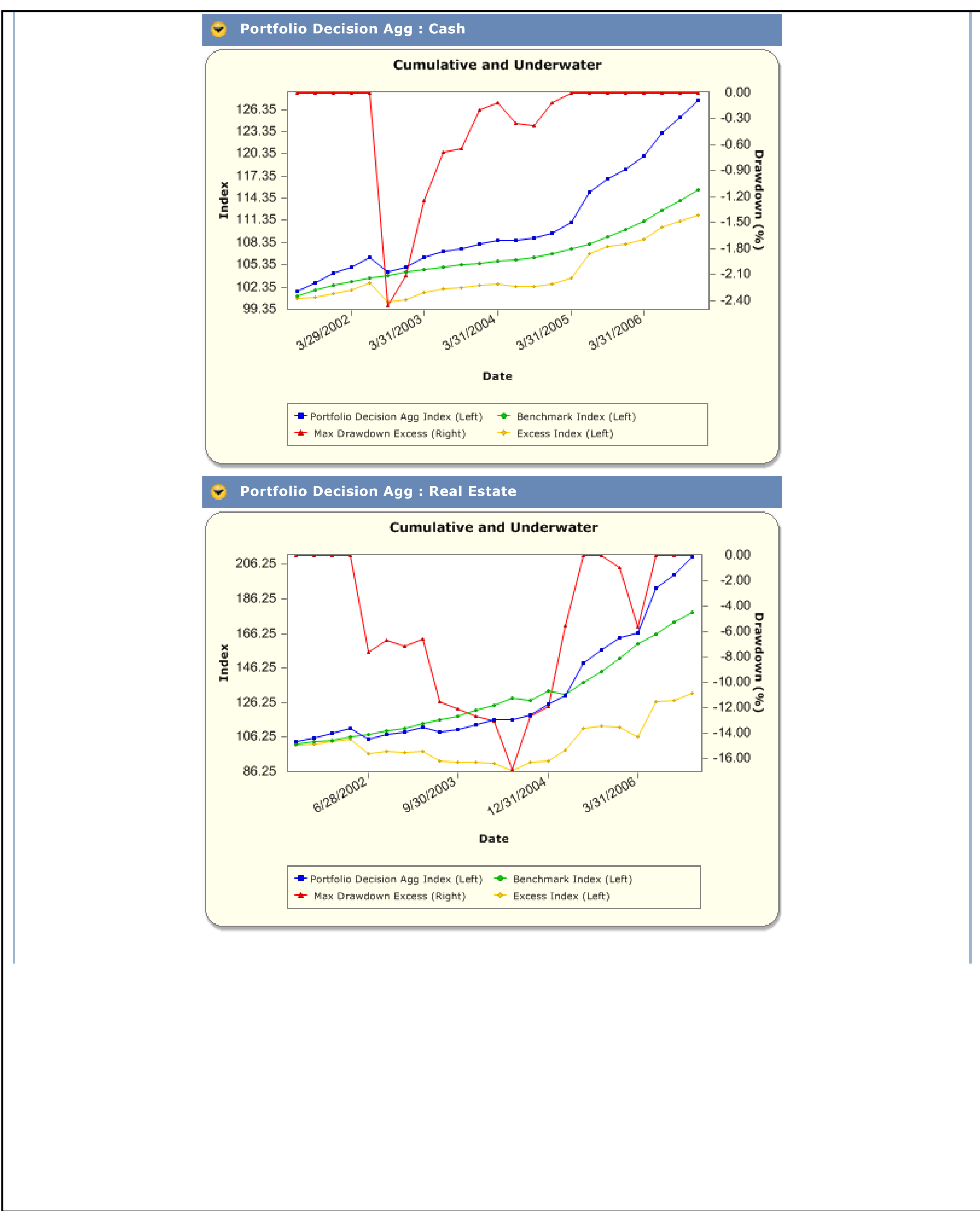
		Portfolio Positive	**Portfolio Negative**	**Total**	**Average Excess**	**Standard Deviation**
LAFFPS Fund : Real Estate	Benchmark Positive	82.61	8.7	91.3	0.46	4.12
	Benchmark Negative	8.7	0	8.7	4.4	1.13
	Total	91.3	8.7	100	0.8	
	Average Excess	1.44	-5.89	0.8		
	Standard Deviation	3.65	1.85			

