LACERS
LOS ANGELES CITY EMPLOYEES' RETIREMENT SYSTEM

Audit Committee Agenda

REGULAR MEETING **TUESDAY, OCTOBER 23, 2018** **TIME: 9:15 A.M.** **MEETING LOCATION:** LACERS Ken Spiker Boardroom 202 West First Street, Suite 500 Los Angeles, California 90012-4401	Chair: Elizabeth Lee Committee Members: Sung Won Sohn Michael Wilkinson Manager-Secretary: Neil M. Guglielmo Executive Assistant: Ani Ghoukassian Legal Counselor: City Attorney's Office Retirement Benefits Division Sign Language Interpreters, Communication Access Real-Time Transcription, Assistive Listening Devices, or other auxiliary aids and/or services may be provided upon request. To ensure availability, you are advised to make your request at least 72 hours prior to the meeting you wish to attend. Due to difficulties in securing Sign Language Interpreters, five or more business days' notice is strongly recommended. For additional information, please contact: Board of Administration Office at (213) 473-7169.

I. PUBLIC COMMENTS ON MATTERS WITHIN THE COMMITTEE'S JURISDICTION

II. APPROVAL OF MINUTES FOR THE AUDIT COMMITTEE MEETING OF MAY 22, 2018 AND POSSIBLE COMMITTEE ACTION

III. PRESENTATION FROM BROWN ARMSTRONG ON THE STATUS OF 2018 FINANCIAL STATEMENT AUDIT

IV. INTERNAL AUDIT AND AUDIT COMMITTEE CHARTER UPDATES AND POSSIBLE COMMITTEE ACTION

V. RECEIVE AND FILE – UPDATE ON 2014 MANAGEMENT AUDIT

VI. OTHER BUSINESS

VII. NEXT MEETING: The next Audit Committee meeting is not scheduled at this time, and will be announced upon scheduling.

VIII. ADJOURNMENT

Board of Administration Agenda

SPECIAL MEETING

TUESDAY, OCTOBER 23, 2018

TIME: 9:15 A.M.

MEETING LOCATION:

LACERS Ken Spiker Boardroom
202 West First Street, Suite 500
Los Angeles, California 90012-4401

Sign Language Interpreters, Communication Access Real-Time Transcription, Assistive Listening Devices, or other auxiliary aids and/or services may be provided upon request. To ensure availability, you are advised to make your request at least 72 hours prior to the meeting you wish to attend. Due to difficulties in securing Sign Language Interpreters, five or more business days' notice is strongly recommended. For additional information, please contact: Board of Administration Office at (213) 473-7169.

President:	Cynthia M. Ruiz
Vice President:	Elizabeth L. Greenwood
Commissioners:	Elizabeth Lee Sandra Lee Nilza R. Serrano Sung Won Sohn Michael Wilkinson
Manager-Secretary:	Neil M. Guglielmo
Executive Assistant:	Ani Ghoukassian
Legal Counsel:	City Attorney's Office Retirement Benefits Division

I. PUBLIC COMMENTS ON MATTERS WITHIN THE COMMITTEE'S JURISDICTION

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VIII. ADJOURNMENT

MINUTES OF THE REGULAR MEETING
AUDIT COMMITTEE
BOARD OF ADMINISTRATION
LOS ANGELES CITY EMPLOYEES' RETIREMENT SYSTEM

LACERS Ken Spiker Boardroom
202 West First Street, Suite 500
Los Angeles, California

May 22, 2018

11:23 a.m.

Agenda of: Oct. 23, 2018
Item No: II

PRESENT:	Chairperson:	Annie Chao
	Committee Member:	Cynthia M. Ruiz
	Manager-Secretary:	Neil M. Guglielmo
	Executive Assistant:	Ani Ghoukassian
	Audit Manager:	Rahoof "Wally" Oyewole
	Legal Counselor:	Anya Freedman
ABSENT:	Committee Member:	Vacant Position

The Items in the Minutes are numbered to correspond with the Agenda.

I

PUBLIC COMMENTS ON MATTERS WITHIN THE COMMITTEE'S JURISDICTION – Chairperson Chao asked if any persons wished to speak, to which there was no response and no public comment cards were received.

II

APPROVAL OF MINUTES FOR THE AUDIT COMMITTEE MEETING OF JULY 25, 2017 AND POSSIBLE COMMITTEE ACTION – A motion to approve the Minutes was moved by Committee Member Ruiz, seconded by Chairperson Chao, and adopted by the following vote: Ayes, Committee Member Ruiz and Chairperson Chao -2; Nays, None.

III

CONTRACT AMENDMENT WITH BROWN ARMSTRONG FOR FINANCIAL AUDIT SERVICES AND POSSIBLE COMMITTEE ACTION – Rahoof "Wally" Oyewole, LACERS Departmental Audit Manager, presented this item to the Committee. After discussion, Committee Member Ruiz, seconded by Chairperson Chao, and adopted by the following vote: Ayes, Committee Member Ruiz and Chairperson Chao -2; Nays, None.

IV

RECEIVE AND FILE – INTERNAL AUDIT REPORT ON RELIABILITY OF INTERNAL RATE OF RETURN (IRR) REPORTED FOR LACERS PRIVATE EQUITY AND REAL ESTATE INVESTMENTS – Rahoof “Wally” Oyewole, LACERS Departmental Audit Manager, presented this item to the Committee. This report was received by the Committee and filed.

V

VERBAL STATUS REPORT ON FISCAL YEAR 2017-18 INTERNAL AUDIT WORKPLAN – Rahoof “Wally” Oyewole, LACERS Departmental Audit Manager, discussed the three ongoing audits that will likely be finalized by July or August and the projects that will be rolled over to the next fiscal year. After discussion, the Committee thanked Mr. Oyewole for his report.

VI

OTHER BUSINESS: There was no further discussion.

VII

NEXT MEETING: Chairperson Chao announced that the next Audit Committee Meeting is not scheduled at this time, and will be announced upon scheduling.

VIII

ADJOURNMENT: There being no further business before the Committee, Chairperson Chao adjourned the Meeting at 12:07 p.m.

Annie Chao
Chairperson

Neil M. Guglielmo
Manager-Secretary

Los Angeles City Employees' Retirement System (LACERS)

Scope of Services Presentation/Audit Status Update of the June 30, 2018 Audit Plan

Brown Armstrong

Accountancy Corporation

4200 Truxtun Avenue, Suite 300 | Bakersfield, CA 93309 | 661.324.4971 | Fax 661.324.4997

www.bacpas.com

Contact: Rosalva Flores, Engagement Partner, CPA – rflores@bacpas.com

October 23, 2018

Los Angeles City Employees' Retirement System (LACERS)
202 W. First Street, Suite 500
Los Angeles, California 90012-4401

We are pleased to have the opportunity to discuss the scope of the audit and audit status update to provide for open and continuous, two-way communication and reporting to management of LACERS for the year ended June 30, 2018.

We look forward to presenting this information, addressing your questions, and discussing any other matters of interest to the management of LACERS.

Sincerely,

Rosalva Flores, Engagement Partner, CPA
Brown Armstrong Accountancy Corporation

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Contents

The Engagement Team

Rosalva Flores, CPA
Engagement Partner

Brooke Baird, CPA
Engagement Manager

Alaina Sanchez, CPA
Technical Review Manager

Paul Sahota
Engagement Senior

Roxanne Perez
Staff Supervisor

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Summary

This document outlines our audit strategy and approach for the 2018 fiscal year audit of LACERS and is provided to give the Audit Committee the opportunity to review, discuss, and comment on our plan.

This document provides:

- An overview of our audit approach.
- Plan for continuous, two-way communication and reporting to the Audit Committee and management.
- Proposed Audit Timeline.
- Management's responsibilities in relation to the audit.

Some modifications of the scope of our plan may be required as we execute our audit. We will advise the Audit Committee of any significant changes.

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Audit Timeline/Critical Dates List

Items	Due Date	Status
AUDITOR to provide population request to LACERS	June 27, 2018	Complete
AUDITOR to provide interim information request list to LACERS	June 28, 2018	Complete
LACERS to provide AUDITOR with population and information for interim fieldwork testing	July 13, 2018	Complete
Items on interim fieldwork information request lists due	July 30, 2018	Complete
LACERS to provide AUDITOR trial balance as of 5/31/18	July 30, 2018	Complete
AUDITOR to provide confirmation templates for custodian, investment managers, legal, and actuary	Week of July 30, 2018	Complete
Expected completion of interim fieldwork	August 3, 2018	Complete
AUDITOR to provide year-end information request list	August 10, 2018	Complete
Custodian, investment managers, legal, and actuary confirmations returned to AUDITOR for mailing/emailing	August 10, 2018	Complete

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Audit Timeline/Critical Dates List (cont.)

Items	Due Date	Status
Custodian, investment managers, and actuary confirmations due to AUDITOR and send 2nd Request via mail/email	August 24, 2018	Complete
LACERS to provide AUDITOR trial balance as of 6/30/18	September 6, 2018	Complete
Beginning of final fieldwork at LACERS' office. Please provide space for four (4) auditors	September 10, 2018	Complete
Items on final fieldwork information request lists due	September 10, 2018	Complete
Expected completion date of fieldwork	Week of September 17, 2018	Complete
Exit teleconference call with LACERS to go over results of fieldwork	September 27, 2018	Complete
AUDITOR will provide authorization to release numbers to ACTUARY	September 28, 2018	Complete
AUDITOR to provide LACERS with draft financial section of CAFR	October 12, 2018	Complete
LACERS to provide AUDITOR with actuarial valuation report	November 13, 2018	
LACERS to provide AUDITOR with MD&A and suggested changes to draft	November 14, 2018	

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Audit Timeline/Critical Dates List (cont.)

Items	Due Date	Status
AUDITOR to provide LACERS with drafts of reports, including findings and recommendations	November 16, 2018	
LACERS to provide AUDITOR with responses to findings and recommendations	November 20, 2018	
AUDITOR to deliver 50 bound copies of the audit report to LACERS	November 28, 2018	
AUDITOR to present Financial Section at LACERS Board Meeting	Pending confirmation of date	
LACERS to provide AUDITOR with draft of entire CAFR	Pending confirmation of date	
AUDITOR will provide all recommendations, revisions, and suggestions for improvement to the CAFR	Pending confirmation of date	
LACERS to send final CAFR to print (information only) - No action	Pending confirmation of date	

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Our Audit Objectives

As the auditors for LACERS, we are responsible for reporting on the financial statements of LACERS for the year ended June 30, 2018. Our engagement is focused on delivering our services at three levels.

For the public and LACERS	Independent opinions and reports that provide assurance on the financial information released by LACERS.
For the Board	Assistance in discharging its fiduciary responsibilities.
For management	Observations and advice on financial reporting, accounting, and internal control issues from our professionals.

Our primary objective is the expression of an opinion on LACERS' financial statements in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States, which includes:

- Obtaining reasonable assurance as to whether the financial statements are prepared in accordance with accounting principles generally accepted in the United States of America and are free of material misstatements, whether caused by error or fraud; and

- Obtaining reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects.

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Audit Strategy

Phase I	Phase II	Phase III	Phase IV
←	Audit Planning	→	
	Interim Field Work	Final Field Work	Completion
Familiarize ourselves with operating environment	Assess internal control environment	Plan and perform substantive audit procedures	Perform completion procedures, including manager, partner, and technical review partner reviews
Perform risk assessment procedures	Perform Statement on Auditing Standards (SAS) 99 (fraud evaluation) procedures	Conduct final analytical review	Assist with the drafting of the financial statements
Determine planning materiality	Identify internal control strengths and weaknesses	Consider audit evidence sufficiency	Draft reports to be issued
Perform preliminary analytical review	Evaluate design and implementation of selected controls	Conclude on critical accounting matters	Obtain legal confirmation
Identify significant audit areas	Test controls over financial reporting and administration	Complete any leftover interim procedures	Draft and obtain a signed management representation letter
Develop an audit plan and communicate with client regarding any new standards that will affect them in the current year	Understand accounting and reporting activities		Conduct exit conference with management, including discussion of proposed audit adjustments, internal control and compliance findings, and management letter
Determine nature and extent of audit procedures	Participant Testing		Issue auditor's reports and management letter
Reevaluate the progress of the audit and make any changes on audit approach and procedures, if necessary	IT Audit- Full scope in current year due to first year pension gold implementation		
Confirmation of account balances			

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Audit Approach

- Investments and Related Earnings
  - Investments in General
    - Identify all investment accounts and portfolios
    - Document our understanding of LACERS' internal controls over investments, including the following:
      - ❖ Establishment of investment policies and guidelines, including asset allocation and securities lending
      - ❖ Hiring and monitoring of asset managers, custodian banks, and other investment consultants
      - ❖ Determining fair values of investments
      - ❖ Account reconciliations and performance reviews
    - Review LACERS' investment reconciliations
    - Confirm year-end balances, including securities lending activities, with master custodian and asset managers (including trade receivables and payables) - Note: This is done on a sampling basis
    - Select a sample of publicly traded investments and test fair values based on quoted market prices
    - Verify accurate identification and financial reporting of deposit and investment risk
    - GASB Statement No. 72
      - ❖ Obtain an understanding of management's methodology for classifying investments to comply with GASB Statement No. 72
      - ❖ Obtain investment schedules and disclosures from management and review for adequacy and compliance with GASB Statement No. 72
  - Investment in Derivatives
    - Review investment reports and third-party statements to substantiate the existence of derivatives
    - Determine the appropriateness of the methodology used to value derivative investments
    - Compare fair values to quoted market prices, if available
    - Perform tests of underlying data to determine the reasonableness of fair values for which quoted market prices are not available

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Audit Approach (cont.)

- Investments in Real Estate
  - Confirm year-end balances - Note: This is done on a sampling basis
  - Review supporting documentation to substantiate the existence of real estate investments
  - Assess the qualifications of and nature of the work performed by external appraisal firms in accordance with Statement on Auditing Standards (SAS) 73
  - Determine the appropriateness of the methodology used to value real estate investments
  - Compare the most recent real estate appraisals to reported real estate investments
  - Analytically review fair values as compared to prior periods and determine the reasonableness of valuations based on known trends and market conditions
  - Read interim investment reports and inquire of management to determine that outstanding commitments have been properly disclosed in the financial statements

- Alternative Investments (Direct Investments and Partnerships)
  - Confirm year-end balances - Note: This is done on a sampling basis
  - Review supporting documentation, such as partnership agreements, to substantiate the existence of alternative investments
  - Determine the appropriateness of the methodology used to value alternative investments
  - Compare the most recent audited financial statements and other investment reports to reported alternative investments
    - Consider fair value changes resulting from timing issues, including subsequent contributions and distributions, and propose adjustments as necessary
    - Analytically review fair values as compared to prior periods and determine the reasonableness of valuations based on known economic and business conditions

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Audit Approach (cont.)

- Investment Income and Expenses
  - Perform analytical procedures over reported balances. Our work should normally cover a comparison of:
    - ❖ Compare current year operating results with the prior year
    - ❖ Key financial and operating ratios with the prior year, the industry, and with each other (e.g., actual, target, and benchmark performances, etc.)
    - ❖ Recalculate investment income and expenses to determine reasonableness
  - Confirm balances with asset managers and custodian bank

- Participant Data and Employee/Employer Contributions
  - Document our understanding of LACERS' internal controls over contributions from participating employees and member employers, including the following:
    - Underlying authority for contributions (established law, contracts, and formulas)
    - Process for enrolling new participants
    - Determination of actuarially required contributions
    - Payment of contributions and related account reconciliations
  - Review LACERS' account reconciliations to determine accuracy and completeness
  - Determine that contributions are consistent with actuarial requirements or plan provisions, as applicable
  - Perform analytical procedures over reported contributions:
    - Compare reported amounts to prior years, considering participation levels and funding requirements
    - Assess the reasonability of contributions based on covered payroll and required contribution rates, as appropriate

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Audit Approach (cont.)

- Participant Data and Benefit Payments
  - Document our understanding of LACERS' internal controls over benefit payments, including the following:
    - Underlying authority establishing benefit provisions
    - Process for determining eligibility to receive benefits
    - Determination of benefit amounts based on established formulas/criteria
    - Payment of benefits and related account reconciliations
    - Select a sample of benefit payments and perform tests of significant internal controls and compliance
  - Review LACERS' account reconciliations to determine accuracy and completeness
  - Perform analytical procedures over reported benefits
    - Compare reported amounts to prior years, considering participation levels, benefit provisions, and inflationary or cost of living adjustment
    - Recalculate benefit payments to determine reasonableness
  - Actuary Information
    - Review the actuarial valuation made by the actuarial firm, as it affects the financial statements
    - Determine that actuarial information presented in the footnotes to the financial statements and as required supplementary information is consistent with information contained in the actuarial valuation report and determine that the requirements of Governmental Accounting Standards Board (GASB) Statement No. 50 have been satisfied
    - Work with LACERS' employer to obtain access to the underlying records of the active, inactive, and retired participants to test and verify the accuracy of the underlying data

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Audit Approach (cont.)

- Actuary Information (cont.)
  - Obtain the GASB Statement No. 67 actuary valuation from Segal and obtain an understanding of the assumptions used by the actuary
  - Obtain the GASB Statement No. 67 disclosures from management and ensure all required disclosures have been included in the financial statement disclosures
  - Review management's calculation of the money weighted rate of return and ensure the calculation is in accordance with GASB Statement No. 67

- Information Technology (IT)
  - Gain an understanding of LACERS' applications and general policies and procedures over IT and identifying risks
  - Determine the IT scope by identifying applications that significantly affect the processing of financial transactions
  - In scope applications identified:
    - Pension Gold (PG) – Member tracking and benefit repayment processing
  - Interview key LACERS personnel responsible for maintaining and managing the IT environment supporting PG

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Significant Changes in Audit Plan from Prior Year

- Full scope for IT due to first year implementation of the PG Version 3 upgrade
  - ➢ Interview staff maintaining/managing IT environment and document our understanding of general controls
    - ✓ Review internal risk assessment process
    - ✓ Review outsourced and 3rd party service providers
  - ➢ Review/test operating environment including:
    - ✓ PG back ups -Test back up logs on a sample basis
    - ✓ Interfaces with PG - multiple exchanges of data
      - o Test interfaces between systems to ensure complete and accurate transfer of data
  - ➢ Review logical and physical security including:
    - ✓ Policies in place
    - ✓ User account access and removal of user account access
      - o Test a sample of new hires with system access to verify access is granted on reasonable business needs and approved my management
      - o Test that shared administrator and account passwords are reset following the departure of IT staff

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Significant Changes in Audit Plan from Prior Year (cont.)

- Full scope for IT due to first year implementation of the PG Version 3 upgrade (cont.)
  - ➢ Review logical and physical security including:
    - ✓ Password authentication requirements
    - ✓ Physical securities and environmental controls
      - o Test for authorized access to the data center and server room
    - ✓ Network security
      - o Test for authorized external access (such as VPN, remote desktop) is appropriate and limited
  - ➢ Testing of Change Management
    - ✓ System changes
      - o Test a sample of system changes during the year for appropriate recording and authorization.
    - ✓ Development projects
      - o Test a sample of development projects to verify if the conversion testing are properly planned and documented with proper review and approval

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Reports Expected to be Issued

←	Government Auditing Standards	→	
GAAS			
Independent Auditor's Report (Opinion) on Financial Statements	Required Communication to the Audit Committee and Board of Retirement in Accordance with Professional Standards	Report on Internal Control over Financial Reporting and on Compliance with Laws and Regulations	Report on Agreed Upon Conditions Designed to Increase Efficiency, Internal Controls, and/or Financial Reporting (Management Letter)

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Accounting Pronouncements or Auditing Standards Applicable to LACERS for the June 30, 2018 Audit

Standard	Title	Effective Date	June 30 Year-End Effective Date	Effect on Retirement Systems?
GASB Statement No. 75	*Accounting and Financial Reporting for Postemployment Benefits Other than Pensions*	Fiscal years beginning after June 15, 2017	July 1, 2017 – June, 30, 2018	Provides guidance for governments that provide OPEB to their employees. Represents significant changes and largely mirror the changes for pension under GASB Statement No. 68, Accounting and Financial Reporting for Pensions, by reporting the OPEB liability on the face of the statements rather than in the footnotes. This statement is for the employer.
GASB Statement No. 81	*Irrevocable Split-Interest Agreements*	Fiscal years beginning after December 15, 2016	July 1, 2017 – June, 30, 2018	Not applicable as LACERS does not have these types of transactions.
GASB Statement No. 85	*Omnibus 2017*	Fiscal years beginning after June 15, 2017	July 1, 2017 – June, 30, 2018	This statement addresses practice issues that have been identified during the implementation and application of certain GASB statements including OPEB, blending component units, and goodwill, which are not applicable to LACERS. The statement also covers fair value measurements, but we do not expect it to have a significant impact on LACERS.

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Accounting Pronouncements or Auditing Standards Applicable to LACERS for the June 30, 2018 Audit (cont.)

Standard	Title	Effective Date	June 30 Year-End Effective Date	Effect on Retirement System?
GASB Statement No. 86	*Certain Debt Extinguishment Issues*	Fiscal years beginning after June 15, 2017	July 1, 2017 – June, 30, 2018	Not applicable as LACERS does not have these types of transactions.

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Future Accounting Pronouncements

Standard	Title	Effective Date	June 30 Year-End Effective Date	Effect on Retirement System?
GASB Statement No. 83	*Certain Asset Retirement Obligations*	Fiscal years beginning after June 15, 2018	July 1, 2018 – June, 30, 2019	Not applicable as LACERS does not have these types of transactions.
GASB Statement No. 84	*Fiduciary Activities*	Fiscal years beginning after December 15, 2018	July 1, 2019 – June, 30, 2020	Not applicable as LACERS does not have these types of transactions.
GASB Statement No. 87	*Leases*	Fiscal years beginning after December 15, 2019	July 1, 2020 – June 30, 2021	Requires the recognition of certain assets and liabilities for leases that were previously classified as operating leases and recognized as inflows or outflows of resources based on the payment provisions of the contract. LACERS potential impact upon implementation has not been determined.
GASB Statement No. 88	*Certain Disclosures Related to Debt, including Direct Borrowings and Direct Placements*	Fiscal years beginning after June 15, 2018	July 1, 2018 – June 30, 2019	LACERS potential impact upon implementation has not been determined.

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Future Accounting Pronouncements (cont.)

Standard	Title	Effective Date	June 30 Year-End Effective Date	Effect on Retirement System?
GASB Statement No. 89	*Accounting for Interest Cost Incurred before the End of the Construction Period*	Reporting periods beginning after December 15, 2019	July 1, 2020-June 30, 2021	Not applicable as LACERS does not have these types of transactions.
GASB Statement No. 90	*Majority Equity Interests- an Amendment of GASB Statements No. 14 and No. 61*	Reporting periods beginning after December 15, 2018	July 1, 2019-June 30, 2020	This statement improves the consistency and comparability of a government's majority equity interest in a legally separate organization and to improve the relevance of financial statement information for certain component units. LACERS potential impact upon implementation has not been determined.

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Audit Status

- Concluded final fieldwork in September
  - ✓ Wrap up of work papers in process
  - ✓ Work substantially reviewed by both manager and partner
- Released numbers to actuary
  - ✓ Pending valuation report
- Draft financial statements provided to LACERS with exception of the valuation information

Questions?

We enjoyed working with your management and appreciate all the assistance during the audit.

Thank you!

Rosalva Flores,
Engagement Partner, CPA

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LACERS
LOS ANGELES CITY EMPLOYEES' RETIREMENT SYSTEM

Report to Audit Committee

From: Rahoof "Wally" Oyewole, Dept. Audit Manager

Agenda of: **OCTOBER 23, 2018**

ITEM: **IV**

SUBJECT: **INTERNAL AUDIT AND AUDIT COMMITTEE CHARTER UPDATES AND POSSIBLE COMMITTEE ACTION**

Recommendation:

That the Committee recommend that the Board consider and approve the proposed changes to Internal Audit Charter (Attachment 1); and reaffirm the current Audit Committee Charter (Attachment 5).

Discussion:

Internal Audit Charter

The International Standards for the Professional Practice of Internal Auditing (IIA Standards) require that the purpose, authority and responsibility of an internal audit function be formally defined in an internal audit charter, and approved by the organization's board.

On November 12, 2013, the Board adopted the initial Internal Audit and Audit Committee charters. The charters were developed to closely align with professional auditing standards and model charters issued by the Association of Public Pension Fund Auditors (APPFA). LACERS' Internal Audit Charter institutionalizes the internal audit function within LACERS, including the nature of its reporting relationship to the Board; define the scope of internal audit activities; and authorize access to records, personnel, and physical properties relevant to the performance of audit engagements.

As part of Internal Audit's periodic review of the charters, staff noted that, in March 2017, the Institute of Internal Auditors issued a "Supplemental Guidance / Model Internal Audit Activity Charter" (Attachment 4) to illustrate common practices typically set out in an internal audit activity charter. Based on a review of this guide, staff proposes changes to Internal Audit's mission, scope and standards of professional practice, as indicated in Attachment 1. A clean version of the charter incorporating the proposed changes is also attached (Attachment 2). The proposed changes would make these sections of the Internal Audit Charter consistent with the new language in the supplemental guidance.

Audit Committee Charter

The Audit Committee assists the Board in fulfilling its fiduciary oversight responsibility to members and other stakeholders relating to LACERS' financial statements, and the legal compliance, ethics programs and other related risks, as established by the Board. Much like the internal audit charter, the Audit Committee Charter (Attachment 5) was developed to align them with IIA standards and APPFA's "Model Audit Committee Charter" (Attachment 6). Staff has reviewed the current Audit Committee Charter and determined that no new changes are needed at this time. Staff is requesting that the Committee recommend that the Board reaffirm the current Audit Committee Charter.

Strategic Impact Statement

Internal Audit and Audit Committee assist the Board in meeting its Governance Goal to "uphold good governance practices which affirm transparency, accountability and fiduciary duty," by providing an independent and objective assessment of the effectiveness of risk management, internal control, and governance processes.

This report was prepared by Rahoof "Wally" Oyewole, Departmental Audit Manager, Internal Audit Section.

RO

Attachments:
1) Proposed LACERS Internal Audit Charter (Redline Version)
2) Proposed LACERS Internal Audit Charter (Clean Version)
3) APPFA Model Internal Audit Department Charter
4) IIA Supplemental Guidance – Model Internal Audit Activity Charter Issued March 2017
5) LACERS' Current Audit Committee Charter – No Changes Proposed
6) APPFA Model Audit Committee Charter

Internal Audit Charter

Adopted by the Board: November 12, 2013; Revised: October 23, 2018

I. PURPOSE

The purpose of this Charter is to formally define LACERS' internal audit function's purpose, authority, and responsibility. The internal audit charter establishes the internal audit function's position within LACERS including the nature of the Departmental Audit Manager's (DAM) functional reporting relationship with the Board; authorizes access to records, personnel, and physical properties relevant to the performance of engagements; and defines the scope of internal audit activities. This Charter shall be reviewed annually and updated as necessary.

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II. MISSION

The Mission of the Internal Audit Section is to enhance and protect organizational value by providing risk-based and objective assurance, advice, and insight. ~~provide independent, objective assurance, and consulting services designed to add value and improve LACERS' operations.~~ Internal Audit helps ~~It is to assist~~ LACERS ~~in~~ accomplish~~ing~~ its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of governance, risk management, and ~~internal~~ control ~~, and governance~~ processes.~~ by:~~

- ~~Providing a wide range of quality, independent internal auditing services for the Executive Management and the Board, and consulting services for management;~~
- ~~Performing independent assessments of the risk management systems, internal controls, and operating efficiency, guided by professional standards and using innovative approaches;~~
- ~~Supporting LACERS' efforts to achieve its objectives through independent auditing and consulting services; and~~
- ~~Maintaining a dynamic, team-oriented environment that encourages personal and professional growth, and challenges and rewards internal audit staff for reaching full potential and excelling.~~

Commented [OR1]: Mission revised to be consistent with Supplemental Guidance Model Internal Audit Activity Charter issued by the Institute of Internal Auditor (IIA) in March 2017.

III. OBJECTIVES AND SCOPE

Assurance Objectives: The objectives of the Internal Audit Section's assurance services are to provide independent assurance to the Board, the Audit Committee, and LACERS' Executive Management that LACERS' assets are safeguarded, operating efficiency is enhanced, and compliance is maintained within prescribed laws, Board Rules, and management policies. Assurance objectives include independent assessment of LACERS' governance, risk management, and control processes.

Consulting Objectives: The objectives of the Internal Audit Section's consulting services, the nature and scope of which are agreed with management, are to provide management with assessments and advice for improving LACERS' governance, risk management and control without the Internal Audit Section assuming management responsibility. For example, consulting services may provide assessments and advice on the front-end projects so that risks can be identified, managed, and internal controls can be designed.

Section 3.0 DUTIES AND RESPONSIBILITIES

Scope: The scope of internal audit activities encompasses, but is not limited to, objective examinations of evidence for the purpose of providing independent assessments to the LACERS' Board, Audit Committee, management, and outside parties on the adequacy and effectiveness of governance, risk management, and control processes for LACERS. Internal audit assessments include evaluating whether:

- Risks relating to the achievement of LACERS' strategic objectives are appropriately identified and managed;
- The actions of LACERS' officers, directors, employees, and contractors are in compliance with Board's policies, procedures, and applicable laws, regulations, and governance standards;
- The results of operations or programs are consistent with established goals and objectives;
- Operations or programs are being carried out effectively and efficiently;
- Established processes and systems enable compliance with the policies, procedures, laws, and regulations that could significantly impact Plan;
- Information and the means used to identify, measure, analyze, classify, and report such information are reliable and have integrity;
- Resources and assets are acquired economically, used efficiently, and protected adequately;

~~The scope of work of the Internal Audit Section is to determine whether LACERS' network of risk management, internal control, and governance processes, as designed and represented by management, is adequate and functioning in a manner to ensure:~~

~~Programs are operating within the highest fiduciary standards and are directed toward the requirements defined in Federal and State law, the Charter of the City of Los Angeles, the Administrative Code of the City of Los Angeles, Board Rules, and LACERS' policies and procedures;~~
~~Processes and practices are consistent with industry best practices, using the best public and private examples as benchmarks;~~
~~Significant legislative and regulatory issues impacting LACERS are recognized and addressed appropriately;~~
~~Operations and processes are consistent with established missions, objectives, and goals;~~
~~Operations and processes are being carried out as planned;~~
~~Existing policies are appropriate and updated;~~
~~Employee data is appropriately reported to LACERS;~~
~~Significant financial, managerial, and operating information is accurate, reliable, and timely;~~
~~Resources are acquired economically, used efficiently, and adequately protected;~~
~~Quality service and continuous improvement are fostered in LACERS control processes;~~
~~Contractors are meeting the objectives of the contracts, while in conformance with applicable laws, regulations, policies, procedures, and best practices; and~~

Commented [OR2]: Language and specific components revised to be consistent with Supplemental Guidance Model Internal Audit Activity Charter issued by the Institute of Internal Auditor (IIA) in March 2017.

~~Specific programs, operations, and processes are review at the request of management or the Board.~~

Opportunities for improving member service, management of risks, internal control, governance, and the organization's effectiveness and image may be identified during audits. This information will be communicated to management and the Audit Committee as appropriate.

IV. AUTHORITY

~~This Charter establishes LACERS' internal audit function.~~ The Internal Audit Section reports functionally to the Board through its Audit Committee, and administratively to the General Manager. The Audit Committee advises on the appointment, replacement, or dismissal of the DAM in consultation with the General Manager as appointing authority.

Commented [OR3]: Internal Audit is now an established function within the Department

The DAM is responsible for managing the Internal Audit Section and preparing an audit plan. The Audit Committee reviews and recommends the approval of the annual audit plan to the Board. The DAM shall periodically inform the Audit Committee regarding the status of the audit plan and changes needed. The DAM is authorized to allocate internal audit resources, set project frequencies, select audit subjects, determine scopes of work, and apply the techniques necessary to accomplish the audit objectives. The DAM is authorized to hire (within budgetary constraints), retain, train, and develop internal audit staff to achieve the internal audit objectives as stated in this Charter.

The DAM and other Internal Audit staff are not authorized to perform operational duties for LACERS and/or its contractors. LACERS Internal Audit staff is not authorized to initiate or approve accounting transactions external to the Internal Audit Section. Internal Audit Section staff is not authorized to direct the activities of any LACERS employee not employed in the Internal Audit Section, except to the extent such employees have been assigned appropriately to auditing teams or to otherwise assist the internal auditors.

V. ACCESS

The DAM and designated audit staff, as appropriate, are granted authority for full, free, and unrestricted access to all of LACERS' functions, records, files and information systems, personnel, contractors, physical properties, and any other item relevant to the function, process or unit under review. All LACERS' contracts with vendors shall contain language enabling the internal auditors, other auditors, and specialists to have access to relevant records and information. All LACERS employees are required to assist the staff of the Internal Audit Section in fulfilling its audit functions and fiduciary duties.

The DAM shall have free and unrestricted access to the Chairperson of the Audit Committee, and the President, Vice President, and Members of the Board of Administration. The DAM shall also have free and unrestricted access to the General Manager, other executive management, and all personnel, contractors and vendors, members, retirees, and beneficiaries of LACERS.

Staff of the Internal Audit Section shall handle documents and information given to them in the same prudent and confidential manner as by those employees normally accountable for them. The DAM shall ensure that the Internal Audit staff is instructed in the handling and safeguarding of confidential information.

VI. INDEPENDENCE

Organizational Placement: To provide for the independence for the Internal Audit Section, its personnel report to the DAM, who in turn reports functionally to the Board and administratively to the General Manager. By reporting functionally to the Board, the DAM is able to maintain independence and objectivity in planning and executing internal audit activities. The Board supports internal audit's role by maintaining internal audit's independence, and by recognizing and promoting internal audit as a value-added activity.

Professional Standards Independence: The Audit Committee recognizes that professional independence requires that the auditors have knowledge of operations and appropriate expertise in the subject matter that is being audited. Therefore, the DAM will include as part of the reports to the Audit Committee, a regular report regarding internal audit personnel, including their qualifications, certifications, and development. The DAM shall periodically discuss standards of professional audit independence with the Audit Committee. The standards of independence used as benchmarks shall be those indicated in the Professional Standards section of this document.

Potential Impairment of Independence: The DAM should discuss any potential issues regarding impairment of independence and/or conflicts of interest and their mitigation(s) with the Audit Committee, as necessary. If objectivity is impaired in fact or in appearance, the details of the impairment should be disclosed to the General Manager and the Audit Committee. The nature of the disclosure will depend on the impairment. Each Internal Audit Section staff member (including the DAM) shall be required to annually certify to the Audit Committee that he/she has no actual or perceived conflicts of interest that would impair their objectivity or independence. The form for such certification is attached to this charter, and may be revised by the DAM with approval of the Audit Committee as needed.~~t any time.~~

VII. RESPONSIBILITIES AND ACCOUNTABILITY

The DAM is responsible for the following in order to meet the mission, objectives, and scope of this Charter and the Internal Audit Section:

1. Select, train, develop, and retain a competent Internal Audit staff who collectively have the abilities, knowledge, skills, experience, expertise, and professional certifications necessary to accomplish the mission, objectives, and scope of this Charter, subject to the General Manager's approval and budgetary considerations. Provide opportunity and support for staff obtaining professional training, professional examinations, and professional certifications.

Section 3.0 DUTIES AND RESPONSIBILITIES

2. Establish polices for conducting and directing internal audit activities, and technical and administrative functions according to LACERS' policies and direction provided by the Audit Committee and the Board, and professional standards described in Section VIII.

3. Perform an annual operational risk assessment. Develop and implement a flexible annual audit plan (audit plan) using an appropriate risk-based methodology, including any risks or concerns identified by management, and submit the audit plan to the Audit Committee for review and approval. The audit plan will include some unassigned hours in order to provide flexibility for changing conditions. Performance of the audit plan will be periodically reviewed and reported to the Audit Committee. The audit plan may be updated, if necessary.

4. Perform independent analyses of significant operations to evaluate the adequacy and effectiveness of existing systems of internal control and the quality of performance (economy, efficiency, and effectiveness) in carrying out LACERS' business objectives.

5. Coordinate with audit clients to finalize recommendations for improvement and identify implementation timelines. Internal Audit staff shall consider costs and benefits while formulating and discussing its recommendations.

6. Establish and maintain a follow-up system to monitor the disposition of results communicated to management and ensure that management actions have been effectively implemented or that senior management has accepted the risk of not taking action.

7. Issue periodic reports to management and the Audit Committee and management summarizing results of assurance and consulting services. Any management letters issued should also be reported to the Audit Committee.

8. At least every three years, assess whether the purpose, authority, and responsibility, as defined in this Charter, continue to be adequate to enable the Internal Audit Section to accomplish its mission, objectives, and scope. The result of this assessment should be communicated to the Audit Committee.

9. Implement a quality assurance and improvement program. Obtain an external assessment no less frequently than every five years as required by the International Standards for the Professional Practice of Internal Auditing. Conduct periodic internal quality assurance and ongoing quality procedures. Results of the quality assurance and improvement program should be reported to the Audit Committee.

10. Lead the process for selecting the external audit firms. Coordinate/manage the contract(s) with any external audit firms and evaluate their performance. Report to the Audit Committee on all activities and associated cost of work performed by the external audit firms.

11. Consider the scope of work of the external auditors and regulators, as appropriate, for the purpose of providing optimal audit coverage to LACERS at a reasonable overall cost

12. Act as the primary point of contact for handling all matters related to audits, examinations, investigations, or inquiries by other City entities, State or Federal agencies. Keep the Audit Committee and/or the General Manager informed as appropriate.

13. Evaluate annually the quality of the annual financial report and suggest improvements in the presentation and disclosure.

14. Consult with LACERS management, as appropriate, regarding potential policy and procedural changes.

15. As appropriate, provide consulting services to management that add value and improve the organization's governance, risk management, and control processes without assuming management responsibility.

16. Participate in professional audit organizations by attending meetings, joining the governing boards, presenting speeches and papers, and networking with other professionals. Network with internal audit staff of other public pension systems to learn and exchange best practices information. Participate in other professional organizations related to LACERS' mission. These may include, but are not limited to, organizations involved with benefits, investments, and accounting.

17. Periodically review LACERS' fraud and ethics policies.

18. Assist in the investigation of significant suspected fraudulent activities within LACERS and notify the General Manager, the Audit Committee, and other executives, as appropriate, of the results.

19. Inform the Audit Committee of significant risk exposures and control issues including fraud risks, governance issues, and other significant matters.

20. Inform the Audit Committee of emerging trends and successful practices in internal auditing.

21. Attend all Audit Committee meetings and ensure the attendance of additional audit staff and attendance by auditees as appropriate.

VIII. PROFESSIONAL STANDARDS

The Internal Audit Section will govern itself by adherence to the mandatory elements of The Institute of Internal Auditors' International Professional Practices Framework, including the Core Principles for the Professional Practice of Internal Auditing, the Code of Ethics, the International Standards for the Professional Practice of Internal Auditing, and the Definition of Internal Auditing.~~shall adhere to the International Standards for the Professional Practice of Internal Auditing (ISPPIA) and to the Code of Ethics, both as promulgated by the Institute of Internal Auditors (IIA), current version of which is attached to this Internal Audit Charter.~~ Internal Audit Section shall also obtain guidance from professional standards of other relevant professional organizations including, but not limited to, the following:

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- Information Systems Auditing Standards, Guidelines, and Procedures, and the Code of Professional Ethics of the Information Systems Audit and Control Association (ISACA);
- Public Company Accounting Oversight Board (PCAOB) auditing standards, as applicable;
- American Institute of Certified Public Accountants (AICPA) Professional Standards and Code of Ethics, as applicable;
- Generally Accepted Government Auditing Standards (GAGAS) from the United States General Accounting Office, as applicable; and
- Other professional standards, such as those of the Institute of Management Accountants (IMA) and the Association of Certified Fraud Examiners (ACFE), as applicable.

IX. RELATIONSHIP TO THE RISK MANAGEMENT AND INTERNAL CONTROLS PROGRAMS

The Board has overall responsibility for ensuring that risks are managed. In practice, the Board delegates to management the operation and implementation of the risk management system. The Internal Audit Section's role is to provide an independent and objective assurance on the effectiveness of the risk management system.

Management is responsible for implementing the system of internal control. The Internal Audit Section is responsible to provide an independent and objective assurance that the internal control system is operating effectively.

X. PROCUREMENT

The DAM occasionally may need to obtain expertise of persons outside of the Internal Audit Section. This expertise may be obtained within LACERS through appropriate arrangements with management. When obtaining this expertise, care must be taken to avoid conflicts of interest within LACERS that could damage the quality of the audit work performed and/or conclusions obtained.

Expertise may also be obtained from outside LACERS through contracts. In such cases, the DAM needs to obtain sufficient information regarding the scope of work of the external service provider to ensure the scope of work is adequate for the purposes of the internal audit activity. The DAM must document the scope of work, professional standards to be used, deliverables, deadlines, and other matters in an engagement letter or contract. The Audit Committee should be informed of the use of an external service provider.

XI. RELATIONSHIP TO PREVENTION, DETECTION, AND CORRECTION ACTIVITIES

Because LACERS recognizes that it is more expensive to detect and correct problems after the fact that it is to prevent them in the initial stages of a project, the Internal Audit Section will strive to participate in the initial stages of major projects so that risks can be managed appropriately and internal controls instituted in the design phase in order to prevent problems and minimize costs.

Auditor Annual Independence Certification

DIRECTIONS: Each auditor must complete this Evaluation form in its entirety. The purpose of this form is for individual auditor and LACERS Internal Audit management to consider all circumstances relative to internal audit projects, in order to identify and address any potential threats to independence by applying appropriate safeguards or controls.

In all matters relating to audit work, LACERS Internal Audit (IAS), and individual auditors must be independent, in compliance with Sections 1100, 1120 and 1130 of the International Standards for the Professional Practice of Internal Auditing (ISPPIA). Auditors should avoid situations that could lead reasonable and informed third parties to conclude that the auditors are not independent and thus are not capable of exercising objective and impartial judgment on all issues associated with conducting the audit and reporting on audit work. Auditors should evaluate these considerations during the course of their audits and immediately report any potential or actual threats.

Threat Consideration: To be completed by all audit staff **annually**:

Threat Categories: Complete the following, considering the threat as a broad category that could potentially influence your independence.	**Yes**	**No**
Self-interest threat – Do you have a direct or indirect financial or other interest that will inappropriately influence your judgment or behavior?		
Self-review threat – Will any of the anticipated audit work put you in a position to audit the work, services, or judgments you previously performed during a non-auditing (consulting) service?		
Familiarity threat – Do you have any relationship with LACERS management or personnel, or personnel of LACERS contractors/consultants which may impact your ability to be objective as LACERS Internal Audit staff?		
Undue influence threat – Are you experiencing pressure from management, LACERS Staff or external parties, which will impact your ability or make independent and objective judgments on internal audit projects?		
Management participation threat – Have you taken on a management or any other role which has or will result in performing management functions for any unit within LACERS? If so, please list the unit(s) ____________________		
Relationship – Do you have any official, professional, financial, or personal relationship with anyone that might limit the extent of inquiry or disclosure, or weaken audit findings in any way?		
Accounting – During the past year, have you approved invoices, payrolls, claims, or other proposed payments for any unit within LACERS? During the past year, did you maintain any part of the official accounting records for LACERS?		
Conflict of Interest or Secondary Employment – Are you or have you been in a conflict of interest position or engaged in any secondary employment activities which may impact your ability, in any way, to perform internal audit projects?		
Other Threat: Is there any other relevant potential threat which may impact your independence or perception regarding any audit? (If so, disclose here. If you are not sure, discuss it with the Departmental Audit Manager.)		

Auditor Annual Independence Certification

Safeguard Consideration: If "yes" is marked in any boxes above, please complete the following section:

Potential Threat	Recommended Safeguard to mitigate Threat (and is risk reduced to an acceptable level?)	Departmental Audit Manager only: Does the safeguard eliminate or reduce the threat to an acceptable level?
Ex. Accounting – I previously worked in the Fiscal Section, but I only handled the accounts payable.	*I don't believe this is an unacceptable risk, as I don't manage or work in investment accounting or other areas within Fiscal Section, and I left about six months ago.*	*No. To avoid the perception of impairment, auditor is not approved to participate in audit projects relating to the Fiscal Section.*

Acknowledgement: (*initial after each statement)*

Comply with ISPPIA: I understand that I have a duty and obligation to ensure audit work is performed in full accordance with ISPPIA. In conducting my work, I have the obligation to immediately report any conditions or situations which may compromise compliance with any ISPPIA to the Departmental Audit Manager (DAM). ______

Remain Independent: I have been advised that during the course of any audit, if any personal, external, or organizational impairments or potential threats arise that may affect my ability to do the work and report findings impartially, I will notify the DAM promptly. Further, I will assess ongoing threats, identify potential safeguards, and engage the DAM in remedying any situations which may give rise to even the perception of bias or conditions which may impact the integrity of any audit work. _______

Policies and Procedures: I have been informed and am familiar with the policies and procedures of IAS, regarding independence and objectivity. I am also familiar with the requirements of the 2012 ISPPIA. _______

Obligation to Report: I understand that I have an obligation to report any instance or information regarding an actual or potential impairment by any auditor in IAS to the DAM. _______

Direct Access to Audit Committee Chair: If for any reason I am uncomfortable discussing any of the foregoing matters with the DAM, I understand that I am expected to discuss the matter with the Audit Committee Chairperson. _______

I certify that all the included information is complete and accurate and reflects my best ability to provide clear, detailed information regarding any activity or condition which may impair or to be perceived to impair independence and/or objectivity.

Signature: ____ Date: ____________________

Name (print): ____

Departmental Audit Manager Review and Approval:

Overall Assessment:

Restrictions:

Signature: ____ Date: ____________________

Section 3.0 DUTIES AND RESPONSIBILITIES

Internal Audit Charter

Adopted by the Board: November 12, 2013; Revised: October 23, 2018

I. PURPOSE

The purpose of this Charter is to formally define LACERS' internal audit function's purpose, authority, and responsibility. The internal audit charter establishes the internal audit function's position within LACERS including the nature of the Departmental Audit Manager's (DAM) functional reporting relationship with the Board; authorizes access to records, personnel, and physical properties relevant to the performance of engagements; and defines the scope of internal audit activities. This Charter shall be reviewed annually and updated as necessary.

II. MISSION

The Mission of the Internal Audit Section is to enhance and protect organizational value by providing risk-based and objective assurance, advice, and insight. Internal Audit helps LACERS accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of governance, risk management, and control processes.

III. OBJECTIVES AND SCOPE

Assurance Objectives: The objectives of the Internal Audit Section's assurance services are to provide independent assurance to the Board, the Audit Committee, and LACERS' Executive Management that LACERS' assets are safeguarded, operating efficiency is enhanced, and compliance is maintained within prescribed laws, Board Rules, and management policies. Assurance objectives include independent assessment of LACERS' governance, risk management, and control processes.

Consulting Objectives: The objectives of the Internal Audit Section's consulting services, the nature and scope of which are agreed with management, are to provide management with assessments and advice for improving LACERS' governance, risk management and control without the Internal Audit Section assuming management responsibility. For example, consulting services may provide assessments and advice on the front-end projects so that risks can be identified, managed, and internal controls can be designed.

Scope: The scope of internal audit activities encompasses, but is not limited to, objective examinations of evidence for the purpose of providing independent assessments to the LACERS' Board, Audit Committee, management, and outside parties on the adequacy and effectiveness of governance, risk management, and control processes for LACERS. Internal audit assessments include evaluating whether:

- Risks relating to the achievement of LACERS' strategic objectives are appropriately identified and managed;

- The actions of LACERS' officers, directors, employees, and contractors are in compliance with Board's policies, procedures, and applicable laws, regulations, and governance standards;
- The results of operations or programs are consistent with established goals and objectives;
- Operations or programs are being carried out effectively and efficiently;
- Established processes and systems enable compliance with the policies, procedures, laws, and regulations that could significantly impact Plan;
- Information and the means used to identify, measure, analyze, classify, and report such information are reliable and have integrity;
- Resources and assets are acquired economically, used efficiently, and protected adequately;

Opportunities for improving member service, management of risks, internal control, governance, and the organization's effectiveness and image may be identified during audits. This information will be communicated to management and the Audit Committee as appropriate.

IV. AUTHORITY

The Internal Audit Section reports functionally to the Board through its Audit Committee, and administratively to the General Manager. The Audit Committee advises on the appointment, replacement, or dismissal of the DAM in consultation with the General Manager as appointing authority.

The DAM is responsible for managing the Internal Audit Section and preparing an audit plan. The Audit Committee reviews and recommends the approval of the annual audit plan to the Board. The DAM shall periodically inform the Audit Committee regarding the status of the audit plan and changes needed. The DAM is authorized to allocate internal audit resources, set project frequencies, select audit subjects, determine scopes of work, and apply the techniques necessary to accomplish the audit objectives. The DAM is authorized to hire (within budgetary constraints), retain, train, and develop internal audit staff to achieve the internal audit objectives as stated in this Charter.