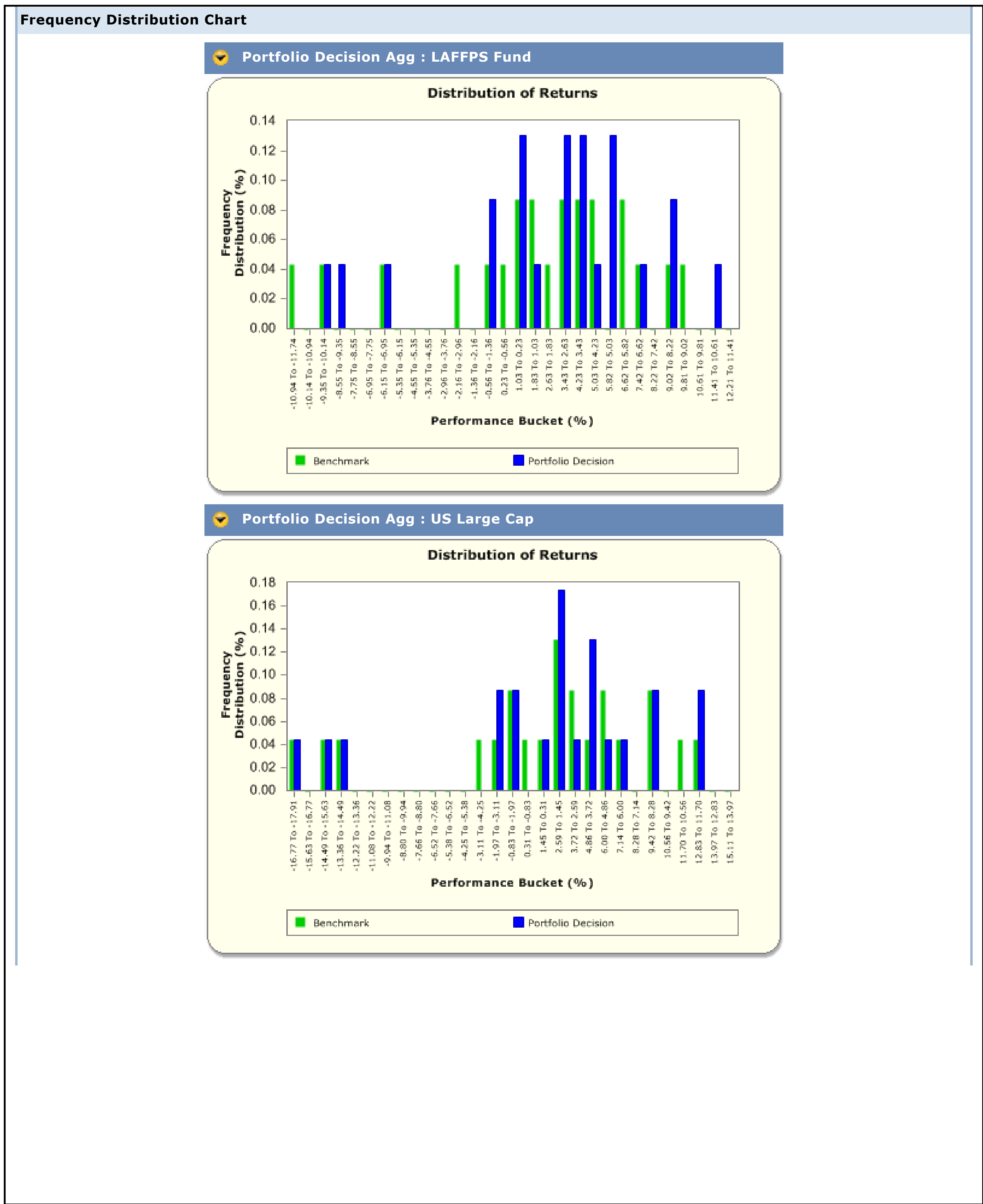

Charts
Cumulative and Underwater Chart
Portfolio Decision Agg : LAFFPS Fund
Cumulative and Underwater
163.30
153.30
143.30
133.30
123.30
113.30
103.30
93.30
83.30
Index
0.00
-0.10
-0.20
-0.30
-0.40
-0.50
-0.60
-0.70
-0.80
-0.90
-1.00
-1.10
-1.20
Drawdown (%)
3/29/2002
3/31/2003
3/31/2004
3/31/2005
3/31/2006
Date
Portfolio Decision Agg Index (Left)
Benchmark Index (Left)
Max Drawdown Excess (Right)
Excess Index (Left)
Portfolio Decision Agg : US Large Cap
Cumulative and Underwater
140.81
130.81
120.81
110.81
100.81
90.81
80.81
70.81
Index
0.00
-0.20
-0.40
-0.60
-0.80
-1.00
-1.20
-1.40
Drawdown (%)
3/29/2002
3/31/2003
3/31/2004
3/31/2005
3/31/2006
Date
Portfolio Decision Agg Index (Left)
Benchmark Index (Left)
Max Drawdown Excess (Right)
Excess Index (Left)

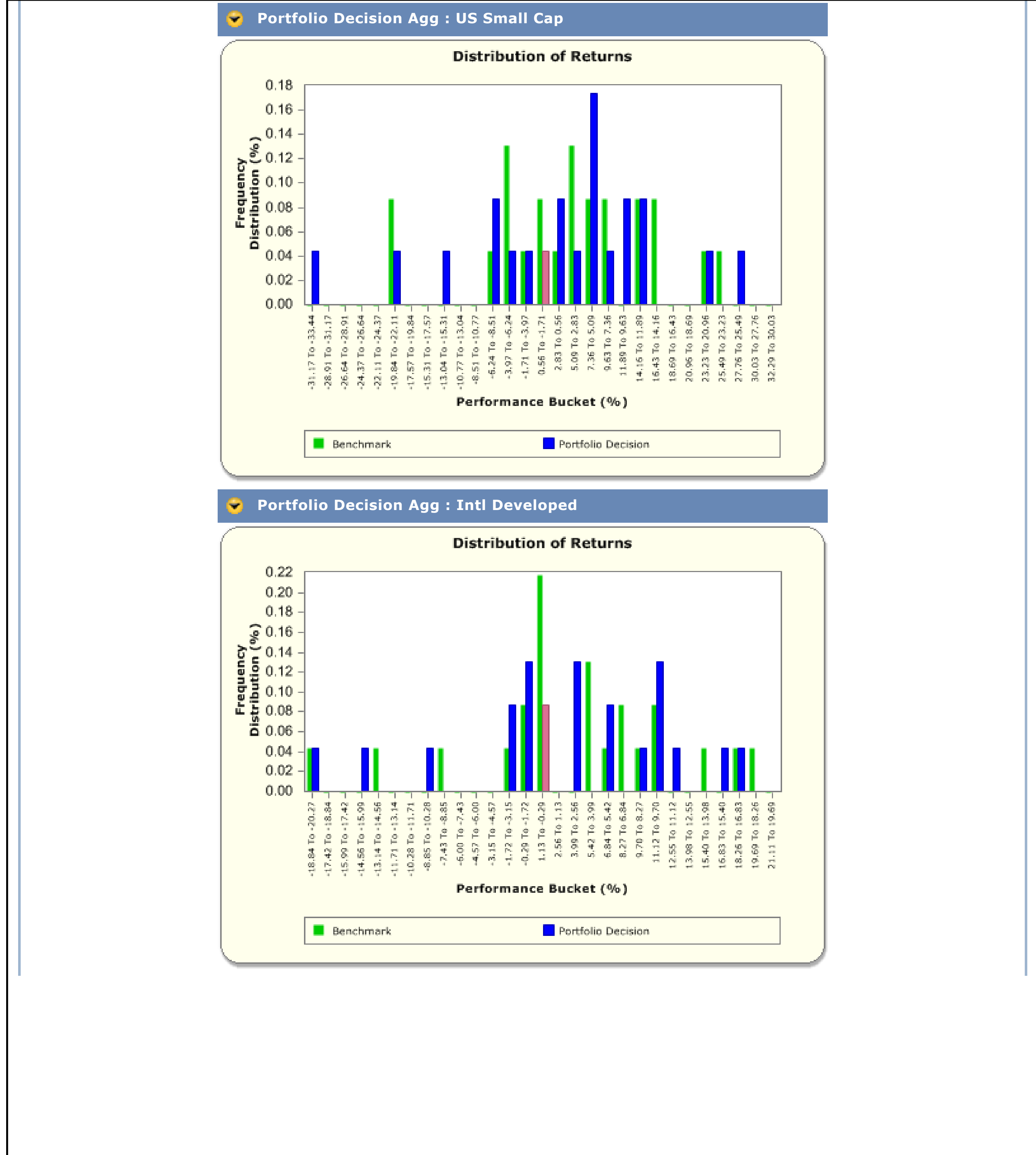

Portfolio Decision Agg : US Small Cap
Cumulative and Underwater
183.75
173.75
163.75
153.75
143.75
133.75
123.75
113.75
103.75
93.75
83.75
73.75
Index
0.00
-2.00
-4.00
-6.00
-8.00
-10.00
-12.00
-14.00
-16.00
Drawdown (%)
6/28/2002
9/30/2003
12/31/2004
3/31/2006
Date
Portfolio Decision Agg Index (Left)
Benchmark Index (Left)
Max Drawdown Excess (Right)
Excess Index (Left)
Portfolio Decision Agg : Intl Developed
Cumulative and Underwater
188.98
168.98
148.98
128.98
108.98
88.98
68.98
Index
0.00
-0.40
-0.80
-1.20
-1.60
-2.00
-2.40
-2.80
-3.20
-3.60
-4.00
Drawdown (%)
3/29/2002
3/31/2003
3/31/2004
3/31/2005
3/31/2006
Date
Portfolio Decision Agg Index (Left)
Benchmark Index (Left)
Max Drawdown Excess (Right)
Excess Index (Left)


Portfolio Decision Agg : Emerging
Cumulative and Underwater
Index
Drawdown (%)
Date
6/28/2002
9/30/2003
12/31/2004
3/31/2006
Portfolio Decision Agg Index (Left)
Benchmark Index (Left)
Max Drawdown Excess (Right)
Excess Index (Left)
Portfolio Decision Agg : Core Bonds
Cumulative and Underwater
Index
Drawdown (%)
Date
3/29/2002
3/31/2003
3/31/2004
3/31/2005
3/31/2006
Portfolio Decision Agg Index (Left)
Benchmark Index (Left)
Max Drawdown Excess (Right)
Excess Index (Left)

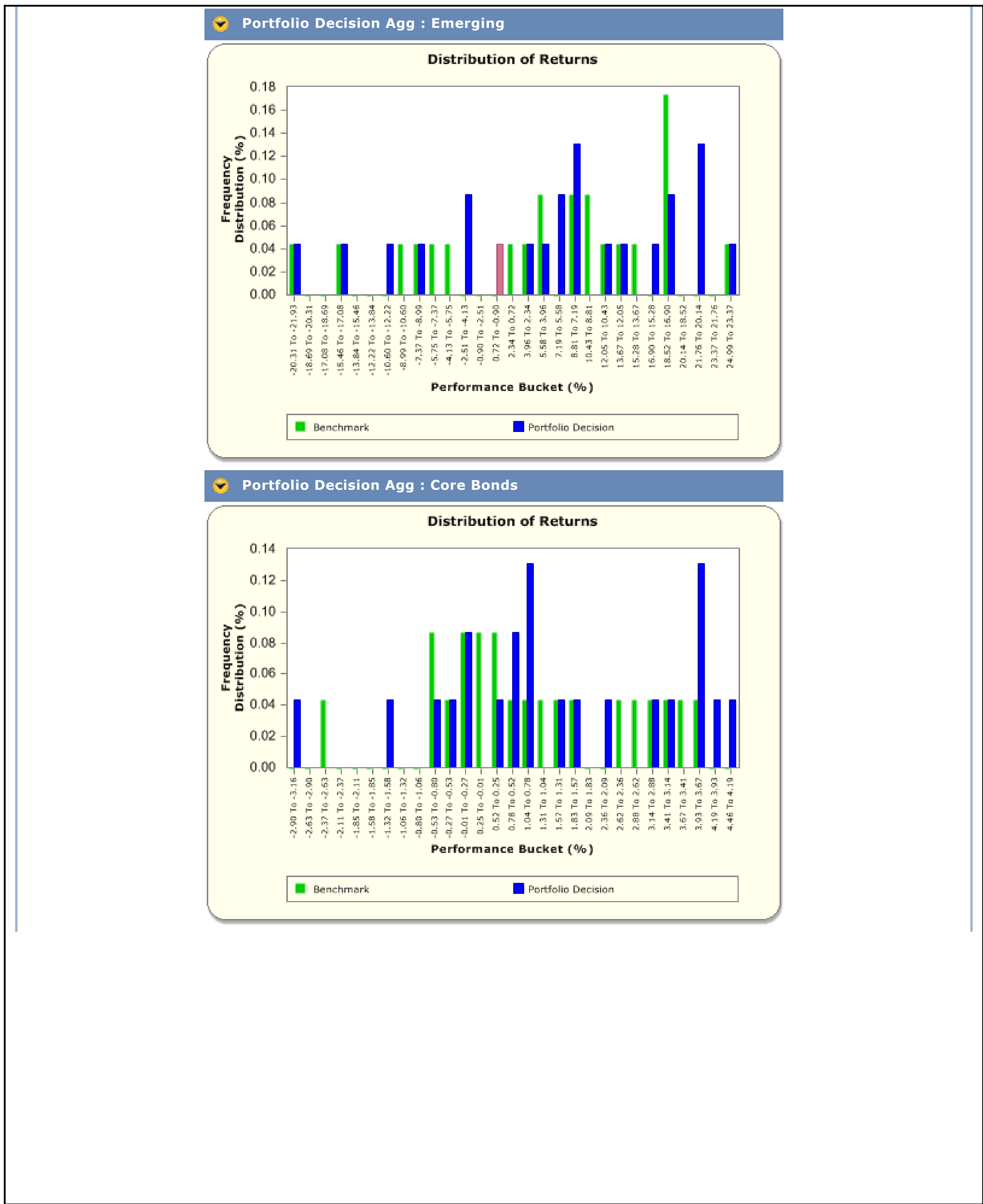

Portfolio Decision Agg : High Yield
Cumulative and Underwater
Index
163.74
153.74
143.74
133.74
123.74
113.74
103.74
93.74
83.74
73.74
63.74
-3.00
-6.00
-9.00
-12.00
-15.00
-18.00
-21.00
-24.00
-27.00
-30.00
-33.00
-36.00
Drawdown (%)
6/28/2002
9/30/2003
12/31/2004
3/31/2006
Date
Portfolio Decision Agg Index (Left)
Benchmark Index (Left)
Max Drawdown Excess (Right)
Excess Index (Left)
Portfolio Decision Agg : Alternatives
Cumulative and Underwater
Index
169.06
159.06
149.06
139.06
129.06
119.06
109.06
99.06
89.06
79.06
69.06
59.06
-4.00
-7.00
-10.00
-13.00
-16.00
-19.00
-22.00
-25.00
-28.00
-31.00
-34.00
-37.00
-40.00
Drawdown (%)
6/28/2002
9/30/2003
12/31/2004
3/31/2006
Date
Portfolio Decision Agg Index (Left)
Benchmark Index (Left)
Max Drawdown Excess (Right)
Excess Index (Left)