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Section 3.0 DUTIES AND RESPONSIBILITIES

V. ACCESS

The DAM and designated audit staff, as appropriate, are granted authority for full, free, and unrestricted access to all of LACERS' functions, records, files and information systems, personnel, contractors, physical properties, and any other item relevant to the function, process or unit under review. All LACERS' contracts with vendors shall contain language enabling the internal auditors, other auditors, and specialists to have access to relevant records and information. All LACERS employees are required to assist the staff of the Internal Audit Section in fulfilling its audit functions and fiduciary duties.

The DAM shall have free and unrestricted access to the Chairperson of the Audit Committee, and the President, Vice President, and Members of the Board of Administration. The DAM shall also have free and unrestricted access to the General Manager, other executive management, and all personnel, contractors and vendors, members, retirees, and beneficiaries of LACERS.

Staff of the Internal Audit Section shall handle documents and information given to them in the same prudent and confidential manner as by those employees normally accountable for them. The DAM shall ensure that the Internal Audit staff is instructed in the handling and safeguarding of confidential information.

VI. INDEPENDENCE

Organizational Placement: To provide for the independence for the Internal Audit Section, its personnel report to the DAM, who in turn reports functionally to the Board and administratively to the General Manager. By reporting functionally to the Board, the DAM is able to maintain independence and objectivity in planning and executing internal audit activities. The Board supports internal audit's role by maintaining internal audit's independence, and by recognizing and promoting internal audit as a value-added activity.

Professional Standards Independence: The Audit Committee recognizes that professional independence requires that the auditors have knowledge of operations and appropriate expertise in the subject matter that is being audited. Therefore, the DAM will include as part of the reports to the Audit Committee, a regular report regarding internal audit personnel, including their qualifications, certifications, and development. The DAM shall periodically discuss standards of professional audit independence with the Audit Committee. The standards of independence used as benchmarks shall be those indicated in the Professional Standards section of this document.

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Section 3.0 DUTIES AND RESPONSIBILITIES

VII. RESPONSIBILITIES AND ACCOUNTABILITY

The DAM is responsible for the following in order to meet the mission, objectives, and scope of this Charter and the Internal Audit Section:

1. Select, train, develop, and retain a competent Internal Audit staff who collectively have the abilities, knowledge, skills, experience, expertise, and professional certifications necessary to accomplish the mission, objectives, and scope of this Charter, subject to the General Manager's approval and budgetary considerations. Provide opportunity and support for staff obtaining professional training, professional examinations, and professional certifications.

2. Establish polices for conducting and directing internal audit activities, and technical and administrative functions according to LACERS' policies and direction provided by the Audit Committee and the Board, and professional standards described in Section VIII.

3. Perform an annual operational risk assessment. Develop and implement a flexible annual audit plan (audit plan) using an appropriate risk-based methodology, including any risks or concerns identified by management, and submit the audit plan to the Audit Committee for review and approval. The audit plan will include some unassigned hours in order to provide flexibility for changing conditions. Performance of the audit plan will be periodically reviewed and reported to the Audit Committee. The audit plan may be updated, if necessary.

4. Perform independent analyses of significant operations to evaluate the adequacy and effectiveness of existing systems of internal control and the quality of performance (economy, efficiency, and effectiveness) in carrying out LACERS' business objectives.

5. Coordinate with audit clients to finalize recommendations for improvement and identify implementation timelines. Internal Audit staff shall consider costs and benefits while formulating and discussing its recommendations.

6. Establish and maintain a follow-up system to monitor the disposition of results communicated to management and ensure that management actions have been effectively implemented or that senior management has accepted the risk of not taking action.

7. Issue periodic reports to management and the Audit Committee and management summarizing results of assurance and consulting services. Any management letters issued should also be reported to the Audit Committee.

8. At least every three years, assess whether the purpose, authority, and responsibility, as defined in this Charter, continue to be adequate to enable the Internal Audit Section to accomplish its mission, objectives, and scope. The result of this assessment should be communicated to the Audit Committee.

9. Implement a quality assurance and improvement program. Obtain an external assessment no less frequently than every five years as required by the International Standards for the Professional Practice of Internal Auditing. Conduct periodic internal

Section 3.0 DUTIES AND RESPONSIBILITIES

quality assurance and ongoing quality procedures. Results of the quality assurance and improvement program should be reported to the Audit Committee.

10. Lead the process for selecting the external audit firms. Coordinate/manage the contract(s) with any external audit firms and evaluate their performance. Report to the Audit Committee on all activities and associated cost of work performed by the external audit firms.

11. Consider the scope of work of the external auditors and regulators, as appropriate, for the purpose of providing optimal audit coverage to LACERS at a reasonable overall cost

12. Act as the primary point of contact for handling all matters related to audits, examinations, investigations, or inquiries by other City entities, State or Federal agencies. Keep the Audit Committee and/or the General Manager informed as appropriate.

13. Evaluate annually the quality of the annual financial report and suggest improvements in the presentation and disclosure.

14. Consult with LACERS management, as appropriate, regarding potential policy and procedural changes.

15. As appropriate, provide consulting services to management that add value and improve the organization's governance, risk management, and control processes without assuming management responsibility.

16. Participate in professional audit organizations by attending meetings, joining the governing boards, presenting speeches and papers, and networking with other professionals. Network with internal audit staff of other public pension systems to learn and exchange best practices information. Participate in other professional organizations related to LACERS' mission. These may include, but are not limited to, organizations involved with benefits, investments, and accounting.

17. Periodically review LACERS' fraud and ethics policies.

18. Assist in the investigation of significant suspected fraudulent activities within LACERS and notify the General Manager, the Audit Committee, and other executives, as appropriate, of the results.

19. Inform the Audit Committee of significant risk exposures and control issues including fraud risks, governance issues, and other significant matters.

20. Inform the Audit Committee of emerging trends and successful practices in internal auditing.

21. Attend all Audit Committee meetings and ensure the attendance of additional audit staff and attendance by auditees as appropriate.

Section 3.0 DUTIES AND RESPONSIBILITIES

VIII. PROFESSIONAL STANDARDS

The Internal Audit Section will govern itself by adherence to the mandatory elements of The Institute of Internal Auditors' International Professional Practices Framework, including the Core Principles for the Professional Practice of Internal Auditing, the Code of Ethics, the International Standards for the Professional Practice of Internal Auditing, and the Definition of Internal Auditing. Internal Audit Section shall also obtain guidance from professional standards of other relevant professional organizations including, but not limited to, the following:

- Information Systems Auditing Standards, Guidelines, and Procedures, and the Code of Professional Ethics of the Information Systems Audit and Control Association (ISACA);
- Public Company Accounting Oversight Board (PCAOB) auditing standards, as applicable;
- American Institute of Certified Public Accountants (AICPA) Professional Standards and Code of Ethics, as applicable;
- Generally Accepted Government Auditing Standards (GAGAS) from the United States General Accounting Office, as applicable; and
- Other professional standards, such as those of the Institute of Management Accountants (IMA) and the Association of Certified Fraud Examiners (ACFE), as applicable.

IX. RELATIONSHIP TO THE RISK MANAGEMENT AND INTERNAL CONTROLS PROGRAMS

The Board has overall responsibility for ensuring that risks are managed. In practice, the Board delegates to management the operation and implementation of the risk management system. The Internal Audit Section’s role is to provide an independent and objective assurance on the effectiveness of the risk management system.

Management is responsible for implementing the system of internal control. The Internal Audit Section is responsible to provide an independent and objective assurance that the internal control system is operating effectively.

X. PROCUREMENT

The DAM occasionally may need to obtain expertise of persons outside of the Internal Audit Section. This expertise may be obtained within LACERS through appropriate arrangements with management. When obtaining this expertise, care must be taken to avoid conflicts of interest within LACERS that could damage the quality of the audit work performed and/or conclusions obtained.

Expertise may also be obtained from outside LACERS through contracts. In such cases, the DAM needs to obtain sufficient information regarding the scope of work of the external service provider to ensure the scope of work is adequate for the purposes of the internal audit activity. The DAM must document the scope of work, professional standards to be used, deliverables, deadlines, and other matters in an engagement letter or contract. The Audit Committee should be informed of the use of an external service provider.

Section 3.0 DUTIES AND RESPONSIBILITIES

XI. RELATIONSHIP TO PREVENTION, DETECTION, AND CORRECTION ACTIVITIES

Because LACERS recognizes that it is more expensive to detect and correct problems after the fact that it is to prevent them in the initial stages of a project, the Internal Audit Section will strive to participate in the initial stages of major projects so that risks can be managed appropriately and internal controls instituted in the design phase in order to prevent problems and minimize costs.

Auditor Annual Independence Certification

DIRECTIONS: Each auditor must complete this Evaluation form in its entirety. The purpose of this form is for individual auditor and LACERS Internal Audit management to consider all circumstances relative to internal audit projects, in order to identify and address any potential threats to independence by applying appropriate safeguards or controls.

In all matters relating to audit work, LACERS Internal Audit (IAS), and individual auditors must be independent, in compliance with Sections 1100, 1120 and 1130 of the International Standards for the Professional Practice of Internal Auditing (ISPPIA). Auditors should avoid situations that could lead reasonable and informed third parties to conclude that the auditors are not independent and thus are not capable of exercising objective and impartial judgment on all issues associated with conducting the audit and reporting on audit work. Auditors should evaluate these considerations during the course of their audits and immediately report any potential or actual threats.

Threat Consideration: To be completed by all audit staff **annually**:

Threat Categories: Complete the following, considering the threat as a broad category that could potentially influence your independence.	**Yes**	**No**
Self-interest threat – Do you have a direct or indirect financial or other interest that will inappropriately influence your judgment or behavior?		
Self-review threat – Will any of the anticipated audit work put you in a position to audit the work, services, or judgments you previously performed during a non-auditing (consulting) service?		
Familiarity threat – Do you have any relationship with LACERS management or personnel, or personnel of LACERS contractors/consultants which may impact your ability to be objective as LACERS Internal Audit staff?		
Undue influence threat – Are you experiencing pressure from management, LACERS Staff or external parties, which will impact your ability or make independent and objective judgments on internal audit projects?		
Management participation threat – Have you taken on a management or any other role which has or will result in performing management functions for any unit within LACERS? If so, please list the unit(s) ________________________________		
Relationship – Do you have any official, professional, financial, or personal relationship with anyone that might limit the extent of inquiry or disclosure, or weaken audit findings in any way?		
Accounting – During the past year, have you approved invoices, payrolls, claims, or other proposed payments for any unit within LACERS? During the past year, did you maintain any part of the official accounting records for LACERS?		
Conflict of Interest or Secondary Employment – Are you or have you been in a conflict of interest position or engaged in any secondary employment activities which may impact your ability, in any way, to perform internal audit projects?		
Other Threat: Is there any other relevant potential threat which may impact your independence or perception regarding any audit? (If so, disclose here. If you are not sure, discuss it with the Departmental Audit Manager.)		

Section 3.0 DUTIES AND RESPONSIBILITIES

Auditor Annual Independence Certification

Safeguard Consideration: If "yes" is marked in any boxes above, please complete the following section:

Potential Threat	Recommended Safeguard to mitigate Threat (and is risk reduced to an acceptable level?)	Departmental Audit Manager only: Does the safeguard eliminate or reduce the threat to an acceptable level?
Ex. Accounting – I previously worked in the Fiscal Section, but I only handled the accounts payable.	*I don't believe this is an unacceptable risk, as I don't manage or work in investment accounting or other areas within Fiscal Section, and I left about six months ago.*	*No. To avoid the perception of impairment, auditor is not approved to participate in audit projects relating to the Fiscal Section.*

Acknowledgement: (*initial after each statement)*

Comply with ISPPIA: I understand that I have a duty and obligation to ensure audit work is performed in full accordance with ISPPIA. In conducting my work, I have the obligation to immediately report any conditions or situations which may compromise compliance with any ISPPIA to the Departmental Audit Manager (DAM). ______

Remain Independent: I have been advised that during the course of any audit, if any personal, external, or organizational impairments or potential threats arise that may affect my ability to do the work and report findings impartially, I will notify the DAM promptly. Further, I will assess ongoing threats, identify potential safeguards, and engage the DAM in remedying any situations which may give rise to even the perception of bias or conditions which may impact the integrity of any audit work. _______

Policies and Procedures: I have been informed and am familiar with the policies and procedures of IAS, regarding independence and objectivity. I am also familiar with the requirements of the 2012 ISPPIA. _______

Obligation to Report: I understand that I have an obligation to report any instance or information regarding an actual or potential impairment by any auditor in IAS to the DAM. _______

Direct Access to Audit Committee Chair: If for any reason I am uncomfortable discussing any of the foregoing matters with the DAM, I understand that I am expected to discuss the matter with the Audit Committee Chairperson. _______

I certify that all the included information is complete and accurate and reflects my best ability to provide clear, detailed information regarding any activity or condition which may impair or to be perceived to impair independence and/or objectivity.

Signature: ____ Date: ____________________

Name (print): ____

Departmental Audit Manager Review and Approval:

Overall Assessment:

Restrictions:

Signature: ____ Date: ____________________

Association of Public Pension Fund Auditors

Model Internal Audit Department Charter

Revised February 2013

Endorsed by:
Association of Public Pension Fund Auditors, Inc.
A Project of the Best Practices Committee

TABLE OF CONTENTS

FOREWORD

The following Model Internal Audit Department Charter (IAD Charter) captures many of the best practices used at the present time, February 2013. This IAD Charter may not encompass all activities that might be appropriate to a particular internal audit department, nor are all activities identified in this IAD Charter relevant to every internal audit department. Accordingly, this IAD Charter should be tailored to each internal audit department's needs and governing rules. Moreover, as applicable laws, rules, and customs change, this IAD Charter should be updated.

Endorsement by the Association of Public Pension Fund Auditors, Inc. (APPFA) means that the document is intended as a starting point of reference and as a guide to public pension funds in developing and/or revising their internal audit department charters. To the extent that a public pension fund has unique circumstances, different applications and modifications of the example passages may be desirable.

The first version of this publication was completed in August 2004 and was updated in February 2013. The update was completed by the following members of the APPFA Best Practices Committee:

Flerida Rivera-Alsing, Chair	State Board of Administration of Florida
Ryan Babin	Louisiana State Employees Retirement System
Jenine Gregory	Ontario Municipal Employees Retirement System
Janet Harris	Public School Retirement System of Missouri
Amen Tam	Ontario Municipal Employees Retirement System
Toni Voglino	Maryland State Retirement and Pension System

The February 2013 version of this publication was approved by the APPFA Board in May 2013.

I. MISSION

The mission of the Internal Audit Department (IAD) is to provide independent, objective assurance, and consulting services designed to add value and improve the organization's operations. The IAD helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of governance, risk management, and control processes.[1] The IAD:

- Provides a wide range of quality independent internal auditing services for the Audit Committee and executive management and consulting services for management.
- Performs independent assessments of the systems of risk management, internal controls and operating efficiency, guided by professional standards and using innovative approaches.
- Supports the organization's efforts to achieve its objectives through independent assurance and consulting services.
- Maintains a dynamic, team-oriented environment that encourages personal and professional growth, and challenges and rewards internal audit staff for excellence and reaching their full potential.

[1] Source: International Standards for the Professional Practice of Internal Auditing issued by The Institute of Internal Auditors, Inc.,

II. OBJECTIVES AND SCOPE

A. Assurance Objectives

The objectives of the IAD's assurance services are to provide independent assurance to the Board of Trustees (Board), Audit Committee, and management that the organization's assets are safeguarded, operating efficiency is enhanced, and compliance is maintained with prescribed laws, and the organization's policies. Assurance objectives include independent assessment of the organization's governance, risk management, and control processes.

B. Consulting Objectives

The objectives of the IAD's consulting services, the nature and scope are agreed with management, are to provide assessments and advice for improving the organization's governance, risk management, and control without the IAD assuming management responsibility. In particular, the consulting objectives are to provide assessments and advice at the beginning of a project so that risks may be identified, managed, and internal controls may be designed adequately.

C. Scope

The scope of work of the IAD is to determine whether the organization's network of risk management, internal control, and governance processes, as designed and represented by management, is adequate and functioning to ensure:

- Programs are operating within fiduciary standards and are in compliance with laws, regulations, ordinances, policies, and procedures.
- Risks are appropriately identified and managed.
- Programs and processes are consistent with industry best practices, using the best public and private examples as benchmarks.
- Operations, processes, and programs are consistent with established missions, objectives and goals and whether they are being carried out as planned.
- Existing policies and procedures are appropriate and updated.
- Significant financial, managerial, and operating information is accurate, reliable, and timely.
- Resources are acquired economically, used efficiently, and adequately protected.

- Quality and continuous improvement are fostered in the organization's control process.

- Employers appropriately enroll employees, accurately report employee earnings, and appropriately report other employee data.

- Significant legislative or regulatory issues impacting the organization are recognized and addressed appropriately.

Opportunities for improving member service, management of risks, internal control, governance, and the organization's effectiveness and image may be identified during audits. This information will be communicated to the Audit Committee and to appropriate levels of management.

III. AUTHORITY

The internal audit function of this organization is established by state statutes XXXX, and enabled by regulations YYYY. The IAD is established by this organization pursuant to these applicable laws and regulations, customs of corporate governance, and best practices. This IAD Charter and all future amendments are to be approved by the Audit Committee through a majority vote. This IAD Charter shall be reviewed at least annually and updated as necessary.

The Chief Audit Executive (CAE) reports functionally to the Audit Committee and reports administratively to the Chief Executive Officer (CEO). The CAE is hired, evaluated, retained, and terminated by the Audit Committee. The Audit Committee will seek input from the CEO in making its selection.

The CAE is delegated the authority to manage the IAD. The CAE is authorized to allocate resources, set project frequencies, select audit subjects, determine scope of work, and apply the techniques necessary to accomplish the audit objectives. The CAE is authorized to hire, retain, train, and terminate internal audit staff, when necessary, to achieve the objectives of the IAD.

The CAE and internal audit staff are not authorized to perform operational duties for the organization and/or its affiliates and contractors. IAD staff is not authorized to:

- Initiate or approve accounting transactions external to the IAD.

- Direct the activities of any organization employee not employed by the IAD, except to the extent such employees have been appropriately assigned to auditing teams or to otherwise assist the internal auditors.

IV. ACCESS

The CAE and designated audit staff, as appropriate, shall have full, free, and unrestricted access to all of the organizations' functions, records, files and information systems, personnel, contractors, physical properties, rental locations, and any other item relevant to the function, process, or department under review. All contracts with vendors shall contain the organization's standard audit language enabling the organization's internal auditors, other auditors and specialists to have access to relevant records and information. All of the employees of the organization are required to assist the staff of the IAD in fulfilling their function.

The CAE shall have free and unrestricted access to the Chair, members of the Audit Committee, and Board of Trustees. The CAE shall also have free and unrestricted access to the CEO, other executives, management, all personnel, contractors, vendors, employers, members, retirees and beneficiaries of the organization.

Documents and information given to the IAD shall be handled in the same prudent and confidential manner as by those employees normally accountable for them. The CAE shall ensure that internal audit staff is adequately coached in the handling and safeguarding of confidential information.

V. INDEPENDENCE

A. Organizational Placement

To provide for the independence of the IAD, its personnel report to the CAE, who in turn reports functionally to the Audit Committee and administratively to the CEO. The CAE shall freely discuss audit policies, audit findings and recommendations, audit follow-up, issues, and other matters as necessary.

B. Professional Standards of Independence

The Audit Committee recognizes that professional independence requires that the internal auditors have knowledge of operations and appropriate expertise in the subject matter that is being audited. Therefore, the CAE will report to the Audit Committee the qualifications, certifications, and training requirements of the internal audit staff. The CAE shall periodically discuss standards of professional audit independence with the Audit Committee. The standards of independence used as benchmarks will be those of the organizations mentioned in Section VII of this document.

C. Impairment of Independence

The CAE should discuss any potential issues regarding impairment of independence and/or conflicts of interest and their mitigation(s) with the Audit Committee, as necessary. If objectivity or independence is impaired in fact or appearance, the details of the impairment should be disclosed to the appropriate parties. The nature of the disclosure will depend on the impairment. The IAD should annually certify to the Audit Committee they have no actual or perceived conflicts of interest that would impair their objectivity or independence.

VI. RESPONSIBILITIES AND ACCOUNTABILITY

The CAE is responsible for the following in order to meet the mission, objectives, and scope of this Charter and the IAD.

1. Select, train, develop, and retain a competent internal audit staff who collectively has the abilities, knowledge, skills, experience, expertise and professional certifications necessary to accomplish the mission, objectives and scope of this Charter. Provide opportunity and support for staff obtaining professional training, examinations, and certifications.

2. Establish policies for conducting IAD activities according to the organization's policies, direction provided by the Audit Committee, and professional standards described in Section VII.

3. Perform an annual risk assessment. Develop and implement a flexible annual audit plan (audit plan) using an appropriate risk-based methodology, including any risks or concerns identified by management, and submit the audit plan to the Audit Committee for review and approval. The audit plan will include some unassigned hours in order to provide flexibility for changing conditions. Performance of the audit plan will be periodically reviewed and reported to the Audit Committee. The audit plan may be updated, if necessary.

4. Prepare a budget that is complementary to the implementation of the audit plan.

5. Perform independent analyses of significant operations to evaluate the adequacy and effectiveness of existing systems of internal control and the quality of performance (economy, efficiency, and effectiveness) in carrying out its business objectives.

6. Establish and maintain a follow-up system to monitor the disposition of results communicated to management and ensure that management actions have been effectively implemented or that senior management has accepted the risk of not taking action.

7. Issue periodic reports to the Audit Committee and management summarizing results of assurance and consulting services. Any management letters issued should also be reported to the Audit Committee.

8. Assess periodically whether the purpose, authority, and responsibility, as defined in this IAD Charter, continue to be adequate to enable the IAD to accomplish its mission, objectives, and scope. The result of this periodic assessment should be communicated to the Audit Committee and the CEO.

9. Implement a quality assurance and improvement program. Obtain an external assessment no less frequently than every five years [*International Standards for the*

Professional Practice of Internal Auditing] or every three years [*Generally Accepted Government Auditing Standards*], as appropriate. Conduct periodic internal quality assurance and ongoing quality procedures. Results of the quality assurance and improvement program should be reported to the Audit Committee.

10. Lead/participate in the selection of external audit firms. Coordinate/manage the contract(s) with any external audit firms and evaluate their performance. Report to the Audit Committee on all activities and associated cost of work performed by the external audit firms.

11. Consider the scope of work of the external auditors and regulators, as appropriate, for the purpose of providing optimal audit coverage to the organization at a reasonable overall cost.

12. Act as the primary point of contact for handling all matters related to audits, examinations, investigations or inquiries of the state auditor or other appropriate state or federal auditors.

13. As appropriate, provide consulting services to management that add value and improve the organization's governance, risk management, and control processes without assuming management responsibility.

14. Assist in the investigation of suspected fraudulent activities within the organization and notify the Audit Committee, the CEO and other Executives, as appropriate, of the results.

15. Inform the Audit Committee of significant risk exposures and control issues including fraud risks, governance issues and other significant matters.

16. Inform the Audit Committee of emerging trends and successful practices in internal auditing.

17. Attend all Audit Committee meetings, and ensure attendance of additional audit staff and auditees, as appropriate.

VII. PROFESSIONAL STANDARDS & GUIDANCE

The IAD shall follow the professional standards of relevant professional organizations. The IAD should consider professional guidance published by these organizations. These professional standards and guidance include, but are not limited to, the following:

- The Institute of Internal Auditors mandatory guidance which includes the International Standards for the Professional Practice of Internal Auditing, Code of Ethics, and Definition of Internal Auditing. The current versions of these documents are part of this IAD Charter and are appended thereto.

- IS Auditing Standards, Guidelines, and Procedures, and the Code of Professional Ethics of the ISACA. The Control Objectives for Information Technology will be used as a reference. The current versions of these documents are part of this Charter and are appended thereto.

- Professional Standards and Code of Ethics of the American Institute of Certified Public Accountants, as applicable.

- Generally Accepted Government Auditing Standards from the United States General Accountability Office, as applicable.

- Public Company Accounting Oversight Board (PCAOB) auditing standards, as applicable.

- Other professional standards, such as those of the Institute of Management Accountants (IMA) and the Association of Certified Fraud Examiners (ACFE), as applicable.

- Other professional guidance such as The Institute of Internal Auditors Practice Advisories, Practice Guides, and Position Papers.

VIII. RELATIONSHIP TO RISK MANAGEMENT AND INTERNAL CONTROL PROGRAMS

The Board has overall responsibility for ensuring that risks are managed. In practice, the Board delegates to management the operation and implementation of the risk management system. The IAD's role is to provide an independent and objective assurance on the effectiveness of the risk management system.

Management is responsible for implementing a system of internal control. The IAD's role is to provide an independent and objective assurance that the internal control system is operating effectively.

IX. PROCUREMENT OF OUTSIDE EXPERTISE

The CAE may occasionally need to obtain the expertise of persons outside of the IAD. When the CAE intends to use and rely on the work of a person outside the IAD, the CAE needs to consider the competence, independence, and objectivity of the person.

Expertise may be obtained within the organization through appropriate arrangements with management. When obtaining this expertise within the organization, care must be taken to avoid conflicts of interest that could damage the quality of the audit work performed and/or conclusions obtained.

Expertise may also be obtained from outside the organization. In such cases, the CAE needs to obtain sufficient information regarding the scope of work of the external service provider to ensure the scope of work is adequate for the purposes of the internal audit activity. The CAE must document the scope of work, professional standards to be used, deliverables, deadlines, and other matters in an engagement letter or contract. The Audit Committee should be informed about the use of an external service provider.

XI. SIGNATURE PAGE

This IAD Charter was adopted by the Audit Committee on (date), and approved by the Board. This IAD Charter is effective this day and is hereby signed by the following persons who have authority and responsibilities under this Charter.

Chair, Audit Committee	Date	Chair, Board of Trustees	Date
Chief Audit Executive	Date	Chief Executive Officer	Date

REFERENCES

The Institute of Internal Auditors' International Standards for the Professional Practice of Internal Auditing.

The Institute of Internal Auditors' Model Internal Audit Activity Charter.

IIA Position Paper: The Role of Internal Auditing in Enterprise-Wide Risk Management.

Internal Audit Charter of the various public pension fund systems who are members of APPFA.

Association of
Public Pension Fund
Auditors

PO Box 16064 • Columbus, OH 43216-6064
www.appfa.org

IPPF

International Professional Practices Framework

Supplemental Guidance

Model Internal Audit Activity Charter

The Model Internal Audit Activity Charter is designed to illustrate common practices typically set out in an internal audit activity charter. The generic nature of this draft is intended to encourage customization.

The document may not reflect all legal or regulatory requirements that exist in the every jurisdiction. Additionally, stakeholder expectations may influence the inclusion or deletion of certain practices.

In drafting an internal audit activity charter, the chief audit executive should exercise care to customize the charter, including replacing bracketed, blue text with language that accurately reflects the user's situation.

Purpose and Mission

The purpose of [name of organization]'s internal audit [department/activity] is to provide independent, objective assurance and consulting services designed to add value and improve [name of organization]'s operations. The mission of internal audit is to enhance and protect organizational value by providing risk-based and objective assurance, advice, and insight. The internal audit [department/activity] helps [name of organization] accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of governance, risk management, and control processes.

Standards for the Professional Practice of Internal Auditing

The internal audit [department/activity] will govern itself by adherence to the mandatory elements of The Institute of Internal Auditors' International Professional Practices Framework, including the Core Principles for the Professional Practice of Internal Auditing, the Code of Ethics, the *International Standards for the Professional Practice of Internal Auditing*, and the Definition of Internal Auditing. The chief audit executive will report periodically to senior management and the [board/audit committee/supervisory committee] regarding the internal audit [department/activity]'s conformance to the Code of Ethics and the *Standards*.

Authority

The chief audit executive will report functionally to the [board/audit committee/supervisory committee] and administratively (i.e., day-to-day operations) to the [chief executive officer].To establish, maintain, and assure that [name of organization]'s internal audit [department/activity] has sufficient authority to fulfill its duties, the [board/audit committee/supervisory committee] will:

- Approve the internal audit [department/activity]'s charter.
- Approve the risk-based internal audit plan.
- Approve the internal audit [department/activity]'s budget and resource plan.
- Receive communications from the chief audit executive on the internal audit [department/activity]'s performance relative to its plan and other matters.
- Approve decisions regarding the appointment and removal of the chief audit executive.
- Approve the remuneration of the chief audit executive.
- Make appropriate inquiries of management and the chief audit executive to determine whether there is inappropriate scope or resource limitations.

The chief audit executive will have unrestricted access to, and communicate and interact directly with, the [board/audit committee/supervisory committee], including in private meetings without management present.

The [board/audit committee/supervisory committee] authorizes the internal audit [department/activity] to:

- Have full, free, and unrestricted access to all functions, records, property, and personnel pertinent to carrying out any engagement, subject to accountability for confidentiality and safeguarding of records and information.
- Allocate resources, set frequencies, select subjects, determine scopes of work, apply techniques required to accomplish audit objectives, and issue reports.
- Obtain assistance from the necessary personnel of [name of organization], as well as other specialized services from within or outside [name of organization], in order to complete the engagement.

Independence and Objectivity

The chief audit executive will ensure that the internal audit [department/activity] remains free from all conditions that threaten the ability of internal auditors to carry out their responsibilities in an unbiased manner, including matters of audit selection, scope, procedures, frequency, timing, and report content. If the chief audit executive determines that independence or objectivity may be impaired in fact or appearance, the details of impairment will be disclosed to appropriate parties.

Internal auditors will maintain an unbiased mental attitude that allows them to perform engagements objectively and in such a manner that they believe in their work product, that no quality compromises are made, and that they do not subordinate their judgment on audit matters to others.

Internal auditors will have no direct operational responsibility or authority over any of the activities audited. Accordingly, internal auditors will not implement internal controls, develop procedures, install systems, prepare records, or engage in any other activity that may impair their judgment, including:

- Assessing specific operations for which they had responsibility within the previous year.
- Performing any operational duties for [name of organization] or its affiliates.
- Initiating or approving transactions external to the internal audit [activity/department].

- Directing the activities of any [name of organization] employee not employed by the internal audit [department/activity], except to the extent that such employees have been appropriately assigned to auditing teams or to otherwise assist internal auditors.

Where the chief audit executive has or is expected to have roles and/or responsibilities that fall outside of internal auditing, safeguards will be established to limit impairments to independence or objectivity.

Internal auditors will:

- Disclose any impairment of independence or objectivity, in fact or appearance, to appropriate parties.
- Exhibit professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined.
- Make balanced assessments of all available and relevant facts and circumstances.
- Take necessary precautions to avoid being unduly influenced by their own interests or by others in forming judgments.

The chief audit executive will confirm to the [board/audit committee/supervisory committee], at least annually, the organizational independence of the internal audit [department/activity].

The chief audit executive will disclose to the [board/audit committee/supervisory committee] any interference and related implications in determining the scope of internal auditing, performing work, and/or communicating results.

Scope of Internal Audit Activities

The scope of internal audit activities encompasses, but is not limited to, objective examinations of evidence for the purpose of providing independent assessments to the [board/audit committee/supervisory committee], management, and outside parties on the adequacy and effectiveness of governance, risk management, and control processes for [name of organization]. Internal audit assessments include evaluating whether:

- Risks relating to the achievement of [name of organization]'s strategic objectives are appropriately identified and managed.
- The actions of [name of organization]'s officers, directors, employees, and contractors are in compliance with [name of organization]'s policies, procedures, and applicable laws, regulations, and governance standards.
- The results of operations or programs are consistent with established goals and objectives.

- Operations or programs are being carried out effectively and efficiently.
- Established processes and systems enable compliance with the policies, procedures, laws, and regulations that could significantly impact [name of organization].
- Information and the means used to identify, measure, analyze, classify, and report such information are reliable and have integrity.
- Resources and assets are acquired economically, used efficiently, and protected adequately.

The chief audit executive will report periodically to senior management and the [board/audit committee/supervisory committee] regarding:

- The internal audit [department/activity]'s purpose, authority, and responsibility.
- The internal audit [department/activity]'s plan and performance relative to its plan.
- The internal audit [department/activity]'s conformance with The IIA's Code of Ethics and *Standards,* and action plans to address any significant conformance issues.
- Significant risk exposures and control issues, including fraud risks, governance issues, and other matters requiring the attention of, or requested by, the [board/audit committee/supervisory committee].
- Results of audit engagements or other activities.
- Resource requirements.
- Any response to risk by management that may be unacceptable to [name of organization].

The chief audit executive also coordinates activities, where possible, and considers relying upon the work of other internal and external assurance and consulting service providers as needed. The internal audit [department/activity] may perform advisory and related client service activities, the nature and scope of which will be agreed with the client, provided the internal audit [department/activity] does not assume management responsibility.

Opportunities for improving the efficiency of governance, risk management, and control processes may be identified during engagements. These opportunities will be communicated to the appropriate level of management.

Responsibility

The chief audit executive has the responsibility to:

- Submit, at least annually, to senior management and the [board/audit committee/supervisory committee] a risk-based internal audit plan for review and approval.

- Communicate to senior management and the [board/audit committee/supervisory committee] the impact of resource limitations on the internal audit plan.
- Review and adjust the internal audit plan, as necessary, in response to changes in [name of organization]'s business, risks, operations, programs, systems, and controls.
- Communicate to senior management and the [board/audit committee/supervisory committee] any significant interim changes to the internal audit plan.
- Ensure each engagement of the internal audit plan is executed, including the establishment of objectives and scope, the assignment of appropriate and adequately supervised resources, the documentation of work programs and testing results, and the communication of engagement results with applicable conclusions and recommendations to appropriate parties.
- Follow up on engagement findings and corrective actions, and report periodically to senior management and the [board/audit committee/supervisory committee] any corrective actions not effectively implemented.
- Ensure the principles of integrity, objectivity, confidentiality, and competency are applied and upheld.
- Ensure the internal audit [department/activity] collectively possesses or obtains the knowledge, skills, and other competencies needed to meet the requirements of the internal audit charter.
- Ensure trends and emerging issues that could impact [name of organization] are considered and communicated to senior management and the [board/audit committee/supervisory committee] as appropriate.
- Ensure emerging trends and successful practices in internal auditing are considered.
- Establish and ensure adherence to policies and procedures designed to guide the internal audit [department/activity].
- Ensure adherence to [name of organization]'s relevant policies and procedures, unless such policies and procedures conflict with the internal audit charter. Any such conflicts will be resolved or otherwise communicated to senior management and the [board/audit committee/supervisory committee].
- Ensure conformance of the internal audit [department/activity] with the *Standards*, with the following qualifications:
    - If the internal audit [department/activity] is prohibited by law or regulation from conformance with certain parts of the *Standards*, the chief audit executive will ensure appropriate disclosures and will ensure conformance with all other parts of the *Standards*.
    - If the *Standards* are used in conjunction with requirements issued by [other authoritative bodies], the chief audit executive will ensure that the internal audit [department/activity] conforms with the *Standards*, even if the internal audit [department/activity] also conforms with the more restrictive requirements of [other authoritative bodies].

Quality Assurance and Improvement Program

The internal audit [department/activity] will maintain a quality assurance and improvement program that covers all aspects of the internal audit [department/activity]. The program will include an evaluation of the internal audit [department/activity]'s conformance with the *Standards* and an evaluation of whether internal auditors apply The IIA's Code of Ethics. The program will also assess the efficiency and effectiveness of the internal audit [department/activity] and identify opportunities for improvement.

The chief audit executive will communicate to senior management and the [board/audit committee/supervisory committee] on the internal audit [department/activity]'s quality assurance and improvement program, including results of internal assessments (both ongoing and periodic) and external assessments conducted at least once every five years by a qualified, independent assessor or assessment team from outside [name of organization].

Approval/Signatures

Chief Audit Executive Date

[Board/Audit Committee/Supervisory Committee] Chair Date

[Chief Executive Officer] Date

About The IIA

The Institute of Internal Auditors (IIA) is the internal audit profession's most widely recognized advocate, educator, and provider of standards, guidance, and certifications. Established in 1941, The IIA today serves more than 190,000 members from more than 170 countries and territories. The association's global headquarters are in Lake Mary, Fla., USA. For more information, visit www.globaliia.org.

About Supplemental Guidance

Supplemental Guidance is part of The IIA's International Professional Practices Framework (IPPF) and provides additional recommended (nonmandatory) guidance for conducting internal audit activities. While supporting the *International Standards for the Professional Practice of Internal Auditing*, Supplemental Guidance is not intended to directly link to achievement of conformance with the *Standards*. It is intended instead to address topical areas, as well as sector-specific issues, and it includes detailed processes and procedures. This guidance is endorsed by The IIA through formal review and approval processes.

For other authoritative guidance materials provided by The IIA, please visit our website at www.globaliia.org/standards-guidance or www.theiia.org/guidance.

Disclaimer

The IIA publishes this document for informational and educational purposes. This guidance material is not intended to provide definitive answers to specific individual circumstances and, as such, is only intended to be used as a guide. The IIA recommends that you always seek independent expert advice relating directly to any specific situation. The IIA accepts no responsibility for anyone placing sole reliance on this guidance.

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March 17

Section 3.0 DUTIES AND RESPONSIBILITIES

Audit Committee Charter

Revised Committee Name Adopted: September 10, 2013; Revised Charter Adopted: November 12, 2013; Revised: September 23, 2014; Reaffirmed: October 23, 2018

I. PURPOSE/ROLE

The Committee will provide assistance to the Board in fulfilling its fiduciary oversight responsibility to the participants, the City of Los Angeles, the investment community, and others relating to LACERS' financial statements, and the legal compliance, ethics programs and other related risks, as established by the Board. In so doing, it is the responsibility of the Committee, with approval of the Board, to maintain free and open communication between the Committee, independent auditors, the internal auditors, and management of LACERS. In discharging its oversight role, the Committee is empowered to investigate any matter brought to its attention with access to all books, records, facilities, and personnel of LACERS.

II. AUTHORITY

The Committee has the authority to direct the Departmental Audit Manager (DAM), external auditors, or consultants to conduct an audit, review, and/or investigation into any matters within the Committee's scope of responsibility. It is empowered to:

- Seek any information it requires from LACERS staff or external parties, all of whom are directed by the Board to cooperate with the Committee's request.
- Appoint, compensate, and oversee the work of all public accounting firms employed by LACERS.
- Resolve any disagreements between LACERS management and the internal or external auditors regarding financial reporting, actuarial audits, or other related matters.
- Retain independent counsel, accountants, or others to advise or assist the Committee in the performance of its responsibilities.
- Approve the consultants, or others retained by the organization to assist in the conduct of an audit, review, and/or special investigation.
- Meet with management, external and internal auditors, or outside counsel as necessary.

III. COMPOSITION OF COMMITTEE

The Committee shall consist of three LACERS Board Members. All members shall be appointed by the LACERS Board President. The LACERS Board President shall appoint a Committee Chair.

The Committee Chair is responsible for setting the agendas for each Committee Meeting. The Chair shall take as an agenda item any matter referred by the LACERS Board. The Chair shall also take as an agenda item any matter submitted by two or more members of the Committee.

IV. FREQUENCY OF MEETINGS

The Committee shall meet no less than four times during the calendar year, or more often as needed. Meetings will be conducted in accordance with open meeting and other applicable laws. Meeting agendas, along with appropriate briefing materials, will be prepared and provided in advance to Committee members and other required attendees. Minutes of the meeting will be prepared and approved by the Committee.

Meeting notices, agendas, and materials will be provided to interested parties in conformance with applicable laws, regulations, customs, and practices. The Committee may invite members of management, external auditors, internal auditors, or other third parties, to attend meetings and provide pertinent information, as the Committee deems appropriate to carry out its responsibilities. The DAM shall support the Committee's activities and ensure appropriate staff and others are available to assist it. The DAM shall review minutes, draft reports, perform research, and render other types of assistance as reasonably requested by the Committee.

V. DUTIES AND RESPONSIBILITIES

The primary responsibility of the Committee is to oversee LACERS' financial reporting process on behalf of the Board and to report the results of its activities to the Board. Management is responsible for preparing LACERS' financial statements, and the independent auditors are responsible for auditing those financial statements. The Committee is responsible for understanding risks affecting LACERS' operations and monitoring how management implements controls to minimize those risks.

The Committee, in carrying out its responsibilities, believes its policies and procedures should remain flexible in order to best react to changing conditions and circumstances. The Committee will take the appropriate actions to set the overall "tone" for quality financial reporting, sound business risk practices, and ethical behavior.

The following are specific responsibilities with respect to LACERS' financial statements, internal controls, internal and external auditors, and compliance with laws and regulations.

A. *Financial Reporting*

- Review significant accounting and reporting issues, including complex or unusual transactions, and recent professional and regulatory pronouncements, and understand their impact on the financial statements.

- Review with management and the external auditors the results of the audit, significant adjustments or revisions to the financial statements, including any difficulties encountered.

- Inquire as to the external auditors' independent judgment about the appropriateness, not just the acceptability, or the accounting principles adopted by the organization and clarity of financial disclosures.

- Review LACERS' annual financial statements and any financial reports related to LACERS submitted to any governmental body; consider whether they are complete, consistent with information known to the Committee, and reflect appropriate accounting principles.

- Review the responsiveness and timeliness of management's actions to address findings and recommendations that resulted from the financial statement audit.

- Review with management and the external auditors all matters required to be communicated to the Committee under general accepted auditing standards.

Section 3.0 DUTIES AND RESPONSIBILITIES

- Review with the City Attorney-Retirement Division the status of legal matters that may have an effect on the financial statements.
- Review, in consultation with the external auditors and the DAM, the integrity of the organization’s financial reporting processes.

B. *Risk Control and Management*

- Review the adequacy of policies and practices designed to avoid or mitigate risks related to benefits administration, investments, and general operations.
- Review the effectiveness of the LACERS’ system for assessing, monitoring, and controlling significant risks or exposures.
- Review LACERS systems of internal accounting and financial controls whenever a significant change occurs.
- Review controls over LACERS’ information systems, including security access and program change controls as well as contingency plans on an annual basis.
- Review annually the internal control reports of LACERS custodian (Service Organization Control Report) and of the City of Los Angeles management letter.
- Review and forward to the Board all internal and external auditors’ significant findings and recommendations, including the management response thereto.
- Make recommendations to the Board for retention of actuarial audit services or other specialized audit services, including review of staff reports pertaining to such services.

C. *Internal Control*

- Consider the effectiveness of the LACERS’ internal control system, including information technology security and control.
- Understand the scope of internal and external auditors’ review of LACERS’ internal control over financial reporting, and obtain reports on significant findings and recommendations, together with management’s response.

D. *Internal Audit*

- Approve the LACERS’ internal audit charter, and any revisions to the charter as needed.
- Advise on the appointment, replacement, or dismissal of the DAM in consultation with the General Manager as appointing authority.
- Review and recommend to the Board, the approval of a risk-based internal annual audit plan and all major changes to the plan. In consultation with the General Manager, review the DAM’s performance relative to such plan.
- Ensure that internal auditors have full, free, and unrestricted access to all functions, documents, information, systems, contractors, consultants, and LACERS’ personnel.

Section 3.0 DUTIES AND RESPONSIBILITIES

- Review all internal audit reports, and bring to the attention of the Board any audit issues the Committee determines significant and appropriate for consideration by the Board.
- Obtain and review the quality assurance report for the Internal Audit Section at least once every five years. Review for any concerns noted.
- Delegate to the DAM the oversight and management of the contracts of all public accounting firms hired by LACERS.
- Designate the DAM as the primary point of contact for handling all matters related to audits, examinations, investigations, or inquiries of the City Controller auditors, state and other federal agencies. The DAM will keep the Committee and/or the General Manager informed as appropriate.

E. *Engagement of External Auditors*

- Obtain a clear understanding with management that the independent auditors are ultimately accountable to the Board and the Committee as representatives of LACERS participants. As appropriate, the Committee will recommend to the Board the appointment, retention, or discharge of the external auditors with input from the DAM, the General Manager, and other parties as appropriate.
- Approve all audit and non-audit services to be performed by the external auditors.
- Review the independent auditors' proposed overall scope and approach, including coordination of efforts with internal audit.
- Discuss with management and the independent auditors the adequacy and effectiveness of the accounting and financial controls, including LACERS system to monitor and manage business risk and legal and ethical compliance programs.
- Review and confirm the independence of the external auditors by obtaining a list of all payments to the external auditors (itemizing payments for audit, other attestation projects, and non-audit services provided) and statements from the auditors on relationships between the auditors and any LACERS staff, and discussing these relationships with the auditors.
- Prove guidelines and mechanisms so that no Committee member or LACERS' staff shall improperly influence the external auditors.
- Review with management and the independent auditor the financial statements of LACERS Comprehensive Annual Financial Report.

F. Compliance

- Review the effectiveness of the LACERS' system for monitoring compliance with laws, regulations, contracts, policies, and the results of management's investigation and follow-up (including disciplinary action) of any instances of noncompliance.

- Review the findings of any examinations by regulatory agencies, any auditor observations related to compliance, and the responsiveness and timeliness of management's actions to address the findings/observations.

- Review the process for communicating and monitoring compliance with the code of ethics, code of conduct, and fraud policies.

- Obtain regular updates from management and the City Attorney's Retirement Division regarding compliance matters.

G. *Special Investigations and Whistleblower Mechanism*

- Institute and oversee special investigations as needed.

- Assess and, if appropriate, oversee the creation and maintenance of an appropriate whistleblower mechanism for reporting any fraud, noncompliance, and/or inappropriate activities.

- As appropriate, recommend to the Board the retention of accountants or other specialists to advise the Committee and the Board or assist in the conduct of an investigation.

H. *Other Responsibilities*

- Regularly report to the Board about Committee activities, issues, and related recommendations.

- Provide an open avenue of communication between internal auditors, the external auditors, and the Board.

- Review any other reports that LACERS issues that relate to Committee responsibilities.

VI. CHARTER REVIEW

The Committee and the Board will review this Charter at least every three years to ensure it remains appropriate. The Committee will recommend any changes to the Board for review and approval. The Board may adjust the Charter at any time.

Association of Public Pension Fund Auditors

Model Audit Committee Charter

Revised February 2013

Endorsed by:
Association of Public Pension Fund Auditors, Inc.
A Project of the Best Practices Committee

TABLE OF CONTENTS

FOREWORD

The following Model Audit Committee Charter (Model AC Charter) captures many of the best practices used at the present time, February 2013. This Model AC Charter may not encompass all activities considered appropriate to a particular audit committee, nor are all activities identified in this Model AC Charter relevant to every audit committee. Accordingly, this Model AC Charter should be tailored to each audit committee's needs and governing rules. Moreover, as applicable laws, rules, and customs change, the audit committee charter should be updated.

Endorsement by the Association of Public Pension Fund Auditors, Inc. (APPFA) means that this document is intended as a starting point of reference and as a guide to public pension funds in formulating or revising their audit committee charters. To the extent that a public pension fund has unique circumstances, different applications and modifications of the example passages may be desirable.

The first version of this publication was completed in July 2003 and was updated in February 2013. The update was completed by the following members of the Best Practices Committee.

Flerida Rivera-Alsing, Chair	State Board of Administration of Florida
Ryan Babin	Louisiana State Employees Retirement System
Janet Harris	Public School Retirement System of Missouri
Amen Tam	Ontario Municipal Employees Retirement System
Toni Voglino	Maryland State Retirement and Pension System

The February 2013 version of this publication was approved by the APPFA Board in May 2013.

I. PURPOSE

The purpose of the Audit Committee (Committee) is to assist the Board of Trustees (the Board) in fulfilling its fiduciary oversight responsibilities in the areas of:

- Financial Reporting,
- Risk Management,
- Internal Control,
- Internal Audit,
- Engagement of External Auditors,
- Compliance, and
- Special Investigations and Whistleblower Mechanism

II. AUTHORITY

The Committee has the authority to direct the Chief Audit Executive (CAE), external auditors, or consultants to conduct an audit, review, and/or investigation into any matters within the Committee's scope of responsibility. It is empowered to:

- Seek any information it requires from employees – all of whom are directed by the Board to cooperate with the Committee's requests – external auditors, consultants, and external parties.

- Appoint, compensate, and oversee the work of all public accounting firms employed by the organization.

- Resolve any disagreements between management and the external auditors regarding financial reporting.

- Retain independent counsel, accountants, or others to advise or assist the Committee in the performance of its responsibilities.

- Approve the consultants, or others retained by the organization to assist in the conduct of an audit, review, and/or a special investigation.

- Meet with management, external and internal auditors, or outside counsel as necessary.

III. COMPOSITION

The Committee will consist of at least three, and no more than seven, members of the Board. The Board, or its nominating committee, will appoint Committee members and the Committee chair. Members of the Committee shall serve until the next such appointment of the Board or until their successors have been duly elected and qualified. The members of the Committee may be removed, with or without cause, by a majority vote of the Board.