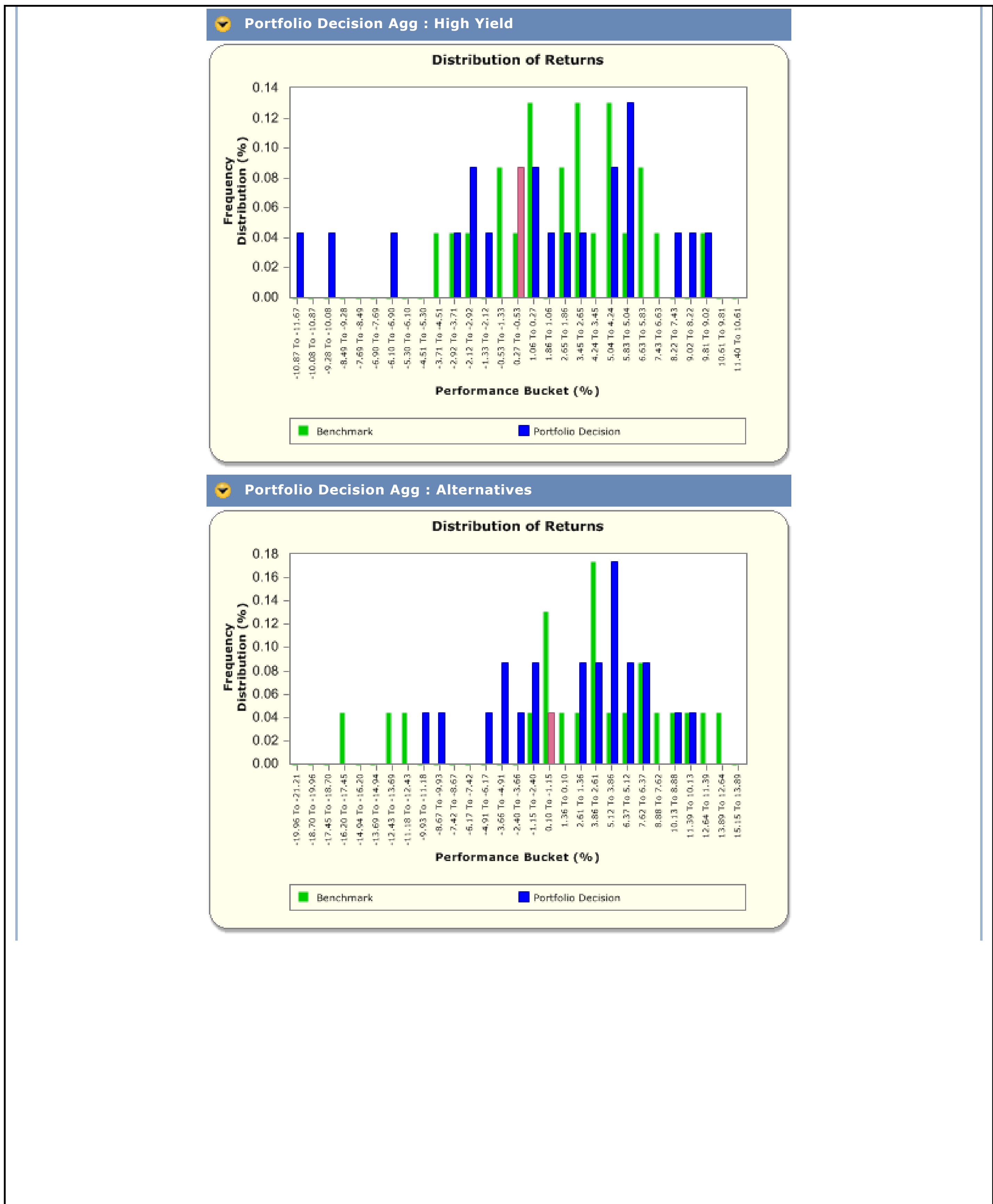

Portfolio Decision Agg : Cash
Cumulative and Underwater
Index
126.35
123.35
120.35
117.35
114.35
111.35
108.35
105.35
102.35
99.35
0.00
-0.30
-0.60
-0.90
-1.20
-1.50
-1.80
-2.10
-2.40
Drawdown (%)
3/29/2002
3/31/2003
3/31/2004
3/31/2005
3/31/2006
Date
Portfolio Decision Agg Index (Left)
Benchmark Index (Left)
Max Drawdown Excess (Right)
Excess Index (Left)
Portfolio Decision Agg : Real Estate
Cumulative and Underwater
Index
206.25
186.25
166.25
146.25
126.25
106.25
86.25
0.00
-2.00
-4.00
-6.00
-8.00
-10.00
-12.00
-14.00
-16.00
Drawdown (%)
6/28/2002
9/30/2003
12/31/2004
3/31/2006
Date
Portfolio Decision Agg Index (Left)
Benchmark Index (Left)
Max Drawdown Excess (Right)
Excess Index (Left)

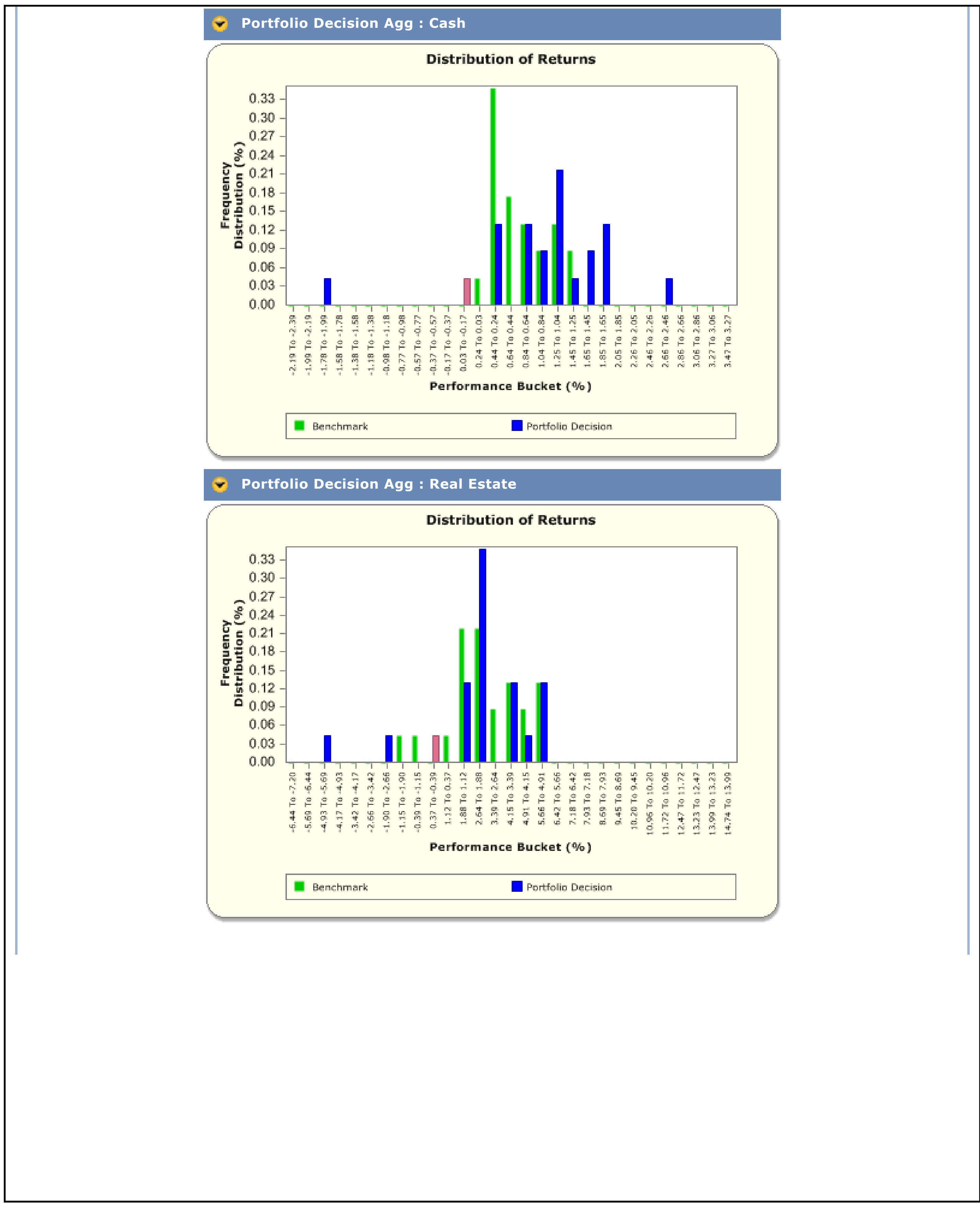

Frequency Distribution Chart
Portfolio Decision Agg : LAFFPS Fund
Distribution of Returns
Frequency Distribution (%)
Performance Bucket (%)
Benchmark
Portfolio Decision
Portfolio Decision Agg : US Large Cap
Distribution of Returns
Frequency Distribution (%)
Performance Bucket (%)
Benchmark
Portfolio Decision

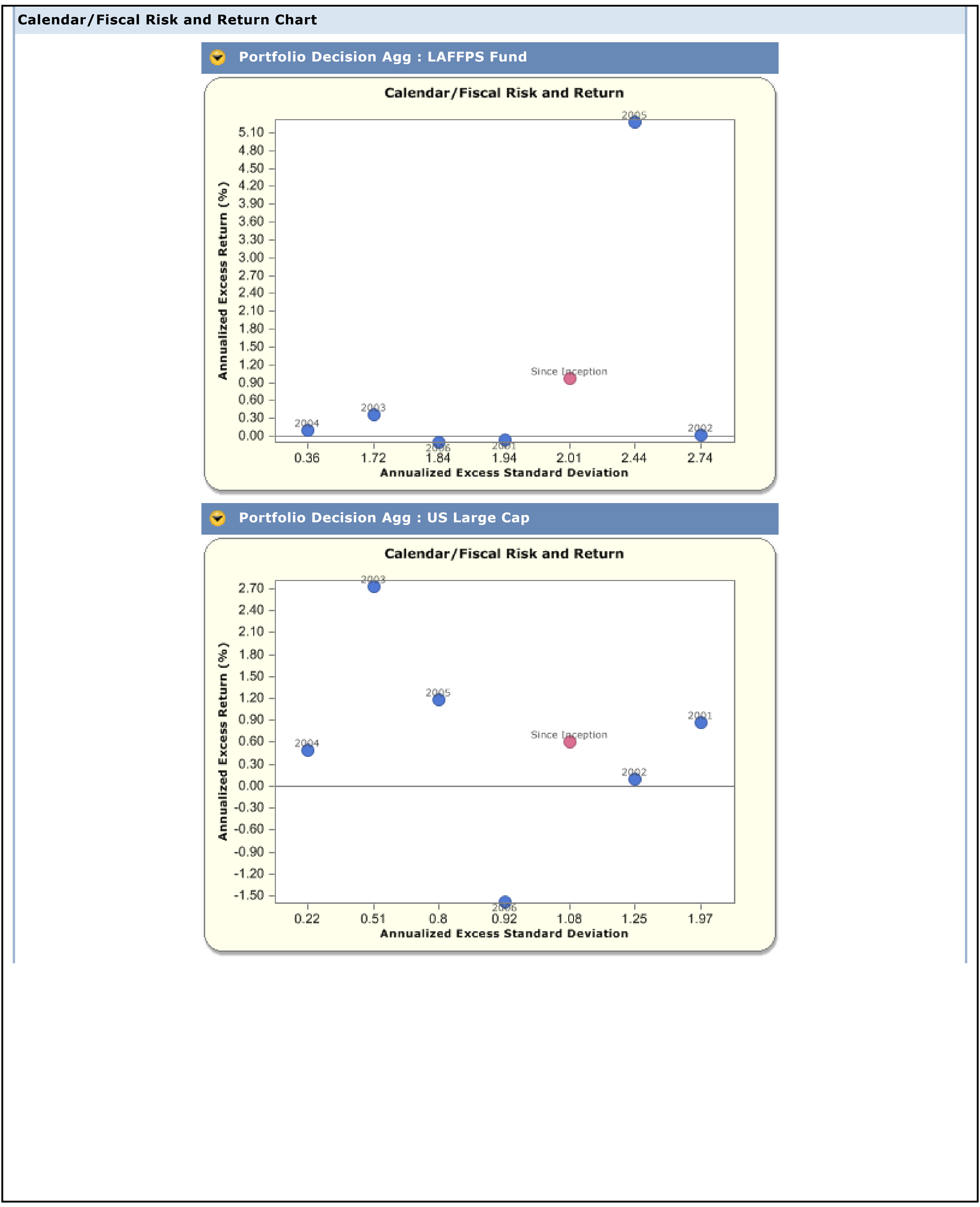


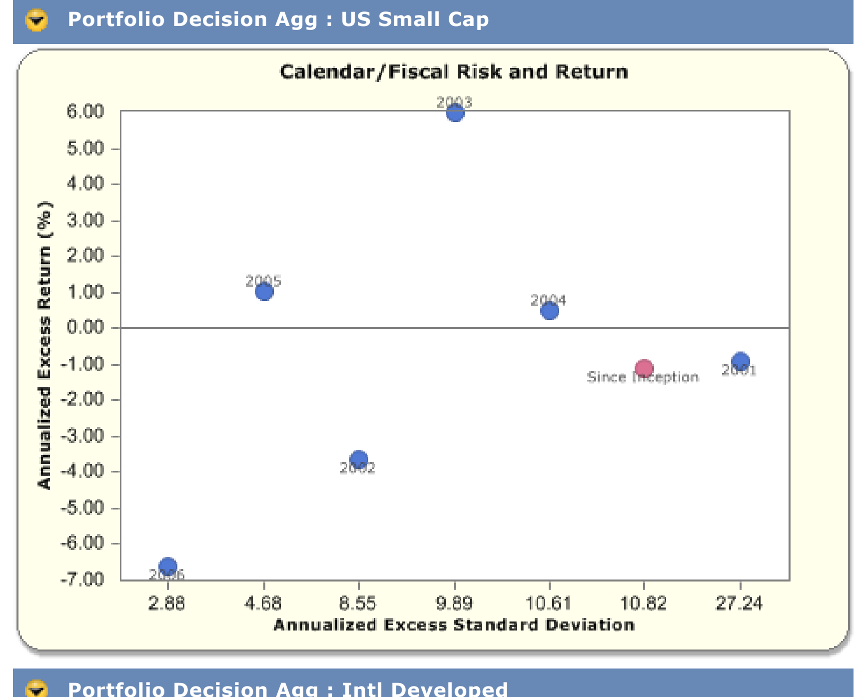
Portfolio Decision Agg : US Small Cap
Distribution of Returns
Frequency Distribution (%)
0.18
0.16
0.14
0.12
0.10
0.08
0.06
0.04
0.02
0.00
-31.17 To -33.44
-28.91 To -31.17
-26.64 To -28.91
-24.37 To -26.64
-22.11 To -24.37
-19.84 To -22.11
-17.57 To -19.84
-15.31 To -17.57
-13.04 To -15.31
-10.77 To -13.04
-8.51 To -10.77
-6.24 To -8.51
-3.97 To -6.24
-1.71 To -3.97
0.56 To -1.71
2.83 To 0.56
5.09 To 2.83
7.36 To 5.09
9.63 To 7.36
11.89 To 9.63
14.16 To 11.89
16.43 To 14.16
18.69 To 16.43
20.96 To 18.69
23.23 To 20.96
25.49 To 23.23
27.76 To 25.49
30.03 To 27.76
32.29 To 30.03
Performance Bucket (%)
Benchmark
Portfolio Decision
Portfolio Decision Agg : Intl Developed
Distribution of Returns
Frequency Distribution (%)
0.22
0.20
0.18
0.16
0.14
0.12
0.10
0.08
0.06
0.04
0.02
0.00
-18.84 To -20.27
-17.42 To -18.84
-15.99 To -17.42
-14.56 To -15.99
-13.14 To -14.56
-11.71 To -13.14
-10.28 To -11.71
-8.85 To -10.28
-7.43 To -8.85
-6.00 To -7.43
-4.57 To -6.00
-3.15 To -4.57
-1.72 To -3.15
-0.29 To -1.72
1.13 To -0.29
2.56 To 1.13
3.99 To 2.56
5.42 To 3.99
6.84 To 5.42
8.27 To 6.84
9.70 To 8.27
11.12 To 9.70
12.55 To 11.12
13.98 To 12.55
15.40 To 13.98
16.83 To 15.40
18.26 To 16.83
19.69 To 18.26
21.11 To 19.69
Performance Bucket (%)
Benchmark
Portfolio Decision