Each Committee member will be independent and will complete an annual independence statement. Each Committee member will have professional experience and expertise in at least one of the following fields: institutional investing, risk management, accounting, auditing, or information technology. All members of the Committee shall have a working familiarity with basic finance and accounting practices. At least one member of the Committee shall be designated as the "financial expert," as defined by applicable legislation and regulation. Committee members shall have other qualifications as the Board determines appropriate.

IV. MEETINGS

The Committee shall meet at least four times a year, with authority to convene additional meetings, as circumstances require. All Committee members are expected to attend each meeting, in person or via tele- or video-conference. Meetings will be conducted in accordance with open meeting and other applicable laws. Meeting agendas, along with appropriate briefing materials, will be prepared and provided in advance to Committee members and other required attendees. Minutes of the meeting will be prepared and approved by the Committee.

Meeting notices, agendas, and materials will be provided to interested parties in conformance with applicable laws, regulations, customs, and practices. The Committee may invite members of management, external auditors, internal auditors, or other third parties, to attend meetings and provide pertinent information, as the Committee deems appropriate to carry out its responsibilities. All members of the Board may attend the meetings of the Committee but may not vote if not a member of the Committee.

To foster open communication, the Committee shall, at least annually, meet separately with the CAE and the external auditors to discuss any matters that the Committee believes should be discussed privately.*{Note: Subject to open meeting laws.}* In addition, the Committee should annually meet with the external auditors to review the organization's financial statements.

V. RESPONSIBILITIES

The Committee will carry out the following responsibilities:

A. Financial Reporting

- Obtain information and/or training to enhance the Committee's understanding of the organization's financial reports and the related financial reporting processes.

- Review significant accounting and reporting issues, including complex or unusual transactions, and recent professional and regulatory pronouncements, and understand their impact on the financial statements.

- Review with management and the external auditors the results of the audit, significant adjustments or revisions to the financial statements, including any difficulties encountered.

- Inquire as to the external auditors' independent judgment about the appropriateness, not just the acceptability, of the accounting principles adopted by the organization and clarity of financial disclosures.

- Review the annual financial statements and any financial reports submitted to any governmental body; consider whether they are complete, consistent with information known to the Committee, and reflect appropriate accounting principles.

- Review the responsiveness and timeliness of management's actions to address findings and recommendations that resulted from the financial statement audit.

- Review with management and the external auditors all matters required to be communicated to the Committee under generally accepted auditing standards.

- Review with the General Counsel the status of legal matters that may have an effect on the financial statements.

- Review, in consultation with the external auditors and the CAE, the integrity of the organization's financial reporting processes.

B. Risk Management

- Obtain information and/or training to enhance the Committee's understanding of the organization's risks and the related risk management processes.

- Review the adequacy of the organization's policy on risk management.

- Review the effectiveness of the organization's system for assessing, monitoring, and controlling significant risks or exposures.

- Review management's reports on risks and related risks mitigations.

- Hire outside experts and consultants in risk management as necessary.

C. *Internal Control*

- Obtain information and/or training to enhance the Committee's understanding of the organizations internal control system.

- Consider the effectiveness of the organization's internal control system, including information technology security and control.

- Understand the scope of the external auditors' review of the organization's internal control over financial reporting.

- Review internal and external auditors' significant findings and recommendations, together with management's responses.

- Ensure that contracts with external service providers contain appropriate record-keeping and audit language.

D. *Internal Audit*

- Obtain information and/or training to enhance the Committee's understanding of the internal audit function.

- Review and approve the Internal Audit Department Charter annually.

- Review and confirm, through organizational structure and/or by other means, the independence of the internal audit function annually.

- Concur in the appointment, replacement, or dismissal of the CAE.

- Review the performance of the CAE and the internal audit function periodically and concur with the annual compensation and salary adjustment of the CAE.

- Ensure that internal auditors have full, free, and unrestricted access to all functions, documents, information, systems, contractors, consultants, and personnel in the organization.

- Review and approve the internal audit function's staffing plan and budget.

- Review and approve the risk-based internal audit annual plan.

- Receive and review all internal audit reports.

- Review the responsiveness and timeliness of management's follow-up activities pertaining to all reported findings and recommendations.

- Bring to the attention of the Board any audit issues the Committee determines significant and appropriate for consideration by the Board.

- On a regular basis, meet separately with the CAE to discuss any matters that the Committee or internal audit believes should be discussed privately. *{Subject to open meeting laws.}*

- Obtain and review the quality assurance report for the Internal Audit Department at least once every five years. Review for any concerns noted.

- Delegate to the CAE the oversight and management of the contracts of all public accounting firms hired by the organization.

- Designate the CAE as the primary point of contact for handling all matters related to audits, examinations, investigations or inquiries of the state auditor, and other state or federal agencies.

E. Engagement of External Auditors

- Obtain information and/or training to enhance the Committee's understanding of the organization's financial statements audit and the role of external auditors.

- Approve the appointment, retention, or discharge of the external auditors. Obtain input from the CAE, management, and other parties as appropriate.

- Approve all audit and non-audit services to be performed by the external auditors.

- Review the external auditors' proposed audit scope and approach, including the coordination of efforts with internal audit.

- Review and confirm the independence of the external auditors by obtaining statements from the auditors on relationships between the auditors and the organization for all audit and non-audit services.

- On a regular basis, meet separately with the external auditors to discuss any matters that the Committee or auditors believe should be discussed privately. *{Note: Subject to open meeting laws.}*

- Provide guidelines and mechanisms so that no Committee member or organization staff shall improperly influence the external auditors.

- Obtain and review annually a list of all payments to the external auditors. The list should separately disclose the payment for the financial statements audit, other attestation projects, and non-audit services provided.

- Obtain and review the peer review report for the external audit firms on a periodic basis. Review for any concerns noted.

F. Compliance

- Review the effectiveness of the organization's system for monitoring compliance with laws, regulations, contracts, and policies and the results of management's investigation and follow-up (including disciplinary action) of any instances of noncompliance.

- Review the findings of any examinations by regulatory agencies, any auditor observations related to compliance, and the responsiveness and timeliness of management's actions to address the findings/observations.

- Review the process for communicating and monitoring compliance with the code of ethics, code of conduct, and fraud policies.

- Obtain regular updates from management and organization legal counsel regarding compliance matters.

G. Special Investigations and Whistleblower Mechanism

- Institute and oversee special investigations, as needed.

- Ensure the creation and maintenance of an appropriate whistleblower mechanism for reporting any fraud, noncompliance, and/or inappropriate activities.

- Retain independent counsel, accountants, or other specialists to advise the Committee or assist in the conduct of an investigation.

H. Other Responsibilities

- Report at least annually to the Board the Committee's activities, audit issues, and related recommendations.

- Confirm annually that all responsibilities outlined in this Model AC Charter have been carried out.

- Review and assess annually the adequacy of this Model AC Charter; request Board approval for proposed changes, and ensure appropriate disclosure as may be required by law or regulation.

- Evaluate annually the Committee's and individual member's performance and report the results of the evaluation to the Board.

- Provide an open avenue of communication between the internal auditors, external auditors, management, and the Board.

- Perform other activities related to this Model AC Charter as requested by the Board.

VI. SIGNATURE PAGE

This Model AC Charter was adopted by the Committee on (date) and approved by the Board. This Model AC Charter is effective this day and is hereby signed by the following persons who have authority and responsibilities under this Charter.

Chair, Audit Committee — Date

Chair, Board of Trustees — Date

REFERENCES

The Institute of Internal Auditors' Model Audit Committee Charter

Audit Committee Charter of the various public pension fund systems who are members of APPFA

Association of Public Pension Fund Auditors

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www.appfa.org

LACERS
LOS ANGELES CITY EMPLOYEES' RETIREMENT SYSTEM

Report to Audit Committee

Rahoof Oyewole

From: Rahoof "Wally" Oyewole, Dept. Audit Manager

Agenda of: **OCTOBER 23, 2018**

ITEM: **V**

SUBJECT: **2014 MANAGEMENT AUDIT- UPDATED STATUS OF RECOMMENDATIONS**

Recommendation:

That the Committee receive and file the status report of the recommendations contained in the LACERS 2014 Management Audit.

Discussion:

Section 1112 of the City Charter requires the City Controller, the Office of the Mayor, and the City Council (referred to as the Joint Administrators) to engage an independent qualified auditing firm to conduct a management audit of City's three pension and retirement systems once every five years. The first LACERS management audit was conducted in 2007. The Joint Administrators engaged P2E Consulting Group to conduct the last LACERS management audit which concluded in 2014. The audit examined whether LACERS was operating in the most efficient and economical manners, and evaluated the asset allocation of the System. The review covered operational activities over a five-year period from 2008 to 2012. Because of the Board's plenary authority, the Board can choose whether to implement the audit recommendations.

Overall, the 2014 audit concluded that LACERS management and accounting practices were generally consistent with other comparable public pension funds and benchmarking studies reviewed. In addition, LACERS was found to be operating in a reasonably efficient and economical manner, and that on the whole, the process to allocate and diversify the assets of the System was done in a reasonable manner. The results of the audit were presented in two reports (Attachment 2). An Interim Report issued on June 27, 2013 contained three recommendations and, the Final Report issued on March 12, 2014 contained 37 recommendations, for a total of 40 recommendations directed to LACERS management and the Board. One additional recommendation related to consolidating the City's pension systems was directed to the Mayor and Council.

The Audit Committee assigned the recommendations in the reports to the Benefits Committee, the Governance Committee and the full Board for review, discussion and concurrence with staff's reported status of each recommendation.

Status of Assigned Recommendations

Staff's response and implementation plans were discussed by the assigned committees and the Board. Based on those discussions, all 40 recommendations are now classified as Completed[1].

The following table shows the number of recommendations assigned to each committee, and the dates when staff's response and implementation plan to each recommendation were discussed.

Board/ Committee	Number of Recommendations Assigned	Dates When the Committee/Board Discussed the Recommendations	Status
Board	14 Investment- Related	November 13, 2014 October 24, 2017	Completed – 14 The Board adopted Revised Investment Policy Statement on October 24, 2017
Governance	18 Administrative and Governance-Related	May 27, 2014 July 8, 2014 September 9, 2014	Completed – 18
Benefits Administration	6 Benefits- Related	July 8, 2014	Completed – 6
Audit Committee	2 Internal Audit - Related	November 13, 2013	Completed - 2

Attachment 1 shows the complete listing of the recommendations, assigned committees and status.

This report was prepared by Rahoof "Wally" Oyewole, Departmental Audit Manager, Internal Audit Section.

RO

Attachments: 1) Status of Recommendations
2) Interim Report Issued June 27, 2013 and Final Report Issued March 12, 2014

[1] As indicated in Attachment 1, some recommendations are classified as completed with status quo. For those recommendations, current policy or procedures were determined to be adequate to address the intent of the recommendations.

Attachment 1

LACERS MANAGEMENT AUDIT
STATUS OF RECOMMENDATIONS
10/23/18

Reco Number	Recommendation	Responsible Division	Assigned Committee/Board	Status
Interim 1	Comprehensive review of active management program; ensure LACERS has taken all relevant factors into consideration.	Investments	Board	Completed
Interim 2	Emerging Manager Fund of Funds Program: terminate or revise Program or revise the Emerging Manager Policy.	Investments	Board	Completed
Interim 3	Update Section V.C. of Investment Policy Statement to reflect the more stringent requirements contained in Section IV of the Manager Search and Selection Policy.	Investments	Board	Completed
Final	The City should consider the matter of consolidation or combination of its pension systems. One aspect of its consideration of the matter should be a comprehensive study to determine an estimate of the potential savings and form the basis for further action.	Mayor/Council	N/A	Unknown - Recommendation was addressed to the Mayor and Council.
Final 1	LACERS should supplement Monte Carlo simulation with scenario analysis. This would allow it to examine the performance of its asset mix policy under a limited number of specific economic scenarios, so as to better understand the risk of lower than anticipated investment returns under adverse capital market condition. It would also enable LACERS to better communicate the risks of the System to the City. The added costs associated with scenario analysis would be minimal.	Investments	Board	Completed
Final 2	The Board should devote more time and effort to reviewing the investment assumptions before the asset/liability study is conducted (in the same ways that it reviews actuarial assumptions prior to the actuarial valuation) to satisfy itself that the assumptions, particularly with respect to the expected returns on asset classes, are realistic, that they reflect the current valuation in capital markets, and that they are a reasonable expectation of investment performance over the period of the study.	Board	Board	Completed
Final 3	LACERS should explore with its investment consultant the feasibility of using alternative methodologies, other than mean-variance optimization, for determining allocations to private market assets.	Investments	Board	Completed
Final 4	LACERS should not invest in any asset class (or sub-asset class) without analyzing the potential implications of any such investment on the expected risk and return of the Fund. More specifically, LACERS should not invest in the real asset sub-asset classes that were recently approved until those sub-asset classes are modeled to determine the impact they may have on total portfolio.	Investments	Board	Completed

LACERS MANAGEMENT AUDIT
STATUS OF RECOMMENDATIONS
10/23/18

Attachment 1

Reco Number	Recommendation	Responsible Division	Assigned Committee/Board	Status
Final 5	The Board should establish maximum-minimum asset allocation ranges as part of the transition plan to guide the rebalancing of the actual allocation if it were to drift too far away from the quarterly target mix.	Investments	Board	Completed
Final 6	LACERS should establish a separate rebalancing policy with comprehensive guidelines and procedures with respect to the rebalancing process. (a) LACERS should examine the feasibility of rebalancing the asset allocation of the System, not just when the allocation exceeds the maximum-minimum ranges, but on an ongoing basis by directing contributions towards portfolios which are under-weighted (i.e. below their target allocations but still within the approved range) and withdrawals from portfolios which are over-weighted with proper allowance for the liquidity issues surrounding private market assets. Purchases and sales of securities in order to rebalance should only be undertaken when the asset allocation exceeds the approved ranges. While we were informed by staff that they consider cash flow in the rebalancing process, this should be more clearly specified in its investment policy. (b) LACERS should explore the use of overly strategies based on market index futures contracts as an alternative and/or a supplement to cash flows and asset purchases and sales for rebalancing.	Investments	Board	Completed
Final 7	The Board should require that the quarterly reports provided by the general investment consultant, real estate consultant, and private equity consultant provide the necessary information to allow the Board to monitor compliance with portfolio diversification requirements contained in LACERS investment guidelines.	Investments	Board	Completed - Status Quo approved by the Board
Final 8	The Board should require investment consultants to submit a compliance report (quarterly or at least annually) that verifies the Systems' compliance with the various provisions and guidelines of its investment policies.	Investments	Board	Completed - Status Quo approved by the Board
Final 9	LACERS should consider stratified rates by Service Range provided by the actuary for retiree medical and dental coverage and continue to monitor the 50% election assumption for deferred vested members.	Administrative Services	Benefits Administration	Completed
Final 10	LACERS should reexamine the data on marital status at retirement and age difference between spouses because it is a more significant factor in an OPEB valuation.	Administrative Services	Benefits Administration	Completed

Attachment 1

LACERS MANAGEMENT AUDIT
STATUS OF RECOMMENDATIONS
10/23/18

Reco Number	Recommendation	Responsible Division	Assigned Committee/Board	Status
Final 11	LACERS should add more automation, if cost beneficial, in the application process to reduce the amount of work, time, and effort spent scanning applications, and ensure applications are complete. An automated system would ensure that all applications are legible and complete before submission, and automatically generate an electronic file, that would likely be easily searchable.	Retirement Services	Benefits Administration	Completed - Status Quo approved by the Board
Final 12	LACERS should establish relationships with area physicians and become more proactive in getting medical records. Specifically, if cost-biennial, creating a mechanism to accept these applications electronically will eliminate delay that may be present with faxing or mailing this information, and allow the Disability Department to keep track of medical records in real time.	Retirement Services	Benefits Administration	Completed - Status Quo approved by the Board
Final 13	LACERS should organize scanned data into additional sub-categories if cost beneficial, to help increase utility.	Retirement Services	Benefits Administration	Completed
Final 14	LACERS should consider ways to expedite the few retirement cases exceeding 90 days.	Retirement Services	Benefits Administration	Completed - Status Quo approved by the Board
Final 15	In accordance with industry best practice and published standards LACERS should propose to the City Council that the City Charter be amended to grant the Board full authority to administer the System subject to fiduciary standards. Such authority would include but not limited to: (a) Appointment of the General Manager; (b) Selection of legal counsel (internal or external); (c) staff compensation and hiring policy(at a minimum, the authority to allocate and reallocate positions without going through the City Personnel Department); and (d) Setting the number and timing of board meetings.	Governance Committee	Governance	Completed - Status Quo approved by the Board
Final 16	LACERS should propose a Charter amendment to stipulate that an appointed Board member may only be removed for cause (except at end of term) and, if removed, that the reason is publicly disclosed.	Governance Committee	Governance	Completed -Status Quo approved based on discussions with Mayor's Office
Final 17	LACERS should establish separate comprehensive charters for the Board, the Board Chair, and the GM, as opposed to having their roles and responsibilities documented in various governance and investment policies. The use of charters (or terms of reference) was a typical practice among Cortex Peer Group.	Administrative Services	Governance	Completed - Status Quo approved by the Board
Final 18	LACERS should establish a charter for Internal Audit position that describes the roles and responsibilities of the position, and the internal auditor's reporting relationship with the Board and the General Manager.	Internal Audit	Audit	Completed

LACERS MANAGEMENT AUDIT
STATUS OF RECOMMENDATIONS
10/23/18

Attachment 1

Reco Number	Recommendation	Responsible Division	Assigned Committee/Board	Status
Final 19	LACERS should remove the Investment Committee Charter from the Governance Manual, as well as various references to the committee found throughout the Governance Manual, as the committee was disbanded in 2011.	Administrative Services	Governance	Completed
Final 20	LACERS should consider instituting a consistent format and content for each committee charter, such as general statement as to the role of the committee, committee composition, frequency of meetings, as well as the specific duties and responsibilities of the committee.	Administrative Services	Governance	Completed
Final 21	As LACERS investment programs get larger and more sophisticated over time, the Board should consider delegating the entire investment selection process to management subject to Board-approved parameters, selection criteria, and relevant internal controls. (Acknowledges Board has moved in this direction)	Board	Board	Completed - Status Quo approved by the Board
Final 22	The Board should establish a separate Audit Committee, and in preparing a charter for the committee, should consider the sample charters prepared by the Association of Public Pension Fund Auditors (APPFA) and the American Institute of Certified Public Accountants (AICPA).	Internal Audit	Audit	Completed
Final 23	The Board should consider eliminating the Strategic Planning Committee.	Board	Governance	Completed
Final 24	LACERS should establish a formal frequency for the periodic review of governance policies. Industry standards in this regard range from every 3 to 5 years. The policy review frequency should be documented (this could be done in the Statement of Governance Principles or in each policy). Ideally, all governance policies should indicate the date the policy was first approved, and last reviewed and/or amended.	Governance Committee	Governance	Completed
Final 25	Establish other governance policies: Monitoring and Reporting Policy; Strategic/Business Planning Policy; and GM Performance Evaluation Policy.	Governance Committee	Governance	Completed - Status Quo approved by the Board
Final 26	LACERS should review and update Investment Policy Statement and other investment policies and include the latest versions in its Governance Manual.	Investments	Board	Completed. The Board adopted the Revised Investment Policy Statement on October 24, 2017
Final 27	LACERS should add the Board Communications Policy to the Board's Governance Manual.	Administrative Services	Governance	Completed
Final 28	LACERS should update the Commitment of a Board Member document, which references committees and sub-committees that no longer exist (e.g. Audit and Risk Control Committee, Private Investment Committee, etc.).	Administrative Services	Governance	Completed

Attachment 1

LACERS MANAGEMENT AUDIT
STATUS OF RECOMMENDATIONS
10/23/18

Reco Number	Recommendation	Responsible Division	Assigned Committee/Board	Status
Final 29	LACERS should reorganize Governance Manual so that ethics-related policies are all contained in the same section of the Manual to assist Board Members to maintain familiarity with them.	Administrative Services	Governance	Completed
Final 30	LACERS should amend its Governance Manual so that it includes a comprehensive list of all applicable ethics legislation, for easy reference by Board Members and staff.	Administrative Services	Governance	Completed
Final 31	LACERS should establish an annual attestation to be completed by Board members in which they affirm they have reviewed and are familiar with LACERS governance and ethics policies (possibly extend to staff).	Administrative Services	Governance	Completed - Status Quo approved by the Board
Final 32	LACERS should work with City's Ethics Commission and City Attorney to ensure at least annual in-person fiduciary and ethics training.	Administrative Services	Governance	Completed
Final 33	LACERS should develop an education needs assessment process for the Board, which would serve as input into Board or Trustee education plan.	Administrative Services	Governance	Completed - Status Quo approved by the Board
Final 34	LACERS should establish consistent accessibility to the meeting minutes of all its Board committees.	Administrative Services	Governance	Completed
Final 35	LACERS should consider conducting fund attribution on a regular basis.	Investments	Board	Completed
Final 36	The Board should reaffirm or remove policies concerning proposed legislation and periodic evaluation of Board's performance.	Board	Governance	Completed
Final 37	The City and LACERS should formalize communication process regarding long-term strategic and financial planning.	Administrative Services	Governance	Completed - Status Quo approved by the Board

Attachment 2

WENDY GREUEL
CONTROLLER

June 27, 2013

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

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

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

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

Sincerely,

WENDY GREUEL
City Controller

Attachment 2

City of Los Angeles

WENDY GREUEL
CONTROLLER

June 27, 2013

Honorable Members of the Los Angeles City Council
Los Angeles City Employees' Retirement System Board of Administration

As required under City Charter Section 1112, the Los Angeles City Controller, the Office of the Mayor, and the Los Angeles City Council jointly cause, once every five years, a management audit to be conducted of the pension and retirement systems by an independent qualified management auditing firm. The audit examines whether the pension or retirement system is operating in the most efficient and economical manner and evaluates the asset allocation of the system. The first Charter-mandated audit of the Los Angeles City Employees' Retirement System (LACERS) was issued on December 3, 2007 and contained 142 recommendations.

The Charter-mandated audits are comprehensive and require many months to complete. Representatives for the Mayor's Office, City Council and Controller's Office (Joint Administrators) identified 13 audit objectives to be addressed in the current management audits. As a means to provide timely information to decision-makers and the public, the Joint Administrators determined that the audit results would be presented in two reports; an Interim Report and a Final Report.

The attached "Management Audit of the Los Angeles City Employees' Retirement System Interim Report" is focused on five audit objectives, including an assessment of the implementation status of the prior audit recommendations. The Interim Report includes the following topics:

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

Attachment 2

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

- Determination as to whether investment consultants and asset custodian services can be consolidated with the Los Angeles Fire and Police Pensions to achieve savings.

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

P2E Consulting Group, LLC is conducting the management audit of LACERS on behalf of the City. If you have any questions about the report, please contact Farid Saffar, Director of Auditing, at (213) 978-7392.

Sincerely,

WENDY GREUEL City Controller	ANTONIO R. VILLARAIGOSA Mayor	HERB J. WESSON, Jr. City Council President 10th District

Enclosure

cc: Honorable Carmen Trutanich, City Attorney
Gaye Williams, Chief of Staff, Office of the Mayor
Thomas Moutes, General Manager, LACERS
Miguel A. Santana, City Administrative Officer
June Lagmay, City Clerk
Gerry F. Miller, Chief Legislative Analyst
Independent City Auditors

CONSULTING
Efficiency Effectiveness Excellence

May 16, 2013

BY EMAIL
Joint Administrators
City of Los Angeles

To the Joint Administrators:

Re: Management Audit of the Los Angeles City Employees' Retirement System

Please find attached our Interim Report on the above referenced project.

Please do not hesitate to call if you have any questions.

Very truly yours,

Steven M. Harding
President and CEO

641 Grooms Road Suite 234 Clifton Park New York 12065 518.399.6301

Attachment 2

MANAGEMENT AUDIT OF THE

LOS ANGELES CITY EMPLOYEES' RETIREMENT SYSTEM

(LACERS)

INTERIM REPORT
May 16, 2013

Pensions to Excellence

P2E Consulting Group, LLC
641 Grooms Road, Suite 234
Clifton Park, NY 12065
www.p2eco.com

INTERIM REPORT - TABLE OF CONTENTS

A. EXECUTIVE SUMMARY

Introduction

The Los Angeles City Employees' Retirement System ("LACERS" and "the System") was established through the Los Angeles City Charter. The City Charter grants authority to the LACERS Board of Administration, General Manager, and staff to administer the System. The City Charter requires that a management audit of LACERS be completed every five years, the broad objectives of which are to examine whether the System is operating in the most efficient and economical manner, and to evaluate the asset allocation of the System. A committee comprised of representatives of the Mayor, the City Council, and the City Controller (the "Joint Administrators") hired P2E Consulting Group, LLC ("P2E Consulting") to perform the management audit. P2E Consulting hired Cortex Applied Research as a key independent sub-contractor on the audit. The period covered by the management audit includes the fiscal years 2008 – 2012 ("the Review Period"). The City pays for the full cost of the management audit.

As the plan sponsor of LACERS, the City has a strong interest in ensuring the effective administration of the System on behalf of its residents and taxpayers. This management audit is one of several mechanisms designed to allow the City to monitor LACERS. This Interim report focuses on certain priority questions identified by the Joint Administrators:

1. Whether the administration of LACERS resulted in minimizing City contributions? (RFP Objectives 2, 4A, 4B, and 12E)
2. Whether LACERS had adequately evaluated the ongoing costs and benefits associated with participation in actively managed funds as compared to passively managed funds? (RFP Objective 8)
3. Whether investment manager performance was adequately reviewed and monitored? (RFP Objectives 6D and 6E)

The above priority questions represent only a few of the objectives included in the scope of the audit. The remaining objectives will be addressed in our final report, as well as a review of the status of the recommendations from the prior Management Audit. Appendix A lists the expected content of the final report.

<u>Minimization of City Contributions</u>

Reasonableness of Actuarial Assumptions

LACERS' economic assumptions concerning the actuarially assumed rate of return on investments (hereinafter the Assumed Investment Return) are generally comparable to those of the Project Peer Group. LACERS lowered its Assumed Investment Return from 8.0% to 7.75% near the end of the Review Period, to be phased in over 5 years. The previous 8.0% Assumed Investment Return was slightly higher relative to the Project Peer Group and lowering it to 7.75% was not unreasonable. Had LACERS lowered its Assumed Investment Return further so that it equalled the average of the Project Peer Group (of 7.6%), required City contributions may have been greater. [1]

The decision by the Board of Administration to implement the lower Assumed Investment Return over 5 years rather than immediately has had the effect of deferring increases in City contributions. Some of the systems in the Project Peer Group used comparable methods during the Review Period to delay contribution increases, while others were faster in implementing higher contributions.

LACERS' Assumed Investment Return, net of price and wage inflation, and assumed mortality rates were comparable to those of the Project Peer Group. These assumptions had no undue impact on City contributions. In fact, LACERS' approach to setting mortality assumptions may have resulted in deferring potential increases in City contributions, also.

Underperformance Compared to the Actuarially Assumed Rate of Return

LACERS' total fund return during the Review Period was substantially below LACERS' Assumed Investment Return. This underperformance translates into approximately $4.9 billion less than what the gains would have been had the Assumed Investment Return been achieved. Such a shortfall puts upward pressure on the contribution rate. It should be noted that approximately $4.6 billion (94.4%) of the underperformance can be attributed to the dramatic decline of the capital markets during the Review Period from late 2007 to early 2009, rather than to the manner in which the LACERS investment program was operated; only $278 million (or 5.6% of the total underperformance) can be attributed to the latter.

While the mandate of this audit is focused on a 5-year Review Period, we also considered fund performance relative to the Assumed Investment Return over a longer time frame. Over the past 10-year period, total fund return was 6.7%, or about 1.3% below the average Assumed Investment Return (the Assumed Investment Return was 8.0% over nine of the 10 years). This underperformance means that over a 10-year time horizon LACERS earned approximately $2.2 billion less than what it would have earned had it achieved the Assumed Investment Return.

Impact of Actuarial Smoothing of Investment Gains and Losses

LACERS' approach to setting the actuarial asset valuation method employed a longer period of smoothing (7 years) investment gains and losses than most of the Project Peer Group. This resulted in deferring the impact of the investment losses incurred during the Review Period to future contribution years. As of June 30, 2012 there remains $1.025 billion of investment losses that have yet to be recognized in the determination of required contributions. (This $1.025 billion represents part of the $4.9 billion shortfall referred to above.) The Board of Administration decision to use a 7 year smoothing period had the effect of reducing required contributions temporarily by deferring some of the losses during the economic downturn.

Administrative Expenses

LACERS' administrative expense was 19.56 basis points of average assets under management during the Review Period (where a basis point represents 1/100 of one percent). This is above the Project Peer Group average. Had LACERS been able to lower expenses to the same level as the Project Peer Group, its

[1] The level of required contributions is a matter that is determined by the Board in concert with its actuary. We are not an actuarial consulting firm and are not providing any actuarial opinion. Throughout this report the term "required contributions" means over the life of the fund generally.

total administrative expenses would have been reduced by approximately $5.7 million per year, or $28.5 million over the duration of the Review Period. LACERS' overall cost of administration per member was also higher than the Project Peer Group by approximately 42%.

The largest component of LACERS' administrative costs relates to personnel which is mostly a fixed cost in the short run. Therefore, any reasonable reduction of administrative expenses would have minimal impact on City contributions. Personnel cost includes salaries and all related benefit costs. It comprises approximately 72% of the total administrative expense and is the largest cost at virtually all pension funds (with the exception of investment management fees). Several factors may explain why LACERS personnel cost is greater than the Project Peer Group. These include negotiated increases in salaries and wage rates, 'thawing' of the freeze on step advances, in-house data processing personnel expense, in-house pension payroll processing personnel, personnel required to support of retirement initiatives, and personnel required to administer health benefits.

Consideration of Cost and Benefits Associated With Active Management

Results of Active Management

LACERS' active management program has had mixed results. Over the 5-year period ending June 30, 2012, active management at the total fund level underperformed its passive policy benchmark by 0.6% or approximately $160 million. Viewed over a 10-year period active management matched its benchmark, net of fees.

The results of active management varied across LACERS' portfolios. Active management efforts were successful in fixed income and private equity, but unsuccessful in U.S. and Non-U.S. equity and real estate (over both the 5- and 10-year periods). LACERS' Corporate Governance Program, Opportunistic Fixed Income Program, and Emerging Manager Fund-of-fund Program have also been sources of active management underperformance.

Costs and Savings

In fiscal year 2011-12, LACERS incurred $20.8 million in investment management fees for its public market portfolios, using a combination of active and passive management strategies. Had the portfolios instead been managed on a fully passive basis (i.e. a less expensive approach), fees would have been only about $3.8 million. If, during the year, none of LACERS' active managers had generated gross excess returns, then the fully passive approach would have better served the fund to the tune of approximately $17 million (i.e., equal to the difference in fees between the fully passive approach and LACERS' actual approach).

If we extrapolate such savings over the entire five years of the Review Period, total estimated fee savings would have been approximately $85 million (i.e., 5 times $17 million). In reality, however, LACERS' active managers, in the aggregate, did generate excess returns, gross of fees, during the Review Period. The potential fee savings of $85 million therefore must be reduced by these excess returns to determine what the net impact of using a fully passive management approach would have been. Such calculation indicates that LACERS would have been better off by an estimated net amount of $21 million over the Review Period, had it used a fully passive management approach.

We propose the following recommendations concerning active management:

1. LACERS should conduct a comprehensive review of its active management program. At a minimum, such a review should consider:

   a. Investment theory and research.
   b. The direct costs of active management (i.e. manager fees)
   c. The indirect costs of active management (e.g. the time and expense of the Board, staff, and consultants).
   d. The mission and objectives stated in LACERS' investment policy.
   e. LACERS' own past performance in active management in different asset classes (e.g. LACERS' active management program has consistently performed well in certain asset classes, but underperformed in others).
   f. LACERS' organizational resources, constraints, and core competencies.

   The objective of the above review should be to ensure that LACERS has taken all relevant factors into consideration when determining the amount of active management to be pursued, and not to focus solely on the historical performance of the broad universe of active managers. Any reduction in active management would free up resources that could be redirected to the asset allocation and risk management activities, which are likely to have a more significant impact on the risk and return of a fund.

2. LACERS has attempted to address active management underperformance by tightening its policies concerning the monitoring of investment managers, which has resulted in the termination of a number of managers. However, the Emerging Manager Fund-of-funds Program (which consists of three funds –of-funds managers) has underperformed its benchmarks on a rather consistent basis since its inception, albeit by a relatively small amount. These fund-of-funds managers however continue to be retained by LACERS.

   In February 2012, LACERS established an Emerging Manager Policy, which we believe sets out reasonable objectives and criteria pertaining to the selection of emerging managers. We are not aware of any formal policy that existed prior to that time that guided the Emerging Manager Fund-of-funds Program.

   Given the performance of the Emerging Manager Fund-of-funds Program and the newly established Emerging Manager Policy, we recommend that the Board review the Emerging Manager Fund-of-funds Program in light of:

   a. the objectives set out in the recently established Emerging Manager Policy;
   b. the performance of the Emerging Manager Fund-of-funds Program since its inception; and
   c. the Board's fiduciary duty to prudently manage the assets of the System in the sole best interests of the beneficiaries of the System.

   If, based on the above review, LACERS determines that the Emerging Manager Fund-of-funds Program does not adequately support the objectives set out in the Emerging Manager Policy, it should either terminate the Program and the underlying managers, modify the Program, or revise the Emerging Manager Policy.

Review of Investment Manager Selection and Termination Policies and Practices

Changes in Manager Selection and Termination Practices

Since 2011, LACERS has made a concerted effort to strengthen its manager selection and termination practices. This is best evidenced by the fact that LACERS established two new policies addressing these areas. We found the two new policies to be clear and comprehensive, and consistent with best practice. The policies and criteria are at least as detailed and comprehensive as policies we reviewed within the Project Peer Group.

The impact of the newly established policies was evident in our review of LACERS' manager monitoring and termination practices during the Review Period. Prior to establishing its Manager Monitoring Policy in July 2011, LACERS had not terminated any underperforming managers, despite having placed 10 managers on its watch list. In just the 18 months following the adoption of the Manager Monitoring Policy, LACERS terminated nine underperforming managers, five of which were on the watch list.

We propose the following recommendation concerning manager selection:

1. LACERS should update Section V.(C) of its Investment Policy Statement to reflect the more stringent requirements contained in section IV of the newly established Manager Search and Selection Policy.

Project Peer Group

A peer group of public retirement funds (hereinafter the Project Peer Group) was established in consultation with the Joint Administrators, LACERS, and the auditors for the Los Angeles Fire and Police Pensions (LAFPP) management audit occurring simultaneously. The Project Peer Group consists of the LAFPP and eight other comparable funds. See Appendix C for a complete list of the funds.

Some of LACERS' Notable Accomplishments

During the review we became aware of several relevant areas of accomplishment at LACERS. The cost of its new office space resulted in reducing occupancy expense and actual occupancy expenses incurred are trending at the projected amount. The office move was performed efficiently and effectively from a process and cost perspective and staff morale is at a high level.

LACERS was successful at obtaining exempt status for the Chief Investment Officer and its new Chief Auditor. In addition, LACERS was successful at upgrading the CIO position. The office space and the success in achieving position upgrades will help LACERS continue to attract and retain skilled staff and provide excellent service to its plan members. In fact, LACERS staff has a significant amount of experience at their jobs and have been, or are being, cross-trained making them extremely valuable. Staff turnover is low and this also helps to provide quality service.

While we will discuss the implementation of the prior management audit recommendations in the final report, we can say that LACERS put significant effort into implementing them, based on our preliminary review and many other accomplishments were developed from that work.

LACERS administrative staff does a thorough job of reviewing published City activities for the LACERS executive team in order to keep them up to date on items they may be tasked with in response to the needs of the Mayor, City Council, Controller, CAO, etc. In other words, LACERS is much attuned to actions by the City that affect City employees and retirement.

LACERS has put a lot of effort into determining what is the best process for strategic planning and how best to operate it and monitor progress toward the achievement of objectives. We think LACERS process of strategic planning is exemplary among public funds. We will discuss strategic planning and long-term planning in the final report.

Acknowledgements

Lastly, we want to comment on the superlative attitude and cooperation of every person at LACERS who helped us and with whom we had interaction. The Board, General Manager, and staff were warmly welcoming, extremely responsive and genuinely cooperative. We particularly want to thank Commissioner Chick for his remarks at the Entrance Conference; Commissioner Rogers for his candor; General Manager Thomas Moutes, who extended the System's hospitality; and our primary contact person, Ms. Angela Berumen, for attending cheerfully to all of our needs and requests for numerous documents in a most timely fashion.

B. DETAILED DISCUSSION AND ANALYSIS

This section provides more detail supporting the Executive Summary. Each of the three topics begins with a summary of observations followed by discussion and analysis.

I. MINIMIZATION OF CITY CONTRIBUTIONS

The City directed us to determine whether the administration of LACERS resulted in minimizing City contributions.

Summary Observations

A. LACERS' economic assumptions concerning the Assumed Investment Return are generally comparable to those of the Project Peer Group. LACERS lowered its Assumed Investment Return from 8.0% to 7.75% near the end of the Review Period, to be phased in over 5 years; the reduction will have the effect of increasing required City contributions starting in fiscal year 2013. The previous 8.0% Assumed Investment Return was slightly higher than the Project Peer Group average and lowering it to 7.75% was not unreasonable. The average Assumed Investment Return for the Project Peer Group is in fact lower (i.e., 7.60%). Had LACERS lowered its Assumed Investment Return further so that it equaled the average of the Project Peer Group, it may have resulted in even higher required City contributions. (Please see footnote 1 above.)

   The 5-year implementation of the lower Assumed Investment Return has the effect of deferring the potential increases in City contributions. Some of the systems in the Project Peer Group used comparable methods during the Review Period to delay contribution increases, while others were faster in implementing higher contributions. To the extent that required contributions are delayed, the investment earnings on these contributions are foregone, which will result in an increase in overall required contributions and/or investment earnings (i.e., pay later but pay more).

B. LACERS' total fund return during the Review Period was substantially below LACERS' Assumed Investment Return. This underperformance translates into approximately $4.9 billion less than what the gains would have been had the Assumed Investment Return been achieved. Such underperformance puts upward pressure on the contribution rate. Approximately $4.64 billion (94.4%) of the underperformance can be attributed to the dramatic decline of the capital markets during the Review Period from late 2007 to early 2009, rather than to the manner in which the LACERS investment program was operated. Approximately $278 million (5.6%) of the $4.9 billion underperformance can be attributed to the manner in which LACERS operated its investment program.

   While the mandate of this audit is focused on a 5-year Review Period, we also considered fund performance relative to the Assumed Investment Return over a longer time frame. Over the past 10-year period, total fund return was 6.7%, or about 1.3% below the average Assumed Investment Return (the Assumed Investment Return was 8.0% over nine of the 10 years). This underperformance means that over a 10-year time horizon LACERS earned approximately $2.2 billion less than what it would have earned had it achieved the Assumed Investment Return.

C. LACERS' approach to setting and implementing actuarial assumptions and methods that determine contribution requirements had varied impacts when compared to the Project Peer Group:

   i. Assumed investment returns net of price and wage inflation and assumed mortality rates were comparable to those of the Project Peer Group, and such assumptions had no undue impact on City contributions. In fact, LACERS approach to setting mortality assumptions may have resulted in deferring increases in City contributions.

   ii. LACERS' approach to setting the actuarial asset valuation method employed a longer period of smoothing investment gains and losses than most of the Project Peer Group, which resulted in deferring the impact of the investment losses incurred during the Review Period to future contribution years. As of June 30, 2012 there remains $1.025 billion of investment losses that have yet to be recognized in the determination of required contributions.[2] This may also result in deferring possible increases in required City contributions. (Please see footnote 1 above.)

D. LACERS' total average administrative expense was 19.56 basis points of average assets under management during the Review Period (where a basis point represents 1/100 of one percent). This is above the Project Peer Group average. Had LACERS' expenses been at the same level as the Project Peer Group, its total administrative expenses would have been lower by approximately $5.7 million per year, or $28.5 million over the duration of the Review Period. LACERS' overall cost of administration per member was also higher than the Project Peer Group by approximately 42%.

E. The largest component of LACERS' administrative expense relates to personnel. Personnel cost includes salaries and all related benefit costs. Personnel cost comprises approximately 72% of the total administrative expense. Personnel cost is the largest cost at virtually all pension funds (with the exception of investment management fees). Several factors may explain why LACERS personnel cost is greater than the Project Peer Group. These include negotiated increases in salaries and wage rates, 'thawing' of the freeze on step advancement, in-house data processing expense, in-house pension payroll processing, support of a mandated government buy-back program, and administration of health benefits. While it may be argued that personnel costs are controllable in the long run, we believe that LACERS would need to simplify or streamline operations to do so.

Analytical Approach

In this section, we describe our approach to addressing the question of how the administration of LACERS impacted City contributions.

[2] Note, this $1.025 billion represents part of the $4.9 billion underperformance noted in B. above.

Under section 1106 of the Los Angeles City Charter, the Board of Administration has sole and exclusive responsibility to administer LACERS 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; (emphasis added) and
(3) to defray[3] the reasonable expenses of administering the system.

As background, City contributions in respect of LACERS are determined to varying degrees by the following factors:

1. The nature or value of the benefits offered (the more generous the benefits the greater the required City contributions);
2. The behaviour and experience of system participants and their beneficiaries, which impact the amounts of the benefits to be paid and the duration of the payments;
3. The investment earnings on the system assets (driven by capital markets and LACERS' investment decisions);
4. The expenses related to delivering the benefits (i.e. benefit administration costs);
5. Actuarial assumptions and methodologies; and
6. The timing of contributions into the fund.

Factors one through four determine the actual cost of LACERS' benefits, and LACERS only has control over some of these factors; i.e., it does not control the nature and the value of the benefits, plan member experience, or the performance of the capital markets. Factors five and six determine how the actual cost of LACERS's will be budgeted and paid over time. LACERS does have some control over these factors, subject to the law and actuarial standards.

Our review focused only on those factors over which LACERS has control.

We began by considering the appropriateness of LACERS' Assumed Investment Return[4] by comparing LACERS' assumption to those of the Project Peer Group and to other industry peers. We then compared LACERS' total fund return to the Assumed Investment Return and calculated the dollar value of fund's gain or loss relative to the Assumed Investment Return.

We also considered other actuarial assumptions and methods which are used in LACERS' annual actuarial valuations that had the potential to impact contribution requirements for the Review Period. In particular, we compared the following assumptions and decisions of LACERS to those of the Project Peer Group:

- assumptions for real rates of return relative to price inflation and wage inflation;
- mortality assumptions;
- the asset valuation smoothing method; and
- the timing of the implementation of any changes in actuarial assumptions.

In cases where LACERS's assumptions or decisions differed significantly from those of the Project Peer Group, we assessed whether such differences had an undue influence on City contributions. Lastly, we

[3] Defray means that LACERS bears or pays all or part of the costs.
[4] The Assumed Investment Return is the long-term rate of return the actuary assumes will be earned by the fund assets, and is used to discount the expected benefit payments for all active, inactive, and retired members of a system when determining funding requirements.

compared LACERS' administrative costs to those of the Project Peer Group to determine if they were reasonable and consistent with the Project Peer Group, and whether they may have had a negative impact on City contributions.

Table 1 shows the City's Annual Required Contribution (ARC) (Line 2) as determined by LACERS' and LAFPP's consulting actuarial firms. In each year of the Review Period, the City paid 100% of the ARC. The ARC is comprised of 1) the value of benefits earned by active employees (Normal Cost), and 2) amortization of the unfunded actuarial liability (UAL).

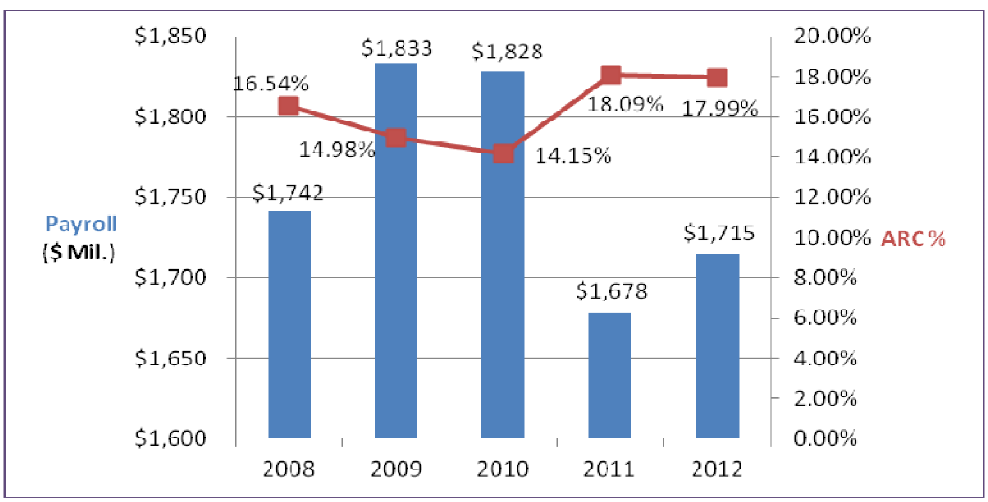
Table 1 – LACERS Contributions from the City and Employees - Relationships

		1	2	3	4	5	LACERS	Peer Group	LAFPP
	Dollars in $Millions	6/30/08	6/30/09	6/30/10	6/30/11	6/30/12	5 Yr. Avg.	5 Yr. Avg.	5 Yr. Avg.
1	Covered Member Payroll	$1,742	$1,833	$1,828	$1,678	$1,715	$1,759		$1,321^
2	Annual Required Employer Contribution	$288.12	$274.56	$258.64	$303.56	$308.54	$286.68	$286.5*	$269.91
3	Contributions Paid by Employees	$114.68	$118.59	$126.96	$114.73	$178.25	$130.64	$135.08	$106.77
4	Total Contributions Paid**	$417.49	$407.11	$393.20	$421.47	$486.96	$425.24	$421.56	$376.68
5	Employee Contributions % Payroll***	Various	6.00%	6.00%	6% or 8%	7%, 9% or 11%			6% to 9%
6	Total Contributions Paid as a % of Pension Liability	3.73%	3.38%	3.12%	3.15%	3.38%	3.34%	2.91%	2.40%

*Figure for Project Peer Group is average total employer contributions; average ARC was not calculated.
** Includes additional contributions from the City and refunds of contributions.
***Percentages are estimates and vary by years of service and tier. ^LAFPP payroll is the average of the actuarial estimate.

Despite the early retirement incentive and other initiatives the City's 5-year average payroll (Line 1) is above what it was in 2008. City-wide payroll for LACERS members is outside the control of LACERS. Line 6 is included because it provides a more relevant size comparison of contributions than do raw dollars.

Chart 1. Trend of Covered Payroll and ARC %[5]



[5] The ARC is the Annual Required Contribution, initially determined as a dollar amount. The ARC is converted into a % of payroll to allocate it to department budgets. ARC% obtained from LACERS' Comprehensive Annual Financial Reports (CAFRs).

Analysis

Given the above background, we assess the potential impact LACERS has had on City contributions in the next sections.

A) Impact of Investment Returns

Assumed Investment Return

The Assumed Investment Return is one of the most significant valuation assumptions. To the extent that system assets earn a rate of return that is less than the Assumed Investment Return, contribution rates may need to increase to cover the shortfall. (Similarly, investment earnings that exceed the Assumed Investment Return may result in a reduction in required contributions).

One half of the Project Peer Group used an Assumed Investment Return of 7.0% to 7.5% per year. The other used an Assumed Investment Return of 7.75% or 8.0% per year. The Assumed Investment Return used by LACERS was 8.0% at the start of the Review Period, and was then lowered to 7.75% at the end of the Review Period.[6]

However, the 8% assumption was slightly higher relative to the current average rate among the Project Peer Group. By reducing the assumption to 7.75%, LACERS' assumption is still above the Project Peer Group's average return assumption and therefore results in lower City contributions than would be required if the mean Assumed Investment Return of 7.6% had been adopted. The reduction was also consistent with the move by other Project Peer Group funds to lower their Assumed Investment Return assumptions during the Review Period (all but two lowered the assumption during the Review Period and one of those was already at 7.5%).

Additional industry data also suggests that LACERS' Assumed Investment Return is comparable to those of other US pension plans. A 2013 Public Fund Survey sponsored by NASRA[7] and NCTR[8] of 126 public funds showed a median Assumed Investment Return of 7.9%, and an average Assumed Investment Return of 7.77%.[9] (The distribution of the assumed investment returns is shown in Chart 1 below). LACERS' Assumed Investment Return for the same time period (7.75%) was slightly lower than the industry average and the median.