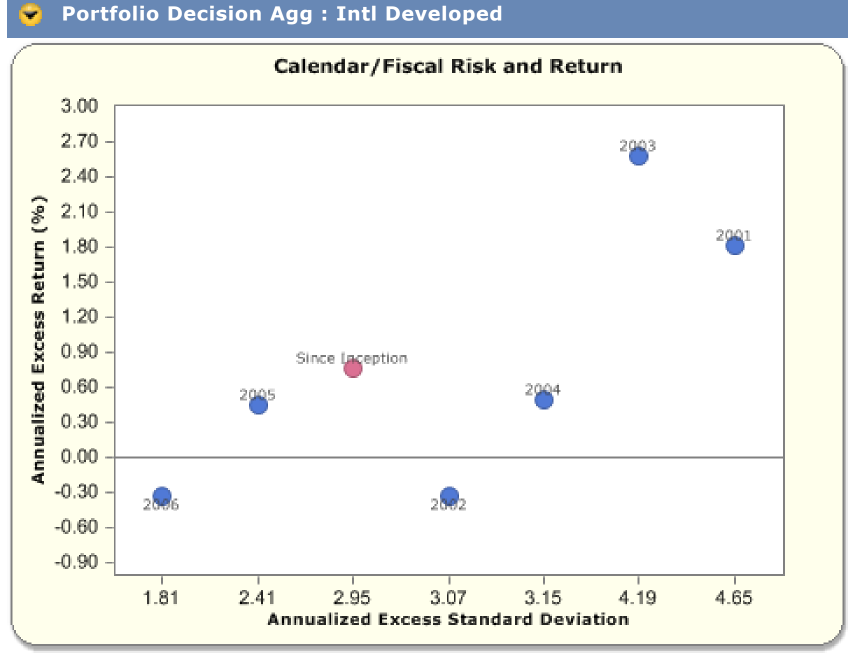

Portfolio Decision Agg : Emerging
Distribution of Returns
0.18
0.16
0.14
0.12
0.10
0.08
0.06
0.04
0.02
0.00
Frequency Distribution (%)
-20.31 To -21.93
-18.69 To -20.31
-17.08 To -18.69
-15.46 To -17.08
-13.84 To -15.46
-12.22 To -13.84
-10.60 To -12.22
-8.99 To -10.60
-7.37 To -8.99
-5.75 To -7.37
-4.13 To -5.75
-2.51 To -4.13
-0.90 To -2.51
0.72 To -0.90
2.34 To 0.72
3.96 To 2.34
5.58 To 3.96
7.19 To 5.58
8.81 To 7.19
10.43 To 8.81
12.05 To 10.43
13.67 To 12.05
15.28 To 13.67
16.90 To 15.28
18.52 To 16.90
20.14 To 18.52
21.76 To 20.14
23.37 To 21.76
24.99 To 23.37
Performance Bucket (%)
Benchmark
Portfolio Decision
Portfolio Decision Agg : Core Bonds
Distribution of Returns
0.14
0.12
0.10
0.08
0.06
0.04
0.02
0.00
Frequency Distribution (%)
-2.90 To -3.16
-2.63 To -2.90
-2.37 To -2.63
-2.11 To -2.37
-1.85 To -2.11
-1.58 To -1.85
-1.32 To -1.58
-1.06 To -1.32
-0.80 To -1.06
-0.53 To -0.80
-0.27 To -0.53
-0.01 To -0.27
0.25 To -0.01
0.52 To 0.25
0.78 To 0.52
1.04 To 0.78
1.31 To 1.04
1.57 To 1.31
1.83 To 1.57
2.09 To 1.83
2.36 To 2.09
2.62 To 2.36
2.88 To 2.62
3.14 To 2.88
3.41 To 3.14
3.67 To 3.41
3.93 To 3.67
4.19 To 3.93
4.46 To 4.19
Performance Bucket (%)
Benchmark
Portfolio Decision

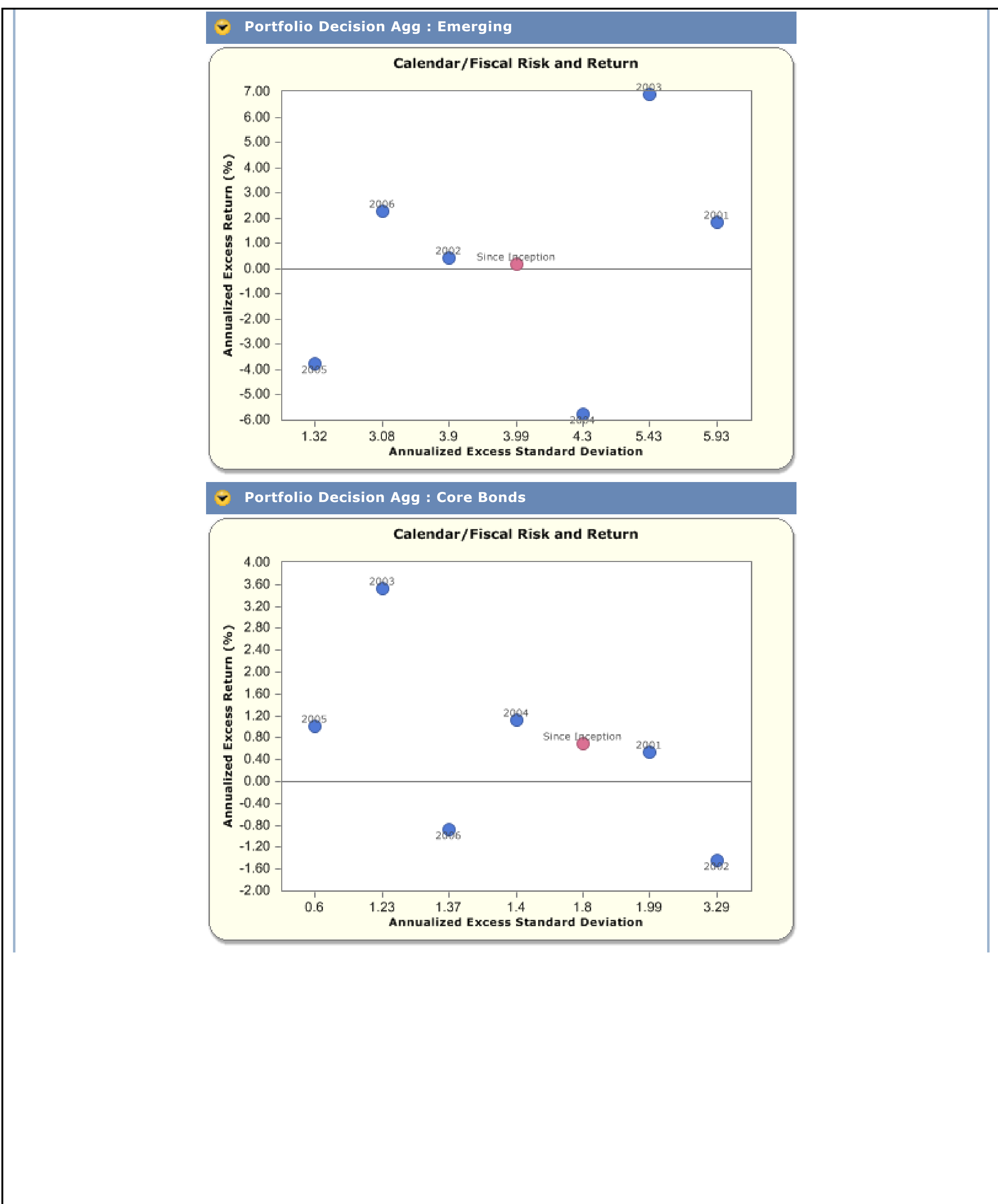

Portfolio Decision Agg : High Yield
Distribution of Returns
Frequency Distribution (%)
0.14
0.12
0.10
0.08
0.06
0.04
0.02
0.00
-10.87 To -11.67
-10.08 To -10.87
-9.28 To -10.08
-8.49 To -9.28
-7.69 To -8.49
-6.90 To -7.69
-6.10 To -6.90
-5.30 To -6.10
-4.51 To -5.30
-3.71 To -4.51
-2.92 To -3.71
-2.12 To -2.92
-1.33 To -2.12
-0.53 To -1.33
0.27 To -0.53
1.06 To 0.27
1.86 To 1.06
2.65 To 1.86
3.45 To 2.65
4.24 To 3.45
5.04 To 4.24
5.83 To 5.04
6.63 To 5.83
7.43 To 6.63
8.22 To 7.43
9.02 To 8.22
9.81 To 9.02
10.61 To 9.81
11.40 To 10.61
Performance Bucket (%)
Benchmark
Portfolio Decision
Portfolio Decision Agg : Alternatives
Distribution of Returns
Frequency Distribution (%)
0.18
0.16
0.14
0.12
0.10
0.08
0.06
0.04
0.02
0.00
-19.96 To -21.21
-18.70 To -19.96
-17.45 To -18.70
-16.20 To -17.45
-14.94 To -16.20
-13.69 To -14.94
-12.43 To -13.69
-11.18 To -12.43
-9.93 To -11.18
-8.67 To -9.93
-7.42 To -8.67
-6.17 To -7.42
-4.91 To -6.17
-3.66 To -4.91
-2.40 To -3.66
-1.15 To -2.40
0.10 To -1.15
1.36 To 0.10
2.61 To 1.36
3.86 To 2.61
5.12 To 3.86
6.37 To 5.12
7.62 To 6.37
8.88 To 7.62
10.13 To 8.88
11.39 To 10.13
12.64 To 11.39
13.89 To 12.64
15.15 To 13.89
Performance Bucket (%)
Benchmark
Portfolio Decision