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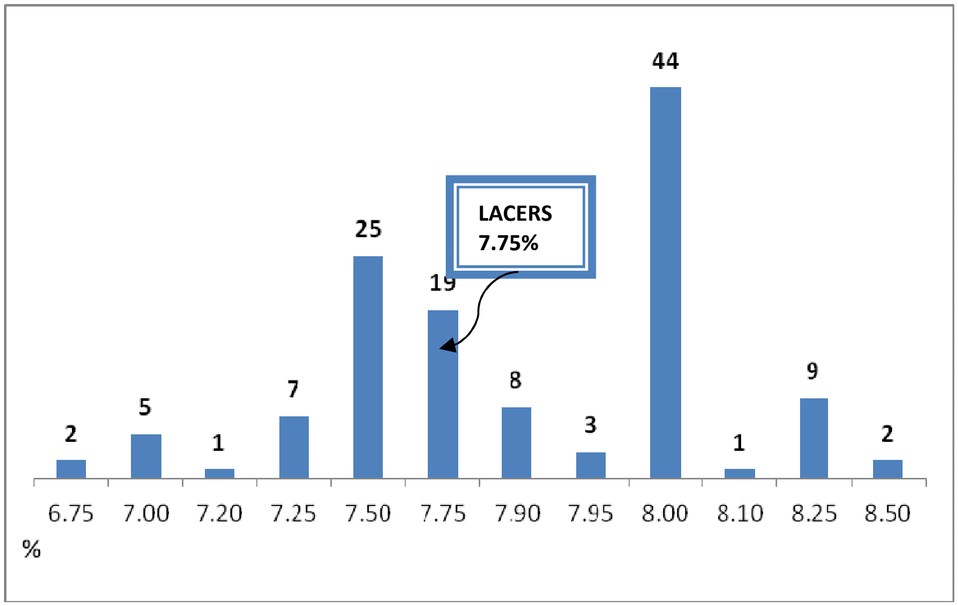
[6] The Board of Administration approved a reduction in the Assumed Investment Return at its October 25, 2011 meeting from 8.0% to 7.75%, to be phased-in over five years starting fiscal year 2012-13. The impact of this change in the assumption had been estimated to increase City contributions by $22 million for fiscal year 2012-13, but its impact did not take affect during the Review Period covered by this management audit due to the Board's decision to phase in the contributions over five years. (LACERS Board of Administration meeting minutes, October 25, 2011, page 3.)
[7] The National Association of State Retirement Administrators.
[8] The National Council on Teacher Retirement.
[9] These figures reflect the nominal assumption in use or announced for use as of March 2013.

Chart 2 - Distribution of Assumed Investment Returns (Public Fund Survey March 2013)



Source: NASRA Issue Brief: Public Pension Plan Assumed investment returns, March 2013.

Overall, when compared to peer practices, the Assumed Investment Return used in the LACERS actuarial valuations in fiscal years 2008 to 2012 are reasonable.[10] LACERS' choice of the Assumed Investment Return did not have an undue negative impact on City contributions.

Total Fund Return Relative to the Assumed Investment Return

LACERS' total fund return for the five years ending June 30, 2012 was 1.0%, net of fees.[11] The Assumed Investment Return was 8% for the first four years of this period and 7.75% for the last year of the period.[12] Thus, total fund return fell short of the Assumed Investment Return over this period. As will be further discussed in this section, this underperformance is primarily due to the performance of the capital markets and not to the administration of LACERS.

On the next page, Table 2 provides an estimate of the impact in dollar terms of LACERS' total fund return relative to the Assumed Investment Return for each of the five fiscal years of the Review Period, as well as the total impact over the entire five-year period. (For the detailed calculations used in Table 2, see Table D1 in Appendix D.)

[10] The reasonableness of the Assumed Investment Return based on other factors will be considered in our final report.
[11] LACERS Portfolio Performance Review, Quarter Ending June 30, 2012.
[12] LACERS Actuarial Valuation reports for each of the five fiscal years.

Table 2 - Total Fund Return vs. the Assumed Investment Return

	2007-08	2008-09	2009-10	2010-11	2011-12	Five-Year Period
Actual Performance						
Total Fund Return - Net of Fees	**-5.7%**	**-19.6%**	**12.7%**	**22.3%**	**0.9%**	**1.0%**
Total Fund Return/Income ($Billions)	**$-0.646**	**$-2.110**	**$1.067**	**$1.950**	**$0.083**	**$0.344 (A)**
Performance Assuming Total Fund Return Equaled the Assumed Investment Return						
Assumed Investment Return	**8%**	**8%**	**8%**	**8%**	**7.75%**	**7.95%**
Income Based on Assumed Investment Return ($Billions)	**$0.920**	**$0.990**	**$1.059**	**$1.128**	**$1.164**	**$5.261 (B)**
Total Fund Return Less Assumed Investment Return ($Billions)	**$-1.566**	**$-3.100**	**$0.008**	**$0.822**	**$-1.081**	**$-4.917**

Table 2 indicates the following:

i. Total fund return over the 5 years ending June 30, 2012 resulted in total investment income (net of all investment management fees and expenses) of only $344 million (see (A) in Table 2).[13]
ii. Had LACERS in fact earned the Assumed Investment Return, the total investment income over the 5 year period would have been approximately $5.3 billion (see (B) in Table 2).[14]
iii. By underperforming the Assumed Investment Return, the value of assets did not grow as planned and, all else being equal, significantly greater contributions will be required to increase or maintain funded status as a result.[15]

The above analysis does not suggest that LACERS' investment policy (specifically its asset allocation policy) was inappropriate. Nor does it indicate that had LACERS selected a different asset allocation policy, the negative pressure on City contributions could have been avoided. In fact, as Table 3 below illustrates, the primary reason LACERS underperformed its Assumed Investment Return was the poor performance of the capital markets in general, which was beyond LACERS' control (and which accounted for approximately $4.64 billion (or 94%) of the underperformance[16]).

[13] Investment income includes all interest, dividends, gain/loss on sales of assets, and any appreciation (depreciation) in the value of investments held at the end of the period, net of investment management fees. It thus shows in dollars the impact of the total fund return during the period.

[14] In order to isolate and measure the impact of total fund return, the analysis has assumed that contributions, benefit payments and expenses during the five years would remain the same. In fact, however, if total fund return had been equal to the Assumed Investment Return, the plan's funded position would have improved considerably over the period, and contributions would accordingly have been much lower.

[15] The correlation between actual investment performance and the amount of City contributions in any given year is not 100%. Other factors such as actuarial smoothing of gains and losses, amortization periods, and formulas for the calculation of the ARC also impact the calculation of the contribution amount.

[16] Calculated as follows: Total underperformance of $4.9 billion less amount due to investment decisions ($278 million), as calculated in Table 4.

Table 3 shows that the rates of return on all major asset classes over the 5 years ending June 30, 2012 were lower, in some cases significantly lower, than the 7.75% and 8% returns assumed by LACERS during the period.[17] In other words, even if LACERS had allocated, with the benefit of hindsight, all of its assets to the highest performing asset class over the last five years (i.e., U.S. fixed income) it still would have underperformed the Assumed Investment Return and put negative pressure on City contributions.

While the mandate of this audit is focused on a 5-year Review Period, we also considered fund performance relative to the Assumed Investment Return over a longer time frame. Over the past 10-year period, total fund return was 6.7%, or about 1.3% below the average Assumed Investment Return (the Assumed Investment Return was 8.0% over nine of the 10 years). This underperformance means that over a 10-year time horizon LACERS earned approximately $2.2 billion less than what it would have earned had it achieved the Assumed Investment Return.

Note that this Interim report does not address the appropriateness or reasonableness of LACERS' asset allocation policy or process. Such analysis will, however, be included in our final report.

Table 3 - Five-Year Performance of Asset Classes

Asset Class	Index	Rate of Return
U.S. Equities	Russell 3000 Index	**0.4%**
Non-U.S. Equities	Morgan Stanley All-Country Index (ex-US)	**-4.6%**
Emerging Market Equities	Morgan Stanley Emerging Markets Free Index	**-0.1%**
U.S. Fixed Income	Barclays U.S. Universal Index	**6.8%**
Real Estate	NCREIF Property Index	**2.9%**
Private Equity	Preqin Horizon IRRs – All Private Equity	**4.7%**
Hedge Funds	HFRI Fund Weighted Composite Index	**1.1%**
Commodities	S&P Goldman Sachs Commodities Index	**-5.5%**

Impact of Active Management & Asset Allocation

Table 4 describes LACERS' total fund return relative to its total fund policy return for each of the five fiscal years, as well as the total impact over the entire five-year period.[18]

[17] Sources: LACERS Portfolio Performance Review, Quarter Ending June 30, 2012; Preqin Private Equity Performance Benchmarks, As of June 2012, http://www.preqin.com/docs/reports/Overview_Benchmark_report_-_Q2_2012.pdf; Hedge Fund Research, https://www.hedgefundresearch.com/ ; S&P Dow Jones Indices, Market Attributes, Commodities, June 2012, http://www.spindices.com/documents/commentary/market-attributes-commodities-201206.pdf.

[18] The total fund policy return is a top-level aggregate benchmark comprised of the average of the returns on market indices or benchmarks for the various asset classes in which a pension fund is invested, weighted by the fund's asset allocation policy. It indicates the return LACERS would have earned, over any given period, if its actual allocation had accurately reflected its asset allocation policy and the various asset classes had earned the same returns as their respective benchmarks. Any difference between the actual total fund return and the total fund policy return can be attributed to either (a) deviation of LACERS' actual asset allocation from its policy target during the period, or (b) over- or underperformance by the investment managers relative to their benchmarks, or (c) a combination of (a) and (b).

Table 4 indicates that if LACERS had allocated its assets precisely in accordance with its asset allocation policy throughout the five years ending June 30, 2012, and had invested all of its assets passively (i.e., no active management), it would have earned an average annual return of 1.6% (see (A) in Table 4). Instead, LACERS' total fund return was 1.0% (net of fees) (see (B) in Table 4). The difference of 0.6% was due to a combination of not being fully invested in accordance with its asset allocation policy and the underperformance of its active investment managers. The bottom three rows of Table 4 describe the same findings in dollar terms.

Table 4 – Total Fund Performance vs. Total Fund Policy

	2007-08	2008-09	2009-10	2010-11	2011-12	5-Year Period
Total Fund Return (% Net of Fees)	-5.7%	-19.6%	12.7%	22.3%	0.9%	1.0%(B)
Asset Mix Policy Return (%)	-5.3%	-19.2%	12.5%	23.4%	2.2%	1.6%(A)
Difference	-0.4%	-0.4%	0.2%	-1.1%	-1.3%	-0.6%
Total Fund Return ($Billions)	$-0.646	$-2.110	$1.067	$1.950	$0.083	$0.344
Asset Mix Policy Return ($Billions)	$-0.601	$-2.071	$1.047	$2.042	$0.205	$0.622
Difference ($Billions)	$-0.045	$-0.039	$0.020	$-0.092	$-0.122	$-0.278

Some numbers rounded.

Effect of Active Management

Table 5 illustrates LACERS' investment performance across asset classes for the five year period ended June 30, 2012. The performance of the total fund underperformed the policy benchmark by 0.6% or $160 million over the five-year period. The total fund however was managed using a combination of active and passive approaches.

The U.S. and non-U.S. equity portfolios employed both active and passive management. Table 5a indicates that the passively managed portions of both portfolios experienced positive tracking error over the period relative to their respective benchmarks (i.e. the performance of the passive portfolios exceeded their benchmarks). Accordingly, the underperformance in the U.S. equities portfolio as a whole would have been worse, had it not been for the passively managed portion of the portfolio. Similarly, while the non-U.S. equities portfolio as a whole met its benchmark, it would have underperformed the benchmark had it not been for the passively managed portion of the non-U.S. equities portfolio.

The fixed income portfolio on the other hand is entirely actively managed and outperformed its benchmark by 0.7% over the period. The real estate and private equity portfolios can only be managed actively. The real estate portfolio underperformed its benchmark while the private equity portfolio outperformed.

Table 5 - Attribution of Under Performance by Asset Class and Total Fund

Portfolio / Investment Manager	5-Year Rate of Return (%)		5-year Excess Return (%)	Estimated Dollar Impact ($ Millions)
	Portfolio	Benchmark		
U.S. Equities	**-0.2**	**0.4**	**-0.6**	**-$130**
Non-US Equities	**-4.6**	**-4.6**	**0**	**0**
Fixed Income	**7.5**	**6.8**	**0.7**	**+$90**
Traditional Fixed Income	**7.9**	**6.8**	**1.1**	**+$120**
Opportunistic Fixed Income	**1.1**	**8.8**	**-7.7**	**-$30**
Real Estate	**-7.3**	**2.9**	**-10.2**	**-$240**
Private Equity	**6.8**	**4.4**	**2.4**	**+$120**
TOTAL FUND	**1.0**	**1.6**	**-0.6**	**-$160**

Table 5(a) – Performance of Passively Managed Assets for 5-Year Period Ended June 30, 2012.

Passively Managed / Indexed Portfolios	5-Year Rate of Return (%)		5-year Tracking Error (%)
	Portfolio	Benchmark	
U.S. Equities			
BlackRock Russell 1000 Value	**-2.1**	**-2.2**	**0.1**
Rhumbline Advisors S&P 500	**0.5**	**0.2**	**0.3**
BlackRock S&P 500 Index Plus	**11.8**	**11.5**	**0.3***
Non-US Equities			
State Street MSCI World ex US	**-5.1**	**-5.4**	**0.3**

* Since inception February 2010

We also examined investment performance over a longer time horizon, to see what effect that would have on our findings. Table 6 below provides 10-year performance data for the LACERS' active management program. Excess returns for the Total Fund over the 10-year period were nil, and therefore had no impact on City contributions. In this time period as well, the public equities and real estate asset classes under-performed their benchmarks.

Table 6 – Investment Performance Over 10 Years (FY 2003 – 2012)

Portfolio / Investment Manager	10-Year Rate of Return (Net of Fees) (%)		Excess Return (%)
	Portfolio	Benchmark	
U.S. Equities	**5.7**	**5.8**	**-0.1**
Non-U.S. Equities	**6.6**	**6.7**	**-0.1**
Fixed Income	**6.9**	**6.0**	**0.9**
Real Estate	**2.9**	**8.2**	**-5.3**
Private Equity	**11.8**	**9.8**	**2.0**
TOTAL FUND	**6.7**	**6.7**	**0**

B) Impact of Actuarial Valuation Assumptions, Methods, and Implementation

This section considers the potential impact of LACERS' decisions concerning actuarial matters on required City contributions. In particular, we have focused on the assumed rates of investment return over price inflation and wage inflation, mortality rate assumptions, the asset valuation method employed, and decisions concerning the implementation of changes in the assumed investment return.

Assumed Investment Returns Over Price and Wage Inflation

Actuarial assumptions are used in a system's actuarial valuation to estimate the present value of liabilities and assets which, in turn, are used to determine current funding requirements. If actual experience turns out to be less (or more) favorable than what was assumed, experience losses (or gains) emerge, which could affect contributions in future years. In the case of the assumed rates of investment return over wage and price inflation, if assumed rates are increased, the required contributions will decrease, as more of the costs of the system are assumed to be provided through investment returns. Alternatively, if the assumed rates of return are decreased, the required contributions will increase.

Because a portion of the salary-increase assumption is related to merit and service recognition – and therefore specific to a system's demographics –focusing on the investment return assumption over wage inflation assumption allows for more meaningful peer comparisons.

Assumed wage inflation and assumed price inflation, and LACERS assumptions concerning both, are described further below:

- **Assumed Wage Inflation:** The wage inflation component of assumed future increases in salaries reflects the assumed overall return on labor in the economy. It is separate from the component for promotion and longevity (merit) which is usually age and/or service related and is unique to a retirement system. The wage inflation assumption is the same for all members, and is normally determined as a percentage (typically 0%-1%) above price inflation.

Again, because it is not unique to a retirement system, one would expect the range of wage inflation assumptions for the Project Peer Group to be narrow. Indeed, a wage inflation assumption of 3.75% to 4.25% per year was used for all but two of the systems.

- **Assumed Price Inflation:** The assumed price inflation is a component for both the wage inflation and Assumed Investment Returns, and is normally used in determining the benefit cost-of-living adjustment assumption. It should be consistently applied throughout the economic assumptions used in the valuation. As it is not unique to a retirement system, one would expect the range of price inflation assumptions for the Project Peer Group to be quite narrow, which it was. A price assumption of 3.25% or 3.50% per year was used in the most recent actuarial valuation for all but two of the systems.

While there are other assumptions that are used in preparing the actuarial valuation, those assumptions are considered less material, or are plan-specific and thus not comparable among the Project Peer Group members.[19]

Table 7 provides a summary of how LACERS' real return net of price and wage inflation assumptions compare to those of the Project Peer Group:

Table 7 – Summary of Real Return Net of Price and Wage Inflation Assumptions

Assumption	Peer Group Assumption for the Most Recent Actuarial Valuation[20]	LACERS
Assumed Investment Return over Wage Inflation	3.25% low 3.50% median (used by 40% of Project Peer Group) 4.00% high	3.50%
Assumed Investment Return over Price Inflation	4.00% low 4.25% median (used by 50% of Project Peer Group) 5.00% high	4.25%

The above table indicates that with respect to the Assumed Investment Return over wage inflation and price inflation, LACERS' assumptions were equal to the median of the Project Peer Group.

Mortality Assumptions

Mortality assumptions are used to estimate the value of death benefits for members before and after retirement, as well as to estimate the number of pension payments members will receive in retirement. In recent years, recognition of increased longevity and its impact on the cost of pension systems have received world-wide attention, and most systems have reviewed their mortality

[19] Other assumptions (e.g., rates of retirement, disability and turnover, merit and seniority pay increases, covered population growth) are developed in accordance with the benefits and membership characteristics and behaviors specific to each system, and are reviewed and updated periodically in actuarial valuations and experience studies.

[20] Assumptions from the June 30, 2012 actuarial valuation for seven of the ten systems, June 30, 2011 for two of the systems. One set of assumptions was recently approved for a system's December 31, 2012 actuarial valuation.

assumptions in light of recent experience within their system as well as anticipated future improvements in longevity.

We found that LACERS' mortality rate assumptions were generally consistent with those of the Project Peer Group. All of the Project Peer Group funds base their mortality assumptions on recent experience studies. All but one system have selected mortality assumptions based on the published RP2000 Mortality Tables (healthy and disabled, sex-distinct or combined), with variations to reflect system-specific demographics and experience.[21] Three of the nine systems have adjusted the tables for projected longevity improvements, while recent experience studies for the remaining six systems have indicated sufficient room for future longevity improvements without adjusting the current tables. The mortality assumption tables for the LACERS valuation do not include projected longevity improvements. Including projected longevity improvements would have had the effect of increasing the required City contributions.

Asset Valuation Method

When determining the contribution requirements in an actuarial valuation, the funding status of the plan compares the accrued actuarial liabilities to the actuarial value of assets. There are a range of methods that can be used to determine the actuarial value of assets, including methods based on the current market value of assets, adjusted book value of assets (which excludes all or a portion of unrecognized investment gains and losses), or a smoothed asset value which delays recognition of realized and unrealized investment gains and losses over a period of years.

Due to the significant volatility in investment returns during the Review Period, especially the investment losses experienced during the fiscal year ending June 2009, we included the asset valuation method in our Project Peer Group comparison.

The method for determining the actuarial value of assets for three of the ten plans (including LACERS) used a 7-year smoothing period to recognize investment gains and losses. The most commonly-used asset valuation method was a 5-year smoothing period, which meant that most of the large investment losses from fiscal 2009 had been recognized in the most recent valuation. This method was used by four plans. The remaining three plans used an asset valuation method which had fully recognized the fiscal 2009 investment losses in the most recent valuation. The net impact of the LACERS 7-year asset smoothing method (adopted for the June 30, 2010 actuarial valuation; previous valuations used a 5-year smoothing period) in the June 30, 2012 actuarial valuation is a deferred asset loss of $1.025 billion which has yet to be recognized in LACERS' funding requirements, and which could lead to higher required contributions in later years.[22]

Implementation of Contribution Rate Changes Pursuant to Actuarial Valuations

The Board of Administration approved a reduction in the assumed investment return at its October 25, 2011 meeting from 8.0% to 7.75%, to be phased-in over five years starting fiscal year

[21] One system used the 1994 Group Annuity Mortality table with adjustments, based on recent reviews of their plan's experience and demographic characteristics and projections.

[22] This loss of $1.025 is included in the $4.64 billion shortfall related to the Assumed Investment Return, as discussed earlier in this report.

2012-13. The impact of this change in the assumption was estimated to increase City contributions by $22 million for fiscal year 2012-13 (before the phased-in approach), but its impact did not take affect during the Review Period.[23] The phased-in approach adopted by the Board of Administration spread the impact to the City over the five year phase-in period.

Some of the systems in the Project Peer Group used comparable methods during the Review Period to delay contribution increases, while others were faster in implementing their higher contributions.

To the extent that required contributions are delayed, the investment earnings on these contributions are foregone, resulting in an increase in overall required contributions to the system (i.e., pay later but pay more).

C) Impact of Administrative Expenses on City Contributions

In assessing LACERS' administrative expenses and their impact on the level of City contributions, we gathered five years of expense data from each of the ten funds in the Project Peer Group. The primary source of the data was each fund's Combined Annual Financial report (CAFR). The data was assembled in a spreadsheet for analytical purposes. A portion of the spreadsheet is included at Appendix B and sections of the spreadsheet are included below in the body of the report. Where helpful, we also created charts from the data for inclusion.

We performed an analysis of administrative expenses. The analysis addresses the questions posed by the Joint Administrators to determine whether the expenses of administering LACERS have been defrayed properly, including expenses related to Board travel activities. This analysis also includes determining whether LACERS has opportunities to minimize administrative expenses by cost-sharing with the City or the City's other pension systems.

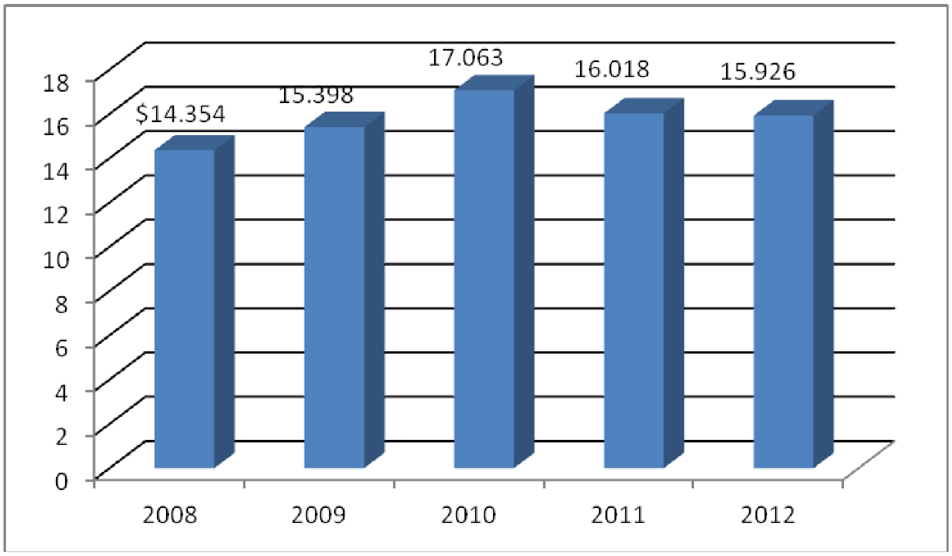
We also performed a more detailed analysis that considered, among other things, the extent and level of the components of administrative expense; the trend in expenses; the relationship of the expenses to the Project Peer Group; the relationship of LACERS' expenses to LAFPP; and various inter-relationships among costs and various causal factors such as asset size, membership size, staff size, to name a few of the drivers of cost.

Basic Administrative Cost Analysis

During the Review Period, LACERS' administrative expenses increased from $14.354 million in 2008 to $17.063 million in 2010 and then decreased to $15.926 million in 2012. This is depicted below in Chart 3.

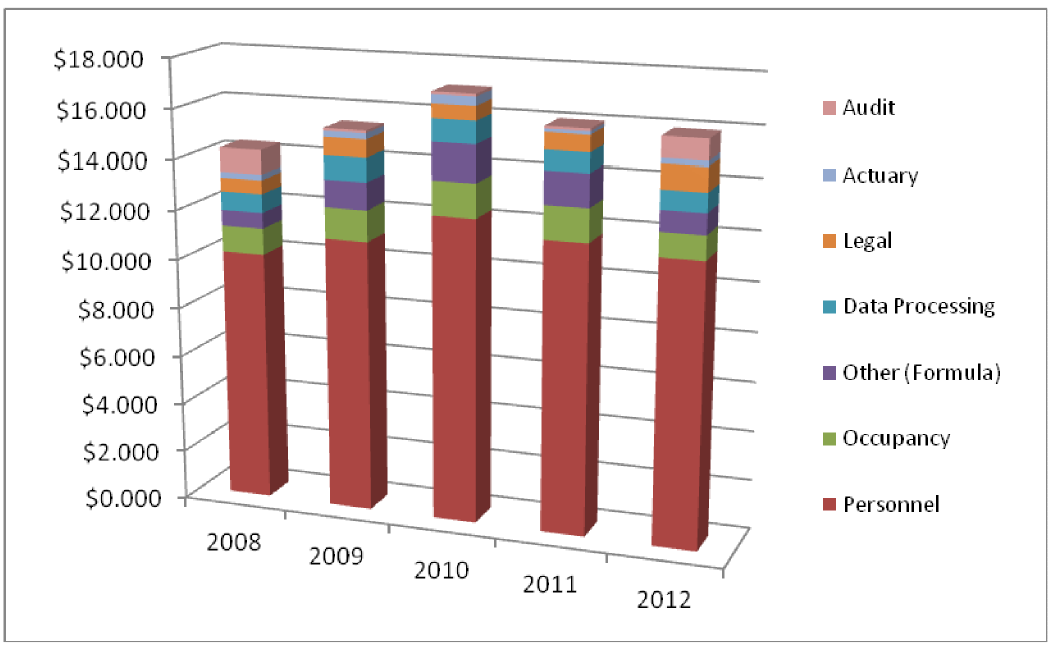
[23] LACERS Board of Administration meeting minutes, October 25, 2011, page 3. Earlier estimates had placed this figure at anywhere from $25 million to $40 million, but the estimate was reduced due to changes made to the other demographic assumptions by the Board of Commissioners in October 2011.

Chart 3 - LACERS Total Administrative Expense by Year ($Millions)



Overall administrative expense was driven largely by changes in personnel costs. This is depicted below.

Chart 4 - Components of LACERS Total Administrative Expense ($Millions)



The five year trends in actual expenses compared to the Project Peer Group and LAFPP are displayed in Table 8 on the next page.

Table 8 - LACERS Administrative Costs versus Peer Group – 5 Year Trend

Administrative Cost Component	6/30/2008	6/30/2009	6/30/2010	6/30/2011	6/30/2012	LACERS 5Yr Avg.	Peer Group 5Yr Avg.	LAFPP 5Yr Avg.
Personnel	$ 10.165	$ 11.038	$ 12.304	$ 11.710	$ 11.400	$11.323	$ 7.181	$9.523
Occupancy	1.062	1.262	1.363	1.338	0.969	1.199	0.679	0.929
Other	0.640	1.096	1.475	1.312	0.830	1.071	3.379	1.113
Data Processing	0.749	0.938	0.897	0.770	0.757	0.822	0.519	0.853
Legal	0.552	0.720	0.561	0.658	0.939	0.686	0.309	0.767
Actuarial	0.226	0.238	0.357	0.125	0.221	0.233	0.191	0.189
Audit	0.960	0.106	0.106	0.105	0.810	0.417	0.069	0.106
Total ($million)	**$ 14.354**	**$ 15.398**	**$ 17.063**	**$ 16.018**	**$ 15.926**	**$15.752**	**$ 12.328**	**$ 13.447**

LACERS' Total Administrative Expenses are, on average, higher than the Project Peer Group average by about 28%, and higher than LAFPP by about 20%. The most significant difference between LACERS and the Project Peer Group was personnel cost. LACERS' personnel costs on average ran 1.6 times the Project Peer Group average. One contributing anomaly to the level of LACERS' cost was the retiring of 2,500 employees as a result of ERIP[24]. The other expense components showed nominal differences, which are variable and not significant.

Other measures of expense and relationships are also informative:

Table 9 – LACERS Administrative Expense Relative to Assets Under Management and Number of Plan Members

Administrative Expense Analysis		1	2	3	4	5	LACERS	Peer Group	LAFPP
		6/30/08	6/30/09	6/30/10	6/30/11	6/30/12	5 Yr. Average	5 Yr. Average	5 Yr. Average
22	**Total Administrative Expense ($mil.)**	**$14.354**	**$15.398**	**$17.063**	**$16.018**	**$15.926**	**$15.752**	**$12.324**	**$13.447**
23	**Tot Admin. Expense/AUM(bps)**	**16.99**	**20.20**	**23.92**	**19.75**	**17.81**	**19.56**	**12.49**	**10.65**
24	**Tot Admin. Expense/Member**	**$290.07**	**$310.38**	**$349.27**	**$331.85**	**$332.15**	**$322.75**	**$229.21**	**$519.63**

Line numbers reference the complete table at Appendix B.

Table 9 shows the relationship of Total Administrative Expense to average Assets Under Management (AUM) in basis points (bps).[25] LACERS' average of19.56 bps during the Review Period is

[24] The Early Retirement Incentive Program in 2009.
[25] A basis point is 1/100 of 1%. At LACERS, the more significant cost driver is benefits administration personnel cost. The relationship of administrative costs to AUM is included because it is widely used. We have also included expense per member.

57% higher than the Project Peer Group average of 12.49 bps. Had LACERS' expenses been at the same level as the Project Peer Group its administrative expenses would have been lower by approximately $5.7 million or $28.5 million over the Review Period. LACERS' overall cost of administration per member was also higher than the Project Peer Group by approximately 42% but significantly lower than the LAFPP administrative cost per member.

The users of this report should keep in mind that differences in the types of plans, investment programs, benefits administered[26] , cost-of-living and compensation packages in different geographic areas are some of the key drivers of benefits required to attract and retain qualified staff, and that these vary greatly among any peer group.

LACERS' Personnel Costs (Compensation and Benefits) are Significantly Higher than the Peer Group

As identified above, the largest administrative cost at LACERS and for all of the Project Peer Group is personnel. The following analysis provides a comparison of those costs.

Table 10 – LACERS Personnel Costs

Administrative and Other Costs Analysis									
		1 6/30/2008	2 6/30/2009	3 6/30/2010	4 6/30/2011	5 6/30/2012	LACERS 5 Yr. Average	Peer Group 5 Yr. Average	LAFPP 5 Yr. Average
25	**Personnel Cost ($mil.)**	**$10.17**	**11.04**	**12.30**	**11.71**	**11.40**	**11.32**	**$7.18**	**$9.52**
26	**Personnel Cost per Plan Member**	**$205.42**	**222.50**	**251.86**	**242.60**	**237.76**	**232.03**	**$143.09**	**$367.97**
27	**# of Plan Employees**	**130**	**134**	**125**	**124**	**125**	**128**	**N/A**	**107**
28	**Avg. Employee Comp.**	**$78,192**	**$82,373**	**$98,432**	**$94,435**	**$91,200**	**$88,927**	**N/A**	**$88,998**
29	**Personnel % of Total Admin. Cost**	**70.8%**	**71.7%**	**72.1%**	**73.1%**	**71.6%**	**71.9%**	**58.3%**	**70.8%**

N/A – Information was not available.

Table 10 displays the trend in personnel costs at LACERS and the relationship to the Project Peer Group. The trend in the number of employees at LACERS was flat (130 to 128) during the Review Period. The table also shows the trend in average compensation and benefits per LACERS employee. While the number of employees was flat, their average compensation and benefits (Line 28) grew by about $13,000 or 17% over the five years. (It grew by about 20% at LAFPP over the same period.) However, relative to the Peer Group, LACERS' cost of compensation and benefit costs are about 1.6 times in cost per member ($232 per member versus $143 for the Project Peer Group average). The significance of personnel cost is also borne out in the percentage that personnel costs contribute to Total Administrative Expenses; 72% at LACERS versus 58% in the Project Peer Group. It appears that LACERS' employees on average receive a high level of compensation and benefits relative to its peers, with the *current level* (at June 30, 2012) of total annual compensation and benefits averaging $91,200 per employee. This compares to total current compensation and benefits per LAFPP employee of

[26] For example, half of the Project Peer Group did not administer a health benefit plan. This factor would tend to lower peer group administrative expenses.

$96,604. The average CPI[27] of the Los Angeles area was about 6% higher than the Project Peer Group. This would explain some of the higher personnel cost in Los Angeles. (Please see Appendix C.)

Personnel cost is the largest administrative expense at virtually all pension funds. Personnel cost includes salaries and all related benefits. Personnel cost comprises approximately 72% of the total administrative expense and is the largest cost, with the exception of investment management fees, at virtually all pension funds. (It comprises 71% of LAFPP's administrative costs.) Several factors may explain why LACERS personnel cost is higher than the Project Peer Group. These include negotiated increases in salaries and wage rates, 'thawing' of the freeze on step advancement, in-house data processing expense, in-house pension payroll processing, support of City retirement program mandates, and administration of health benefits. While it may be argued that personnel costs are controllable in the long run, we believe that LACERS would need to simplify or streamline operations to do so. Such operational changes could include more passive management, which may require less expense in terms of staff and outside monitoring services; and more efficient benefits administration systems which may result in fewer staff required to process benefits.[28]

Expenses Related to Board Travel and Education

Table 11 – LACERS Education and Related Travel

Education & Related Travel Expenses								
		1	2	3	4	5	LACERS	Peer Group
Line		6/30/08	6/30/09	6/30/10	6/30/11	6/30/12	5 Yr. Average	5 Yr. Average
-	Education and Related Travel	$108,878	$79,870	$68,882	$81,392	$63,918	$80,588	N/A

LACERS' expenses related to Board and other travel for meetings and education were nominal and reasonable based on our experience and as shown in Table 11. No information on board travel was obtainable from the Project Peer Group. The prior management audit made several extensive recommendations on Board travel and education, which the Board of Administration seriously considered and adopted through formal changes to its policies and procedures.

These include:

- A formal Board Education and Travel Policy which includes delegation of authority to the General Manager to certify and approve travel pursuant to Los Angeles Administrative Code (LAAC) Section 4.242.
- Limits on annual cost of travel for Commissioners
- Compulsory orientation program requirements for new Commissioners
- List of approved educational seminars and conferences with ratings
- Conference and training recommendations for new trustee education
- Detailed written reimbursement procedures and checklist
- An education evaluation form to be completed by a Commissioner

[27] U.S. Bureau of Labor Statistics. Five year average Consumer Price Index (CPI-U) for the relevant area.
[28] LACERS is in the midst of implementing a multi-year benefit system overhaul.

We find the travel policies and processes at LACERS to be comprehensive and that they were adopted formally by the Board of Administration.

Feasibility Consolidation of Services of Investment Consultants and Custodians

In the following section we evaluate the feasibility of consolidating services of investment consultants and custodians, and whether opportunities exist to minimize administrative expenses by cost-sharing with the City or the City's other pension systems.

LACERS has worked with LAFPP in ways to cut costs. LACERS and LAFPP continue to share resources when possible. LACERS' staff and staff from the two other City pension Departments communicate with each other when the need arises. Some cost and resource sharing continues between LACERS and LAFPP, e.g., shared City Attorney services and legal resources and sharing of the LACERS Board Room for LAFPP Board and Committee meetings. However, as far as we know, the efforts did not include the joint use of investment consultants or custodians. As separate legal entities, there is a need for separate contracts and the contracting processes of the two funds rarely parallel each other in terms of need, timing or other matters. Such joint efforts are doubtful to achieve much benefit under the circumstances, especially now that the funds are located in separate buildings. LACERS reported that no cost sharing efforts were attempted with the Los Angeles Water and Power Retirement Plans on disability and death benefits due to a general lack of similarities between the Departments on these particular issues.

The LACERS Board of Administration and its management team did a thorough job of considering the consolidation recommendations that were made in the prior management audit. Our final report will provide more detail on the status of this and other prior recommendations.

Feasibility of Common Custody

Historically, LACERS records $0 custody costs because of the common industry practice of sharing securities-lending revenue with the custody bank, and because of a legal settlement with the custody bank in LACERS' favor. LAFPP also records $0 in custody costs. The Systems have little incentive to reduce a cost that is already zero. We recognize 'there is no free lunch' in this business, but it is not uncommon for pension funds to incur artificially low custody costs when securities lending is involved.

In our opinion, it would be extremely difficult under the current arrangement to combine the custody contracts. Combined custody has been accomplished in other systems though. The state of Pennsylvania is one example. In Pennsylvania the State Treasurer is the named custodian and the Treasurer selects and hires the custody bank. At least in this case, economies of scale were achieved by bringing all of the state's pension (and other) assets under one custody umbrella. But, here again, the enabling feature is a statute that makes the consolidation feasible. We doubt that in the absence of a statutory requirement the separate boards of the Pennsylvania funds would have arrived at the same consolidated custody arrangement.

Feasibility of a Common Investment Consultant

Some economy of scale may be achieved if both systems were to hire the same general investment consultant. However, we believe the potential savings would likely be nominal because each plan would still require distinct services such as asset allocation and other services such as asset-liability studies, manager searches, due diligence, and selection, risk consulting and special services that are all driven by the requirement for separate and distinct asset allocations. These differences would continue if the systems remain legally separate. In our opinion, it would be impractical under the current arrangement to combine the consulting contracts.

Conclusion on Feasibility of Consolidation of Custody and Consulting Services

We believe that piece-meal consolidation of common expenses such as custody and investment consulting is not very practical in terms of significant cost savings and need. Since we deem it to be impractical, we feel it is also not very likely that the systems would be motivated to pursue it. Practicality and likelihood are both necessary to make the concept feasible. Therefore, our opinion is that it is not feasible under the current governance structure.

Conclusion on Administrative Expense Impact on City Contributions

As identified above, LACERS administrative expenses are higher on average than the Project Peer Group. The primary contributing factor is the level of personnel cost which is mostly fixed in the short run. Therefore, it is reasonable to expect that any *acceptable* reductions of personnel costs and other administrative expenses would have minimal impact on required City contributions in the short run.

Cost comparison is not an exact science. LACERS, LAFPP and the Project Peer Group have similar missions but very different benefit plans, tier structures, and member services that drive costs. The varying complexity of structures may explain why total administrative expense vary and, since personnel costs is the major component of administrative expense, local salary structures and benefit levels are also major drivers. We believe however that the Project Peer Group is representative of LACERS for purposes of comparing salaries, given that it includes five California funds and two additional funds in major metropolitan areas.

Our analysis attempts to make a subjective matter more objective; but decision making must weigh all of the qualitative factors as well as the quantitative. While we recognize that the City pension funds are large in absolute terms (> $10 billion), and that even the relatively 'small' costs represent hundreds of thousands of dollars, many of these administrative costs are less than one basis point of average assets. Legal, audit, custody and actuarial costs rarely exceed one basis point of total assets and all of these cost categories are necessary for the fund to operate.

There is not much manoeuvring room in terms of impacting required City contributions through lower administrative expenses. However, the concept of reducing administrative expenses to save contributions is not without merit; for *over the life of the fund*, every dollar that is saved becomes one more dollar available to reduce contributions. Finding the balance between efficiency and effectiveness is a worthy pursuit, and always a challenge.

II. CONSIDERATION OF COST AND BENEFITS ASSOCIATED WITH ACTIVE MANAGEMENT

The City directed us to assess the adequacy of LACERS' evaluation of the ongoing costs and benefits associated with participation in actively managed funds as compared to passively managed funds. The City recognizes that the need to both diversify investments and maximize return on investment are critical to LACERS; however, the City also understands there are significantly more costs associated with actively managed funds.

Summary Observations

A. LACERS's active management program has had mixed results:

i. Over the 5-year period of our review, the LACERS active management program at the total fund level underperformed its passive policy benchmark by 0.6% or $160 million. Viewed over a 10-year period, however, the active management program matched its benchmark, net of fees, and therefore had no impact on the funded status of LACERS or on City contributions.

ii. The success of active management has varied across LACERS' portfolios. LACERS' active management efforts have been successful in the following asset classes over both the last 5-year and 10-year periods:

- Fixed income
- Private equity

iii. LACERS' active management efforts have been unsuccessful over both the last 5 and 10 year periods in the following asset classes:

- U.S. equity
- Non-U.S. equity
- Real estate

B. LACERS' real estate portfolio has had the largest impact on the underperformance of LACERS' active management program. The real estate portfolio underperformed by 10.2% or $240 million over the Review Period.

C. Certain of LACERS' specialized investment programs have also been sources of active management underperformance. These programs consist of the Corporate Governance Program, the Opportunistic Fixed Income Program, and the Emerging Managers Fund-of-funds Program. These programs have underperformed their benchmarks by a combined total of approximately $90 million since their inception. This is a relatively large amount, considering these programs currently represent less than 10% of the Total Fund.

i. The Corporate Governance Program has underperformed by an estimated $55 million in the seven years since its inception.

ii. The Opportunistic Fixed Income Program underperformed by an estimated $30 million in the two plus years since its inception.

iii. The Emerging Managers Program represents a relatively small portion (5.5%) of the specialized program shortfall, having underperformed by approximately $5 million in the seven-plus years since its inception.

D. The fees LACERS incurred in connection with its active management program during the Review Period were significantly lower than the average of the Project Peer Group. LACERS' fees incurred in its public market portfolios (equities and fixed income[29]) were lower than the average public market fees incurred by the Project Peer Group, while the fees LACERS incurred in its real estate and private equity portfolios were higher than the average of the Project Peer Group. Incurring relatively higher fees in private equity should not be a concern, given that LACERS' net return in private equity has been positive over both 5-year and 10-year time frames. The relatively higher fees paid by LACERS in its real estate portfolio, on the other hand, increased underperformance in the real estate portfolio.

E. In fiscal year 2012, LACERS incurred $20.8 million in investment management fees for its public market portfolios, using a combination of active and passive management approaches. Had the portfolios instead been managed on a fully passive basis (i.e., a less expensive approach), fees would have been only about $3.8 million. If none of LACERS' active managers had generated gross excess returns then the fully passive approach would have performed better by approximately $17 million (i.e., equal to the difference in fees between the fully passive approach and LACERS' actual approach). Extrapolating such savings over the entire five years of the Review Period, the total potential fee savings would have been approximately $85 million (i.e. 5 times $17 million).[30] Because some active managers generated gross excess returns, the potential fee savings of $85 million is reduced by the excess returns to determine the net impact of full passive management, which would have improved performance by $21 million over the Review Period.

F. LACERS appears to have undertaken limited formal efforts at evaluating the cost and benefits of active management. The Board of Administration received a report on the use of active and passive management in the non-U.S. equity portfolio in 2007 from its general investment consultant. The report recommended the increase use of active management, but did not appear to factor in cost considerations as part of that review. LACERS also considered the issue of active and passive management for the total fund in 2012 as part of the risk budgeting project. The risk budgeting project however was narrow in scope and did not explicitly consider the direct and indirect costs associated with active management.

Analytical Approach

In assessing the adequacy of LACERS's evaluation of the ongoing costs and benefits associated with participation in actively managed funds, we undertook the following analysis:

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[29] "Public market" refers to the equities and fixed income portfolios, since the underlying securities of such portfolios are traded through a public exchange, or well-organized over-the-counter markets.

[30] We recognize this is a simplification, as the size of LACERS' public markets portfolios varied over the five year period. Such simplification however does not alter our general findings.

1. We determined the extent to which LACERS' assets are currently actively managed.
2. We reviewed LACERS' investment reports to determine the extent to which LACERS' actively managed portfolios have outperformed their passive market benchmarks.
3. We identified those segments of the portfolio in which active management has proved effective and ineffective.
4. We reviewed the costs of active management and compared them to the fees that are likely to be charged using passive management.
5. Finally, we reviewed minutes of meetings and various other documentation to determine if LACERS had undertaken any formal evaluations or analyses of the costs and benefits associated with active management. Also, during interviews with LACERS staff, board members, and advisors, we inquired as to whether such evaluations had occurred. We then reviewed all studies to assess the nature and extent of the evaluations.

Current Use of Active & Passive Management

Approximately 70% of the Total Fund was actively managed as of June 30, 2012. The 30% of the portfolio that is passively managed is in the US and non-US equity portfolios. Traditional fixed income investments are fully actively managed. By their very nature, real estate and private equity must be actively managed.[31]

Table 12 below provides an overview of the use of active and passive management for the total fund and for each asset class within the fund.

Table 12 – Overview of LACERS' Active & Passive Management Structure (June 30, 2012)

Asset Class	Assets ($Millions)	Percent of Total Fund	Actively Managed		Passively Managed	
			$Millions	%	$Millions	%
U.S. Equities	$4,126	38.8%	$1,578	38.2%	$2,548	61.8%
Non-US Equities	$1,829	17.2%	$1,210	66.2%	$619	33.8%
Fixed Income	$2,758	26.0%	$2,758	100%	-	-
Real Estate	$642	6.1%	$642	100%	-	-
Private Equity	$1,195	11.2%	$1,195	100%	-	-
TOTAL FUND	**$10,624**	**100%**	**$7,457**	**70.2%**	**$3,167**	**29.8%**

U.S. Equities

LACERS' US equity assets are invested in 14 portfolios managed by 13 investment managers as shown in Table 14 below. Close to 40% of the assets are actively managed; more than 60% are managed using passive or mainly passive strategies.

[31] These private market assets tend to be highly illiquid. Individual real estate properties and private companies are not widely owned, and do not trade on organized stocks exchanges or over-the-counter networks. Investments in such assets cannot be easily replicated through passive investment strategies.

There are two types of specialized investment programs within the equity class. One is a Corporate Governance Program with two investment managers[32] who manage concentrated portfolios that invest in stocks of small to mid-size public companies and take an activist position with company management and boards to unlock shareholder value through governance and operational initiatives. The other is an Emerging Managers Fund-of-funds Program with three managers whose primary distinguishing feature is that the firms are owned either by women or by minorities, have been founded fairly recently and have relatively few assets under management. The assets invested in these two programs comprise slightly over 5% of the total US equity portfolio.

The passively managed assets are in three portfolios managed by two different investment managers. Two of these portfolios are index funds, one benchmarked against the S&P 500 Index, the other against the Russell 1000 Value Index. One of the managers also manages the third portfolio which is the largest, and which is again benchmarked against the S&P 500 Index but has an "index plus" mandate.[33]

Non-U.S. Equities

LACERS' non-US equity assets are managed by eight investment managers. (Table 14) Approximately two-thirds of the assets are actively managed and one-third is passively managed.

The actively managed assets are invested in both developed markets in Europe and the Pacific region, as well as in the developing or emerging markets of Asia, Latin America and the rest of the world. There is also a portfolio with a corporate governance mandate, similar to the ones for US equity assets, but this one is focused on European companies.

The passively managed assets are in one index fund benchmarked against the Morgan Stanley Capital International (MSCI) World ex-US Index of developed markets, i.e. Europe, and the Pacific region, plus Canada. It excludes emerging markets.

Fixed Income

LACERS' fixed income assets are all actively managed by seven investment managers. (Table 14)

The substantial majority of these assets are invested in traditional fixed income securities such as U.S. government and corporate bonds with two different mandates. Most of the traditional fixed income investments are in broadly diversified or core portfolios. About 10% is invested in a portfolio of intermediate term bonds.

Slightly less than 3% of total fixed income assets are invested in opportunistic or high yield strategies, either (a) in securities of companies in some operating or financial difficulty and anticipating a turnaround, or which are temporarily undervalued due to some very unusual and specific situation; or (b) in other high-yield debt obligations.

[32] One manager, Blum Capital, was terminated in July 2012; assets were fully withdrawn by the end of September.
[33] An index plus strategy is designed to not only replicate the index but also to outperform it by a small margin. We classify it as passive management because it is driven mainly by operational issues related to index maintenance, rather than by investment considerations. The fees (zero base fee + 20% of alpha with an 8 basis points cap) is also far closer to a passive fee.

Real Estate & Private Equity

The LACERS real estate and private equity assets are all actively managed. They are typically invested in pooled or commingled closed-end funds under a limited liability partnership (LLP) structure. There are more than 50 LLPs in real estate and in excess of 80 LLPs in the private equity portfolio.

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Performance of LACERS Active Investment Management Program

Table 13 summarizes the results of LACERS' active management for the five years ending June 30, 2012, which corresponds to the Review Period. We have included greater detail, including the performance of the LACERS total fund, major asset classes, and all investment portfolios, both actively and passively managed. The table shows the rate of return on the portfolio and its respective benchmark, net of investment management fees, as well as the excess return over this period.

Table 13 – Investment Performance of Portfolios versus Benchmark

Portfolio / Investment Manager	Type of Portfolio	5-Yr Rate of Return (%)		Excess Return (%)	Dollar Impact ($Millions)
		Portfolio	Benchmark		
U.S. Equities		**-0.2**	**0.4**	**-0.6**	**-$130**
Aronson Johnson & Ortiz	Large Cap Value	**-1.8**	**-2.2**	**0.4**	
Thomson Horstmann	Small Cap	**0.1**	**0.5**	**-0.4**	
Franklin Advisers	Small Cap Growth	**2.1**	**2.0**	**0.1**	
Sit Investment	Small Cap Growth	**2.2**	**2.0**	**0.2**	
Donald Smith & Co.	Small Cap Value	**-1.5**	**-1.0**	**-0.5**	
PanAgora	Small Cap Value	**-1.8**	**-1.0**	**-0.8**	
Blum Capital	Corp. Governance	**1.6***	**5.9***	**-4.3***	
New Mountain	Corp. Governance	**3.1***	**0.2***	**2.9***	
Attucks	Emerging Mgr.	**-0.4**	**0.5**	**-0.9**	
Capital Prospects	Emerging Mgr.	**-0.7**	**0.4**	**-1.1**	
Progress Investment	Emerging Mgr.	**-1.8**	**0.4**	**-2.2**	
RhumbLine – S&P 500	Index Fund	**0.5**	**0.2**	**0.3**	
BlackRock – Russell 1000 Value	Index Fund	**-2.1**	**-2.2**	**0.1**	
BlackRock – S&P 500 Index	Index Plus	**11.8***	**11.5***	**0.3***	
Non-U.S. Equities		**-4.6**	**-4.6**	**0.0**	**$0**
Franklin Templeton	All Markets	**1.0**	**-2.9**	**3.9**	
Capital Guardian	Dev. Markets	**-6.3**	**-7.0**	**0.7**	
Daiwa SB Investments	Dev. Markets	**-4.8**	**-4.1**	**-0.7**	
TT International	Dev. Markets	**-7.7**	**-5.7**	**-2.0**	
Batterymarch Financial	Emerging Markets	**6.5***	**7.7***	**-1.2***	

Portfolio / Investment Manager	Type of Portfolio	5-Yr Rate of Return (%)		Excess Return (%)	Dollar Impact ($Millions)
		Portfolio	Benchmark		
The Boston Company	Emerging Markets	-0.7	-0.1	-0.6	
Knight Vinke	Corp. Governance	-14.9	10	-24.9	
State Street Global Advisors	Index Fund	-5.1	-5.4	0.3	
Fixed Income		7.5	6.8	0.7	+$90
LM Capital Group	Traditional	6.6	6.3	0.3	
Loomis, Sayles	Traditional	7.5	6.8	0.7	
Neuberger Berman	Traditional	8.6	6.8	1.8	
Baird Advisors	Traditional	6.4	6.0	0.4	
Highbridge Capital	Opportunistic	3.3*	6.0*	-2.7*	
Torchlight Investors	Opportunistic	-15.0*	7.3*	-22.3*	
Whippoorwill	Opportunistic	-16.2	8.1	-24.3	
Real Estate		-7.3	2.9	-10.2	-$240
Private Equity		6.8	4.4	2.4	+$120
TOTAL FUND		1.0	1.6	-0.6	-$160

* *For portfolios which have not been in existence for the full 5 -year period, the rate of return is since their inception date, and is shown above as gross of fees. This information was available gross of fees only.*

The bottom row of Table 13 indicates that the total assets of the LACERS fund earned a rate of return of 1% over the 5-year period, 0.6% a year less than the fund's asset mix policy benchmark. This translates into underperformance, from active management, of $160 million.

Table 13 also indicates that two asset classes experienced negative excess returns: U.S. equity and real estate. Below we provide additional information about the performance of each of these asset classes, in addition to the above described specialized investment programs.

Real Estate

The largest source of underperformance was the real estate portfolio, which underperformed by 10.2% a year versus its benchmark. According to our estimate, and based on the average value of assets in the portfolio over the 5 years, the underperformance of real estate amounted to approximately $240 million. Interviews with staff and the real estate consultant indicated the underperformance was due largely to allocations between 2003 and 2007 to opportunistic real estate. LACERS' focus on opportunistic real estate resulted in the composition of the LACERS' real estate portfolio differing significantly from the real estate benchmark. When the real estate market subsequently collapsed, LACERS' opportunistic and capital development real estate investments performed particularly poorly and in many cases have not recovered.

We were informed by LACERS staff and the current real estate consultant (Courtland Partners, which replaced the prior real estate consultant in 2008) that LACERS' is in the process of reducing the level of active risk relative to the real estate portfolio benchmark and results for the portfolio have begun to improve. However, substantially reducing the mismatch between LACERS' real estate portfolio and the real estate portfolio's benchmark will require more time. Furthermore, the impact of the under-performing investments made in the last decade will continue to serve as a drag on the portfolio's performance for at least several more years.

It should also be noted that pension funds invest in real estate for reasons other than simply returns (e.g. diversification and inflation protection); furthermore, as indicated earlier in our report, it is currently not possible to invest in real estate on a passive basis. We will research the real estate portfolio further to confirm the information provided to us by staff and the real estate consultant, and will update our findings in our final report.

U.S. Equity

The other major source of underperformance was in US equities, which lagged its benchmark by 0.6% a year, net of fees. Seven of the 11 actively managed portfolios underperformed their benchmarks. We estimate that the underperformance of the U.S. equity portfolio had a negative impact on the total fund of about $130 million over the 5-year period.

10 Year Performance

Table 14 summarizes the results of LACERS' active management program for the 10-year period ended December 31, 2012. Overall, the total fund generated no excess return from active management. Asset classes that underperformed their benchmarks include real estate (-5.3%), US equity, and non-US equities (both -0.1%).

Table 14 – LACERS' Investment Performance (net of fees) over 10 Years to June 30, 2012

Asset Class	10-Year Rate of Return (%)		Excess Return (%)
	Portfolio	Benchmark	
U.S. Equities	5.7	5.8	-0.1
Non-U.S. Equities	6.6	6.7	-0.1
Fixed Income	6.9	6.0	0.9
Real Estate	2.9	8.2	-5.3
Private Equity	11.8	9.8	2.0
TOTAL FUND	**6.7**	**6.7**	**0**

Corporate Governance, Opportunistic Fixed Income and Emerging Manager Fund-of-funds Programs

In assessing the sources of negative active performance in the LACERS' total fund, it is not enough to look at the performance of the broad asset classes alone, as LACERS' difficulties in active management have occurred in certain specialized investment programs within asset classes. These specialized investment programs include the Corporate Governance Program, the Opportunistic Fixed Income Program, and the Emerging Managers Fund-of-funds Program. While the assets invested in these programs have never been more than 5% of the total fund (and roughly 3% as of June 30, 2012), the performance, relative to their benchmarks, has been consistently and/or significantly negative since their inception.

The Corporate Governance Program underperformed by an estimated $55 million in the seven years since its inception. The Opportunistic Fixed Income Program may have too little history to evaluate fully, but it has underperformed by an estimated $30 million in the four-plus years since it started. The Emerging Managers Program underperformed by a relatively small amount, $5 million, in the six years since inception. Combined, these three specialized investment program have underperformed by approximately $90 million. The following sections contain additional detail about each of these programs. These figures do not reflect management fees, which would increase the underperformance.

Corporate Governance Program

The Corporate Governance Program was established in 2005 with an initial allocation of $150 million. Four investment managers were appointed in late 2005 and early 2006, one with a US mandate and three with non-US mandates. The program was expanded in size to $450 million in 2008 and two more investment managers were appointed with US mandates. The underlying rationale for the program was that by taking sizable positions in a few small to mid-cap companies, investment managers could engage directly with company management and boards to improve their governance and operations and in this way increase long-term shareholder value.

The performance of the Corporate Governance portfolios relative to their benchmarks, net of fees, for each fiscal year ending June 30 since their inception is shown in Table 15 below. The program has clearly underperformed and the periods of underperformance for each manager have been highlighted.

Table 15 – Performance of the Corporate Governance Program

Excess Return (Portfolio – Benchmark)	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	Since Inception
Blum Capital		-----		13.4%	-15.2%	-23.6%	-20.2%	-4.3%
New Mountain Capital	-----		4.6%	10.0%	6.6%	-16.0%	-2.5%	2.9%
Relational Investors	-4.8%	6.8%	-14.9%	-2.3%	-0.5%	10.6%	-4.7%	-3.2%
Hermes Focus Asset	-1.7%	11.9%	-19.3%	8.1%		-----		-0.9%
SPARX Asset	-6.0%	-1.5%	-27.7%	19.0%		-----		-6.2%
Knight Vinke	-----	-5.5%	7.4%	3.0%	-22.9%	-12.2%	-46.6%	-21.6%

Note: The rate of return since inception is reported gross of fees.

Based on the average assets in each portfolio over its lifetime and the rate of return since inception, the Corporate Governance Program has underperformed by approximately $55 million relative to its benchmark.

Opportunistic Fixed Income Program

The Opportunistic Fixed Income Program was established in September 2007 to take advantage of potential opportunities arising from the volatility and lack of liquidity in the bond market at that time. An initial allocation of $75 million was approved in two funds. One fund, to be managed by Oaktree, would invest in high yield bank debt in the form of senior secured loans that are being re-priced and restructured and may be available at a discount. The other, to be managed by ING Clarion, would invest in a variety of high yield real estate debt such as commercial mortgage-backed securities and mezzanine loans. In addition, a third fund, managed by Whippoorwill Associates, with an existing allocation of $10 million, invested in distressed debt as part of the LACERS private equity portfolio, was re-classified as fixed income, with a further allocation of $50 million.

Table 16 shows the performance of the Opportunistic Fixed Income portfolios relative to their benchmarks, net of fees, for each fiscal year ending June 30 since their inception. The periods of underperformance have been highlighted.

Table 16 – Performance of the Opportunistic Fixed Income Program

Excess Return (Portfolio – Benchmark)	2007-08	2008-09	2009-10	2010-11	2011-12	Since Inception
Highbridge Capital Management	n/a	n/a	n/a	-7.6%	2.4%	-2.7%
Oaktree	n/a	n/a	n/a	0.1%	-2.6%	-0.8%
ING Clarion / Torchlight	n/a	n/a	n/a	10.3%	-1.5%	-22.3%
Whippoorwill Associates	n/a	n/a	n/a	-7.5%	-68.4%	-18.0%
Total Portfolio	-4.5%	-13.8%	-22.9%	-5.4%	-2.3%	-7.7%

Note: The rate of return since inception is reported gross of fees. Performance of individual managers was not reported during the first three years of the program.

The Opportunistic Fixed Income Program has underperformed quite substantially over its lifetime. All four funds have produced negative excess returns versus their benchmarks. We estimate, based on the average assets in each portfolio over its lifetime and the rate of return since inception, the Program has underperformed by approximately $30 million relative to its benchmark.

Emerging Managers Fund-of-funds Program

The Emerging Managers Fund-of funds Program was also established in 2005 with an initial allocation of $100 million. Two managers were appointed in late 2005 and another manager in September 2006. All three firms were owned by women or minorities operating in a fund-of-funds structure in which the individual fund managers were also women or minority-owned firms.

On the next page, Table 17 shows the performance of the Emerging Manager portfolios relative to their benchmarks, net of fees, for each fiscal year ending June 30 since their inception. The periods of underperformance have been highlighted.

Table 17 – Performance of the Emerging Managers Fund-of funds Program

Excess Return (Portfolio – Benchmark)	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	Since Inception
Attucks	0.7%	5.2%	0.0%	-3.5%	1.1%	2.5%	-2.4%	-0.2%
Capital Prospects	-2.4%	0.0%	1.6%	-2.5%	-0.7%	1.8%	-3.0%	-0.6%
Progress Investment	----	0.2%	-1.1%	-0.4%	-1.8%	-1.2%	-5.3%	-1.4%

Note: The rate of return since inception is reported gross of fees.

All three emerging manager portfolios have underperformed their benchmarks since the inception of the program. Underperformance has been fairly consistent for two of three managers. We estimate that, based on the average assets in each portfolio over its lifetime and the rate of return since inception, the Emerging Managers Fund-of funds Program has underperformed by approximately $5 million relative to its benchmark.

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Assessment of LACERS' Active Management Fees

In this section we consider the fees associated with LACERS' actively managed assets compared to the fees that could be realized by investing passively. Table 18 below provides an overview.

Table 18 – LACERS' Investment Management Fees - Current Approach vs. an All-Passive Alternative Fiscal Year Ending June 30, 2012

	Fees Under Current LACERS Active/Passive Approach (FY 2012)		Estimated Fees Under a 100% Passive Approach (FY 2012)	
Asset Classes	($000)	(%)	($000)	(%)
US. Equities				
Large Capitalization Stocks				
Actively Managed	$1,979	0.209%	-	-
Passively Managed	$553	0.026%	$803	0.026%
Small Capitalization Stocks	$5,659	0.563%	$604	0.06%*
Other Small Cap Equities				
Emerging Managers	$671	0.599%	$67	0.06%*
Corporate Governance	$2,466	1.023%	$145	0.06%*
Subtotal for US Equities	**$11,328**	**0.467%**	**$1,619**	
Non-US Equities				
Developed Markets				
Actively Managed	$3,500	0.326%	-	-
Passively Managed	$161	0.027%	$448	0.027%
Corporate Governance	$194	0.388%	$13	0.027%
Emerging Markets	$1,984	0.640%	$310	0.10%*
Subtotal - Non US Equities	**$5,839**	**0.396%**	**$771**	
Fixed Income				
Traditional	$2,448	0.094%	$1,299	0.05%*
Opportunistic	$1,204	1.400%	$112	0.13%*
Subtotal - Fixed Income	**$3,652**	**0.136%**	**$1,411**	
TOTAL	**$20,819**	**0.313%**	**$3,801**	**0.042%**

* The passive management fee assumptions are based on fee schedules for equivalent institutional index funds provided by Vanguard to investors such as DC and 401(k) plans, less any associated 12-b-1 fees.

The two columns at the right of the table provide estimates of what it would have cost if the public market assets were all passively managed in index funds, keeping the same portfolio structure for US equities, non-US equities, and fixed income. According to our estimate, it would have cost approximately $3.8 million in investment management fees if all *public* market assets had been passively managed, compared to the actual cost of $20.8 million, for a net fee savings of $17.0 million for the 2011-12 fiscal year, or about $85 million over 5 years.[34] It is important to note, however, that although management fees would have been significantly lower under a fully passive approach, the actual financial impact on LACERS of a fully passive approach would have only been approximately $21 million. This is because LACERS's active managers, in the aggregate, generated excess returns gross of fees, which must be deducted from the $85 million difference in fees to arrive at the net impact on LACERS. This is further illustrated in Table 19 below.

Table 19 - Net Difference in Excess Returns: LACERS' Investment Strategy vs. a 100% Passive Strategy
Public Market Portfolios
Fiscal Years 2008-12

Approach to Managing LACERS's Public Markets Portfolios	Gross Excess Return (A)	Manager Fees (B)	Net Excess Returns (A-B)
Current (70% active management/30% passive)	**$64**	**$104**	**-$40**
100% Passive Management	**$0**	**$19**	**-$19**
Difference	**$64**	**$85**	**-$21**

All figures in $ Millions

Table 20 – Investment Management Fees: LACERS vs. Peer Group

Peer Group	**US Equity**	**Non-US Equity**	**Fixed Income**	**Real Estate**	**Private Equity**	**Total Fund**
	Investment Management Fees – Percent of Portfolio					
Idaho Public Employees	0.42%		0.14%	0.64%	0.71%	0.37%
Los Angeles Fire & Police	-----------	-----------	-----------	-----------	-----------	0.39%#
Ohio School Employees	0.35%	0.53%	0.22%	1.29%	1.58%	0.75%
Orange County Employees	0.60%	0.41%	0.22%	0.56%	-----------	0.35%
Sacramento County Employees	0.33%	0.36%	0.15%	0.62%	1.01%	0.43%
San Diego County Employees	0.68%	-----------	0.10%	1.05%	1.08%	1.01%
Average of Peer Group	**0.48%**	**0.43%**	**0.17%**	**0.83%**	**1.10%**	**0.55%**
LACERS	**0.26%**	**0.29%**	**0.14%**	**1.48%**	**1.41%**	**0.42%**

* *Five years ending June 30, 2012.*
\# *Calendar year 2011*

[34] This is an estimate based on 2011/12 average fund assets and management fees.

Table 20 compares LACERS' investment management fees to those of members of the Project Peer Group for which data was made available. It shows that fees incurred with respect to LACERS' public markets portfolio are less than the average of the Project Peer Group. The fees for US and non-US equities are, in fact, significantly less, which could reflect the relatively higher proportion of LACERS' assets that are passively managed. Real estate and private equity fees, on the other hand, are substantially higher for LACERS compared to its peers, higher than almost every other fund.

LACERS' Active Management Performance Relative to a Broader Universe

Table 21 is adapted from a recent study of the asset allocation and investment performance of 69 state pension systems.[35] It shows the distribution of excess returns (portfolio return minus benchmark return) for the five major asset classes for all the state funds in the sample over 10 years ending June 30, 2011. We compared that distribution to the excess returns for LACERS' portfolios for the 10-year period ending September 30, 2011.[36]

Table 21 – Distribution of Excess Returns, 10 Years Ending June 30, 2011

	US Equity	Non-US Equity	Fixed Income	Real Estate	Private Equity
Top Decile	1.1%	1.1%	1.5%	1.9%	5.1%
1st Quartile	0.6%	0.2%	1.1%	1.4%	3.6%
Median	0.3%	-0.1%	0.6%	-0.3%	2.8%
3rd Quartile	-0.1%	-1.2%	0.2%	-2.0%	0.4%
Bottom Decile	-0.6%	-1.6%	0.0%	-4.6%	-2.3%
LACERS*	0.4%	0.1%	0.7%	-4.6%	2.0%

* *10 Years ending September 30, 2011*

LACERS' active management of public market assets – US equities, non-US equities and fixed income – has performed better than the median fund in the Cliffwater study. It ranks below the median, however, in the two private market asset classes. Its performance in real estate, in fact, would be in the bottom decile among the 69 state funds.

LACERS' Evaluation of the Ongoing Costs/Benefits of Active vs. Passive Management

We are not aware from our review of documents, reports, and minutes of Board meetings that LACERS has undertaken any recent study or evaluation which explicitly looked at the costs and benefits of active and passive management for the total fund. LACERS' previous general investment consultant delivered a presentation to the Board of Administration in 2007 on the relative merits of active versus

[35] Cliffwater LLC, "Trends in State Pension Asset Allocation and Performance" June 26, 2012. The firm was established in 2004 by a number of former principals of Wilshire Associates. http://www.cliffwater.com/index.html

[36] LACERS did not report 10-year returns in its quarterly performance reports prior to that date. The slight difference in time periods should not have a material impact in terms of comparing excess returns.

passive management in the non-US equity portfolio, and recommended that the proportion of actively managed assets in the portfolio be increased from 70% to 80%. The consultant argued that the "median active manager had outperformed the market most of the time" and that the LACERS non-US equity portfolio was "sufficiently small relative to the market to allow [it] to potentially profit from active management." The relative costs of active and passive management do not appear to have been specifically addressed in the report. The Board of Administration accepted the recommendation.

More recently (in 2011 and 2012) the current general investment consultant, Wilshire Associates, conducted a risk budgeting study to determine the structure of the major asset classes – i.e. to determine the allocation between large and small cap stocks, value versus growth, developed versus emerging markets, traditional versus high-yield bonds, etc. The study was based on analysis of the expected return from various strategies relative to the index or benchmark (i.e. excess return) versus the active risk in terms of "tracking error" relative to the benchmark. A passive investment strategy would have zero return and risk. The analysis did not explicitly consider the additional costs associated with active management, though it did use excess return figures that were net of management fees. Indirect costs associated with active management do not appear to have been considered.

The study recommended higher allocation to passive management in: (a) large cap US stocks, (b) developed non-US equity markets, and (c) US government bonds. It did not recommend any allocation to the Corporate Governance Program, the Emerging Managers Fund-of-funds Program, or the Opportunistic Fixed Income Portfolio within the LACERS Total Fund.

Summary & Conclusion on Active Management

A substantial portion of the LACERS portfolio employs active management, which is inherently more costly than passive management. There is nothing inappropriate about using active management in the LACERS' investment program provided the actively managed assets, on balance, generate net returns above the relevant passive benchmark. At a minimum, one would expect the actively managed assets to *at least match* the passive benchmark, net of fees.

LACERS' active management program however has yielded mixed results:

1. LACERS' active management program underperformed its total fund policy benchmark by 0.6% or approximately $160 million over the past five year period.
2. Using a longer time-frame, total fund performance, net of fees, over the past 10 years has exactly matched the benchmark. This result is consistent with what academic theory would predict. That is, modern portfolio theory suggests the average active investor should achieve a return equal to the market return, less active management fees.[37]
3. The performance of LACERS' different asset class portfolios has varied. U.S. equities, non-U.S. equities, and real estate have underperformed their respective benchmarks, while fixed income and private equity have outperformed.
4. The real estate portfolio has been the largest source of underperformance for LACERS. We were informed however that LACERS' has changed its real estate strategy and begun to reduce the risk in its real estate portfolio. We will report further on this in our final report.

[37] See The *Arithmetic of Active Management,* William F. Sharpe, From the Financial Analysts' Journal Vol. 47, no. 1, January/February 1991. pp. 7-9.

5. Certain of LACERS specialized investment programs have been a source of active management underperformance. These include the Corporate Governance Program and the Opportunistic Fixed Income Program, and to a much lesser extent, the Emerging Managers Fund-of-funds Program.

Our primary focus here is whether LACERS had adequately evaluated the ongoing costs and benefits associated with participation in actively managed funds. From our review of meeting minutes and LACERS documentation, and interviews with staff, board members, and advisors, we found that LACERS has evaluated the costs and benefits of active management to a very limited degree. The only formal report to the Board of Administration on this subject occurred in 2007. The report was limited to the non-U.S. equity portfolio, and it did not appear to factor in cost considerations. LACERS recently also completed a risk budgeting project, which may have indirectly evaluated the direct costs and the benefits associated with active and passive management.

While the risk budgeting project is an excellent approach to allocating active management risk within the LACERS Total Fund, we do not believe it constitutes a broad evaluation of the costs-benefits of active management. The risk budget process appears to focus on optimizing the allocation of active risk based on expected active manager performance; it does not focus on the broader question of whether LACERS should accept any amount of active risk where acceptable passive strategies are available. We would suggest that a broader evaluation would take into consideration not just expected manager performance data, but also issues such as:

- The stated high-level portfolio objectives in the Investment Policy.
- An assessment of LACERS' internal resources and competencies (Board and staff) available to devote to an active management program.
- The indirect costs of active management (i.e. Board and staff time and the extent to which active management takes away from the time that can be devoted to other activities within LACERS).
- LACERS' past success in active management.
- The success of industry peers in active management.
- Academic research and perspectives on the issue.

We are aware of public funds that have undertaken broad evaluations of their investment beliefs including those pertaining to active and passive management, and whose approaches may provide some guidance to LACERS. For example, we understand CalPERS is in the process of just such an exercise, which is expected to be completed in the fall of 2013.

III. REVIEW OF INVESTMENT MANAGER SELECTION AND TERMINATION POLICIES AND PRACTICES

The City directed us to assess LACERS' investment manager selection and termination policies relative to peer practices and best practices; and whether LACERS evaluated the performance of its investment managers periodically. The City also directed us to assess the actions LACERS has taken to remove poorly performing managers.

Summary Findings

1. Since 2011, LACERS has made a concerted effort to strengthen its manager selection and termination practices. This is best evidenced by the fact that LACERS established two new policies addressing these areas. We found the two new policies to be clear and comprehensive, and consistent with best practice. The policies and criteria are at least as detailed and comprehensive as policies we reviewed within the Project Peer Group.[38]

2. The impact of the above newly established policies was evident in our review of LACERS' manager monitoring and termination practices during the Review Period. Prior to establishing its Manager Monitoring Policy in July 2011, LACERS had not terminated any underperforming managers, despite having placed 10 managers on its watch list. In just the 18 months following the adoption of the Manager Monitoring Policy, LACERS terminated nine underperforming managers, five of which were on the watch list.

Analytical Approach

In assessing LACERS' investment manager selection and termination policies, we compared the policies of LACERS to best practice criteria and to the policies of the Project Peer Group, and identified any gaps and improvement opportunities.

In assessing LACERS' manager oversight practices, we reviewed 21 quarterly investment performance reports covering the audit period and we reviewed the associated Board meeting minutes. We identified all instances of managers underperforming their benchmarks. We also tracked placement of managers on the watch list, removal of managers from the watch list, as well as termination of managers.

Manager Selection and Termination Policies

Best practice suggests that retirement systems should establish the following written procedures and guidelines with respect to the manager selection and termination process:

- Minimum manager selection criteria

[38] Two Peer Group members did not provide their investment policies and these policies were not available on their websites.

- Search and selection process (setting out responsibilities for search and due diligence activities, authority for selection of managers, and key steps in the process)
- Manager monitoring guidelines (setting out the frequency and content of manager reporting to the fund, responsibility for reviewing such information, and details on board reporting).
- Watch list guidelines (setting out the process and criteria for placing a manager on the watch list; the increased monitoring activities for managers on the watch list, board reporting, and criteria for removing a manager from the watch list)
- Manager termination criteria and procedures

Prior to 2011, selection and termination of investment managers was guided only by the Investment Policy Statement (IPS). The IPS contains six manager selection criteria, and eight termination criteria. The selection criteria in LACERS' IPS are consistent with those of three Project Peer Group members, and more comprehensive than the remaining Project Peer Group members. The manager termination criteria were similar to those we found in two Project Peer Group members' policies. The other Project Peer Group members had not documented their termination criteria.

Since 2011, LACERS recognized the need for more comprehensive policies in this area and initiated a significant policy exercise, which resulted in the development of two new policies including a) the Manager Search and Selection Policy, and b) the Manager Monitoring Policy.

The Manager Search and Selection Policy, which was adopted by the Board of Administration in March 2012, covers the following issue in reasonable detail:

- Roles and responsibilities of the Board of Administration, staff, and investment consultant in the manager search and selection process (which also identify key elements of the search process).
- Separate manager selection criteria for active and passive managers, as well as weighting of the selection criteria (note: the selection criteria differ somewhat from those found in LACERS' IPS).
- The treatment of emerging managers in the process.

The Manager Monitoring Policy, which was adopted by the Board of Administration in July 2011, covers the following issues in reasonable detail:

- The scope, frequency and content of manager monitoring.
- Criteria for determining whether a manager is in "Good Standing".
- Quantitative and qualitative triggers for placing managers on watch list.
- Application of the criteria for newly-hired managers.
- Procedures for placing managers on the watch list, for reporting to the board, and for restrictions concerning such managers (e.g., limits on funding and contributions).
- Grounds for terminating investment managers.
- Application of the monitoring criteria to private market managers.
- Sample notification letter for managers placed on the watch list.

Taken together, the above policies are more comprehensive and detailed than those of the Project Peer Group we reviewed. See Appendix D for details. Only two other Project Peer Group members have established separate, detailed procedures separate from their IPS on these topics.

The only issue we noted with the LACERS procedures and criteria is that the minimum manager selection criteria set out in its IPS (Section V.(C)) differ considerably from those set out in the Manager Search and Selection Policy (Section IV). Given that the IPS has not been updated since the new policy was adopted, we believe this is a simple matter of reviewing the IPS and harmonizing it with the new policies.

Investment Manager Oversight

We found that during the audit period, the LACERS Board reviewed the performance of each of its public markets managers on at least a quarterly basis. The Board was provided quarterly investment performance reports that contain among other things:

- A review of the performance of the total LACERS fund.
- A review of each of the U.S. equity managers, and the U.S equity portfolio as a whole.
- A review of each of the non-U.S. equity managers, and the non-U.S equity portfolio as a whole.
- A review of each of the fixed income managers, and the fixed income portfolio as a whole.

For each of the LACERS investment managers, the quarterly report provides appropriate information including:

- The size of the manager's portfolio in absolute terms and as a percentage of the respective asset class portfolio.
- The manager's investment performance for the quarter, 1-year, 3- year, and 10-year periods, all net of fees.
- The manager's investment performance since inception to the LACERS's portfolio, gross of fees.
- The manager's 5-year tracking error.
- A Manager report Card summarizing the manager's standing relative to the watch list.

Each manager's performance is also compared to the relevant passive benchmark to indicate any excess return earned by the manager.

As indicated earlier in our report, LACERS established a Manager Monitoring Policy in July 2011. The new policy introduced considerably more detail and structure to the process for monitoring and terminating investment managers. Prior to the adoption of the Manager Monitoring Policy, the monitoring of managers was guided only by the provisions of the Investment Policy Statement, which was general in nature, particularly with respect to what actions should be taken once a manager was placed on the watch list and the triggers for terminating a manager.

We analyzed LACERS' practices, both before and after the adoption of the Manager Monitoring Policy. Our analysis suggests that the new policy appeared to add considerable rigor to the manager oversight process.

- In September 2007 (the outset of the Review Period) we noted that there were no managers on watch, despite the fact that the five-year performance of three investment managers was at least 1.5% below their benchmarks.
- Between September 2007 and July 2011, 10 of the 26 public markets managers were placed on the watch list at some point, but no managers were terminated by LACERS. In fact, the only two manager relationships that ended during that period did so because the investment managers themselves discontinued their own strategies due to poor performance. These managers were Hermes Focus Asset Management and Sparx Asset Management, both part of the Corporate Governance Program within the US equity portfolio.

Table 22 indicates that just prior to LACERS adopting the Manager Monitoring Policy, the following managers had underperformed on at least a three-year basis:

Table 22 - Manager Performance at June 30, 2011
(Note: only underperformance is shown)

Manager	Mandate	1-Year	3-Year	5-Year	List
US Equity					
AllianceBernstein	LC Growth	-3.5%	-2.2%	-1.6%	On watch since March 2011
SIT Investments	SC Growth	-3.2%	-2.2%		
PanAgora	SC Value			-1.9%	Removed from watch December 2010
Relational Investors	Corp. Gov.			-1.8%	On watch since June 2011
Capital Prospects	Fund of Funds		-1.2%	-0.7%	On watch since June 2011
Non-US Equity					
Capital Guardian	Europe	-1.9%		-0.2%	On watch since February 2010
Marvin & Palmer	Dev. Markets		-5.4%		On watch since March 2009
TT International	Dev. Markets		-2.6%	-1.1%	On watch since January 2009
Knight Vinke	Corp. Gov.	-12.2%	-9.0%	-5.1%	On watch since June 2011
Opportunistic					
Oaktree	Bank Loan		-0.7%		
Torchlight	Distressed		-24.2%		
Whippoorwill	Distressed	-7.5%	-9.3%	-5.6%	

In approximately the 18-month period beginning the month before the Manager Monitoring Policy was approved by the Investment Committee, LACERS terminated (or elected not to renew) five investment managers including:

- Relational Investors; US Equity, Corporate Governance Program (terminated November 2011)
- Marvin Palmer; Non-US Equity (terminated January 2012)
- Alliance Bernstein; US Equity (terminated February 2012)
- Knight Vinke; Non-US Equity, Corporate Governance Program (terminated December 2012)
- Blum Stimson; US Equity, Corporate Governance Program (in redemption September 2012)

In addition, all four of the managers in LACERS's Opportunistic Fixed Income Program were terminated. These terminations may have also been driven by LACERS' recent asset allocation policy amendments and the risk budgeting project. All four managers in the Program, however, had been underperforming, most by considerable amounts.

Despite the above terminations, we noted that a number of managers continue to be on LACERS' watch list as at December 31, 2012. A number of the underperforming managers manage non-U.S. equities with regional mandates. The status of these managers is being considered by LACERS.

With respect to the underperforming emerging managers, they have each been granted specific deadlines to improve their performance, failing which staff will recommend to the Board that the managers be terminated.

Summary and Conclusion on Manager Monitoring and Termination

In summary, due in part to a lack of clear internal policy guidelines, LACERS was in the past able to identify underperforming managers and place them on watch status, but had difficulty terminating them.

We recognize the difficulty involved in knowing precisely when to terminate underperforming managers. For example, it is not unusual for highly skilled managers to experience extended periods of underperformance. It is also common for underperforming managers to begin improving just as the boards and staffs are considering terminating them. In addition, the significant transaction costs associated with terminating a manager and transferring the assets to another manager require that public funds be careful not to terminate managers prematurely.

Since 2011, LACERS has implemented a more rigorous policy framework for monitoring managers and addressing the challenges noted above. This new framework appears to have resulted in a much more decisive approach to dealing with underperforming managers as demonstrated by the numerous terminations completed since 2011.[39]

[39] The recent risk budgeting project can also be credited with introducing greater discipline in the allocation of assets to active managers within the LACERS fund.

Summary of Interim Report Recommendations

1. LACERS should conduct a comprehensive review of its active management program. At a minimum, such a review should consider:

    a. Investment theory and research.
    b. The direct costs of active management (i.e. manager fees)
    c. The indirect costs of active management (e.g. the time and expense of the Board, staff, and consultants).
    d. The mission and objectives stated in LACERS' investment policy.
    e. LACERS' own past performance in active management in different asset classes (e.g. LACERS' active management program has consistently performed well in certain asset classes, but underperformed in others).
    f. LACERS' organizational resources, constraints, and core competencies.

    The objective of the above review should be to ensure that LACERS has taken all relevant factors into consideration when determining the amount of active management to be pursued, and not to focus solely on the historical performance of the broad universe of active managers. Any reduction in active management would free up resources that could be redirected to the asset allocation and risk management activities, which are likely to have a more significant impact on the risk and return of a fund.

2. LACERS has attempted to address active management underperformance by tightening its policies concerning the monitoring of investment managers, which has resulted in the termination of a number of managers. However, the Emerging Manager Fund-of-funds Program (which consists of three funds –of-funds managers) has underperformed its benchmarks on a rather consistent basis since its inception, albeit by a relatively small amount. These fund-of-funds managers however continue to be retained by LACERS.

    In February 2012, LACERS established an Emerging Manager Policy, which we believe sets out reasonable objectives and criteria pertaining to the selection of emerging managers. We are not aware of any formal policy that existed prior to that time that guided the Emerging Manager Fund-of-funds Program.

    Given the performance of the Emerging Manager Fund-of-funds Program and the newly established Emerging Manager Policy, we recommend that the Board review the Emerging Manager Fund-of-funds Program in light of:

    a. the objectives set out in the recently established Emerging Manager Policy;
    b. the performance of the Emerging Manager Fund-of-funds Program since its inception; and
    c. the Board's fiduciary duty to prudently manage the assets of the System in the sole best interests of the beneficiaries of the System.

If, based on the above review, LACERS determines that the Emerging Manager Fund-of-funds Program does not adequately support the objectives set out in the Emerging Manager Policy, it should either terminate the Program and the underlying managers, modify the Program, or revise the Emerging Manager Policy.

3. LACERS should update section V.C of its Investment Policy Statement to reflect the more stringent requirements contained in section IV of the newly established Manager Search and Selection Policy.

D. Caveats and Disclaimers

This Interim report should be read and evaluated with several caveats in mind.

First, many of the subjects addressed 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 LACERS' evolving investment program.

Second, in conducting this review, we relied on oral and written representations of the people we interviewed and on the contents of the documentary information we obtained. We sought to verify certain information among different interviewees and documents, but the process of 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 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 LACERS, independent analysis, and our experience and expertise.

Third, this report does not provide legal, actuarial or accounting advice that would ordinarily be provided by a firm organized to provide such services. Also, we did not conduct an examination of LACERS' internal control system. This 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.

Fourth, our observations are based on the information we considered as of and during the Review Period. Our report 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 LACERS' practices, as represented to us, will be observed in the future. It is often the case that some recommendations contained in the report have already been implemented prior to the report issuance date. Where this is the case, LACERS has the ability note such implementation in their response to the report. Please also note that our report does not replace or reduce the fiduciary duty of the Board and staff regarding their policies and procedures.

Fifth, our approach to various organizational issues in this 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 State and City government.

Finally, in accordance with the City Charter, the extent to which our report and recommendations are adopted or implemented is the decision of the LACERS Board of Administration.

Appendix A – EXPECTED FINAL REPORT CONTENT

The Joint Administrators also stipulated that the remaining topics are to be addressed in the Final report. These topics are:

A. Follow up on the status of prior management audit recommendations.

B. Board Governance
- Are LACERS' fiduciaries carrying out their responsibilities in a manner consistent with the City Charter and with best industry standards and practices? (Obj. 11)

C. Funding and Asset Allocation Policy
- Are LACERS' actuarial methods appropriate and its assumptions valid? (Obj. 7)
- Is LACERS' asset allocation process reasonable and does it provide adequate diversification, prudently balance risk and return, and sufficiently address the risk of unexpected contribution increases for the City, e.g., when market returns are lower than anticipated, and the need to ensure City contributions are sustainable? (Obj. 3, 5 & 9)
- Does LACERS have effective procedures for long-term financial planning to enable appropriate financial strategies and decisions to be made timely by the System and the plan sponsor? (Obj. 13)

D. Benefit Administration
- Have LACERS' plan participants been provided the benefits they are entitled to in a timely manner? (Obj. 1)
- Are procedures in place at LACERS adequate to review applications for disability pensions? (Obj. 10)

E. Investment Administration
- Is the LACERS's investment program being managed in accordance with LACERS' own investment objectives and policies, e.g., has LACERS taken action to remove poor performing investment managers? (Obj. 6)
- Does the System adequately evaluate investment performance with costs to ensure costs are minimized? (Obj. 12 A-D)

F. Cost Control/ Management

Consider how the amount of office space that is available or may become available in the near future fits in with the requirements of LACERS. (Obj. 4 C)

Appendix B – Cost and Statistical Analysis

Administrative and Other Costs Analysis							LACERS		LAFPP
		1	2	3	4	5		Peer Group	
		6/30/2008	6/30/2009	6/30/2010	6/30/2011	6/30/2012	5Yr Avg.	5Yr Avg.	5 Yr. Avg.
1	Ending Assets ($mil.)	$8,450.3	$6,796.6	$7,472.8	$8,750.9	$9,132.2	$8,120.6	$ 11,049.0	$ 13,366.8
2	Average Assets ($mil.)	$8,450.3	$7,623.4	$ 7,134.7	$ 8,111.8	$ 8,941.6	$8,052.4	$ 10,173.6	$ 12,624.5
3	Net Investment Earnings ($mil.)	$(646.39)	$(2,110.24)	$1,066.83	$1,950.15	$ 83.02	$ 68.67	$ 194.59	$ 192.30
4	Return on Avg. Assets (Line 3÷2)	-7.65%	-27.68%	14.95%	24.04%	0.93%	0.92%	1.84%	1.52%
5	Ratio of Inv. Earnings to Benefits Paid (3÷20)	(1.33)	(4.13)	1.87	2.98	0.12	-0.10	0.32	0.25
6	Total Investment Management Cost ($mil.)	$ 46.644	$ 46.898	$ 54.206	$ 55.478	$ 48.431	$ 50.331	$ 45.592	$ 54.942
7	Investment Management Fees ($mil.)	$ 44.859	$ 45.093	$ 52.544	$ 53.849	$ 46.861	$ 48.641	$ 40.648	$ 54.942
8	Investment Consultant Fees ($mil.)	$ 1.785	$ 1.805	$ 1.662	$ 1.629	$ 1.570	$ 1.690	$ 1.690	N/A
9	Total Investment Cost in Basis Points (Bps)	55.2	61.5	76.0	68.4	54.2	62.5	49.3	43.5
10	Employer Contributions ($ mil.)	$302.810	$288.516	$266.240	$306.737	$308.712	$294.603	$ 286.478	$ 269.907
11	Covered Payroll ($ mil.)	$1,742	$1,833	$1,828	$1,678	$1,819	$1,715	N/A	$1,321
12	Employee Contributions ($ mil.)	$114.678	$118.592	$126.961	$114.731	$178.246	$130.642	$135.084	$106.775
13	Employee Contributions % of Payroll	Various	6.00%	6.00%	6% or 8%	7%, 9%, or 11%	N/A	N/A	6% to 9%
14	Total Contributions ($ mil.)	$417.488	$407.108	$393.201	$421.468	$486.958	$425.245	$ 421.563	$ 376.682
15	Total Contributions % of Liability	3.73%	3.38%	3.12%	3.15%	3.38%	3.34%	2.91%	2.40%
16	Number of Retirees and Beneficiaries	14,975	14,991	17,264	17,197	17,223	16,330	30,005	12,323
17	Active Members	30,236	30,065	26,245	25,449	24,917	27,382	54,377	13,556
18	Total Active & Retired Members/Beneficiaries	49,484	49,610	48,853	48,269	47,948	48,833	84,688	25,879
19	Average Total members	48,899	49,547	49,232	48,561	48,109	48,869	84,688	25,879
20	Benefits Paid ($mil.) (DB Plan)	$ 484.55	$ 510.63	$ 569.94	$ 654.38	$ 664.63	$576.826	$ 656.21	$ 780.54
21	Avg. Benefit Paid Per Retiree/Beneficiary	$ 32,357	$ 34,063	$ 33,013	$ 38,052	$ 38,589	$ 35,323	$ 29,161	$ 63,339
22	Total Administrative Cost ($mil.)	$ 14.354	$ 15.398	$ 17.063	$ 16.018	$ 15.926	$ 15.752	$ 12.289	$ 13.133
23	Tot Admin. Cost in Bps	16.99	20.20	23.92	19.75	17.81	19.56	12.46	10.40
24	Tot Admin. Cost/Member	$ 290.07	$ 310.38	$ 349.27	$ 331.85	$ 332.15	$ 322.75	$ 227.86	507.46
25	Personnel Cost ($mil.)	$ 10.17	$ 11.04	$ 12.30	$ 11.71	$ 11.40	$ 11.32	$ 6.89	N/A
26	Personnel Cost per Member	$ 205.42	$ 222.50	$ 251.86	$ 242.60	$ 237.76	$ 232.03	$ 114.97	N/A
27	# of Plan Employees	130	134	125	124	125	128	N/A	N/A
28	Avg. Plan Employee Compensation & Benefits	$ 78,192	$ 82,373	$ 98,432	$ 94,435	$ 91,200	$ 88,927	N/A	N/A
29	Personnel % of Total Admin. Cost	70.8%	71.7%	72.1%	73.1%	71.6%	71.9%	56.1%	N/A
30	Average Health Plan Assets ($mil.)	$1,268.86	$1,074.50	$1,030.15	$1,250.60	$1,446.39	$1,214.10	$ 200.10	$ 676.94
31	Health Plan Benefits Paid ($mil.)	$ 70.10	$ 73.84	$ 83.20	$ 98.16	$ 91.44	$ 83.34	$ 42.23	$ 82.82
32	One Basis Point Equivalent on Avg. Assets	$845,031	$762,345	$713,468	$ 811,183	$894,155	$805,236	$ 1,017,360	1,262,452

Appendix C – Project Peer Group

Peer Group Members	Net Investment Assets ($Millions)	Metro Area CPI Average 5 Years
1. San Francisco Employees' Retirement System	$ 15,631.54	225.8
2. Employees' Retirement System of Georgia	$ 13,764.60	205.7
3. Los Angeles Fire and Police Pensions	$ 13,366.76	221.3
4. Arkansas Teacher Retirement System	$ 11,817.30	210.3
5. Public Employee Retirement System of Idaho	$ 12,027.01	220.5
6. School Employees Retirement System of Ohio	$ 9,413.33	198.1
7. Orange County Employees Retirement System	$ 8,787.35	221.3
8. San Diego County Employees Retirement Association	$ 8,527.81	221.3
9. Sacramento County Employees' Retirement System	$ 6,105.28	220.5
Peer group – average net investment assets	**$11,049.00**	**215.4**
Los Angeles City Employees' Retirement System	**$ 9,132.23**	**221.3**

Appendix D: Supporting Tables

Table D1 – Calculation of the Difference Between Total Fund Return and Assumed Investment Return

	2007-08	2008-09	2009-10	2010-11	2011-12	Five-Year Period
Actual Performance						
Total Fund Return - Net of Fees	-5.7%	-19.6%	12.7%	22.3%	0.9%	1.0%
Total Assets – Start of Period ($b)	$11.072	$10.372	$8.143	$9.001	$10.694	$11.072
Plus: Investment Inc. – Net of Fees ($b)	-0.646	-2.110	1.067	1.950	0.083	0.344
Plus: Contributions ($b)	0.537	0.502	0.490	0.529	0.602	2.660
Less: Benefits, Expenses, etc. ($b)	(0.590)	(0.621)	(0.698)	(0.787)	(0.783)	(3.479)
Total Assets – End of Period ($b)	$10.372	$8.143	$9.001	$10.694	$10.596	$10.596
Performance Assuming Total Fund Return Equaled the Assumed Investment Return						
Assumed Investment Return	8%	8%	8%	8%	7.75%	7.95%
Total Assets – Start of Period ($b)	$11.072	$11.939	$12.810	$13.661	$14.531	$11.072
Plus: Income Based on Assumed Return	0.920	0.990	1.059	1.128	1.164	5.261
Plus: Contributions	0.537	0.502	0.490	0.529	0.602	2.660
Less: Benefits, Expenses, etc.	(0.590)	(0.621)	(0.698)	(0.787)	(0.783)	(3.479)
Total Assets – End of Period ($b)	$11.939	$12.810	$13.661	$14.531	$15.514	$15.514
Total Fund Return Less Assumed Investment Return						
Total Fund Return/Income ($b)	$-0.646	$-2.110	$1.067	$1.950	$0.083	$0.344 **(A)**
Income Based on Assumed Investment Return ($b)	$0.920	$0.990	$1.059	$1.128	$1.164	$5.261 **(B)**
Difference ($ billion)	**$-1.566**	**$-3.100**	**$0.008**	**$0.822**	**$-1.081**	**$-4.917**

Table D2 - Documentation of Manager Selection, Monitoring and Termination Procedures and Guidelines[40]

Policy provisions	LACERS	Fund A	Fund B	Fund C[41]	Fund D	Fund E	Fund F
Minimum manager selection criteria	Six (6) minimum criteria in the Investment Policy Statement (IPS) and the Manager Search and Selection Policy – separate criteria for active and passive managers	Six (6) minimum criteria in the Manager Selection and Retention Policy (MSRP)	Very high level description of "emphasis" for evaluation set out in the IPS.	Three (3) minimum criteria in the IPS.	Five (5) guidelines are set out in the IPS.[42]	Not documented in the policy	Seven (7) selection criteria set out in IPS.
Search and Selection process	Roles and responsibilities described in the Manager Search and Selection Policy	Not documented in policies	Not documented in policies	Not documented in policies	High level overview of authority and responsibilities are set out in the IPS. Six (6) "conditions" for making investments have been established.	Not documented in the policy	
Manager monitoring guidelines	Detailed guidelines in the Manager Monitoring Policy	Basic details in the MSRP	Very brief description in IPS	Documented in the IPS.	Very brief reference to performance benchmarks in IPS.	Guideline are set out in the Investment Policy and Objectives Statement (IPOS)	Set out in the Guidelines for Manager Monitoring and Retention
Watch List Procedures	Detailed procedure and guidelines in the Manager Monitoring policy	Procedure set out in the MSRP	Not documented in policies	Not documented in policies	Not documented in the policy.	Process and criteria are set out in the IPOS	Set out in the Guidelines for Manager Monitoring and Retention
Manager termination criteria/factors	Detailed criteria in the IPS and in the Manager Monitoring policy	Factors to analyze listed in Manager Selection and Retention Policy	Not documented in policies	Not documented in policies	Not documented in the policy.	Not documented in the policy	Eight (8) termination criteria set out in IPS.
Termination Procedures	Brief procedures in Manager Monitoring policy	Not documented in policies	Not documented in policies	Not documented in policies	Not documented in the policy.	Process is set out in the IPOS	Set out in the Guidelines for Manager Monitoring and Retention

[40] Data is based on policies and guidelines provided by the peer group members, or found on their website. Not all peer group members provided their complete Investment Policy Statement, stand-alone investment manager selection and termination guidelines or procedures (i.e., that are not included in the IPS.)
[41] Fund C has established selection and monitoring guidelines for its Choice Plan, a self-directed defined contribution plan, which are documented in the Choice Plan Investment Policy.
[42] Separate conditions and selection criteria have been established for Fund D's opportunistic investment strategies and are documented in the Opportunistic Investment Policy.