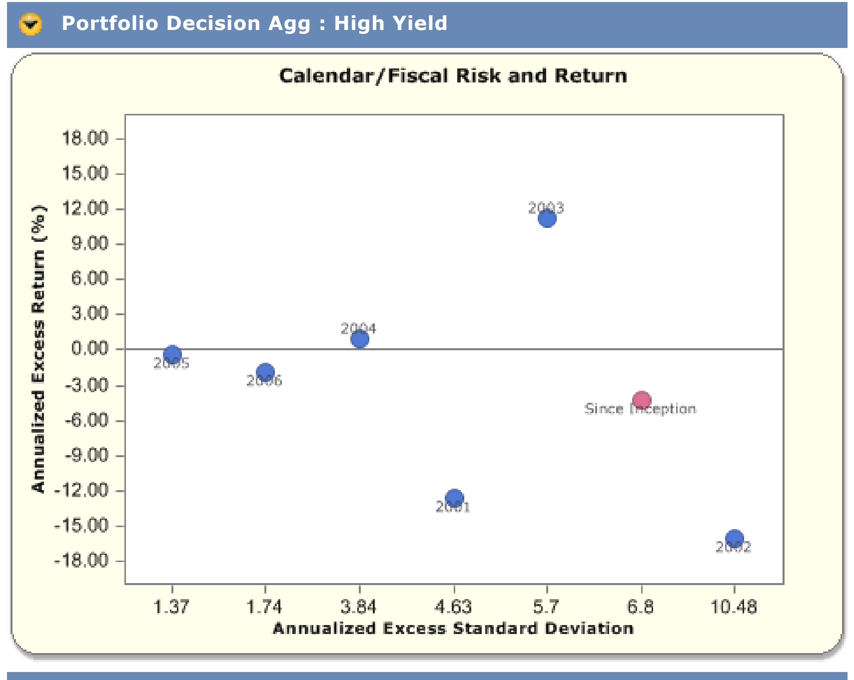

Portfolio Decision Agg : Cash
Distribution of Returns
Frequency Distribution (%)
0.33
0.30
0.27
0.24
0.21
0.18
0.15
0.12
0.09
0.06
0.03
0.00
-2.19 To -2.39
-1.99 To -2.19
-1.78 To -1.99
-1.58 To -1.78
-1.38 To -1.58
-1.18 To -1.38
-0.98 To -1.18
-0.77 To -0.98
-0.57 To -0.77
-0.37 To -0.57
-0.17 To -0.37
0.03 To -0.17
0.24 To 0.03
0.44 To 0.24
0.64 To 0.44
0.84 To 0.64
1.04 To 0.84
1.25 To 1.04
1.45 To 1.25
1.65 To 1.45
1.85 To 1.65
2.05 To 1.85
2.26 To 2.05
2.46 To 2.26
2.66 To 2.46
2.86 To 2.66
3.06 To 2.86
3.27 To 3.06
3.47 To 3.27
Performance Bucket (%)
Benchmark
Portfolio Decision
Portfolio Decision Agg : Real Estate
Distribution of Returns
Frequency Distribution (%)
0.33
0.30
0.27
0.24
0.21
0.18
0.15
0.12
0.09
0.06
0.03
0.00
-6.44 To -7.20
-5.69 To -6.44
-4.93 To -5.69
-4.17 To -4.93
-3.42 To -4.17
-2.66 To -3.42
-1.90 To -2.66
-1.15 To -1.90
-0.39 To -1.15
0.37 To -0.39
1.12 To 0.37
1.88 To 1.12
2.64 To 1.88
3.39 To 2.64
4.15 To 3.39
4.91 To 4.15
5.66 To 4.91
6.42 To 5.66
7.18 To 6.42
7.93 To 7.18
8.69 To 7.93
9.45 To 8.69
10.20 To 9.45
10.96 To 10.20
11.72 To 10.96
12.47 To 11.72
13.23 To 12.47
13.99 To 13.23
14.74 To 13.99
Performance Bucket (%)
Benchmark
Portfolio Decision

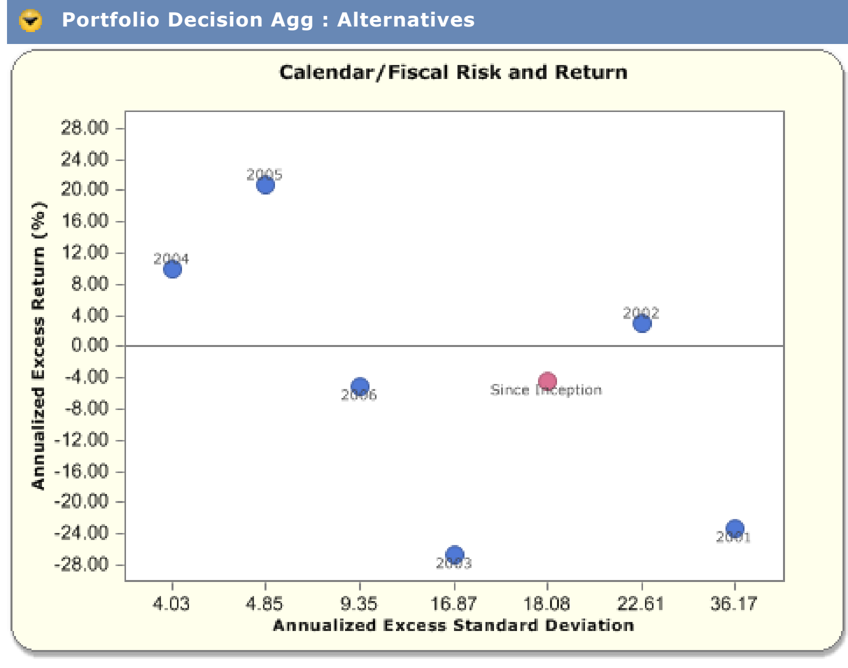

Calendar/Fiscal Risk and Return Chart
Portfolio Decision Agg : LAFFPS Fund
Calendar/Fiscal Risk and Return
Annualized Excess Return (%)
5.10
4.80
4.50
4.20
3.90
3.60
3.30
3.00
2.70
2.40
2.10
1.80
1.50
1.20
0.90
0.60
0.30
0.00
2005
Since Inception
2003
2004
2002
2006
2001
0.36
1.72
1.84
1.94
2.01
2.44
2.74
Annualized Excess Standard Deviation
Portfolio Decision Agg : US Large Cap
Calendar/Fiscal Risk and Return
Annualized Excess Return (%)
2.70
2.40
2.10
1.80
1.50
1.20
0.90
0.60
0.30
0.00
-0.30
-0.60
-0.90
-1.20
-1.50
2003
2005
2001
Since Inception
2004
2002
2006
0.22
0.51
0.8
0.92
1.08
1.25
1.97
Annualized Excess Standard Deviation