Table D3 - Manager Minimum Selection Criteria or Qualifications

LACERS Investment Policy Statement	LACERS – Manager Search and Selection Policy	Fund A	Fund B
1. The firm must be experienced in managing money for institutional clients in the asset class/product category/ investment style specified by the Board of Administration. 2. The firm must display a record of stability in retaining and attracting qualified investment professionals, as well as a record of managing asset growth effectively, both in gaining and in retaining clients. 3. The firm must have an asset base sufficient to accommodate the Board's portfolio. In general, managers should have at least $100 million of discretionary institutional assets under management, and the Board's portfolio should make up no more than 20% of the firm's total asset base. Exceptions shall be made on a case-by-case basis. 4. The firm must demonstrate adherence to the investment style sought by the Board of Administration and adherence to the firm's stated investment discipline. 5. The firm's fees should be competitive with industry standards for the product category. 6. The firm must comply with the "Duties of the Investment Managers" outlined herein and conform to CFA Institute (formerly AIMR) standards for performance reporting.	1. (Evidence of fiduciary status) Firm is registered investment advisor under the Investment Advisors Act of 1940 possesses bank exemption; 2. (Evidence of product viability) Must have a proven and verifiable track record of at least five (5) years as of the most recent quarter end; 3. Must conform to CFA Institute's Global Investment Performance Standards ("GIPS"); 4. (Evidence of risk-adjusted value-adding skill) At least 60% of rolling four (4) quarter information ratios (i.e., excess return divided by excess risk) must be positive versus a mandate-appropriate benchmark, gross of fees, for the last five (5) years (12 of 20 quarters); **[Note: not applicable to passive managers]** 5. (Evidence of business risk) Firm AUM must be of sufficient size that LACERS' expected mandate size would not comprise more than 20% of the proposed product assets.	1. The firm must be experienced in managing money for institutional clients in the asset class/product category/investment style specified by the Board. 2. The firm must display a record of stability in retaining and attracting qualified investment professionals, as well as a record of managing asset growth effectively, both in gaining and in retaining clients. 3. The firm must have an asset base sufficient to accommodate the Board's portfolio. In general, managers should have at least $100 million of discretionary institutional assets under management, and the Board's portfolio should make up no more than 20% of the firm's total asset base at the time of hiring. Exceptions shall be made on a case-by-case basis. 4. The firm must demonstrate adherence to the investment style sought by the Board and adherence to the firm's stated investment discipline. 5. The firm's fees should be competitive with industry standards for the product category. 6. The firm must comply with the "Duties of the Investment Managers" outlined herein and conform to CFA Institute (formerly AIMR) standards for performance reporting.	The Board will evaluate all qualified investment managers candidates with emphasis on: • Demonstrated professional performance • Organizational depth • Institutional investment management capability • Reasonableness of fees structures (regardless of the amount of investment assets under management or the age of the investment management firm)

Table D3 - Manager Minimum Selection Criteria or Qualifications (Cont'd)

Fund C	Fund D	Fund F
Investment managers shall: 1. Be registered with the Securities and Exchange Commission (unless they are banks, insurance companies, or other category exempted from such registration requirements), 2. Have been in the business of investment management at least two years (or the main personnel of the investment management firm have worked together in the business of investment management for at least two years), and, 3. Usually, have other United States pension fund assets under management.	1. Selected Investment Managers and Funds will have proven track records in the strategy; 2. Monthly reporting by the Fund or Investment Manager is preferred, but there shall be no less than quarterly reporting; 3. The liquidity of an investment will be prudent, both for the strategy and for the Total Fund; 4. The amount invested with an Investment Manager or in a Fund will be prudent for the strategy; 5. Investment limits established by Board resolution remain in effect unless modified or eliminated by the Board.	1. The firm must be SEC-registered or exempt from registration. Firms claiming exemption from registration requirements must provide appropriate documentation and disclosures indicating reasons for exemption. 2. The firm or its senior investment professionals must be experienced in managing money for institutional clients in the asset class/product category/investment style specified by Fund F. 3. The firm must display a record of stability in attracting and retaining qualified investment professionals, as well as a record of managing asset growth effectively, both in gaining and retaining clients. 4. The firm must have an asset base sufficient to accommodate Fund F' portfolio. In general, firms should have at least $250 million of discretionary institutional assets under management, and Fund F' portfolio should make up no more than 20% of the firm's total asset base after funding. Exceptions may be made on a case-by-case basis. 5. The firm must demonstrate adherence to the investment style sought by Fund F, and adherence to the firm's stated investment discipline. 6. The firm's fees should be competitive with industry standards for the product category. 7. The firm must comply with the "Duties of the Investment Managers" outlined herein and conform to CFA Institute/Global Investment Performance Standards for performance reporting.

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LACERS
LOS ANGELES CITY EMPLOYEES' RETIREMENT SYSTEM

CITY OF LOS ANGELES

ANTONIO R. VILLARAIGOSA
Mayor

THOMAS MOUTES
General Manager

LI HSI
Assistant General Manager

LITA PAYNE
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May 16, 2013

The Honorable Wendy Greuel, Controller
200 North Main Street, Suite 300
Los Angeles, CA 90012

Attention: Mr. Farid Saffar, CPA
Director of Auditing

Re: Response to Final Interim Management Audit Report

Dear Controller Greuel:

Thank you for the opportunity to provide our response to the Interim Management Audit Report (Report). Our comments are based on that Report, our May 1, 2013 exit conference, and several follow-up emails with your staff. Our response refers to comments and observations generally contained in the Report as opposed to specific page numbers as some comments and observations are referenced in several different places in the Report.

First, we would like to thank P2E Consulting for noting several areas of accomplishment at LACERS, including:

- The high level of morale among our staff;
- Our significant efforts in implementing the prior management audit recommendations;
- The observation that LACERS is "much attuned to the actions by the City that affect City employees and retirement"; and
- Noting that our strategic planning process is "exemplary among public funds".

We also appreciate the comment "on the superlative attitude and cooperation of every person at LACERS..." as we pride ourselves on transparency and service to all of our stakeholders.

Attachment 2

Comments Regarding Investment Program

If the comments and data relating to fees for passive-only investment management solely are meant to aid in the ongoing discussion of active versus passive investment management, we welcome that information. If those comments and data are meant to imply that LACERS should invest its public market assets only in passively-managed index funds, we would disagree with that implication as there is substantial research and experience to the contrary.

Further, as an indication that we understand the benefits of passive management for certain aspects of the investment portfolio, we already employ passive management for a greater percentage of our portfolio than many other public pension funds. The following table shows the percentage of LACERS investments that were passively managed as of June 2012 compared with public funds with assets of greater than $5 billion, pursuant to a recent Market Trends 2012: United States Investment Consulting Business report by Greenwich Associates:

Description	Greenwich Average	LACERS
Passive Investments as a % of Domestic Equities	39.0%	61.8%
Passive Investments as a % of International Equities	18.0%	33.8%
Passive Investments as a % of Total Assets	17.8%	29.8%

Based on the information in the above table, LACERS has a significantly greater percentage of its domestic equities, international equities, and total assets passively managed than do other public pension funds with assets greater than $5 billion.

Comments Regarding Actuarial Assumptions

We appreciate that the Report goes beyond the specified time frame of the audit to provide ten-year returns in comparison to our Assumed Investment Return. However, the process for establishing an Assumed Investment Return presumes that it is based on a very long time horizon, typically 30 to 40 years. Therefore, a five or even ten year comparison creates a mismatch with the time period inherent in the assumption. Over the last 30 years (matching the lower threshold of the assumption time horizon), **LACERS has earned a compound annual return of 10% gross of fees, which is significantly higher than our Assumed Investment Return.**

The observation regarding our Assumed Investment Return indicated underperformance over the five-year period of the audit. While we are concerned about any perceived past underperformance of our investments, we believe that the asset allocation adopted by our Board in January 2012 along with the manager selection and termination policies now in place will help mitigate any investment underperformance attributable to the manner in which we operate our investment program. Our manager selection and termination policies were noted in the Report as being "at least as detailed and comprehensive as policies we reviewed within the Project Peer Group."

Comments Regarding City's Contribution
We appreciate the information that was added to make explicit the link between the payroll of employees covered by LACERS and the dollar value of the City's contributions. As you know, the City's contribution is calculated by multiplying the percentage of payroll (determined by our actuary and adopted by our Board) times the payroll of employees covered by LACERS. Therefore, increases in the payroll necessitate increases in the contributions to LACERS.

In reference to the phase-in of the Assumed Investment Return, it is appropriately noted that "To the extent that required contributions are delayed, the investment contributions are foregone, which will result in an increase in overall required contributions and/or investment earnings." Please note that the City, as Plan Sponsor requested the phase-in of the lower Assumed Investment Return, presumably with the knowledge that it may need to pay more later, but was attempting to minimize near-term City contributions.

Comments Regarding Administrative Expense
We appreciate that the Report was amended to reflect that higher administrative costs during the fiscal year ending June 30, 2010 were related to LACERS retiring approximately 2,500 members – or roughly five times the number of members we typically retire in a year. Most of these retirements took place under the City's Early Retirement Incentive Program (ERIP). We are proud that LACERS was able to rise to the challenge to retire so many members, but that effort necessitated renting additional space, purchasing additional equipment, paying overtime to existing employees, and hiring temporary employees. We were able to retire the members whose salaries were funded by the City's General Fund in such an expeditious manner that the General Fund savings were even greater than had been projected for that year and those savings dwarfed any additional expense we incurred to retire those members.

The Report provides a few different administrative expense comparisons. One such comparison is the amount of administrative expense compared with the assets under LACERS management. We question the meaningfulness of such a comparison given that only approximately 10% of LACERS direct and indirect personnel expense is attributable to the investment of funds and the other 90% is attributable directly or indirectly to providing benefits to our members (and thus more meaningful comparisons might be the number of members per employee or the number of members compared with the administrative expense, which was also included).

Conclusion
At LACERS, our Vision is that we aspire to be valued by our members for excellence in all we do. As such, we always appreciate feedback regarding how we can do even better. We also appreciate that several of our accomplishments were noted in the Report and look forward to further considering the recommendations.

Attachment 2

Should you have any questions or require further information, please do not hesitate to contact me at 213-473-7280.

Sincerely,

Thomas Moutes
General Manager

TM:bc
2013-0516-046

c: Neil M. Guglielmo, Joint Administrator, Mayor's Office
Karen E. Kalfayan, Joint Administrator, City Council/CLA
Steven M. Harding, President and CEO, P2E Consulting
LACERS Board of Administration

Attachment 2

RON GALPERIN
CONTROLLER

March 12, 2014

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

Re: <u>RELEASE OF THREE PENSIONS FUNDS RELATED AUDITS</u>

I. <u>SUMMMARY</u>

A. City Pension Costs and Liabilities:

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

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

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

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

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

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

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

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

B. Three Audits:

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

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

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

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

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

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

II. FINDINGS, RECOMMENDATIONS & GENERAL OBSERVATIONS

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

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

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

A. Management Audits of LACERS AND LAFPP

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

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

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

LACERS: Due to severe market downturns during the period audited, LACERS underperformed by $4.9 billion. While $4.6 billion of this underperformance was a result of declines in capital markets, the audit identifies $278 million of the underperformance attributed to shortcomings in LACERS' investment program.

LAFPP: During the five year audit period, LAFPP underperformed by approximately $2.4 billion compared to what would have been gained had the assumed rate been achieved.

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

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

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

Investment Management Fees

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

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

Administrative Expenses

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

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

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

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

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

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

Investment Assumptions

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

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

Governance and Fiduciary Responsibilities

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

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

Review of Status of Prior Audit Recommendations

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

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

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

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

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

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

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

III. ACKNOWLEDGEMENTS

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

Sincerely,

RON | GALPERIN
Los Angeles City Controller

Attachment 2

City of Los Angeles

Honorable Members of the Los Angeles City Council
Los Angeles City Employees' Retirement System Board of Administration

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

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

The attached "Report on the Management Audit Los Angeles City Employees' Retirement System Part 2 of 2" represents the final report addressing the remaining eight audit objectives, and an assessment of the implementation status of the prior audit recommendations. This Final Report includes the following topics:

- The adequacy and reasonableness of the Los Angeles City Employees' Retirement System's (LACERS) asset allocation and investment diversification to minimize the risk of loss and maximize the return rate;
- Compliance with Investment Policies;
- Consideration of certain other administrative costs such as office space leasing;
- Reasonableness of actuarial methods and validity of assumptions;

Attachment 2

- Disability and Retirement Benefit Administration Process;
- Governance and Fiduciary Responsibilities;
- Adequacy of Long-Term Strategic and Financial Planning to enable timely decisions by the System and the City.

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

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

Sincerely,

RON GALPERIN
City Controller

ERIC GARCETTI
Mayor

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

Enclosure

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

Management Audit of the Los Angeles City Employees' Retirement System

NOVEMBER 21, 2013

P2E Consulting Group, LLC
641 Grooms Road, Suite 234
Clifton Park, New York 12065

Attachment 2

P2E CONSULTING
Pensions to Excellence

January 8, 2014

Mr. Farid Saffar, Director of Auditing
Officer of the City Controller
200 North Main Street, Suite 460
Los Angeles, CA 90012

RE: Final Report - Management Audit of the Los Angeles City Employees' Retirement System

Dear Mr. Saffar,

Enclosed please find our final report on the above referenced project. After a lot of hard work by all, we are pleased to issue this second of two parts of the Report on the Management Audit of the Los Angeles City Employees' Retirement System (LACERS).

We thank you for your assistance and diligence in working with everyone to accomplish the project and we look forward to making a presentation of the report, if desired.

Thank you.

Sincerely,

Steven M. Harding
President and CEO

Cc: Cynthia Varela, Controllers' Office
Thomas Iannucci, Cortex Consulting

641 Grooms Road Suite 234 Clifton Park New York 12065 518.399.6301

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EXECUTIVE SUMMARY

Introduction

The City of Los Angeles ("the City") has three main employee retirement systems of which the Los Angeles City Employees' Retirement System ("LACERS" and "the System") is one. For the year ended June 30, 2012, LACERS paid in excess of $664,000,000 in pension benefits to approximately 17,000 retirees and beneficiaries for an average of approximately $39,000 each. The portfolio of investments that provided support in part for these payments was valued by LACERS in excess of $9.6 billion at the same point in time. For the same period, LACERS paid approximately $91.4 million in retiree health benefits that are supported in part by approximately $1.6 billion in investments in the separate Post-employment Health Care Plan ("OPEB"). Other support for benefits comes from City and employee contributions.

LACERS was established through the City Charter. The City Charter grants authority to the LACERS Board of Administration, General Manager, and staff to administer the System. The City Charter requires that a management audit of LACERS be conducted at least every five years, the broad objectives of which are to examine whether the System "is operating in the most efficient and economical manner"[1], and to evaluate the asset allocation of the System. Representatives of the Mayor, the City Council, and the City Controller ("Joint Administrators") hired P2E Consulting Group, LLC ("P2E Consulting" and "We") to perform the management audit. P2E Consulting hired Cortex Applied Research ("Cortex") and PRM Consulting Group ("PRM") as key independent sub-contractors. The period covered by the management audit includes the fiscal years 2008 – 2012 ("the Review Period").

As the plan sponsor of LACERS, the City has a strong interest in ensuring the effective administration of the System on behalf of its residents and taxpayers. This management audit is one of several mechanisms designed to allow the City to monitor LACERS[2] and indeed, we found LACERS' operations to be very transparent.

This Part Two Final Report of the Management Audit of LACERS dated November 21, 2013 includes the remaining objectives outlined in the scope of the audit as well as a review of the status of the recommendations from the prior Management Audit issued in 2007. A synopsis of Part One, the Interim Report, is included later in this section.

<u>Project Peer Group</u>

A peer group of public retirement funds (hereinafter the Project Peer Group) was established in consultation with the Joint Administrators, LACERS, and the auditors for the Los Angeles Fire and

[1] City Charter §1112(a). It would be highly unlikely that an organization such as LACERS would ever operate without room for some improvement in economy and efficiency. Therefore, this report considers the degree of economy and efficiency applied at LACERS. We did not consider economies of scale that might be achieved through consolidation of the three City pension systems.

[2] For example, LACERS is monitored by numerous independent professional firms of auditors, actuaries, and consultants whose reports are a matter of public record and has to submit its annual budget to Council. Its staffing is also subject to review by the City Administrative Officer. Its Board meetings are also open to the public and members of the public may participate. Five City Attorneys also play an active role in the legal affairs of the fund and have offices at LACERS.

Police Pension (LAFPP) management audit occurring simultaneously. The Project Peer Group consists of LAFPP and eight other comparable funds. See Appendix D for a complete list of the funds.

Summary of Key Observations and Recommendations

I.A. Asset Allocation

On the whole, the assets of the System are allocated in a reasonable manner and are adequately diversified. The current asset mix policy was determined on the basis of an asset/liability study conducted by its investment consultant. The study followed a methodology that reflects standard practice among most public and private sector pension funds.

A summary of our recommendations on asset allocation includes:

- In addition to using standard methods, LACERS should also examine the performance of its asset mix policy under a limited number of specific economic scenarios in order to better understand the risk of lower than anticipated investment returns under adverse capital market conditions. (This would supplement the current use of Monte Carlo simulation, which examines the performance of the fund's portfolio over a wide range of statistical outcomes. The underlying economic conditions which would produce a particular outcome, however, cannot be specifically identified under the Monte Carlo methodology.)
- LACERS should devote more time and effort to reviewing the investment assumptions at the outset of any asset/liability study that is conducted.
- LACERS should explore, with its investment consultant, alternative methodologies, other than mean-variance optimization, in determining the allocation to private market assets. (To our knowledge, these alternative methodologies have not been adopted by any public pension funds, but have been utilized in other sectors. Accordingly, if LACERS determines that such alternative methodologies are not feasible for LACERS, then it should continue using its existing methodology.)

I.B. Compliance with Investment Policy

LACERS' current asset mix *policy* has been established in compliance with the Investment Policy Statement and it meets the requirement of that Statement concerning diversification. The *actual* allocation of assets, however, has on a couple of occasions over the past five years exceeded the maximum-minimum ranges specified in the Statement. The current allocation is well outside the ranges specified in the asset mix policy approved by the Board in January 2012. The Board has established a transition plan to implement the policy by September 2014 with a net target asset mix set every quarter. It has not, however, established guidelines for rebalancing the asset allocation if it drifts from the quarterly target mix.

The Retirement System has generally been in compliance with the *portfolio structure guidelines* set out in the Investment Policy Statement. It has also been in compliance with the *Investment Risk Management Policy* established in December 2011 with respect to managing strategic and asset class risk using a risk budgeting process.

It has also generally been in compliance – or substantially in compliance – with the various guidelines, limits and constraints set out in its Real Estate and Alternative Investment Policies. However, we note that the regular reporting provided to the LACERS Board does not specifically address certain diversification requirements set out in the policies, i.e., the reports do not allow the LACERS Board to fully monitor policy compliance in these asset classes. Specific examples of policy guidelines that cannot be monitored using the current reports are identified in the main body of this report.

A summary of our recommendations on compliance with investment policy includes:
- LACERS should establish maximum-minimum asset allocation ranges as part of the transition plan to guide the rebalancing of the actual allocation if it were to drift too far away from the quarterly target mix.
- LACERS should establish a separate rebalancing policy with comprehensive guidelines and procedures concerning the rebalancing process.
- LACERS should examine the feasibility of rebalancing the asset allocation of the Retirement System, on an ongoing basis rather than rebalancing only when the allocation exceeds the allowable ranges.
- LACERS should explore the use of overlay strategies, based on market index futures contracts, as an alternative and/or a supplement to rebalancing using only cash flows and asset purchases/sales.
- LACERS should require that quarterly performance reports include all necessary information to allow LACERS to verify compliance with all of the requirements set out in LACERS' investment policies pertaining to portfolio diversification.
- LACERS should require the investment consultants to submit a compliance report (at least annually), that verifies the System's compliance with the various provisions and guidelines of its investment policies. The compliance report could be either a separate report or be included in a separate section in the quarterly performance report.

II. Consideration of Certain Costs

Office Space Leasing Activities and Occupancy

In mid-2012 LACERS negotiated a lease under terms favorable to it and moved into its present location in the LA Times building. The present value at the time of the savings difference between its then current space and the new space was projected to be over $300,000. Updated reports on the move show favorable economic results with a net projected savings over the lease term in keeping with its expectations and compared to its old lease.

LACERS enjoys numerous benefits in the improved space such as proximity to government center, use of the LA Times cafeteria, reasonable parking, and excellent facilities, all at lower cost than the old space. The relationship between LACERS and LA Fire and Police Pensions (LAFPP) continues with LAFPP now benefitting from being able to use space at LACERS for Board and committee meetings. There are also plans for the City Attorney to move offices into the LACERS space.

All in all, we believe that LACERS is now well situated for office accommodations and that hurdle is now behind it. We have no recommendations on LACERS office space or the process used to arrive at the decision to lease the current space. Our analysis and conclusion is based in part on a review of the February 2012 Department of General Services Asset Management Division report titled Municipal Facilities Space Optimization Project Status. This report indicated at the time LACERS was searching for new offices that sufficient adequate and contiguous space was either unavailable or claimed in the future by other City departments.

Investment Transaction Costs

The prior management audit issued in 2007 recommended that LACERS should expand the Investment Policy Statement to define how transactions costs such as brokerage commissions should be monitored. The finding was related to the perceived issue of measuring transactions costs and not merely relying on the managers to do so. However, LACERS determined that its existing process was sufficient and that it had sufficient assurance that the portfolios are monitored and managed appropriately.

We agree with the LACERS decision in this regard because, for a fund that is entirely externally managed, trading and execution costs directly impact performance of the manager. LACERS' managers' performance is calculated based on the return on investment, net of fees and transaction costs. Therefore, it is in the best interest of the external managers to be diligent when it comes to paying the cost of trading and execution and there is a built in incentive for them to monitor their investment costs. We discussed investment management fees in the Interim Report.

III. Reasonableness of Retiree Health Benefits Actuarial Assumptions (OPEB)

The actuarial assumptions used by LACERS for the retiree health plan are generally reasonable. In prior years, downgrading the health trends rate was done in increments of 1%. Since the adoption of the downgrading of health trends by 0.5% per year, LACERS' ultimate rate of 5.0% represents a more reasonable range. LACERS also will need to reflect in its assumptions going forward the effects of the Patient Protection and Affordable Care Act (PPACA) which will impact the plan beginning in 2014. LACERS expects premiums to increase by 2% to 3%.

A summary of our recommendations on the retiree health plan assumptions includes the following:

- The assumption for deferred vested members should continue to be monitored and, the set of stratified rates by Service Range provided by the actuary for retiree medical and dental coverage should be considered.
- Data on marital status at retirement and age difference of spouses should be examined more closely because it is a more significant factor in an OPEB valuation than in a retirement valuation.

IV. Disability and Retirement Benefit Administration Process

Evaluation of LACERS Retirement Disability System

While tremendous steps have been made in using technology to enhance the disability retirement process, more work can be done to streamline this process in the future. As possible areas for enhancement, LACERS should:

- Add more automation in the application process;
- Establish relationships with area physicians to obtain medical records; and

- Coordinate with the City payment requests for evaluating physicians to eliminate unnecessary delays.

Disability Benefit Calculations
Our review indicated that LACERS' system accurately calculated disability retirement benefits.

Retirement Benefit Payment Timing
LACERS generally processes retirements in a timely manner, but should reduce the number of payments that are taking more than 60 days to process. The number of cases that are more than 90 days outstanding is small but may present a burden to those retirees. LACERS should consider ways to expedite these cases.

Retirement Benefit Calculations
Calculations we sampled followed plan provisions and agreed to member data and the administrative cost of living adjustments (COLA). Our review indicated that LACERS' system accurately calculated retirement benefits.

V. Governance and Fiduciary Responsibilities

We evaluated LACERS' governance practices and policies against published best practice standards (Published Standards), and the practices of over 25 public retirement boards as documented in the Cortex Governance Benchmarking Database (the "Cortex Peer Group").

Governing Authority and Autonomy
LACERS and its board have autonomy in many key areas, including setting investment policy, appointing most (but not all) service providers, and approving its own operating budget. We did, however, identify certain limits on LACERS' autonomy which are contrary to Published Standards and peer group best practice. These included limits on the Board's authority to select the General Manager, select external legal counsel, establish staff compensation and hiring policy (especially the authority to allocate or reallocate positions without going through the City's Personnel Department), and set the board meeting schedule.

The LACERS Board of Administration should consider proposing that the City Charter be amended to grant the Board full authority to administer the System subject to fiduciary standards, including the authority over the items noted above.

On a related matter, we noted that the prior Mayor had removed board members in mid-term without advance warning and for no stated reason. While we believe it is appropriate for the plan sponsor to have the authority to remove board members under appropriate circumstances, such removals can nevertheless be disruptive to board and staff operations.

The LACERS Board of Administration should propose that the City Charter be amended to stipulate that an appointed board member may only be removed prior to the end of his or her term for cause relating to the exercise of their fiduciary and statutory duties. Furthermore, if an appointed board member is removed from office prior to the expiry of his or her term, that the Charter should require that the specific reason(s) for such removal be publicly disclosed.

Board Committee Structure
The Board's current committee structure is reasonable, in light of the wide range of practices among the peer group, subject to two caveats. The Board should have a stand-alone audit committee, and it should consider eliminating its strategic planning committee.

Documentation of Roles and Responsibilities
LACERS' Governance Manual documents roles and responsibilities of most key decision-making bodies. We noted, however, that the responsibilities of the Board, Board Chair, and General Manager and staff are not centralized in clear and concise charters, which is a common practice among the peer group. We recommend that LACERS establish separate charters for the Board, Board Chair, and General Manager, as well as a charter for the Internal Audit position, once that position is established.

Governance and Ethics Policy Framework
We found LACERS' governance policies to be relatively clear and comprehensive. We noted, however, that some policies in the Governance Manual appear to be out of date; accordingly the Governance Manual should be updated. We also believe that the board would benefit from documenting policies in the following areas: board monitoring and reporting, strategic planning, and the General Manager's performance evaluation process.

The scope and content of LACERS' ethics policies and applicable ethics legislation appear generally consistent with published standards, as well as the prevailing practices of the Cortex Peer Group. We identified a number of minor implementation improvement opportunities, which are described in this report.

Board Education Policies and Practices
LACERS' education practices and policies are comprehensive and rigorous, and are generally consistent with Published Standards and the prevalent practices of the Cortex Peer Group. Our review found that LACERS has undertaken considerable efforts in this area. Notwithstanding LACERS' efforts, we noted that LACERS has not been receiving sufficient resources from the City's Ethics Commission (CEC) and/or the City Attorney's Office for board and staff ethics training. The City should work together with the CEC and the City Attorney's Office to ensure that the LACERS Board receives at least annual in-person training on the City's ethics laws.

Public Disclosure and Reporting
LACERS routinely discloses plan information in a manner consistent with the prevalent practices of the Cortex Peer Group. The LACERS Board receives many of the reports commonly provided to the boards of the Cortex Peer Group, and with comparable frequency.

VI. Long-term Strategic and Financial Planning

LACERS has adequate long-term strategic and financial policies and procedures in place to allow for timely and effective financial strategies and decisions to be made, including adjustments for financial market behavior and implementation of benefit structure changes made by the City. Our recommendation is that while the components of long-term strategic and financial planning exist and are in place, the City and LACERS should formalize that part of its communication process.

VII. Review of the Status of Prior Management Audit Recommendations

LACERS' Board and staff were diligent in their consideration of the prior management audit recommendations. Their efforts in that regard are well documented. The prior audit report contained 142 recommendations. We reviewed the status of a substantial number of them in Sec. VII of this report. The LACERS Board minutes and a comprehensive summary of the status prepared by LACERS staff indicate the following status:

Status	Number
Fully Implemented	68
Partially Implemented	16
Not Yet Implemented	13
Chose Not to Implement	36
Not Empowered to Implement	6
Not Applicable	3
Total	142

Several of the prior recommendations that were made may have required a City Charter change that was not within LACERS authority. These are included in the "Not Empowered" category.

Prior Management Audit Recommendation on Consolidation of LACERS and LAFPP
The prior management audits issued in 2007 made a recommendation that the Systems consider combining the assets of LACERS and LAFPP (Systems) into one fund to realize significant cost savings through economies of scale. While the Boards of both Systems considered the recommendation, they also both decided that they were not in a position to implement the recommendation because a Charter change would be required.

For this management audit, we were asked by the Joint Administrators to revisit the recommendation. In order to comply with this request, we compared the combined management fees of the two Systems at June 30, 2012 to a published benchmark[3] ("SACRS study") of fees for funds over $20 billion at the same date and estimated the cost of management fees for the hypothetical combined fund. Our limited analysis showed that the savings does not seem significant and this is primarily due to the fact that the SACRS study shows that fees increase for larger funds rather than decrease, as expected. It was not in the scope of our agreement with the City to perform a more detailed study of the matter. In order to judge more accurately, a study of the matter should be performed by the City.

The reader should also refer to our more detailed analysis of active vs. passive management in the Interim Report. We caution that actual savings resulting from a hypothetical combination of the two funds could be greater or less than estimated. Future changes in the level and structure of fees, market values of the portfolios, and asset allocations would impact the cost of management fees, and savings from other areas, where duplication of effort exists, would impact the estimated savings from

[3] State Association of County Retirement Systems ("SACRS") Public Fund Universe Analysis conducted by R.V. Kuhns. June 30, 2012. SACRS Web-site accessed October 18, 2013.

combination. Relatively recently the Boards of the Indiana Public Employees' Retirement Fund and the Indiana Teacher Retirement Fund combined the two funds. We understand that the new entity was successful in ensuring appropriate and balanced representation of each of the constituencies in the new entity.

Recommendation for the City

The City should consider the matter of consolidation or combination of its pension systems. One aspect of its consideration of the matter should be a comprehensive study to determine an estimate of the potential savings and form a basis for further action.

LACERS' Funded Status and Overall Conclusion

As reported in LACERS' audited financial statements at June 30, 2012, LACERS' pension plan was 69% funded (its funded ratio). The funded ratio is a point-in-time measurement that relates the value of the assets of the fund to the value of its liabilities as determined by LACERS' actuarial firm. Also, in each year of our review the financial statements reported that the City contributed the full Annual Required Contribution (ARC) to LACERS. The ARC is an amount, also calculated by LACERS' actuary, that is designed to fund the System to 100% ("fully funded") over a period of time not to exceed 30 years (the amortization period).

LACERS amortization period of 30 years or less[4], its *targeted* funding level of 100%, and the City's full payment of the ARC are consistent with best practices for government defined benefit pension plans.[5] That said, during the review period LACERS funded status reported at fiscal year-end declined from 84% in June 2008 to 69% in June 2012. The key reasons for this are primarily that actual investment returns did not meet assumed rates of return and benefit liabilities grew from $11.2 billion to $14.4 billion for the same reporting periods. These issues are discussed in detail in our Interim Report.

Compared to the Project Peer Group which had funded levels ranging from 62% to 85%, LACERS was in the lower third. According to a recent study, the estimated aggregate ratio of assets to liabilities in a sample of 109 state-administered plans and 17 locally administered plans was 73 percent. Compared to the plans in this study, LACERS' funded level was 4% lower.[6] At June 30, 2012, the funded status of the LACERS OPEB Plan was about 72% according to actuarial reports. In this respect, the LACERS plan leads the pack among large municipal retiree health plans in the U.S.

A commonly used benchmark cites 80% as a respectable funding ratio.[7] This figure is not supported by an authority that could require LACERS, as a public pension fund, to comply with such a benchmark. Rather, for public funds, it is a 'rule of thumb' that developed "as a healthy or minimum public pension funding level [that] seems to have its genesis in corporate plans, for which it was a statutory

[4] LACERS has several groups of pension liabilities, some of which are amortized over less than 30 years.
[5] Sustainable Funding Practices of Defined Benefit Pension Plans, Government Finance Officers Association. 2009.
[6] State and Local Pension Plans, Number 32, July 2013. *The Funding of State and Local Pensions: 2012-2016.* Alicia H. Munnell, Jean-Pierre Aubry, Josh Hurwitz, and Madeline Medeni.
[7] U.S. Government Accountability Office. The Pension Protection Act of 2006 provided that large private sector pension plans will be considered at risk of defaulting on their liabilities if they have less than 80 percent funded ratios under standard actuarial assumptions and less than 70 percent funded ratios under certain additional 'worst-case' actuarial assumptions.

threshold. This standard was also applied to private sector multiemployer plans."[8] By this measure the City could improve LACERS' funding ratio. However, in the absence of a statutory funded ratio requirement, the funded level that is acceptable for LACERS is determined ultimately by the City of Los Angeles as its plan sponsor which sets benefits, negotiates employee contribution levels, and decides the amount of its contribution to the plan.

In conclusion, it is important to consider that the five-year project audit period included the worst economic downturn since the Great Depression. Further, from the market peak before the downturn and recession to the fall of 2013, the markets have recovered and are in positive territory. Isolating a five year period presents inherent dangers in making comparisons, projections and judgments.

Considering the impact of that global economic calamity on LACERS, and based on all of the factors we reviewed, which included the difficulties associated with making comparisons of LACERS to other funds because no two plans are alike, we conclude that, when taken together with the results of our Interim Report for the five years audited, the System operated in a reasonably efficient and economical manner, and that on the whole, the process to allocate and diversify the assets of the System was also done in a reasonable manner. We identified several areas where we had observations and identified findings with recommendations for improvement to economy and efficiency. These observations, findings and recommendations are summarized in the Interim Report and immediately above in this Final Report, and also in more detail in the bodies of both reports. A Table of Final Report Recommendations follows the Synopsis of the Interim Report, which is the next section.

Synopsis of the Interim Report[9] issued June 27, 2013

An Interim Report issued June 27, 2013, focused on certain priority questions identified by the Joint Administrators. **The following section of the Executive Summary provides a brief summary of the Interim Report which can be accessed at the Controller's web site: http://controller.lacity.org/stellent/groups/electedofficials/@ctr_contributor/documents/contributor_web_content/lacityp_026044.pdf**

The Interim report focused on certain priorities identified by the Joint Administrators:

1. Minimization of City Contributions
2. Cost and Benefit of Active Management
3. Investment Manager Selection and Termination Policies and Practices

1. Minimization of City Contributions

Reasonableness of Actuarial Assumptions

LACERS' economic assumptions concerning the actuarially assumed rate of return on investments (hereinafter the Assumed Investment Return) are generally comparable to those of the Project

[8] Keith Brainard and Paul Zorn, *What is the source of the 80-percent threshold as a healthy or minimum funding level for public pension plans*? http://www.nasra.org/files/Topical Reports/Funding Policies/80_percent_funding_threshold.pdf; accessed September 10, 2013. (Note: On publication date of this report all hyperlinks were tested and found working.)
[9] The synopsis is a truncated version of the executive summary from the Interim Report. The reader is encouraged to read the full report including our recommendations therein which can be downloaded from the Controller's web site at LACERS Management Audit Interim Report.

Peer Group. LACERS lowered its Assumed Investment Return from 8.0% to 7.75% near the end of the Review Period, to be phased in over 5 years. The previous 8.0% Assumed Investment Return was slightly higher relative to the Project Peer Group and lowering it to 7.75% was not unreasonable. The decision by the LACERS Board of Administration to implement the lower Assumed Investment Return over 5 years rather than immediately has had the effect of deferring increases in City contributions.

Underperformance Compared to the Actuarially Assumed Rate of Return

LACERS' total fund return during the Review Period was substantially below LACERS' Assumed Investment Return. This underperformance translates into approximately $4.9 billion less than what the gains would have been had the Assumed Investment Return been achieved. Such a shortfall puts upward pressure on the contribution rate. Approximately $4.6 billion (94.4%) of the underperformance can be attributed to the dramatic decline of the capital markets during the Review Period from late 2007 to early 2009, rather than to the manner in which the LACERS investment program was operated; only $278 million (or 5.6% of the total underperformance) can be attributed to the latter.

Impact of Actuarial Smoothing of Investment Gains and Losses

LACERS' approach to setting the actuarial asset valuation method employed a longer period of smoothing (7 years) investment gains and losses than most of the Project Peer Group. This resulted in deferring the impact of the investment losses incurred during the Review Period to future contribution years. As of June 30, 2012 there remains $1.025 billion of prior investment losses that have yet to be recognized in the determination of required contributions. (This $1.025 billion represents part of the $4.9 billion shortfall referred to above.)

Administrative Expenses

LACERS' administrative expense was 17.18 basis points of average assets under management during the Review Period (where a basis point represents 1/100 of one percent). This is above the Project Peer Group average. Had LACERS been able to lower expenses to the same level as the Project Peer Group, the estimate of its total administrative expenses would have been approximately $4.7 million per year lower, or $23.5 million over the duration of the Review Period. LACERS' overall cost of administration per member was also higher than the Project Peer Group by approximately 42%. This Final Report reflects a change from the previously reported estimate in our Interim Report derived from applying the peer group average. While the adjusted estimate is lower, the overall observation remains relevant. No recommendation was made in the Interim Report (see explanation in next paragraph).

The largest component of LACERS' administrative costs relates to personnel which is mostly a fixed cost in the short run. Therefore, any reasonable reduction of administrative expenses would have minimal impact on City contributions. Personnel cost comprises approximately 72% of the total administrative expense. Several factors help explain why LACERS personnel cost is greater than the Project Peer Group. These include negotiated increases in salaries and wage rates, 'thawing' of the City's freeze on step advances, in-house data processing personnel expense, in-house pension payroll processing personnel, personnel required to support early retirement initiatives, and personnel required to administer health benefits.

2. Cost and Benefits of Active Management

Results of Active Management

LACERS' active management program has had mixed results. Over the 5-year period ending June 30, 2012, active management at the total fund level underperformed its passive policy benchmark by 0.6% or approximately $160 million. Viewed over a 10-year period active management matched its benchmark, net of fees.

The results of active management varied across LACERS' portfolios. Active management efforts were successful in fixed income and private equity, but unsuccessful in U.S. and Non-U.S. equity and real estate (over both the 5- and 10-year periods). LACERS' Corporate Governance Program, Opportunistic Fixed Income Program, and Emerging Manager Fund-of-fund Program have also been sources of active management underperformance.

In fiscal year 2011-12, LACERS incurred $20.8 million in investment management fees for its public market portfolios, using a combination of active and passive management strategies. Had the public market portfolios instead been managed on a fully passive basis, fees would have been only about $3.8 million. If during the year none of LACERS' active managers had generated gross excess returns, then the fully passive approach would have better served the fund to the tune of approximately $17 million.

Over the five years of the Review Period the potential estimated fee savings would have been approximately $85 million. However, LACERS' active managers, in the aggregate, did generate excess returns, gross of fees, during that period. The potential fee savings of $85 million therefore must be reduced by these excess returns to determine what the net impact of using a fully passive management approach would have been. Such calculation indicates that LACERS would have been better off by an estimated net amount of $21 million over the Review Period, had it used a fully passive management approach.

3. Investment Manager Selection and Termination Policies and Practices

Changes in Manager Selection and Termination Practices

Since 2011, LACERS has made a concerted effort to strengthen its manager selection and termination practices. This is best evidenced by the fact that LACERS established two new policies addressing these areas. We found the two new policies to be clear and comprehensive, and consistent with best practice. The policies and criteria are at least as detailed and comprehensive as policies we reviewed within the Project Peer Group.

The Executive Summary concludes with a Table of Final Report Recommendations that begins on the next page.

Table of Final Report Recommendations

Page	Recommendation
10	The City should consider the matter of consolidation or combination of its pension systems. One aspect of its consideration of the matter should be a comprehensive study to determine an estimate of the potential savings and form a basis for further action.
	Section I.A. Asset Allocation
30	1. LACERS should supplement its Monte-Carlo simulation with scenario analysis. This would allow it to examine the performance of its asset mix policy under a limited number of specific economic scenarios, so as to better understand the risk of lower than anticipated investment returns under adverse capital market conditions. It would also enable LACERS to better communicate the risks of the System to the City. The added costs associated with scenario analysis would be minimal. (Obj. 3, 5 & 9)
31	2. The Board should devote more time and effort to reviewing the investment assumptions before the asset/liability study is conducted (in the same way that it reviews actuarial assumptions prior to the actuarial valuation) to satisfy itself that the assumptions, particularly with respect to the expected returns on asset classes, are realistic, that they reflect the current valuations in capital markets, and that they are a reasonable expectation of investment performance over the period of the study. (Obj. 3, 5 & 9)
31	3. LACERS should explore with its investment consultant the feasibility of using alternative methodologies, other than mean-variance optimization, for determining the allocation to private market assets. (Obj. 3, 5 & 9)
31	4. LACERS should not invest in any asset class (or sub-asset class) without analyzing the potential implications of any such investment on the expected risk and return of the Fund. More specifically, LACERS should not invest in the real asset sub-asset classes that were recently approved until those sub-asset classes are modeled to determine the impact they may have on the total portfolio. (Obj. 3, 5 & 9)
	Section I.B. Compliance with Investment Policy
46	5. The Board should establish maximum-minimum asset allocation ranges as part of the transition plan to guide the rebalancing of the actual allocation if it were to drift too far away from the quarterly target mix. (Obj. 6)
47	6. LACERS should establish a separate rebalancing policy with comprehensive guidelines and procedures with respect to the rebalancing process. (Obj. 6) a. LACERS should examine the feasibility of rebalancing the asset allocation of the System, not just when the allocation exceeds the maximum-minimum ranges, but on an ongoing basis by directing contributions towards portfolios which are under-weighted (i.e. below their target allocation but still within the approved range) and withdrawals from portfolios which are over-weighted – with proper allowance for the liquidity issues surrounding private market assets. Purchases and sales of securities in order to rebalance should only be undertaken when the asset allocation exceeds the approved ranges. While we were informed by staff that they consider cash flows in the rebalancing process, this should be more clearly specified in its investment policy.

Page	Recommendation
	b. LACERS should explore the use of overlay strategies based on market index futures contracts as an alternative and/or a supplement to cash flows and asset purchases and sales for rebalancing.
47	7. The Board should require that the quarterly performance reports submitted by the general investment consultant, real estate consultant, and private equity consultant provide the necessary information to allow the Board to monitor compliance with the portfolio diversification requirements contained in LACERS' investment guidelines. (Obj. 6)
47	8. The Board should require that investment consultants submit a compliance report (on a quarterly basis or at least annually) that verifies the System's compliance with the various provisions and guidelines of its investment policies. The compliance report could be either a separate report or be included in a separate section in the quarterly performance report. (Obj. 6)
	Section III. Reasonableness of Actuarial Assumptions – Retiree Health Plan
55	9. LACERS should consider the set of stratified rates by Service Range provided by the actuary for retiree medical and dental coverage and continue to monitor the 50% election assumption for deferred vested members. (Obj. 7)
55	10. LACERS should re-examine the data on marital status at retirement and age difference of spouses because it is a more significant factor in an OPEB valuation. (Obj. 7)
	Section IV. Disability and Retirement Benefits Administration
61	11. LACERS should add more automation if cost-beneficial, in the application process to reduce the amount of work, time, and effort spent scanning applications, and ensure applications are complete. An automated system would ensure that all applications are legible and complete before submission, and automatically generate an electronic file, that would likely be easily searchable. (Obj. 10)
61	12. LACERS should establish relationships with area physicians and become more proactive in getting medical records. Specifically, if cost-beneficial, creating a mechanism to accept these applications electronically will eliminate the delay that may be present with faxing or mailing this information, and allow the Disability Department to keep track of medical records in real time. (Obj.10)
61	13. LACERS should organize scanned data into additional sub categories if cost-beneficial, to help increase utility. (Obj.10)
63	14. LACERS generally processes retirements in a timely manner. The number of cases that are more than ninety days outstanding (3 out of 595) is relatively minor but may present a burden to those retirees. LACERS should consider ways to expedite these few cases. (Obj. 1)
	Section V. Governance and Fiduciary Responsibility
67	15. In accordance with industry best practices and published standards, LACERS should propose to the City Council that the City Charter be amended to grant the Board full authority to administer the System subject to fiduciary standards. Such authority would include but is not limited to:

Page	Recommendation
	a. Appointment of the General Manager; b. Selection of legal counsel (internal and external); c. Staff compensation and hiring policy (at a minimum, the authority to allocate or reallocate positions without going through the City's Personnel Department); and d. Setting the number and timing of board meetings. If the City does not have sufficient confidence that the Board will exercise such authority appropriately, it should then consider establishing any necessary safeguards to protect against the improper exercise of such authority; e.g. enhancing the qualifications and independence of the Board. Such added safeguards would be more effective than constraining the Board's ability to administer the System, and would therefore better serve the interests of all stakeholders. (Obj. 11)
67	16. LACERS should propose to the City Council that the City Charter be amended to stipulate that an appointed board member may be removed prior to the end of his or her term, but only for cause relating to the board member's fiduciary or statutory duties, and that if an appointed board member is removed from office prior to the expiry of his or her term, that the reason(s) for such removal be publicly disclosed. (Obj. 11)
71	17. LACERS should establish separate comprehensive charters for the Board, the Board Chair, and the General Manager (i.e., staff), as opposed to having their roles and responsibilities documented in various governance and investment policies. The use of charters (or terms of reference) was a typical practice among the Cortex Peer Group. (Obj. 11)
72	18. LACERS should establish a charter for the internal audit position that describes the roles and responsibilities of the position, and the internal auditor's reporting relationship with the Board and the General Manager. (Obj. 11)
72	19. LACERS should remove the Investment Committee charter from the Governance Manual, as well as various references to the committee found throughout the Governance Manual, as the committee was disbanded in 2011. (Obj. 11)
72	20. LACERS should consider instituting a consistent format and content for each committee charter, such as a general statement as to the role of the committee, committee composition, frequency of meetings, as well as the specific duties and responsibilities of the committee. (Obj. 11)
72	21. As LACERS investment programs get larger and more sophisticated over time, the Board should consider delegating the entire selection process to management, subject to board-approved parameters, selection criteria, and relevant internal controls. As we noted above, the Board has already moved in this direction. (Obj. 11)
72	22. The Board should establish a separate audit committee, and in preparing a charter for the committee, should consider the sample charters prepared by the Association of Public Pension Fund Auditors (APPFA) and the American Institute of Certified Public Accountants (AICPA). (Obj. 11)

Page	Recommendation
72	23. The Board should consider eliminating the strategic planning committee. (Obj. 11)
73	24. LACERS should establish a formal frequency for the periodic review of its governance policies. Industry standards in this regard range from every 3 to 5 years. The policy review frequency should be documented (this could be done in the Statement of Governance Principles, or in each policy). Ideally, all governance policies should indicate the date the policy was first approved, and last reviewed and/or amended. (Obj. 11)
73 74 74	25. LACERS should establish other governance policies which we view as best practice, and which were common among the Cortex Peer Group: a. A Monitoring and Reporting Policy: this policy would set out the routine reports to be provided to the Board and/or its committees. (This type of policy would satisfy the requirement in section D of the Statement of Governance Principles concerning identifying information needs.) b. A strategic/business planning policy: LACERS has established a rigorous strategic planning process, which involves regular reporting to the Board and its committees. We suggest that there would be value in documenting the parameters of this process in a board policy or staff procedure. c. A General Manager Performance Evaluation Process: the only documentation we received concerning the evaluation of the General Manager was a memorandum to the Board dated August 8, 2006 which briefly described the evaluation process, and incorporated the City's General Manager Performance Evaluation form. (The memorandum referred to an Executive Evaluation Committee, which we understand no longer exists.) The Board should establish a formal evaluation policy and evaluation tool for the General Manager. It may use the August 2006 memorandum as a starting point but should also explore best practices in the industry. (Obj. 11)
74	26. LACERS should review and update its Investment Policy Statement and other investment policies, and include the latest versions in its Governance Manual. (Obj. 11)
74	27. LACERS should add the Board Communications Policy to the Board's Governance Manual. (Obj. 11)
74	28. LACERS should update the Commitment of a LACERS Board Member document, which references committees and subcommittees that no longer exist (e.g., Audit and Risk Control Committee, Private Investment Committee, etc.) (Obj. 11)
78	29. LACERS should reorganize the Governance Manual so that its ethics-related policies are all contained in the same section of the Manual to assist board members in maintaining familiarity with them. (Obj. 11)
78	30. LACERS should amend its Governance Manual so that it includes a comprehensive list of all applicable ethics legislation, for easy reference by board members and staff (such as, the City's Governmental Ethics Ordinance, and the Mayor's Executive Directives No. 1 and No. 7). The City Ethics Commission or the City Attorney's Office should assist LACERS in this regard. (Obj. 11)
78	31. LACERS should establish an annual attestation to be completed by board members, in which they affirm that they have reviewed and are familiar with LACERS' governance and ethics policies. The affirmation could also be extended to staff, with respect to applicable ethics policies. (Obj. 11)

Page	Recommendation
78	32. Public fund trustees are subject to the highest level of fiduciary duty that exists in law, as well as complex ethics legislation and policy at the state, city and board level. Accordingly, the City should work together with the CEC and the City Attorney's Office to ensure that the LACERS Board receives at least annual in-person training on the City's ethics laws. (Obj. 11)
80	33. LACERS should develop an education needs assessment process for the Board, which would serve as input into a Board or trustee education plan. This is an emerging practice, which involves periodically surveying individual board members on certain education-related issues, including: a. Educational topics for further study that relate to the duties of the trustees. (We often find that staff is in a good position to identify a list of potential topics for the Board's consideration.) b. Trustee preferences as to how best to obtain that education (e.g., internal versus external education, amount of education per year, educational tools, etc.). (Obj. 11)
81	34. LACERS should establish consistent accessibility to the meeting minutes of all its board committees. (Obj. 11)
82	35. LACERS should consider conducting fund attribution on a regular basis. In doing so, although not a common industry practice, LACERS should discuss with its investment consultant the feasibility of obtaining attribution data on a broader time horizon (i.e., quarterly, annually, every 3 years, 5 years and 10 years). In the June 2012 investment performance report, attribution data is provided only for the latest quarter. (Obj.11)
83	36. The Board should review Section D of the Statement of Governance Principles with respect to the following requirements, and decide whether to reaffirm them or remove them from the policy statement: a. Have in place policies and guidelines concerning proposed legislation (state and federal); adoption/amendment of administrative code, rules and regulations; and b. The periodic evaluation of the Board's performance. (Obj. 11)
	Section VI. Long-term Strategic and Financial Planning
90	37. While the components of long-term strategic and financial planning exist and are in place, the City and LACERS should formalize that part of its communication process. (Obj. 13)

Acknowledgements

Lastly, as we stated in the Interim Report, everyone at LACERS had a great attitude of cooperation. We want to thank Tom Moutes, LACERS' General Manager, who worked diligently to provide us with access to the staff and information needed to prepare the Interim and Final Reports. We hope that LACERS finds both reports useful in managing its employee benefit plans as a part of the City's employee retirement security programs.

Detailed Discussion and Analysis

The following main body of the Report contains the detailed discussion and analysis of the objectives. The report format in each section sets out the task area and objectives, in some cases the criteria we used, analysis and observations, and finally, our recommendations. **(Note: Audit Objectives are numbered based on the Request for Proposals but are grouped for reporting based on topic and flow. Objectives are not addressed sequentially primarily for this reason and also because several Objectives were addressed in the Interim Report.)**

I. Asset Allocation and Investment Administration

I.A. Asset Allocation

Objective 3: As the Plan Sponsor, the City incurs significant costs to the pension/ retirement system when the market returns are lower than anticipated. Evaluate whether the pension/retirement system has adequate processes to account for this type of occurrence while ensuring that the Plan Sponsor's contributions are sustainable.

Objective 5: Determine whether pension plan/retirement system investments are diversified adequately in order to minimize the risk of loss and to maximize the return rate.

Objective 9: Evaluate the adequacy and reasonableness of the manner in which pension/retirement system assets are allocated.

For these objectives we attempted to answer the following questions: is LACERS' asset allocation process reasonable; does it provide adequate diversification; does it prudently balance risk and return, and does it sufficiently address the risk of unexpected contribution increases for the City, e.g., when market returns are lower than anticipated; and, are City contributions sustainable?

Asset Allocation Process Evaluation Criteria

In order to determine whether the assets of a pension fund are allocated in a reasonable manner and adequately diversified, consistent with best practice, the asset allocation study should meet the following criteria:

(a) The allocation study should be based on a comprehensive and rigorous study of both the assets and liabilities of the pension plan, and should analyze their expected performance over an appropriate future time period.

(b) The study should examine the performance of the assets and liabilities under a range of different economic and capital market conditions, reflecting both strong as well as weak economic growth, and even recessions. They should incorporate both rising and falling markets, and include periods of very high returns as well as very low, and even negative, returns.

(c) The study should analyze a number of alternative asset mix policies that would generate the maximum expected return for a given level of investment risk. It should evaluate the impact of each asset mix policy on the plan's expected level of contributions, funded status, or both, not only in the most likely case, but also under adverse or "worst case" economic scenarios.

(d) It should consider all available asset classes, including both public and private market assets, which other pension and institutional funds either invest in or consider suitable for potential investment. The asset classes should have meaningfully different expectations with respect to return, volatility and correlation.

(e) For a public defined benefit retirement plan, the asset/liability model should be "stochastic", at least with respect to the modeling of the assets. This means that the model should at a minimum, allow the value of assets to vary over time with changes in inflation, interest rates, actuarial discount rates, and the volatility of capital markets.

(f) The analysis should be based upon investment assumptions about the expected return, volatility and correlation of the various asset classes, and upon actuarial assumptions with respect to expected inflation and the actuarial discount rate. The assumptions should be forward-looking (particularly for the expected return on assets), realistic, and internally consistent with each other, taking into account current valuations in capital markets – rather than merely a projection of historical trends.

Asset Allocation Process Background and Current Practices

LACERS' current asset allocation policy was approved by the Board on January 10, 2012 based on an asset/liability study conducted by the Board's investment consultant, Wilshire Associates (Wilshire). The study simulated the future performance of the System over a 10-year period using an asset allocation methodology (termed "Commitment Driven Investing" by Wilshire) which had two goals: (i) maximizing the security of pension benefits while (ii) minimizing the cost of funding the benefits.[10] The initial step in the process was the development of Wilshire's assumptions of expected returns, volatility (measured by the standard deviation of returns) and correlation, something the consultant does annually for a wide range of asset classes.

The investment assumptions used in the asset/liability study are set out in Table 1 on the next page. According to the investment consultant, the assumptions were forward-looking with respect to expected return, and based on historical data for volatility and correlation, adjusted "to incorporate recent trends."

[10] Our review is based on a series of presentations that Wilshire Associates made to LACERS' Board, including in particular one titled "Asset Allocation and Wilshire Asset-Liability Methodology Overview" on October 25, 2011, and another titled "Asset Allocation Analysis and Recommendation" on January 10, 2012. We also conducted interviews with LACERS' investment staff and the investment consultant.

Table 1 – Asset Classes and Investment Assumptions

	US Equity	Non-US Equity	Private Equity	Core Bonds	Credit Opp.	Cash	Real Assets
Expected Return (%)	7.75	8.00	11.00	3.00	6.30	1.75	4.45
Volatility (%)	16.00	17.25	26.00	5.00	9.80	1.25	7.80
Correlation							
US Equity	1.00						
Non-US Equity	0.83	1.00					
Private Equity	0.75	0.69	1.00				
Core Bonds	0.29	0.09	0.32	1.00			
Credit Opportunities	0.57	0.57	0.38	0.25	1.00		
Cash	-0.05	-0.08	0.00	0.20	-0.06	1.00	
Real Assets	0.36	0.36	0.36	0.25	0.46	-0.03	1.00

The US equity asset class was reflective of the broad domestic equity market and included both large and small capitalization stocks. Similarly, non-US equities included both developed and emerging markets stocks.[11] The Credit Opportunities portfolio was to consist of 50% high yield bonds, 35% emerging market bonds, 10% leveraged bank loans, and 5% distressed debt.[12] The Real Assets portfolio would be 50% private real estate (a mix of core, value-added and opportunistic), 30% Treasury Inflation Protected Securities (TIPS), 10% Real Estate Investment Trusts (REITS), and 10% commodities.[13]

These asset class assumptions were then used to determine the expected return and risk (measured by the volatility of returns) of the existing asset mix policy, as well as to derive a set of optimal portfolios using a mean-variance optimization model. The following four portfolios on the "efficient frontier" were selected for further analysis:

(a) The portfolio which would match the expected return of the current asset mix policy while minimizing investment risk or volatility;
(b) One which would match the volatility of the current policy while maximizing return;
(c) One which would maximize expected return (subject to the asset allocation constraints); and finally
(d) The portfolio which would maximize expected return while setting the fixed income allocation (core bonds plus cash) equal to 20%.

[11] This was indicated in a subsequent presentation by Wilshire to the Board on January 24, 2012, titled "Risk Budget Analysis and Recommendations" which recommended a portfolio and manager structure for each of the major asset classes.
[12] This was proposed in Wilshire's presentation to the Board on December 27, 2011, titled "Overview of Credit Opportunities".
[13] In a presentation to the Board on November 27, 2011, titled "Overview of Real Assets", Wilshire had indicated that a real assets portfolio could also include infrastructure, timberland, farmland, natural resources and oil & gas. However, these additional sub-asset classes were not explicitly modeled as part of the Real Assets portfolio in the asset/liability study.

Table 2 shows the asset allocation, expected return and volatility for the current asset mix and the four optimal portfolios.

Table 2 – Current & Optimal Portfolios: Asset Allocation, Expected Return & Volatility

		Existing Policy	Matched Return	Matched Volatility	Maximum Return	Fixed Income 20%
Equities (%)	US Equity	**37.0**	20.0	22.0	29.7	24.0
	Non-US Equity	**20.0**	24.4	26.9	36.3	29.0
	Private Equity	**9.0**	11.3	12.0	12.0	12.0
Fixed Income (%)	Core Bonds	**26.0**	23.3	18.1	14.0	19.0
	Cash	**1.0**	1.0	1.0	1.0	1.0
	Credit Opportunities	**---**	5.0	5.0	0.0	5.0
Real Assets (%)		**7.0**	15.0	15.0	7.0	10.0
Total Allocation (%)		**100.0**	100.0	100.0	100.0	100.0
Expected Return – Median (%)		**7.05**	7.05	7.33	7.74	7.40
Volatility – Std. Deviation (%)		**11.61**	10.85	11.61	13.52	12.02

The following constraints on minimum and maximum allocations were imposed on the model to ensure that it would produce "reasonable" results:

US and Non-US equity:	20% - 40% each
Core Bonds:	15% - 30%
Private Equity:	7% - 12%
Real Assets	7% - 15%
Credit Opportunities	0% - 5%
Cash:	0% - 2%

The four portfolios were "optimized", subject to the above constraints, to produce the maximum level of expected return for that particular level of investment risk or volatility.

The other major input to the asset liability model was the stream of future benefit payments, based on expected pay and service for the member population, as projected in the actuarial valuation as of June 30, 2011 by the Plan's actuary, The Segal Company (Segal). The liability assumptions with respect to the actuarial discount rate, as well as demographic assumptions were also taken from that actuarial valuation.

The performance of the pension plan under the existing asset mix policy and for the four optimal portfolios was then simulated over the 10-year period. Each asset mix policy or portfolio was analyzed with respect to its impact on the following measures of the plan's financial position:

- Employer Cost – defined as the present value of employer contributions required to generate sufficient additional assets to pay all current and future benefits.

- Present Value of Contributions – measured over the 10-year future period.
- Economic Cost – defined as the present value of employer contributions over 10 years plus the present value of the unfunded liability at the end of year 10.[14]

The expected or median outcome over the 10-year period, for each of the measures above, was compared against the risk – i.e. the outcome under a "very pessimistic" or "worst case" scenario (defined as one at the 99th percentile of probability). The results of the analysis are shown in Table 3.

Table 3 – Existing Policy & Optimal Portfolios: Impact on Contributions & Funded Status

		Existing Policy	Matched Return	Matched Volatility	Maximum Return	Fixed Income 20%
Total Employer Cost ($ billion)	Expected	**$10.0**	$9.9	$9.2	$7.8	$8.9
	Worst Case	**$28.4**	$26.8	$26.5	$27.4	$26.7
PV of Contributions ($ billion)	Expected	**$4.8**	$4.8	$4.7	$4.6	$4.7
	Worst Case	**$6.2**	$6.2	$6.2	$6.3	$6.2
Economic Cost ($ billion)	Expected	**$7.3**	$7.3	$7.1	$6.6	$7.0
	Worst Case	**$11.4**	$11.2	$11.2	$11.5	$11.3

The total cost to the employer of paying all current and future benefits to the existing plan membership was shown to be lower for all four optimal portfolios compared to the existing asset mix policy. It would be appreciably lower, by about $1.1 billion to $2.2 billion, in the case of the 20% fixed income and maximum return portfolios respectively. The cost would be lower both in the median case (i.e. on average) as well as under the "worst case" scenario.

The present value of employer contributions over the next 10 years would be roughly the same or slightly lower than in the existing asset mix policy for all four portfolios – both on average as well as in the worst case scenario.

The economic cost – measured as the present value of employer contributions plus the present value of the unfunded liability at the end of 10 years – would be moderately lower for the matched volatility and 20% fixed income portfolios compared to the existing policy, both in the median case as well as under the worst case scenario. It would be quite significantly lower on average for the maximum return portfolio compared to the existing policy, but slightly higher in the worst case scenario. The difference between the economic cost and the present value of contributions measures the PV of the unfunded liability at the end of year 10. Since the economic cost is lower for three of the four portfolios compared to the existing policy, whereas the present value of contributions is about the same, it means there would be a slight improvement in the plan's funded status over the 10 years. The fact that the economic cost is higher than the present value of contributions means the plan would still be expected to remain in a deficit position at the end of the 10-year period.

Wilshire concluded its analysis by recommending that LACERS adopt the 20% fixed income portfolio as its new asset mix policy. The Board discussed and approved that recommendation. Table 4 on the next page compares the new asset allocation to the previous asset mix policy.

[14] Present values were measured using the current actuarial discount rate of 7.75%.

Table 4 – New vs. Previous Asset Mix Policy

Asset Classes	New Asset Mix Policy	Previous Policy	Change
Equities	**65%**	**66%**	**-1%**
US Equity	24	37	-13
Non-US Equity	29	20	+9
Private Equity	12	9	+3
Fixed Income	**25%**	**27%**	**-2%**
Core Bonds	19	26	-7
Credit Opportunities	5	---	+5
Cash	1	1	0
Real Assets	**10%**	**7%**	**+3%**
Private Real Estate	5	7	-2
Public Real Assets	5	---	+5

The new (now current) asset mix policy calls for a significant reduction in the allocation to US equities, a moderate reduction in core bonds, and a slight reduction in private real estate, offset by a big increase in non-US equities, and a modest increase in private equity.

The policy also proposed a 5% allocation to each of two new portfolios: credit opportunities and public real assets. LACERS already had a small opportunistic fixed income program (less than 1% of total assets) as part of its overall fixed income allocation, as well as some exposure to high yield and emerging markets debt through the main core-plus bond portfolio. Wilshire recommended, however, that there be a separate allocation to credit opportunities, so that the Board could control the allocation (not the bond managers) and better manage the risk of such investments. The public real asset portfolio would be invested in TIPS, real estate securities or REITS, and commodities.

Asset Allocation Process Findings & Analysis

The foregoing information provides the basis to determine if the assets of the System are allocated in a reasonable manner, and if the System is adequately diversified. We assessed the process LACERS followed in arriving at its current asset mix policy in place as of June 30, 2012 against the criteria or standards of best practice set out earlier in this report. Our findings are as follows:

1. ***Comprehensive Study of Assets & Liabilities:*** The current asset mix policy was based on a study of the expected performance of the assets and liabilities of the plan over a 10-year future period. The nature and scope of the study was very similar to those undertaken by other public and corporate pension plans. This study was conducted by the LACERS' general investment consultant, Wilshire Associates, which has considerable experience in performing such studies.

2. ***Asset Mix Policies Were Simulated Under a Variety of Economic Conditions:*** The study simulated the future performance of a number of alternative asset mix policies (or optimal portfolios) using

a Monte-Carlo simulation model[15], based on a set of assumptions for various asset classes over a 10-year period. For each asset mix policy, the computer-based model generated a thousand or more iterations of fund performance, each iteration reflecting a particular economic and capital market scenario. This resulted in a probability distribution of investment returns reflecting a wide spectrum of economic and capital market conditions. The use of a Monte Carlo simulation model is a standard and generally-accepted practice in conducting asset/liability studies.

Table 5 shows the range of expected returns for the current asset mix policy for various time periods during the 10 years, as indicated in the asset/liability study.

Table 5 – Current Asset Mix Policy: Range of Expected Returns

Total Fund Return (%)	One Year	Three Years	Five Years	Ten Years
Very Optimistic	28.8%	19.3%	16.5%	13.8%
Optimistic	15.7	12.1	11.0	10.0
Expected (Median)	**7.4**	**7.4**	**7.4**	**7.4**
Pessimistic	-0.4	2.9	3.9	4.9
Very Pessimistic	-10.5	-3.3	-1.0	1.4

The asset allocation process took into account the possibility of low and even negative total fund returns over periods as long as 5 years.

As part of their asset/liability studies, some pension funds supplement Monte Carlo analysis with scenario analyses (i.e. examinations of the performance of different asset mix policies under specific, adverse economic scenarios such as "high inflation", "slow growth", "recession", etc.). Scenario analysis allows pension funds to gain a better understanding of how their plan will perform in specific environments, and allows them to communicate this to the plan sponsor in more clear and meaningful terms, thus allowing the plan sponsor to better understand and prepare for the funding needs of the plan.

The LACERS asset/liability study was based on Monte Carlo analysis only, and did not include scenario analysis. Given that the added cost associated with introducing scenario analysis would be minimal, and that scenario analysis can lead to more effective decision-making on the part of both LACERS and the City, we believe LACERS should consider including scenario analysis as part of future asset allocation studies.

3. ***Multiple Asset Mix Policies Were Evaluated:*** The asset/liability study analyzed a number of alternative asset mix policies which were determined to be "efficient" in generating the maximum expected return for a given level of investment risk or volatility. The study evaluated each asset mix policy in terms of its expected impact on plan contributions as well as on funded status, in the median or most likely case and also under a "worst case" scenario.

[15] In the context of pension fund asset/liability studies, the so-called Monte Carlo method simulates the potential range of performance of a fund's asset allocation under numerous economic scenarios (e.g., 1000 or more) and variable economic and capital market assumptions. The method can determine the range of expected performance of the fund's asset allocation policy under various economic environments, and can estimate the probabilities of any particular outcome (e.g., strong, mediocre or poor performance).

4. ***Numerous Asset Classes Were Considered:*** LACERS' asset/liability study took into consideration a range of different asset classes, in both public and private markets, and in traditional and alternative investments. In addition to the conventional assets – stocks and bonds, plus private equity and real estate – the study also considered two other portfolios, credit opportunities and real assets, each comprised of a number of sub-asset classes. Credit opportunities included high yield bonds, emerging market debt, bank loans and distressed debt. Real assets included (in addition to private real estate) TIPS, real estate securities or REITS, and commodities.

   Table 6 shows a list of the asset classes and sub-classes in the current asset mix policy as well as the actual allocation of the System as of June 30, 2012.[16]

   Table 6 – Asset Allocation (%)

Asset Classes	Asset Mix Policy	Actual Allocation
Equity	**65%**	**67.2%**
US Equity	24	38.8
Non-US Equity	29	17.2
Private Equity	12	11.2
Fixed Income	**25%**	**26.7%**
Core Bonds	19	25.3
Credit Opportunities	5	0.7
Cash	1	0.7
Real Assets	**10%**	**6.1%**
Private Real Estate	5	6.1
Public Real Assets	5	0.0

   Wilshire's presentation to the Board in January 2012 on the asset/liability study indicated that real assets would consist of 50% private real estate, 30 % TIPS, 10% REITS, and 10% commodities. However, a subsequent "Real Assets Strategy Statement" approved by the Board in February states that the real assets investment program would also consider timber/farmland, natural resources, infrastructure and oil & gas funds as appropriate for investment. LACERS however does not currently have any investments in these additional sub-asset classes.

   As confirmed with Wilshire, the sub-asset classes of timber/farmland, natural resources, infrastructure and oil and gas funds were not specifically modeled as part of the real assets portfolio during the asset/liability study. As a result, the impact of any future investment in these sub-asset classes on the risk and return of the real asset portfolio and the total Fund would not have been analyzed or fully considered. We recommend that should LACERS decide it, in fact,

[16] The current asset mix policy, approved in January 2012, has not yet been fully implemented. LACERS has adopted a transition plan to complete the implementation of the policy by September 2014.

wishes to invest in the above sub-asset classes, proper modelling of the sub-asset classes should be performed.

Table 7 compares LACERS' asset mix policy against the average asset allocation of other public retirement systems. The information is derived from two recent studies. One is a survey published in June 2012 by Cliffwater LLC, a firm that provides advisory services on alternative investments to institutional investors, of the asset allocation and investment performance of 69 state pension systems. The other is a study of state retirement systems by the National Institute on Retirement Security (NIRS) published in January 2013. The data is for the year 2011.[17]

Table 7 – Asset Allocation: LACERS vs. Other Public Funds

<table>
<tr><th>Asset Classes</th><th>LACERS</th><th>Cliffwater</th><th>NIRS</th></tr>
<tr><td>Public Equity</td><td>53%</td><td>51%</td><td>51.0%</td></tr>
<tr><td>US Equity</td><td>24</td><td>NA</td><td>31.1</td></tr>
<tr><td>Non-US Equity</td><td>29</td><td>NA</td><td>19.9</td></tr>
<tr><td>Private Equity</td><td>12%</td><td>9%</td><td>8.2%</td></tr>
<tr><td>Fixed Income</td><td>25%</td><td>27%</td><td>25%</td></tr>
<tr><td>Core Bonds</td><td>19</td><td rowspan="2">25</td><td rowspan="2">25</td></tr>
<tr><td>Credit Opportunities</td><td>5</td></tr>
<tr><td>Cash</td><td>1</td><td>2</td><td>NA</td></tr>
<tr><td>Real Estate</td><td>5%</td><td>6%</td><td>6.4%</td></tr>
<tr><td>Other Real Assets</td><td>5%</td><td>2%</td><td rowspan="3">9.5%</td></tr>
<tr><td>Hedge Funds</td><td>---</td><td>3%</td></tr>
<tr><td>Other</td><td>---</td><td>1%</td></tr>
</table>

LACERS' asset allocation is comparable to other public pension funds with respect to public market investments (equities and fixed income). It has slightly higher allocations to private equity and real assets, but no investment in hedge funds.

LACERS' asset/liability study did not consider an allocation to hedge funds. This is an asset class which many public pension funds invest in – and which is an important component of the asset allocation of most endowment funds. Whether hedge funds should be considered an asset class at all is, in our view, open to question. The name "hedge funds" encompasses a variety of active investment strategies with very different risk/return profiles – some are relatively low risk, such as market neutral and arbitrage strategies, while others are extremely aggressive, often involving the use of leverage. Hedge funds invest in a range of asset classes from conventional stocks and bonds to emerging market equities and debt, commodities, currencies, and derivative and synthetic

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[17] Cliffwater LLC, "Trends in State Pension Asset Allocation and Performance" June 26, 2012.
http://www.seanc.org/files/3813/7354/8866/Cliffwater_Research_-_Trends_in_State_Pension_Asset_Allocation_and_Performance_June_2012.pdf
National Institute on Retirement Security, "How Do Public Pensions Invest? A Primer" January 2013
http://www.nirsonline.org/index.php?option=com_content&task=view&id=742&Itemid=49

instruments. We believe that it may be more appropriate to consider hedge fund strategies in determining the investment and manager structure of individual asset portfolios, rather than as part of the System's overall asset allocation policy.

The asset/liability study used a mean-variance optimization model to determine the allocation to both public as well as private market assets. Private market assets are, however, very different when it comes to their trading, valuation and liquidity. Since they do not trade on well-regulated public exchanges or organized over-the-counter networks, information on prices, valuations and returns is difficult to come by and may not reflect the true risk and return of these asset classes. For example, real estate valuations rely mainly on appraisals rather than transaction prices. The performance of a private equity fund cannot be properly measured until the fund is wound up. Liquidity risk is often a major consideration for private market assets, as important, if not more important, than volatility. In particular, it is usually difficult to separate the actual potential of the asset class from the influence of active management. In other words, one cannot have a great deal of confidence in the assumptions of expected return, volatility and correlation for private market assets.

The optimization model commonly used in asset liability studies, on the other hand, is highly sensitive to the investment assumptions. Even small changes in the assumptions can produce wide swings in the "optimal" asset allocation. Because future returns and risks of private market assets are so uncertain (past history is a poor guide and current valuations are very unreliable) investment consultants typically place very tight constraints on their allocation in order for the model to produce "reasonable" results. For example, in the LACERS January 2012 asset/liability study minimum-maximum limits of 7%-12% were imposed on the allocation to private equity and 7%-15% on the allocation to real estate. These limits are essentially judgment calls on the part the consultant as to what an "appropriate" allocation to these asset classes should be. If the asset allocation model were allowed to run unconstrained, it would be likely to produce quite "unreasonable" allocations. Asset allocation, in other words, is more an art than a science. The use of a mathematical model tends to lend a somewhat artificial and spurious analytical rigour which we feel may be unwarranted. We believe, for all of these reasons, that a mean-variance "efficient frontier" optimization model may not necessarily be the best method for determining the allocation to private market assets.

At least a couple of alternative approaches have been put forward, one by Russell Investments and the other by UBS Global Asset Management. [18] To our knowledge, these alternative approaches have not been adopted by any public pension funds. The mean-variance optimization model, inadequate as it may be, remains the standard for determining the asset allocation for both public and private market assets. We believe, however, that the alternative methods are worth exploring.

5. ***Stochastic Modeling of Assets:*** Consistent with common and best practices, the asset/liability study used a "stochastic process" to model the assets based on the assumptions of expected return, volatility and correlations for the various asset classes. That is to say, the return on individual assets and portfolios, and the value of assets, varied over time from one year to another. The liabilities, however, were based on a single projected stream of benefits which did

[18] See Russell Investments, "Establishing Higher Confidence Policy Exposures to Private Real estate, Private Equity and Hedge Funds Using Two-Stage Asset Allocation", July 2002; UBS Global Asset Management, "An Appropriate Policy Allocation for Alternative Investments", July 2002.

not allow for any variability over time, particularly with respect to the actuarial discount rate. To our knowledge, this is common practice among public funds and reflects the fact that when valuing their liabilities, public funds, unlike corporate funds, typically use an actuarial discount rate that is very stable over time.

6. ***Forward Looking, But Somewhat Optimistic Assumptions***: The expected returns for all asset classes shown in the table above appear to be forward-looking and not just projections of historical returns.

This is demonstrated in Table 8, which compares the expected returns for various asset classes assumed in the asset/liability study to the actual historical returns over various periods ending 2010.[19]

Table 8 – Expected vs. Actual Returns

Asset Classes	Expected Return (%)	Actual Return (%)			
		2001-2010	1991-2010	1981-2010	1926-2010
US Equities	7.75	1.4*	9.1*	11.4	9.9*
International Equities	8.00	3.9	6.2	10.1	NA
Bonds	3.00	5.8	6.9	NA	5.5-5.9**
Cash	1.75	2.2	3.5	NA	3.6
Real Assets	4.45	5.2***	6.2***	NA	NA

* Large cap stocks ** Government-corporate bonds *** Real estate

However, the investment assumptions, based on generally accepted methods for measuring investment performance, seem to reflect a somewhat optimistic outlook for future long-term performance, particularly for public and private equities. They may not have been entirely consistent with capital market valuations prevailing at the time of the asset/liability study.

For example, it is generally accepted that the rate of return on any asset (stocks or bonds) over any time period can be broken down into four fundamental components:

(i) the current income yield (interest or dividends);
(ii) real growth in earnings and dividends per share (in the case of stocks);
(iii) inflation; and
(iv) the change in the valuation basis (P/E multiple for stocks, yield to maturity / reinvestment rate for bonds).

The dividend yield on US equities at the end of 2011 was slightly over 2.0%. When added to a 2%-2 ½% real growth in earnings and dividends, plus 2%-2 ½% inflation (which most people would consider a reasonable expectation over a 10-year period), it produces an expected return of about

[19] Sources: Ibbotson – "Stocks, Bonds, Bills and Inflation 1926-2010" © Morningstar 2011; Morningstar – Ibbotson® SBBI® Classic Yearbook; NACREIF Fund Index.

6%-7% - with no expansion in the P/E multiple. The expected return of 7.75% assumed in the asset/liability study would thus require either: (a) higher real growth in earnings – the long-term average growth rate was 1.7%, and earnings were already at a cyclical peak, or (b) higher inflation, or (c) an increase in the P/E multiple – which at that time was already above the long-term mean of 16 times earnings – over the next 10 years.[20]

The expected return on private equity of 11% assumed in the study may also be aggressive, not only in absolute terms but also as a premium versus public market equities. The 3%+ premium may not be out of line for buyout funds. The average buyout fund has outperformed the S&P 500 Index for most vintage years over a long period of time by more than 3% a year. But venture capital funds, while they outperformed public equities in the 1990s, have underperformed public equities in the 2000s.[21] LACERS' private equity portfolio as of June 30, 2012, was invested 68% in buyouts and 14% in venture capital, with the balance in distressed, and secondary and mezzanine financing.

The expected return on bonds, we feel, is also somewhat optimistic. The rate of return on bonds over any period will be equal to the initial yield to maturity, the return from the reinvestment of coupon interest during the period, plus any gain or loss in the value of the bonds arising from changes in interest rates. Over 10 years, the gain or loss in value for a core bond portfolio would be roughly offset by lower or higher reinvestment income. The yield to maturity on bonds was slightly over 2% at the time of the study. An expected return of 3% would require a fairly substantial increase in interest rates over the period.

Conclusion on Asset Allocation Process

On the whole, the assets of the System are allocated in a reasonable manner and are adequately diversified. The current asset mix policy was determined on the basis of an asset/liability study conducted by the System's investment consultant. The study followed a methodology and process that are standard practice among most public and private sector pension funds.

Recommendations

1. **LACERS should supplement its Monte-Carlo simulation with scenario analysis. This would allow it to examine the performance of its asset mix policy under a limited number of specific economic scenarios, so as to better understand the risk of lower than anticipated investment returns under adverse capital market conditions. It would also enable LACERS to better communicate the risks of the System to the City. The added costs associated with scenario analysis would be minimal.**[22]

[20] See the following article for a good explanation of this approach: Christopher J. Brightman, "Expected Return", *Investments & Wealth Monitor*, January/February 2012. http://www.researchaffiliates.com/Our%20Ideas/Insights/Papers/Documents/IWM_Jan_Feb_2012_Expected_Return.pdf

[21] Robert S. Harris, Tim Jenkinson and Steven N. Kaplan, "Private Equity Performance: What Do We Know?", working paper, February 2012. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2010405

[22] The Monte Carlo simulation examines the performance of the fund's portfolio over a wide range of statistical outcomes. The underlying economic conditions which would produce a particular outcome, however, cannot be specifically identified under the Monte Carlo methodology.

2. **The Board should devote more time and effort to reviewing the investment assumptions before the asset/liability study is conducted (in the same way that it reviews actuarial assumptions prior to the actuarial valuation) to satisfy itself that the assumptions, particularly with respect to the expected returns on asset classes, are realistic, that they reflect the current valuations in capital markets, and that they are a reasonable expectation of investment performance over the period of the study.**

3. **LACERS should explore with its investment consultant the feasibility of using alternative methodologies, other than mean-variance optimization, for determining the allocation to private market assets. If LACERS determines that such alternative methodologies are not feasible for LACERS, then it should continue using its existing methodology.**

4. **LACERS should not invest in any asset class (or sub-asset class) without analyzing the potential implications of any such investment on the expected risk and return of the Fund. More specifically, LACERS should not invest in the real asset sub-asset classes that were recently approved until those sub-asset classes are modeled to determine the impact they may have on the total portfolio.**

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I. Asset Allocation and Investment Administration (Cont.)

I.B. Compliance with Investment Policy

Objective 6: Evaluate whether investment activities and plans are in compliance with established investment objectives and policies for the pension/retirement system, and that investment managers' performance is evaluated periodically (i.e., over a market cycle of 3-5 years).

Our review focuses on the broad policy areas relating to asset allocation and rebalancing, diversification, portfolio structure, and risk management.[23] It excludes policies relating to the review of investment performance, and the selection, monitoring and evaluation of investment managers, as these have been reviewed elsewhere in this report.

We reviewed the set of investment policies contained in the LACERS' Board Governance Manual to identify those which fall within the scope of our review. For each policy evaluated below, we set out *in italics* the major guidelines, limits and constraints within those policies dealing with asset allocation, portfolio structure and diversification. We reviewed quarterly performance reports, minutes of Board and committee meetings, and other documents and reports necessary to verify compliance over the 5 years ending June 30, 2012.

Scope of the Policy Framework

The Board Governance Manual (Updated January 8, 2013) contains the following investment policies:

I. Investment Policy
II. Geopolitical Risk Investment Policy
III. Alternative Investment Policy
IV. Specialized, Non-Traditional Alternative Investment Policy
V. Real Estate Investment Policy
VI. Proxy Voting Policy
VII. Securities Lending Investment Policy
VIII. Manager Monitoring Policy
IX. Investment Risk Management Policy
X. Emerging Investment Manager Policy
XI. Credit Opportunities Strategy Statement
XII. Real Assets Strategy Statement
XIII. Manager Search and Selection Policy

We examined each of the above policies and found that the following sections contain provisions with respect to asset allocation, portfolio structure and diversification, and thus fall within the scope of our review. The implementation of several of the other policies not included here was examined in the Interim Report.

[23] The review does not cover: (i) governance or other non-investment matters which may be included as part of LACERS' investment policies, such as the duties and responsibilities of decision-making bodies; (ii) matters only peripherally related to investments such as securities lending, proxy voting, etc.; (iii) guidelines relating to individual securities and investments; and (iv) operational and procedural matters dealing with the implementation of investment transactions, cash management, brokerage, etc.

Discussion and Observations on LACERS' Investment Policy

Policy I. Investment Policy Statement

LACERS' Investment Policy Statement as revised and approved June 24, 2008 contains the following guidelines, limits and constraints relating to asset allocation, portfolio structure and diversification. **(Note: Language inside a text box is quoted from LACERS' investment policy statement.)**

Asset Allocation Process

> **LACERS' Policy - Asset Allocation Process**
>
> *The Board adopts and implements an asset allocation policy that is predicated on a number of factors, including:*
> 1. *A projection of actuarial assets, liabilities, benefit payments, and required contributions;*
> 2. *Historical and expected long-term capital market risk and return behavior;*
> 3. *An assessment of future economic conditions, including inflation and interest rate levels; and*
> 4. *The current and projected funding status of the System.*

LACERS' current asset mix policy, approved by the Board in January 2012, was based on an asset/liability study conducted by its general investment consultant, Wilshire Associates. The study used long-term assumptions of expected return and risk (volatility) for various asset classes to project the future value of assets and liabilities over a 10-year period. The study analyzed the impact of various optimal asset mix policies on plan contributions and funded status.

The previous asset mix policy, approved by the Board in October 2009, was based on an asset allocation study, conducted by the former investment consultant, Pension Consulting Alliance (PCA), which also used what appear to be long-term assumptions of expected return and volatility of asset classes to construct a number of "efficient" or optimal portfolios. It then analyzed the expected return and risk of these portfolios where risk was measured as the volatility (standard deviation) of returns as well as the probability of falling short of the actuarial or target return.

The asset mix policy prior to that had also been based on what was probably a similar asset allocation study. We were able to review a staff memo to the Board recommending approval of the asset mix policy, and the Board minutes and resolution approving the recommendation. The objective of the study was to establish an asset mix policy that would maximize the probability of achieving the actuarial required return while minimizing transaction costs. It analyzed a number of alternative asset mix policies with optimal risk/return characteristics.

LACERS' current asset mix policy has been established in compliance with this provision of its Investment Policy. However, the two previous asset mix policies were not fully in compliance. They were not based on a projection of both assets and liabilities, and they did not examine the impact of the asset mix policy on future plan contributions and funded status as required.

Diversification

LACERS' Policy – Diversification

This policy provides for diversification of assets in an effort to maximize the investment return of the System consistent with market conditions.

The System has been invested in a variety of asset classes, in both public and private markets, and in traditional and alternative investments, over the past five years. In addition to the conventional assets – stocks and bonds, plus private equity and real estate – the current asset mix policy also calls for investment in two other portfolios, credit opportunities and real assets, each comprised of a number of sub-asset classes. Credit opportunities will include high yield bonds, emerging market debt, bank loans and distressed debt. Real assets will include (in addition to private real estate) TIPS, real estate securities or REITS, and commodities.

The asset mix policy has been based on the expected return and risk of the various asset classes, taking into account current market valuations. It has been optimized to produce the maximum expected return for the given level of investment risk.

The System has been in compliance with the provision in the Investment Policy Statement concerning diversification.

Asset Mix Policy and Rebalancing

LACERS' Policy - Asset Mix Policy and Rebalancing

The Board has approved a long term policy benchmark which is scheduled to be met in 2009. Below is the interim 2008 target percentages that apply for the current policy benchmark:

	Target	*Ranges*
Fixed Income	*24%*	*22% - 28%*
Cash	*1%*	*1% - 1%*
US Equity	*43%*	*39% - 49%*
Non-US Equity	*20%*	*17% - 23%*
Real Estate	*5%*	*3% - 10%*
Alternative Investments	*7%*	*4% - 10%*

The Board will monitor and assess the actual asset allocation versus policy and will rebalance as appropriate. The investment portfolio shall, on an ongoing basis in accordance with market fluctuations, be rebalanced to remain within the range of targeted allocations and distributions among investment advisors. The Board has a long-term investment horizon and utilizes an asset allocation that encompasses a strategic, long-run perspective of capital markets. It is recognized that a strategic long-run asset allocation plan implemented in a consistent and disciplined manner will be the major determinant of the System's investment performance.

The Investment Policy Statement, which was last revised and approved by the Board in June 2008, does not show LACERS' current asset mix policy. The policy shown in the Statement was established back in February 2006 when the Board approved a long-term asset mix policy as well as an implementation plan to transition from the existing policy to the new asset mix policy by the start of the 2009 fiscal year. The implementation plan specified the asset mix benchmarks and ranges to become effective at the start of each fiscal year from 2007 to 2009. The Investment Policy Statement shows the asset mix benchmark and ranges for the 2008 fiscal year.

The current asset mix policy target and ranges, approved by the Board in January 2012, are substantially different from the previous policy, with significantly lower allocations to US and bonds, higher allocation to non-US equities, and two new asset classes, credit opportunities and real assets. The Board also approved a transition plan for implementation to be completed by September 2014. The transition plan sets out the target asset mix for the end of each quarter during the transition period.

Since the current asset mix policy is so different from the previous policy, the actual allocation of the System for the three major public market asset classes is well outside their minimum-maximum range. This is depicted in Table 9 in red type. The table compares the actual allocation as of June 30, 2012 to the asset mix policy and ranges as well as the quarterly target mix.[24]

Table 9 – Asset Allocation: Actual vs. Policy, June 30, 2012

Asset Classes	Actual ($ Millions)	Actual Allocation (%)	Asset Mix Policy (%)			Target Mix 2nd Qtr 2012
			Target	Minimum	Maximum	
US Equities	$4,126	38.8	24	19	29	40
Non-US Equities	$1,829	17.2	29	24	34	18
Bonds	$2,688	25.3	19	15	22	25
Credit Opportunities	$74	0.7	5	0	10	0
Private Equity	$1,195	11.2	12	NA	NA	10
Private Real Estate	$648	6.1	5	NA	NA	6
Public Real Assets	-	0.0	5	2	8	
Cash	$64	0.7	1	0	2	1

The actual allocation was close to the quarterly target mix set out in the transition plan, so that no rebalancing would have been required. However, the Board has not established ranges around the quarterly target mix to provide guidance with respect to rebalancing should the actual allocation move significantly away from the target mix due to capital market fluctuations.

We understand, from our discussions with investment staff, that LACERS has in the past rebalanced the asset allocation of the System by directing cash flows (contributions and withdrawals) to and from asset classes as necessary from time to time. The quarterly performance reports show the actual allocation at the end of the quarter compared to the asset mix target and minimum-maximum ranges. Our review of these reports over the five years ending June 30, 2012, as well as other documents

[24] The asset allocation as of December 31, 2012, which appears in the most recent quarterly performance report to date, is not materially different.

(Board minutes, staff memos and investment consultant presentations), indicates that the Board does monitor the System's asset allocation and recognizes the importance of rebalancing the allocation periodically.

There have, however, been two occasions in the past five years when the asset allocation went beyond the specified ranges. The allocation to US equities fell below the minimum during the second calendar quarter of 2008, as indicated in the quarterly performance report as of June 30, 2008. The allocation went back above the minimum in the following quarter. However, equity markets remained volatile and declined sharply in the fourth quarter during the height of the financial crisis. As a result, the allocations to both US and non-US equities fell below the minimum, with a corresponding increase in the allocations to bonds and alternative investments (private equity). (The private equity allocation rose above the maximum not necessarily due to a rise in the value of private equity assets but because the value of the total assets of the System had declined.) The underweighting in US and non-US equities and the overweighting in bonds and private equity remained through the first calendar quarter of 2009. By March 31, 2009 bonds had also exceeded their maximum limit. LACERS could have rebalanced its asset allocation by selling some bonds and investing the proceeds in US and international equities. No rebalancing was undertaken, however, as far as we can tell from Board minutes and staff reports submitted to the Board.

On April 28, 2009 the Board was advised by staff that "the rebalancing mechanism was being temporarily suspended." The investment consultant, PCA, with the concurrence of staff, recommended that the Board approve a temporary expansion of the asset allocation ranges in order that the System "remains in compliance with adopted Board policy." PCA outlined three options for the Board. It could: (a) rebalance the asset allocation in accordance with the current policy; (b) adopt new policy benchmarks and ranges; or (c) temporarily expand the ranges. It argued that the costs of rebalancing would be substantial given the then current volatility and illiquidity in markets. The risk of not rebalancing would be to forego the recapture of any potential upswing in equity markets, the likelihood of which, according to PCA, was "non-material" over the next few months. Adopting a new asset mix policy in short order without a robust process would be inadvisable. Therefore, expanding the ranges would be the best option until an asset allocation review, then underway, could be completed, and a new asset mix policy approved by the expected date of May/June 2009. The Board approved that recommendation.

Equity markets rebounded in the second and third quarter of 2009. The allocation to non-US equities, bonds and private equity moved back within the (former) approved ranges by the end of the second quarter, as did the allocation to US equities during the third quarter. A new asset mix policy – including minimum-maximum ranges – was not approved by the Board until October 2009.

The asset allocation in 2010-2011 remained within those policy ranges until January 2012 when a revised asset mix policy was approved by the Board. Since then, the allocations to US and non-US equities as well as bonds have been well outside the new policy ranges.

The Board approved LACERS' current asset mix policy target and ranges in January 2012. The existing Investment Policy Statement does not reflect the current policy – a revision and update of the Statement is overdue.

Compliance with the asset mix policy has been inconsistent over the past five years. On two occasions in 2008, the asset allocation exceeded the policy limits, once in the 2nd quarter, when the allocation to US equities declined below the minimum limit, and then again during the 4th quarter, when the allocation to both US and non-US equities fell below the range while the allocation to private equity rose above the maximum limit. The allocations remained outside the approved ranges through the 1st quarter of 2009, during which the allocation to bonds also increased slightly above the maximum limit. It was not until the end of April 2009 that the Board took action to address the issue. In other words, the asset allocation was not in compliance with policy for a period of at least 4 and as long as 7 months, at the end of which the Board decided to temporarily expand the ranges so that the System remains in compliance with policy, rather than rebalance to the policy target.

In our view, this defeats the primary purpose of a rebalancing program, which is to help manage the risk of the System by systematically maintaining the System's exposure to various asset classes at predetermined target levels, despite any fluctuations in the capital markets that shift the System's allocations away from those target levels. As noted above, LACERS' rebalancing program was not implemented at a very significant point during the 2008-09 financial crisis when the System was most in need of rebalancing.

A by-product of rebalancing is that it forces the System to buy assets that have recently dropped in value and sell assets that have recently risen in value (i.e. buy low and sell high). This process has the potential to add value to the System. As noted above, by not rebalancing through the purchase of equities in 2008 when the equities markets dropped, LACERS missed on significant gains that would have accrued when the equity markets subsequently rebounded in 2009.

The asset allocation of the System as of June 30, 2012 was well outside the minimum-maximum ranges of its current asset mix policy. The Board has established a transition plan with a target asset mix every quarter, but there are no guidelines that require the allocation to be rebalanced if it were to drift significantly away from the quarterly target mix. As a result, systematic rebalancing within ranges is not possible at the present time.

Portfolio Structure

LACERS' Policy - Portfolio Structure

The Board will utilize the following portfolio components to fulfill the asset allocation targets and total fund performance goals established in this document.

- *(a) US equities – index funds/core stocks, large value stocks, large growth stocks, small value stocks and small growth stocks.*
- *(b) Non-US equities – index funds/core stocks, Asia/Pacific stocks, European stocks and emerging markets.*
- *(c) Fixed income – core plus bonds, index bonds, intermediate term bonds, and opportunistic fixed income.*
- *(d) Real estate – stated separately in the real estate investment objectives and investment policy.*
- *(e) Alternative investments – stated separately in the alternative investment policy statements.*

Based on a review of the quarterly performance reports over the past five years, we find that the assets of the System have generally been invested according to the portfolio structure set out above. Table 10 on the next page shows the portfolio structure as of June 30, 2012 for the three public market asset classes.

Table 10 – LACERS Portfolio Structure: June 30, 2012

Portfolios	Investment Managers and Mandates
US Equity	**Fourteen (14) investment managers**
Index & Index Plus Funds	Two managers with large cap and one manager with large cap value mandates.
Large Cap	One manager with a value mandate. (The growth manager had been terminated in February 2012.)
Small Cap	Two value managers, two growth managers, and one manager with both a broad small cap mandate.
Corporate Governance	Two managers, one with a small cap mandate (later terminated in September 2012), the other with a mid cap mandate.
Emerging Managers	Three fund-of-fund managers, one with a small cap mandate and two with broad market mandates.
Non-US Equity	**Eight (8) investment managers**
Index Fund	One manager with a developed markets mandate.
Developed Markets	One manager investing in both European and Asia/Pacific markets.
European Markets	Two managers, one with a corporate governance mandate. (The corporate governance portfolio was in redemption as of December 2012)
Asia/Pacific Markets	Two managers, one investing in only developed markets, the other in both developed and emerging markets.
Emerging Markets	Two managers.
Fixed Income	**Six (6) investment managers**
Core Plus Bonds	Four managers with core plus mandates.
Opportunistic Fixed Income	Two managers with opportunistic mandates.

The portfolio structures for real estate and alternative investments are reviewed later in this report.

The US equity, non-US equity and fixed income portfolios of the System have generally been in compliance with the portfolio structure guidelines set out in the Investment Policy Statement over the past five years.

The Investment Risk Management Policy, approved on December 27, 2011, sets out guidelines with respect to strategic risk, asset class risk, and the risk budgeting process.

Strategic Risk

LACERS' Policy - Strategic Risk

The most important decision that the Board must make is the strategic asset allocation decision. This decision explains most of the long-term performance and risk (defined as the annualized standard deviation of policy benchmark returns) of a Fund. The Board selects its asset allocation policy objective via the industry standard methodology of mean variance optimization to determine the optimal allocation of multiple asset classes having varying risk and correlation assumptions. The Board selects the policy based on an assets/liabilities valuation process provided by its Consultant, its risk tolerance (based upon the combination of variability of investment returns, particularly downside or "tail" risk and the risk of funding shortfall), and considerations from Staff. The selected policy provides long-term return and risk expectations for the Fund. As new asset allocation policies are adopted in the course of periodic review, or as economic or other conditions of the Fund change, new return and risk expectations may be set.

The current asset mix policy was approved by the Board in January 2012 after the Investment Risk Management Policy had been established. The policy was based on a study of the assets and liabilities of the plan which simulated their performance over a 10-year future period. The study analyzed a number of alternative asset mix policies which were determined to be "efficient" or "optimal" in generating the maximum expected return for a given level of investment risk or volatility. The study evaluated each asset mix policy in terms of its expected impact on plan contributions as well as funded status, in the median or most likely case and also under a "worst case" scenario.

LACERS is in compliance with the guidelines of the Investment Risk Management Policy with respect to managing strategic risk.

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Asset Class Risk

LACERS' Policy - Asset Class Risk

The second most important strategic decision the Board must make after the establishment of the System's asset allocation policy objective is the asset class structure decision. While the asset allocation policy is responsible for the majority of the Fund's return and risk experience, the next greatest driver of the Fund's return and risk is the asset class structure. Asset class structure decisions involve setting the active versus passive exposure, determining which strategies will be included within the asset class, and what the allocations to these strategies will be. A "risk budget" represents the amount of active risk the Board is willing to take for each asset class. As fiduciaries, the Board recognizes the need to manage and monitor risk at the asset class level in addition to the total fund and individual manager/strategy levels. Additionally, the Board is aware it is considered a best practice to set risk limits at all relevant measurement levels (i.e., total fund, asset class, and individual manager). The Board has adopted a risk budgeting approach to constructing, measuring, and monitoring public markets asset classes. The Board believes that this approach provides an objective and systematic yet flexible means of constructing asset classes in a way which will maximize the probability of meeting long term asset class objectives while managing the risk of its public markets asset classes in a proactive manner.

The Board approved a risk budget and portfolio structure – for the US equities, non-US equities and fixed income asset classes in January 2012, and for the credit opportunities and real asset portfolios in March 2012 – based on a risk budgeting study. The objective of the study was to determine the level of active management risk for each asset class which would be acceptable to the Board, and to identify the optimal portfolio structure which would maximize the expected excess return over the benchmark (i.e. alpha) for that level of active risk.

LACERS is in compliance with the guidelines of the Investment Risk Management Policy with respect to managing asset class risk.