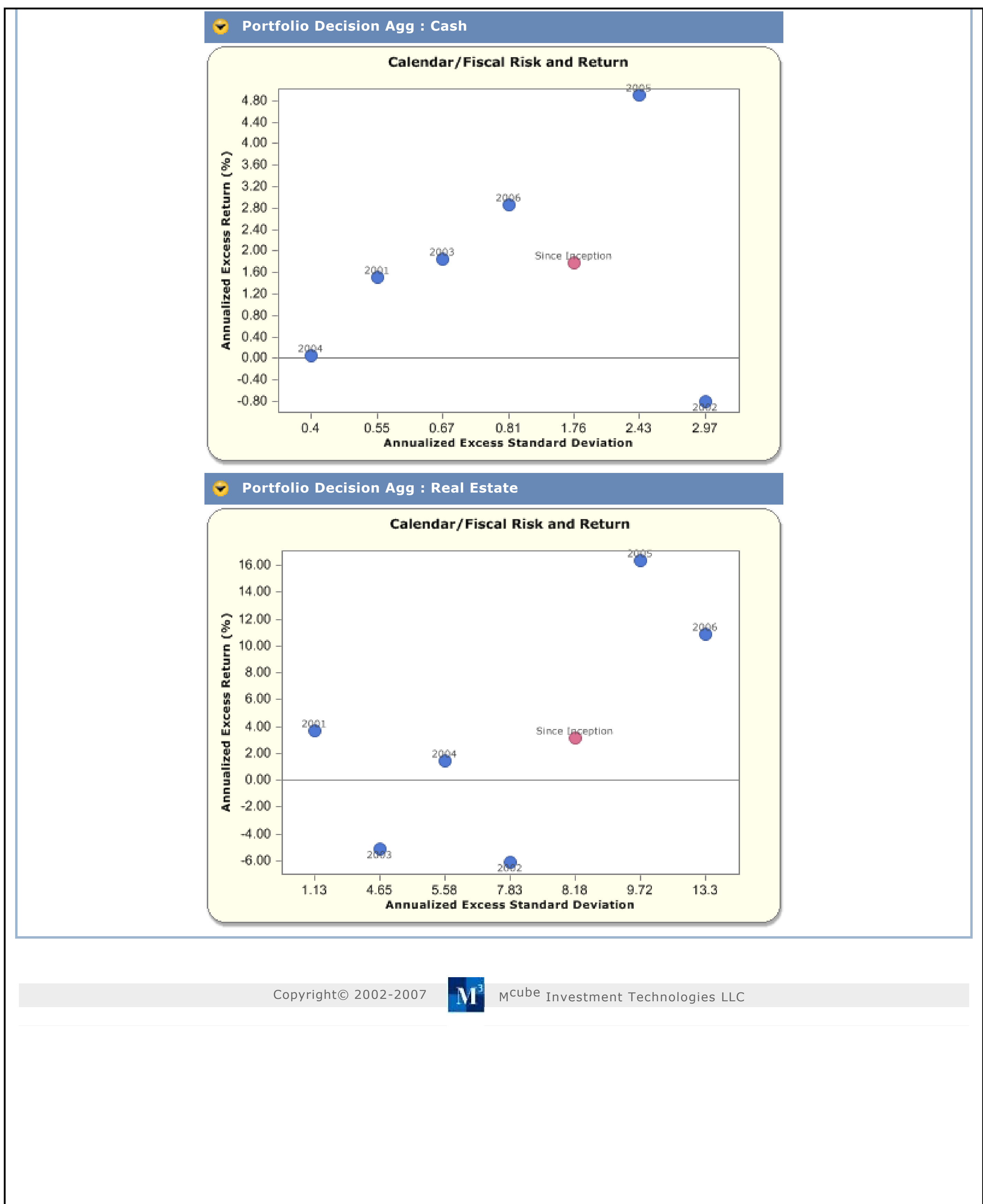

Portfolio Decision Agg : US Small Cap
Calendar/Fiscal Risk and Return
Annualized Excess Return (%)
6.00
5.00
4.00
3.00
2.00
1.00
0.00
-1.00
-2.00
-3.00
-4.00
-5.00
-6.00
-7.00
2003
2005
2004
Since Inception
2001
2002
2006
2.88
4.68
8.55
9.89
10.61
10.82
27.24
Annualized Excess Standard Deviation


Portfolio Decision Agg : Intl Developed
Calendar/Fiscal Risk and Return
Annualized Excess Return (%)
3.00
2.70
2.40
2.10
1.80
1.50
1.20
0.90
0.60
0.30
0.00
-0.30
-0.60
-0.90
2003
2001
Since Inception
2005
2004
2006
2002
1.81
2.41
2.95
3.07
3.15
4.19
4.65
Annualized Excess Standard Deviation


Portfolio Decision Agg : Emerging
Calendar/Fiscal Risk and Return
Annualized Excess Return (%)
7.00
6.00
5.00
4.00
3.00
2.00
1.00
0.00
-1.00
-2.00
-3.00
-4.00
-5.00
-6.00
2003
2006
2001
2002
Since Inception
2005
2004
1.32
3.08
3.9
3.99
4.3
5.43
5.93
Annualized Excess Standard Deviation
Portfolio Decision Agg : Core Bonds
Calendar/Fiscal Risk and Return
Annualized Excess Return (%)
4.00
3.60
3.20
2.80
2.40
2.00
1.60
1.20
0.80
0.40
0.00
-0.40
-0.80
-1.20
-1.60
-2.00
2003
2005
2004
Since Inception
2001
2006
2002
0.6
1.23
1.37
1.4
1.8
1.99
3.29
Annualized Excess Standard Deviation


Portfolio Decision Agg : High Yield
Calendar/Fiscal Risk and Return
Annualized Excess Return (%)
18.00
15.00
12.00
9.00
6.00
3.00
0.00
-3.00
-6.00
-9.00
-12.00
-15.00
-18.00
2003
2004
2005
2006
Since Inception
2001
2002
1.37
1.74
3.84
4.63
5.7
6.8
10.48
Annualized Excess Standard Deviation


Portfolio Decision Agg : Alternatives
Calendar/Fiscal Risk and Return
Annualized Excess Return (%)
28.00
24.00
20.00
16.00
12.00
8.00
4.00
0.00
-4.00
-8.00
-12.00
-16.00
-20.00
-24.00
-28.00
2005
2004
2002
2006
Since Inception
2001
2003
4.03
4.85
9.35
16.87
18.08
22.61
36.17
Annualized Excess Standard Deviation


Portfolio Decision Agg : Cash
Calendar/Fiscal Risk and Return
Annualized Excess Return (%)
4.80
4.40
4.00
3.60
3.20
2.80
2.40
2.00
1.60
1.20
0.80
0.40
0.00
-0.40
-0.80
2005
2006
2003
2001
Since Inception
2004
2002
0.4
0.55
0.67
0.81
1.76
2.43
2.97
Annualized Excess Standard Deviation
Portfolio Decision Agg : Real Estate
Calendar/Fiscal Risk and Return
Annualized Excess Return (%)
16.00
14.00
12.00
10.00
8.00
6.00
4.00
2.00
0.00
-2.00
-4.00
-6.00
2005
2006
2001
Since Inception
2004
2003
2002
1.13
4.65
5.58
7.83
8.18
9.72
13.3
Annualized Excess Standard Deviation
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