Risk Budgeting Process

LACERS' Policy - Risk Budgeting Process

In order to arrive at the optimal risk budget objective for each asset class, the Board will engage in an objective, disciplined process that will be uniformly applied to all public markets asset classes. This process will involve a mean variance optimization approach which will employ the following inputs for each strategy under consideration by the Board:

1. *Expected excess return over the asset class benchmark*
2. *Expected excess risk over the asset class benchmark*
3. *Expected correlations between strategy excess returns*
4. *Constraints to ensure prudent exposures to strategies and risk factors*

The objective of this mean variance optimization exercise is to arrive at a target excess risk (i.e., the risk budget) which will maximize the excess return desired by the Board. The risk budget will reflect the amount of excess risk the Board is willing to take for that desired excess return.

The risk budgeting study used the following process. First, it identified the various investment strategies (active and passive) that would be considered for each asset class. It then developed assumptions with respect to:

(a) Expected excess return (i.e. alpha) over the benchmark for each strategy;

(b) Active risk (or tracking error); and
(c) Correlations of excess returns across strategies

The study also imposed some maximum-minimum constraints on the allocation to individual strategies "to control for potential biases." It then used a mean-variance optimization model to determine a set of optimal portfolio structures which would maximize the expected excess return for a given level of active risk. One of these optimal structures was the recommended portfolio structure for that asset class.

LACERS is in compliance with the guidelines of the Investment Risk Management Policy with respect to the risk budgeting process.

Policy III. Alternative Investment Policy

The Alternative Investment Policy as revised and approved July 7, 2009 contains the following guidelines, limits and constraints relating to portfolio structure and diversification which are included in the quarterly performance reports submitted by the alternative investments consultant.

Alternative Investments - Eligible Investments

LACERS' Policy Alternative Investments - Eligible Investments

LACERS will invest in Top Tier limited partnership interests of pooled vehicles covering the broad spectrum of private investments as follows:

1. *Private equity partnerships – including corporate finance/buyout, special situations and venture capital;*
2. *Co-investments – direct investments made alongside a partnership;*
3. *Direct Secondary Purchases – purchases of existing partnership interest or pool of partnership interests from an investor;*
4. *Other investments that are deemed appropriate within LACERS' risk profile.*

The selected quarterly performance reports that we examined indicate that almost all alternative investments have been in the form of limited partnerships. For example, of the 156 separate investments in the portfolio as of June 30, 2012, only four (amounting to 4.5% of the portfolio) were in the form of something other than primary limited partnerships. Two of these were secondary purchases and two were other types of investments.

The alternative investments portfolio has been in compliance with the guidelines with respect to eligible investments during the period.

Alternative Investments – Diversification

LACERS' Policy Alternative Investments – Diversification

Partnerships – No more than 15% of the portfolio's total exposure (market value plus unfunded commitments) to private equity may be attributable to partnerships by the same manager at the time the commitment is made.

Sub-Asset Classes – This Policy sets forth enhanced guidelines that provide a general framework for selecting, building, and managing LACERS' investments in private equity, including corporate finance / buyout, special situations (including distressed debt, distressed turnaround and mezzanine strategies), and venture capital partnerships. The current optimal sub-asset class allocation ranges and targets for LACERS' private equity investments are as follows:

Sub-Asset Class	***Long-Term Target***	***Range***
Corporate Finance/Buyout	*65%*	*60% - 75%*
Venture Capital	*15%*	*5% - 15%*
Special Situations	*20%*	*10% - 25%*

Based on our examination of selected quarterly reports, the proportion of the portfolio invested in buyouts and special situations (distressed debt, mezzanine, etc.) was within the ranges specified in the alternative investment policy over the five-year period. The percentage invested in venture capital had been slightly above its range at 16%-17% for much of the past five years, but had declined to 14% as of June 30, 2012.[25]

Accordingly, the alternative investment portfolio has been substantially in compliance with the guidelines with respect to sub-asset classes during the period.

However, the quarterly performance reports do not show the percentage of alternative assets attributable to partnerships by the same manager. Given that this information is not present in the reports, we were not able to verify compliance with these guidelines. This also implies that, based on the performance reports, the LACERS Board would not have been able to verify compliance with these guidelines.

Policy IV. Real Estate Investment Policy

The Real Estate Investment Policy as revised and approved April 27, 2010 contains the following guidelines, limits and constraints relating to portfolio structure and diversification. We reviewed quarterly performance reports by the real estate investment consultant, Courtland Partners, over the five years ending June 30, 2012, that were available on LACERS' website, to determine if the real estate portfolio was in compliance with the policy guidelines over that period.

[25] The long-term target allocation of 15% for venture capital is somewhat inconsistent with the range of 5%-15% specified in the policy as it does not allow the allocation to move any higher than 15% at any given point in time.

Real Estate - Risk/Return Categories

LACERS' Policy Real Estate - Risk/Return Categories

The Portfolio shall be comprised of three different but complementary risk/return categories or risk strategies. These categories or risk strategies generally define the three basic risk and return levels ranging from low to high risk associated with institutional real estate investments. These categories or strategies are referred to as the following: (1) core, (2) value and (3) opportunistic investments. The following table sets forth investment policy ranges for the previously defined real estate risk/return strategies.

LACERS' Real Estate Portfolio Risk/Return Diversification Guidelines	
Risk/Return Strategy	***Policy Range***
Core	*10% - 70%*
Value	*20% - 80%*
Opportunistic	*10% - 50%*

We examined selected quarterly performance reports submitted by the real estate investment consultant over five years ending June 30, 2012. The percentage of assets in the portfolio invested in the various risk/return categories was within the ranges specified in the real estate investment policy over that period.

The real estate portfolio has been in compliance with the risk/return guidelines of the investment policy over the five-year period.

Real Estate – Diversification

LACERS' Policy Real Estate – Diversification

The real estate portfolio shall be diversified by risk factors which can be reduced through diversification (e.g., geographic region and property type).

LACERS' Real Estate Portfolio Property Diversification Guidelines		***LACERS' Real Estate Portfolio Geographic Diversification Guidelines***	
Property Types	***Policy Range***	***Geographic Regions***	***Policy Range***
Residential	*Up to 40%*	*West*	*Up to 50%*
Industrial	*Up to 35%*	*South*	*Up to 40%*
Office	*Up to 40%*	*Midwest*	*Up to 40%*
Retail	*Up to 40%*	*East*	*Up to 50%*
Hotel	*Up to 15%*	*International*	*Up to 40%*
Other Real Estate	*Up to 30%*		

The distribution of the portfolio by types of property and geographic regions was within the ranges specified in the real estate investment policy based on our examination of selected quarterly reports over the five-year period.

The real estate portfolio has been in compliance with diversification guidelines with respect to types of property and geographic regions during the period.

Real Estate - Investment Life Cycle

LACERS' Policy Real Estate - Investment Life Cycle

At no time shall the Portfolio have an exposure exceeding 30% to total non-operating investments (i.e., the total of pre-development/land, development/redevelopment and leasing).

Based on our examination of selected quarterly reports, the percent of non-operating investments exceeded the maximum limit of 30% only once in the past five years – by 0.5% in the 1st quarter of 2008.

The real estate portfolio has been substantially in compliance with guidelines with respect to investment life cycle during the period.

Real Estate - Investment Structures/Vehicles

LACERS' Policy Real Estate - Investment Structures/Vehicles

The Portfolio may include real estate public and private equity and debt investments. The following table sets forth the guidelines governing the Portfolio's investment structure.

LACERS' Real Estate Portfolio Investment Structure Diversification Guidelines	
Investment Structure	***Policy Range***
Private Equity Real Estate	*30% - 100%*
Private Debt	*0% - 50%*
Public Equity	*0% - 20%*
Public Debt	*0% - 10%*

The investment vehicle exposure ranges are set forth in the table below:

LACERS' Real Estate Portfolio Investment Structure Diversification Guidelines	
Investment Vehicle	***Policy Range***
Open-end Commingled Funds	*Up to 60%*
Closed-end Commingled Funds	*Up to 90%*
Separate Accounts - Private	*Up to 30%*
Separate Accounts – Public Real Estate & Real Estate Securities	*Up to 20%*

The quarterly performance reports do not show a breakdown of the real estate portfolio by investment structures and vehicles. Given that this information is not present in the reports, we were not able to verify compliance with the guidelines with respect to investment structures and vehicles set out in the investment policy. This also implies that, based on the performance reports, the LACERS Board would not have been able to verify compliance with these guidelines.

Real Estate – Leverage

LACERS' Policy Real Estate – Leverage

The maximum leverage for the Portfolio shall be sixty-five percent (65%) with established maximum levels for each investment style based on the risk/return profile of the underlying investments as shown in the following table.

LACERS' Real Estate Portfolio Leverage Guidelines	
Investment Strategy	***Policy Range***
Core	*Up to 50%*
Value	*Up to 65%*
Opportunistic	*Up to 75%*
Total	*Up to 65%*

The extent of leverage for the various investment categories as well as the total portfolio did not exceed the maximum limits specified in the real estate investment policy based on our examination of selected quarterly reports over the five-year period.

The real estate portfolio has been in compliance with guidelines with respect to leverage during the period.

Findings and Recommendations on Certain LACERS' Investment Policies

LACERS' *current asset mix policy* has been established in compliance with the Investment Policy Statement and it meets the requirement with respect to diversification. The *actual allocation of assets*, however, has at times over the past five years exceeded the maximum-minimum ranges specified in the Statement. The current allocation is well outside the ranges specified in the asset mix policy approved by the Board in January 2012. The Board has established a transition plan to implement the policy by September 2014 with a net target asset mix set every quarter. It has not, however, established guidelines for rebalancing the asset allocation if it drifts from the quarterly target mix.

The System has generally been in compliance with the *portfolio structure guidelines* set out in the Investment Policy Statement.

LACERS is in compliance with its *Investment Risk Management Policy* established in December 2011 with respect to managing strategic and asset class risk using a risk budgeting process. It has also generally been in compliance – or substantially in compliance – with the various guidelines, limits and constraints set out in its Real Estate and Alternative Investment Policies. In some cases, it has not been possible to verify compliance as the quarterly performance reports do not track the information necessary to do so.

Recommendations

5. **The Board should establish maximum-minimum asset allocation ranges as part of the transition plan to guide the rebalancing of the actual allocation if it were to drift too far away from the quarterly target mix.**

6. **LACERS should establish a separate rebalancing policy with comprehensive guidelines and procedures with respect to the rebalancing process.**

   a. **LACERS should examine the feasibility of rebalancing the asset allocation of the System, not just when the allocation exceeds the maximum-minimum ranges, but on an ongoing basis by directing contributions towards portfolios which are under-weighted (i.e. below their target allocation but still within the approved range) and withdrawals from portfolios which are over-weighted – with proper allowance for the liquidity issues surrounding private market assets. Purchases and sales of securities in order to rebalance should only be undertaken when the asset allocation exceeds the approved ranges. While we were informed by staff that they consider cash flows in the rebalancing process, this should be more clearly specified in its investment policy.**

   b. **LACERS should explore the use of overlay strategies based on market index futures contracts as an alternative and/or a supplement to cash flows and asset purchases and sales for rebalancing.**

7. **The Board should require that the quarterly performance reports submitted by the general investment consultant, real estate consultant, and private equity consultant provide the necessary information to allow the Board to monitor compliance with the portfolio diversification requirements contained in LACERS' investment guidelines.**

8. **The Board should require that investment consultants submit a compliance report (on a quarterly basis or at least annually) that verifies the System's compliance with the various provisions and guidelines of its investment policies. The compliance report could be either a separate report or be included in a separate section in the quarterly performance report.**

II. Consideration of Certain Other Costs

Objective 4C: The City directed us to consider how the amount of office space that is available or may become available in the near future fits in with the requirements of LACERS. Objective 12 A-D: Does the System adequately evaluate investment performance with costs to ensure costs are minimized?

Our interim report considered numerous costs of the LACERS investment program and administration. These included a thorough analysis and discussion of the costs and benefits associated with its mix of active and passive management and the performance of the System for five and ten year periods. Our comprehensive analysis addresses the impact of the largest cost on LACERS' results---management fees. The interim report also analysed other investment costs such as investment consulting, custody and securities lending fees and compared them to LAFPP and the Project Peer Group. In this report we analyze two remaining areas of LACERS cost structure; the first being administrative in nature---occupancy, and what LACERS has done to try to join with LAFPP in that endeavor, consolidate its leased space into space owned by the City, or seek other alternatives; and the second being investment in nature---transaction costs, and what it has done based on recommendations from the prior management audit issued in 2007.

Office Space Leasing Activities and Occupancy

LACERS currently occupies the 5th floor of the LA Times building in close proximity to City Hall and other government offices. However, for many years LACERS was a tenant in another private building with its sister fund, LAFPP. The two funds benefited somewhat from joint space utilization, at least for a time. As both of their needs for space evolved, the funds attempted to search together for more suitable space, including the possibility of acquiring a building to serve the purpose and as an investment. They formed the Joint Space Planning Committee back in 2006 and proceeded to identify needs with the hopes of finding space that would work for both funds. The joint Committee worked for several years on the effort. In December 2011, LACERS hired a real estate consultant to assist with lease negotiations as its current lease was expiring. During the negotiations additional lease opportunities became available, including the LA Times building. This was determined to be the best option.

Needs Identification

LACERS and LAFPP identified their needs with the help of a real estate consultant (HOK) and developed a Vision Document. However, after some time working at this, the Systems determined mutually that the joint process was ineffective and made the decision that it could not wait any longer. Finally, after six years of trying to solve the space problem jointly with LAFPP, a decision was made to move ahead with LACERS' own plans and needs. The timing was such that it coincided with the City's study on space utilization in conjunction with the City's own efforts to save money on rent and occupancy cost because of budgetary necessities and changes made in workforce levels.

Search Process

In February 2012 the Asset Management Division of the Department of General Services issued its <u>Municipal Facilities Space Optimization Project Status Report</u> (Study). The report was part of an effort by the City to maximize occupancy of it operations, among other goals. The plan targeted an overall 32% reduction of identified space. It also identified available, and soon to be available, vacant space at Civic Center and Figueroa Plaza, among others. The plan was/is for consolidation of terminated leases and relocation of associated City workers to these sites. The Study identified a timeline for the whole process that stretched into fiscal year 2017 and beyond. The report also recommended that a space planning firm be used by the City.

The impact of the Study on LACERS was to confirm that all of the identified space was/is already planned for immediate and future occupancy by other City departments well into the future. The Study reported that its own efforts were exhaustive, time consuming and costly. The analysis by the City confirmed to LACERS that City owned space was not an option considering its imminent need and timing.

Conclusion on Occupancy

In mid-2012 LACERS negotiated a lease under terms favorable to it and moved into its present location in the LA Times building. The present value at the time of the savings difference between its then current space and the new space was projected to be over $300,000. Updated reports on the move show favorable economic results with a net projected savings over the lease term in keeping with its expectations and compared to its old lease.

LACERS enjoys numerous benefits in the improved space such as proximity to government center, use of the LA Times cafeteria, reasonable parking, enhanced security, and excellent facilities, all at lower cost than the old space. The relationship between LACERS and LAFPP continues, with LAFPP now benefitting from being able to use space at LACERS for Board and committee meetings. There are also plans for the City Attorney to move offices into the LACERS space. All in all, we believe that LACERS is now well situated for office accommodations and that hurdle is now behind it.

Investment Transaction Costs

The prior 2007 management audit recommended that LACERS should expand the Investment Policy Statement to define how transactions costs such as brokerage commissions should be monitored. This is related to the overall issue of measuring transactions costs and not merely relying on the managers to do so. However, the Board determined that the existing process was sufficient and that its current process ensures that the portfolios are monitored and managed appropriately.

In essence, LACERS relies on its external investment managers to responsibly manage the costs of trading and execution of trades. LACERS is an externally managed investment program and the primary determinant of whether a manager is retained is based on its performance. In that sense, we tend to agree with the LACERS Board because trading and executions costs for an external manager are much the same as other costs it incurs to effect a profit, such as the salary of the trading desk. A manager's performance is calculated based on the return on investment net of fees, including all transaction costs. It is in the best self-interest of managers to be diligent when it comes to paying the cost of trading and execution because it directly impacts their returns and performance. Therefore, it is not entirely unexpected to allow the managers to control the costs.

III. Reasonableness of Actuarial Assumptions - Retiree Health Benefits

Objective 7: Are LACERS' actuarial methods appropriate and its assumptions valid?

Actuarial principles dictate the use of actuarial assumptions and include those relating to:

- **Turnover** (the rates at which employees will leave employment at different age and service intervals before becoming eligible for benefits),
- **Disability** (the rates at which employees will become disabled at different ages, leave employment and, possibly, become eligible for benefits by virtue of their disablement),
- **Retirement** (the probability at each age at which participants are eligible to retire),
- **Mortality** (the rates used to project life expectancies and the probability of dying at each age for purposes of estimating how many employees will die before retirement and when and, after retirement, how long they will live and receive benefits under the plan).
- **Investment Rate of Return** (the expected rate of return on actual or expensed "plan assets")
- **Inflation Rate** (the general rate of increase in the cost of goods and services)
- **Salary Increases** (the assumed increases in active employee salaries during the plan's future)
- **Health care trend Rates** (the rate of increase in the cost of health care over the plan's duration, a combination of inflation and utilization)

Typically, for the same covered population, demographic assumptions are the same for a retirement plan and a retiree medical plan. Experience studies analyzing demographic assumptions are often completed as part of the retirement plan valuation and, for the same population, applied to the OPEB (Other Post-Employment Benefits) valuation. For this reason, to evaluate the demographic assumptions currently employed in the OPEB valuation, PRM reviewed the Actuarial Experience Study for the period July 1, 2008 through June 30, 2011 prepared by the Segal Company, the Retirement Plan actuary. This experience study utilized census data from the last three retirement plan actuarial valuations and includes proposed actuarial assumptions, both demographic and economic, for future actuarial valuations.

Pursuant to the above June 30, 2011 Triennial Experience Study on the City's Retirement and Health Plans, the Board elected on October 25, 2011, to phase in the impact of the new actuarial assumptions over a five-year period beginning in the 2012-2013 Fiscal Year. The Segal report states that "the study was performed in accordance with 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." These Standards of Practice put forth guidelines for the selection of the actuarial assumptions utilized in an actuarial valuation, and are the recognized guidance in the actuarial profession for selecting these types of assumptions. They are applicable to both OPEB and pension valuations. Therefore, these assumptions serve as the basis for determining the reasonableness of the assumptions for the *Los Angeles City Employees' Retirement System 2012 Management Audit Final Report.* We [Segal] examined the salary increase assumptions on this same basis, while the economic assumptions, e.g., were analyzed in accordance with ASOP No. 27. We [Segal] also took into account expectations of future inflation and investment returns in addition to examining actual investment returns on plan assets, and inflation over the three-year period."

The Segal experience study recommended the following changes in assumptions:

Inflation – Assumed future inflation, as measured by the Consumer Price Index (CPI) was reduced from 3.75% to 3.50%.

Investment return – The estimated net investment return on current and future plan assets was reduced from 8.00% to 7.75%. Since inflation impacts investment return which consists of real return plus inflation, then in effect reducing the interest assumption means that the assumed real return was maintained at 4.25%.

Table 11 shows how the LACERS' assumptions compare with those of the Project Peer Group:

Table 11 – Summary of Real Return Net of Price and Wage Inflation Assumptions

Assumption	Peer Group Assumption for the Most Recent Actuarial Valuation[26]	LACERS
Assumed Investment Return over Wage Inflation	3.25% low 3.50% median (used by 40% of Project Peer Group) 4.00% high	3.50%
Assumed Investment Return over Price Inflation	4.00% low 4.25% median (used by 50% of Project Peer Group) 5.00% high	4.25%

Salary increases – The components of the assumed salary increase assumption were changed, with a relatively small impact on the "total" resulting assumption.

There are two components:

1. Inflation, as stated above, was reduced from 3.75% to 3.50%.
2. Real "across the board" salary growth was increased from 0.50% to 0.75%.

Retirement rates – This is the probability at each age at which participants are eligible to retire. For active employees the assumed rates, which are stratified by age, starting at 8% at age 50 and ranging to 15% at age 60, 20% at age 65, and 100% at age 70, were revised to reflect somewhat later retirements. Table 12 on the next page displays the retirement rates for those without 30 years of service and those with 30 years of service.

[26] Assumptions from the June 30, 2012 actuarial valuation for seven of the ten systems, June 30, 2011 for two of the systems. One set of assumptions was recently approved for a system's December 31, 2012 actuarial valuation.

Table 12 - Retirement Rates by Age

Actual Rate of Retirement		
Age	**Non-55/30**	**55/30**
45-49	0.00%	0.00%
50	8.00%	0.00%
51	4.00%	0.00%
52	4.00%	0.00%
53	4.00%	0.00%
54	15.00%	0.00%
55	8.00%	20.00%
56	8.00%	15.00%
57	8.00%	15.00%
58	8.00%	15.00%
59	8.00%	15.00%
60	8.00%	15.00%
61	8.00%	16.00%
62	8.00%	17.00%
63	8.00%	18.00%
64	8.00%	19.00%
65	13.00%	20.00%
66	13.00%	20.00%
67	13.00%	20.00%
68	13.00%	20.00%
69	13.00%	20.00%
70	100.00%	100.00%

Terminated employees with eligibility for deferred benefits were assumed to retire at age 58 instead of age 57.

Mortality – These rates are used to project life expectancies and the probability of dying at each age. For healthy lives, the assumption was changed from the RP-2000 Combined Healthy Mortality tables with a one year set-back for both males and females, to the same Mortality table, but with a two-year set-back for males and the females remain at one year set-back. For disabled retirees the same table with a five year set-forward for males and a six year set-forward for females was used. Preretirement mortality is assumed to use the same table as for healthy retirees.

Turnover (termination rates) – the assumed rates were revised based on the experience study and are as follows:

Table 13 - Rates of Termination (Under Five Years of Service)			
Years of Service	**Actual Rate**	**Current Assumption**	**Proposed Assumption**
0	12.78%	9.75%	11.25%
1	8.08%	8.00%	8.00%
2	8.35%	6.25%	7.25%
3	7.12%	5.50%	6.25%
4	6.23%	4.75%	5.50%

Table 14 - Rates of Termination (Five or More Years of Service)			
Age	**Actual Rate**	**Current Assumption**	**Proposed Assumption**
20 – 24	13.36%	4.75%	5.50%
25 – 29	10.01%	4.75%	5.50%
30 – 34	5.56%	4.75%	5.25%
35 – 39	4.06%	3.50%	3.75%
40 – 44	3.32%	2.40%	2.75%
45 – 49	2.26%	1.75%	2.00%
50 – 54	1.96%	1.50%	1.75%
55 – 59	3.18%	1.25%	1.75%
60 – 64	3.47%	1.25%	1.75%
65 – 69	4.34%	0.00%	0.00%

Disability rates – the assumed rates were increased based on the experience study and are shown below:

Table 15 - Rates Disability Incidence			
Age	**Actual Rate**	**Current Assumption**	**Proposed Assumption**
20 – 24	0.00%	0.00%	0.00%
25 – 29	0.00%	0.01%	0.01%
30 – 34	0.03%	0.05%	0.04%
35 – 39	0.02%	0.08%	0.06%
40 – 44	0.03%	0.19%	0.11%
45 – 49	0.08%	0.24%	0.17%
50 – 54	0.16%	0.28%	0.20%
55 – 59	0.09%	0.22%	0.20%
60 – 64	0.29%	0.22%	0.20%
65 – 69	0.23%	0.22%	0.20%

Observations on Reasonableness of Actuarial Assumptions - Retiree Health Benefits

We have the following comments on the recommended assumptions and the justification presented in the experience study report:

Demographic assumptions - In general, the changes in demographic assumptions appear reasonable based on the experience during the three-year period July 1, 2008 through June 30, 2011.

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. With regard to inflation, as measured by the CPI, the prior 3.75% assumption is higher than inflation has been for the last 15 years or so, and higher than economists' expectations. Therefore, a reduction is reasonable, and a reduction to 3.50% seems to be in the general range of acceptable long-range predictions. As a comparison, the median percent of the Project Peer Group was also 3.5%. Based on our analysis, neither the 3.50% inflation assumption nor the 7.75% net assumed investment return appears to be unreasonable.

Salary increases – This assumption is only used in the OPEB valuation for the amortization of the Unfunded Actuarial Accrued Liability. The salary increase assumption is composed of inflation, and real growth. A real growth component had not been explicitly used in prior valuations, and was introduced for the first time in the last 2011 valuation. Along with the reduction in the inflation assumption from 3.75% to 3.50%, a real growth assumption of 0.75% was increased from 0.50%, and allows the "payroll growth" assumption to remain at 4.25%. The assumed payroll growth is used to amortize the OPEB unfunded liability as a level percent of increasing payroll. Based on our analysis these assumptions are reasonable.

Retirement rates – Experience during the 2008 – 2011 three-year period shows substantially heavier early retirement. Note that in 2009, the City offered an Early Retirement Incentive Program (ERIP) which was elected by over 2,000 active members. Because of the statistical distortion created by the large number of members who elected the ERIP, they were excluded from the experience analysis of the retirement rates. The experience study shows that the actual experience rates are substantially lower than the assumed rates. The retirement rates were adjusted in the 2012 to reflect this understatement for those retirees with less than 30 years of service. Note that, for the "55 and 30" members, there was relatively little experience during the two years studied. As a result, the recommendation was made to leave the retirement rates for this group unchanged.

The assumption for deferred vested members, which is applicable to both OPEB and retirement valuation, was reduced from age 58 to age 57 in prior valuations. The average age at retirement over the current three-year experience study period was 58.4, while the average age for the prior three-year experience study period was 56.5.

Recommendation on Reasonableness of Actuarial Assumptions - Retiree Health Benefits

9. **LACERS should consider the set of stratified rates by Service Range provided by the actuary for retiree medical and dental coverage and continue to monitor the 50% election assumption for deferred vested members.**

Marriage and dependents – The experience study found that "during the last three years, about 78% of all male members and 53% of all female members were married or had a domestic partner at retirement. This assumption is generally more significant for OPEB and as such merits additional review, since the liability for a married retiree where the spouse is covered can be twice the liability for a single retiree. In addition, the report recommends changing the assumption that female spouses are four years younger than their husband to the assumption that female spouses are three years younger than their husband based on "observed experience". The observed experience for members who retired during the last three years indicates that female spouses were about 3.5 years younger than their male-member spouses, and male spouses were about 2.0 years older than their female-member spouses, on average.

Recommendation

10. **LACERS should re-examine the data on marital status at retirement and age difference of spouses because it is a more significant factor in an OPEB valuation.**

Mortality – For healthy lives experience Table 16 below shows the actual and current mortality.

Table 16a – Healthy Pensioners

Year Ending June 30,	Actual Deaths	Expected Deaths
2009	408	366
2010	412	373
2011	369	398
Total	1,189	1,137
	Actual/Expected	**105%**

Table 16a – Healthy Pensioners and Beneficiaries

Year Ending June 30,	Actual Deaths	Expected Deaths
2011	1,725	1,658

LACERS' decision to change to the RP-2000 table is appropriate and incorporates the improvements in life expectancy.

Termination rates – Experience during the three year period generally showed significantly more terminations during the 2009-2010 Fiscal Year than the prior two years. It was assumed that this was due to layoffs during this time. The study showed that the actual rates were trending higher that the assumed rates and the termination rates were increased accordingly.

LACERS' decision to change to increase the termination rates was appropriate.

Disability rates –The recommended change in assumptions appears to be reasonable.

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 which 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.

The assumed medical trend rate is approximately 8.25% in 2013 and trends down 0.5% per year to an ultimate rate of 5.00% in 2020 and later. The Dental and Medicare Part B premium trend rate is 5.00% for all years.

Observations on Health-Specific Assumptions

The assumptions are generally reasonable. In prior years, downgrading the health trends rates was in increments of 1%. Since the adoption of the downgrading of health trends by 0.5% per year, LACERS' ultimate rate of 5.0% represents a more realistic range of reasonableness. LACERS also needs to reflect the effects of the Patient Protection and Affordable Care Act (PPACA) which will impact the plan beginning in 2014. LACERS expects premiums to increase by 2% to 3%.

IV. Disability and Retirement Benefit Administration Process

Evaluation of LACERS Retirement Disability System

Objective 10: Are procedures in place at LACERS adequate to review applications for disability pensions?

The efficiency of a public pension system's disability application review process is key to ensuring that disability applicants receive timely and accurate benefits. Any assessment should take into account the policies and procedures that govern benefit determinations, as well as the actual implementation of these policies and procedures. Accordingly, pension systems must strike an appropriate balance between determining that applicants are actually unable to work, and creating a sensible administrative process that is not unnecessarily burdensome.

The use of technology has been instrumental in reducing the administrative burden on applicants and LACERS' staff members in allowing the necessary parties to gather and disseminate the extensive paperwork that is necessary to make an educated determination. Further, technology has allowed for greater accuracy in record-keeping. It is imperative to gather and maintain comprehensive medical records related to each disability claim. The proper maintenance of records guards the plan against fraudulent claims, allows consistency in claim administration, and safeguards the fund's assets from unwarranted claims.

Effective staff training and the clear delineation of roles and responsibilities helps to ensure that disability applications are processed appropriately. While staff members may receive on-the-job training, equally important is ensuring that Board members understand their roles and responsibilities related to disability determinations. Staff members and Board members must be familiar both with government-mandated rules and regulations and agency-specific rules and requirements.

A well-documented process for receiving and evaluating disability claims helps to mitigate errors and limit inconsistent determinations. Documentation should walk staff through a step-by-step system for processing and recording disability claims. The process should clearly outline roles and ensure clear communication between stakeholders. Further, this documentation can be used to communicate evaluation standards to disability applicants, thus ensuring that the application review process remains fair and transparent.

In addition to ensuring that the disability evaluation process is well-documented, it is also important that there exists a quality assurance process. The quality assurance process is in place to safeguard against miscalculations and to ensure there is no discrimination in the determination process. Further, the review process must be responsive to applicant needs, allowing them to understand the status of their application and next steps in the process. Lastly, the applicants should understand the timeline necessary to process their application.

Observations on the Disability and Retirement Benefit Administration Process

Disability retirement is available to any LACERS' member who has five or more years of continuous service and who has become physically or mentally incapacitated and therefore is incapable of performing job duties. Ultimately, LACERS' Board renders a decision on whether an employee should be granted disability retirement based upon evidence collected by the LACERS' Disability Department employees and the recommendation of three evaluating doctors.

LACERS' Disability Department is comprised of three staff members who are dedicated to counseling potential disability applicants, compiling applicant files and processing applications. The Disability Department is led by a Disability Supervisor, who is supported by a Benefits Specialist and a Clerk Typist. The Disability Supervisor and Benefits Specialist help counsel employees who may be eligible for disability retirement. The Disability Supervisor has primary responsibility for leading the department and for ensuring that all applications are completed in accordance with LACERS' policy. The Benefits Specialist is responsible for counseling potential applicants and making sure that completed applications are filed in a correct and timely manner. The Clerk Typist is primarily responsible for administrative tasks, such as compiling documentation for disability retirement files, coordinating appointments and entering applicant data in the correct computer systems.

LACERS' Disability Department relies on the Disability Retirement Procedure Guidelines, last updated in September 2012, to guide them through the disability retirement process. Documentation of the processes is maintained both in hard copy and electronic form, to ensure the Disability Department has easy access to the documentation. Documentation incorporates references to all necessary laws and related information from the health and retirement system. Our review indicates that LACERS has sufficiently documented the disability review process.

When an employee believes they may be eligible for disability retirement they first schedule an appointment with LACERS to discuss their situation. Prior to the appointment they are typically provided with all necessary paperwork, in order to expedite the review and evaluation process. During the appointment the employee is counseled to better understand their options and understand the timing and required steps throughout the disability review process. LACERS' staff indicated that they are increasingly focusing energy on the counseling process to ensure only those employees who are viable candidates for disability retirement are going forward with the process. Thus, while statistically it appears they are processing fewer applications than they were five years ago, in actuality they are using the counseling process to ensure that employees are only going forward with disability retirement when it is truly the best option.

If an employee decides to go forward with the process and submit a disability retirement application, they complete a disability packet that is available in its entirety in PDF form. This indicates significant progress since the 2007 review of LACERS' system, but indicates that the process is still not fully automated. The New York City system, while not a perfect comparison because it includes safety, school and hospital employees, allows applicants to complete all paperwork online using dynamic forms. This eases the administrative burden and reduces errors. Additionally, this may help to ensure that papers are not lost in transmission and that all applications are typed and legible. LACERS may want to consider ways to introduce more automation into their application process in the future. However, LACERS notes that much value is added to the process by interfacing with applicants through the manual process.

The disability retirement packet includes an authorization allowing the release of medical records to LACERS. Once authorization allowing the release of medical records is received, the Clerk Typist will reach out to the employee's current treating physician's office to coordinate receipt of the applicant's medical records. This process requires coordination between LACERS and the employee's private treating physician, and often results in a delay in the application process. Typically the doctor's office is required to fax documentation to LACERS, which may take up to 3 weeks. Further automation of this system, for instance including the use of a secure online web-service to transfer and store the documentation, could help to streamline the disability review process. Most importantly, LACERS needs to be more proactive in asking for required records and following up with the private treating physicians.

After receiving an employee's medical records, LACERS' Disability Department staff will coordinate the scheduling of an evaluation appointment with three treating physicians. Following recommendations issued during the last review of LACERS' disability retirement process, LACERS has contracted with two organizations that provide a slate of evaluating physicians who can make a determination about disability retirement eligibility.

Once the medical report is received, the Benefits Specialist works to create a file for each applicant. The applicant materials are all scanned and an electronic record is created. The electronic record is a new development. The ability to share information electronically is a new development that helps to streamline application review process and get information to Board members in an efficient manner. Further, electronic records may be linked to or referenced in the new Pension Gold System disability screen and an Excel tracking spreadsheet that is updated with the status of each disability retirement application.

The Board uses the medical reports to make determinations as to whether an employee is eligible for disability retirement. When the three medical professionals, or a majority of medical professionals involved, reach a decision that an employee is unable to work then the Board typically grants disability retirement. Only when there is significant disagreement or dissention does the Board typically rely on additional expert testimony during a hearing to determine whether an employee should be granted retirement disability. When there is significant disagreement, the Board may reserve the right to revisit the decision during a future review at the time of their discretion.

LACERS' staff indicated that they believe their staffing is adequate to fulfill their responsibilities. In 2011-2012 staff was charged with ushering 42 disability retirement applicants through the review process. This is a significant increase from the 29 applications which were submitted in 2010-2011. While, this may be a decrease from all-time high numbers of applications, the Benefits Specialist indicates there is an increasing emphasis in the Benefits Department on counseling, to help employees find the best solution for their situation, be it disability retirement or another arrangement. Accordingly, we believe the current staffing level is appropriate, although it should be reviewed at regular intervals to ensure the Disability Department is meeting applicant needs.

Table 17 on the next page is a break-down of disability application actions.

Table 17 - Disability Application Actions

Year	Applications Approved	Applications Denied	Applications Deferred	Applications Withdrawn	Total
2011-2012	35	0	1	6	42
2010- 2011	22	2	0	5	29
2009-2010	27	0	0	5	32
2008- 2009	23	2	0	6	31
2007- 2008	36	2	2	6	46

The typical timeframe required by the Disability Department to process an application is six months and is as follows:

Step	Time Estimate	Timing
Request for medical records	3 weeks – 2 months	Can occur concurrently
Request for duties assessment	2 – 3 weeks	
Independent medical exams	4 weeks – 2 months	Successive
Receipt of report	2- 6 weeks	Successive
Compile file for Board presentation	1- 2 weeks	Can occur concurrently
Provide file for Board review	1 month	
Board presentation and deliberation	1 month	

Moreover, we do not believe increased staffing can help expedite the process. But, we do believe that increased use of technology and automation, in addition to taking a proactive approach to establishing and maintaining relationships with area doctors may be beneficial to streamlining the disability retirement review process. LACERS noted in response that implementation of automation in many cases is provider dependent and they have no control over a patient's choice of provider. They also note that for one very large provider, Kaiser, this is not a problem.

Currently, the disability application process requires collecting, faxing, scanning and copying medical records of applicants. LACERS has policies and procedures in place to protect the privacy and confidentiality of these medical records. Additionally, the Board adopted a policy to retrieve and dispose of disability related information to protect the health information of applicants, in accordance with HIPAA and privacy laws. All medical records are kept in secure file cabinets, when not in use. Further, only employees in the Disability Department and the LACERS' Board have access to these documents.

Finally, while specifics about disability determinations were previously contained in Board minutes/ records, this policy has recently been revised. Since the fall of 2011 transcripts of Board meetings no longer contain confidential health information. Unfortunately, earlier records continue to be available on the LACERS' website. In an effort to protect confidential health information of applicants, including information about specific disabilities, these Board documents should be edited. Any information about employees and their medical conditions should be redacted.

Recommendations on the Disability and Retirement Benefit Administration Process

While tremendous steps have been made in using technology to enhance the disability retirement process, more work can be done to streamline this process in the future.

11. **LACERS should add more automation if cost-beneficial, in the application process to reduce the amount of work, time, and effort spent scanning applications, and ensure applications are complete. An automated system would ensure that all applications are legible and complete before submission, and automatically generate an electronic file, that would likely be easily searchable.**

12. **LACERS should establish relationships with area physicians and become more proactive in getting medical records. Specifically, if cost-beneficial, creating a mechanism to accept these applications electronically will eliminate the delay that may be present with faxing or mailing this information, and allow the Disability Department to keep track of medical records in real time.**

LACERS' Disability Benefit Calculations

LACERS' members who have five (5) or more years of continuous service and who have become physically or mentally incapacitated and are incapable, as a result thereof, of performing his or her job duties generally qualify for disability retirement. LACERS has a defined benefit pension plan to provide disability retirement benefits for their employees. The amount of the retirement benefit is based upon a combination of final pay and a percentage of final pay (33.333%).

Observations on LACERS' Disability Benefit Calculations

The employee data provided to conduct the calculations was in a paper format that was well documented and contained the necessary information to perform the calculations.

Our review resulted in differences that were no more than $0.02 for any calculation, an indication that LACERS' calculation system accurately calculated the disability retirement benefits for the sample employees.

LACERS' staff provided all the necessary tools to facilitate the review and the ability to replicate the retirement benefits. They were knowledgeable about the subject matter and able to explain to us in great detail the calculation rules and methodology.

Recommendation on LACERS' Disability Benefit Calculations

13. **LACERS should organize scanned data into additional sub categories if cost-beneficial, to help increase utility.**

Review of LACERS' Retirement Benefit Payment Timing

Objective 1: Have LACERS' plan participants been provided the benefits they are entitled to in a timely manner?

The expectation of a timely benefit payment is common to most newly retired employees. They are migrating from a salary to a pension, and a seamless transition is critical to ensure that retirees continue to be able to pay their bills and meet their financial obligations. It is optimal that public retirement systems provide a retirement benefit that is payable to new retirees within 30 - 50 days of their effective retirement date.

Observations on LACERS' Retirement Benefit Payment Timing

The review covers the timeliness of benefit payments for new retirees beginning in 2011. Our review analyzes the number of days from effective date of retirement to date of the first payment:

The average number of days between the effective date for retirement and date of first payment is 43. The median amount of days was 41 (i.e., half of the cases took longer than 41 days and half took less than 41 days). The minimum number of days to receive a payment was 20, and the maximum number of days was 121. Seventy five percent (75%) of retirement requests were completed within the optimum 50-day period.

Table 18 shows the count of the number of days between an employee's effective retirement date and date of actual receipt of their retirement benefit, as well as a break-down by percentage of retirees receiving payments in a time-frame:

Table 18 - Days Between Retirement Date and Receipt of Retirement Benefit

Days	Counts	%
< 30	28	5%
30-39	232	39%
40-49	187	31%
50-60	87	15%
> 60	61	10%
Grand Total	595	100%

As demonstrated by the table above, 75% of payments occur within the 50 day period. While there are always mitigating circumstances that may result in some of the payments being delayed, the expectation is that the majority of retirement requests are processed in a timely manner. During this audit period there was a significant such case from May 2009 to September 2013 while the City was under a fiscal emergency. During that time members were given additional retirement incentives and certain requirements were waived. LACERS reported that 61% and 85% of the applications in the 50-60 and >60 days categories, respectively were received within 30 days of the retirement date.

Recommendation on LACERS' Retirement Benefit Payment Timing

14. LACERS generally processes retirements in a timely manner. The number of cases that are more than ninety days outstanding (3 out of 595) is relatively minor but may present a burden to those retirees. LACERS should consider ways to expedite these few cases.

Benefit Calculations

LACERS has a defined benefit pension plan to provide retirement benefits for eligible City employees. The value of an individual's retirement benefit is based upon a combination of final pay and years of service.

As allowed under City Charter Section 1168 ("CODE"), employees are eligible to retire under the following conditions (§4.1020):

Attaining Age 70;
Attaining Age 60 with 10 years of continuous service; and
Attaining Age 55 with 30 years of continuous service.

Upon retirement LACERS provides former employees with a retirement benefit based on the following formula (CODE §4.1056.2):

2.16% per year of service (not to exceed 100%) of the average of the highest salary during a continuous 12 month period.

LACERS also provides a cost of living adjustment (COLA) which increases the retirement benefits annually (CODE §4.1040). The provisions of the COLA are 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.

LACERS uses a retirement benefits administration system called PensionGold, which calculates the retirement benefit.

Observations on Benefit Calculations

The Summary Plan Descriptions were well written and contained all the necessary information to perform the review. The employee data provided to conduct the calculations was in a paper format that was well documented and contained the necessary information to reperform the calculations. LACERS' staff were knowledgeable about the subject matter and able to explain the calculation rules and methodology in great detail.

Calculations followed plan provisions and agreed to member data and the administrative (COLA) adjustments. Differences between our calculations and the observed condition were no more than $0.02 for any calculation; an indication that LACERS' calculation system accurately calculated the retirement benefits for the sample employees.

We have no recommendations in this area.

V. Governance and Fiduciary Responsibilities

Objective 11: Evaluate whether plan fiduciaries are properly fulfilling their responsibilities, as related to LACERS.

We evaluated LACERS' governance practices and policies against published best practice standards (Published Standards), and the Cortex Governance Benchmarking Database (the "Cortex Database"). The Published Standards were drawn from the works of a number of bodies around the world including the Stanford Institutional Investor's Forum Committee on Fund Governance and the Government Finance Officers Association. The Cortex Database is comprised of over 200 metrics relating to the governance practices of 25 U.S. public retirement systems. We refer to these systems as the "Cortex Peer Group", so as to distinguish it from the Project Peer Group used in other sections of this report.

A description of our criteria for evaluating governance, a list of the Published Standards that were relied upon, and a list of systems in the Cortex Peer Group is provided in Appendix A. It includes several California municipal and county funds, including LAFPP, the Los Angeles County Employees Retirement Association, the San Francisco Employees Retirement Systems, and the two San Jose city retirement plans.

For each of the key governance issues that we have examined, we have provided the following information:

i) A summary of published standards relating to the issue;
ii) An assessment of how LACERS' practices compare to both the Published Standards and the Cortex Peer Group; and
iii) Recommendations, where appropriate.

Enabling Legislation and Governing Authority

A fundamental aspect of a public retirement system's governance structure is the autonomy and authority the system has relative to the plan sponsor (e.g. a state or local government). *The Clapman Report*[27] and *The Uniform Management of Public Employees Retirement Systems Act* (UMPERSA), 1997, a model law developed in the United States, provide guidance on the matter. They recommend that a governing board of a public retirement system should be highly independent of the plan sponsor and should have exclusive authority to:

1. Manage the assets of the system;
2. Establish the operating budget of the system;
3. Approve human resource and compensation matters, including the hiring of personnel and setting of compensation;
4. Make procurement decisions; and
5. Retain advisory and other services.

[27] *The Committee on Fund Governance Best Practice Principles,* issued by the Stanford Institutional Investor's Forum, is also known as *The Clapman Report.*

In setting out the rationale for granting governing boards a high degree of independence, the UMPERSA model law states that:

> *"Independence is required because it permits trustees to perform their duties in the face of pressure from others who may not be subject to such obligations. In the absence of independence, trustees may be forced to decide between fulfilling their fiduciary obligations to participants and beneficiaries or complying with the directions of others who are responding to a more wide-ranging (and possibly conflicting) set of interests."*[28]

The California Pension Protection Act of 1992 (also referred to as Proposition 162), also reflects this thinking, as it explicitly states in Section 3(e) that one of the legislative purposes and intents of the 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."*

Observations on Enabling Legislation and Governing Authority

LACERS' enabling legislation is set out in the Los Angeles City Charter (the "City Charter"), namely Article XI – Pension and Retirement Systems (specifically sections 1100 to 1120 and sections 1150 to 1170). LACERS is also guided by State legislation and other City Charter and Administrative Code provisions, including but not limited to:

- The California Pension Protection Act of 1992
- City Charter, Article V – Departments (Sections 500-514)
- City Charter, Article X – Employment Provisions
- The Los Angeles Administrative Code (the "Administrative Code"), Division 4 – Employment
- Administrative Code, Division 10 - Contracts, and Division 9 - Purchasing

LACERS and its board has autonomy in many key areas, including setting investment policy, appointing most (but not all) service providers, and approving its own operating budget. We did, however, identify the following limits on LACERS' autonomy.

1. The Board of Administration does not have independent authority to select its chief executive (i.e., the General Manager). The Board's appointment is subject to confirmation by the Mayor and the Los Angeles City Council (as per section 1108 of the City Charter). Almost all boards in the Cortex Peer Group had authority to select their chief executive (the only exception was

[28] *The Uniform Management of Public Employees Retirement Systems Act* (UMPERSA), Section 5: Power of Trustees, Comments section.

another California city fund). It is also considered best practice for the governing body of a retirement system (or any organization for that matter) to select its chief executive.

2. LACERS does not have independent authority to select external legal counsel. It is required by the City Charter to use the City Attorney's Office as its general counsel. 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 City Charter.)

   The City Attorney's Office has established a team of lawyers, referred to as the Retirement Benefits Division (RBD), to provide service exclusively to the City's three retirement boards. The RBD works out of offices at the LAFPP, but will soon be relocating to LACERS' offices. The RBD is currently staffed by five lawyers and one administration assistant. The RBD provides legal services in the areas of benefit administration, plan interpretation, litigation, and standard municipal law, as well as other areas.

   The City Attorney's Office may engage outside legal counsel (at the retirement system's expense) when a particular matter before the board requires specialized expertise that is not available within the City Attorney's Office, or where the City or the City Attorney's Office may be conflicted. Access to external counsel must be facilitated by, and is at the discretion of, the City Attorney's Office. LACERS has access to external legal counsel on certain matters, and currently utilizes such services in the areas of tax law, investments, securities litigation, fiduciary counsel (specifically for the Board), and investment matters.

   While LACERS management has good relations with the RBD, management has expressed concerns over the current level of staffing in the RBD, and its ability to provide the level of service that LACERS requires. It has also indicated that in the past, there have been differences of opinion between LACERS and the RBD as to the need for independent legal counsel (i.e., independence from the City and the City Attorney's Office).

   The LACERS Board is not alone in its reliance on the City Attorney's office, as many public plans have similar constraints. Among the Cortex Peer Group, however, 76% of retirement systems reported having independent authority to appoint their own legal counsel. Furthermore, *The Clapman Report* and UMPERSA clearly recommend that a public retirement system appoint its own service providers, which would include legal counsel.

3. LACERS is subject to certain limitations with respect to staffing. While the Board can hire for existing position classifications, any new position classifications require approval from the City's Administrative Officer. Furthermore, LACERS is also subject to the pay scale established by the City for the various job classifications (subject to a limited number of exempt positions). LACERS is also required to fill certain positions from within existing City staff. As noted above, the UMPERSA model law suggests that as part of the autonomy required by retirement systems, such systems should have independent authority to determine their own staffing needs (e.g., the type and number of positions and classifications), and set their own compensation levels and policies.

4. LACERS is constrained with respect to its board meeting schedule, as it is required to meet twice each month, as per section 503 of the City Charter, a provision which applies to all City charter boards. In fiscal year 2012, LACERS held 24 regular board meetings, as well as five special meetings. This was well over the average of the Cortex Peer Group, which was 12 meetings per year. Mandating a set number of board meetings is inconsistent with best practices. A retirement board should be free to set its own meeting schedule, and in doing so should be guided by prudence in a manner consistent with its fiduciary duty. From a practical perspective, excessive meetings can impact board and staff efficiency. For each board meeting, there is a fixed amount of staff and board preparation, travel time, post meeting follow-up activity, and general disruption from normal duties, regardless of the length of meeting. Accordingly, there appear to be efficiencies that can be gained from holding less frequent, albeit longer meetings throughout the year.[29]

5. We noted that the prior Mayor had removed board members in mid-term without advance warning and for no stated reason.[30] While we believe it is appropriate for the plan sponsor to have the authority to remove board members under appropriate circumstances, such removals can nevertheless be disruptive to board and staff operations.

Recommendations on Enabling Legislation and Governing Authority

15. In accordance with industry best practices and published standards, LACERS should propose to the City Council that the City Charter be amended to grant the Board full authority to administer the System subject to fiduciary standards. Such authority would include but is not limited to:
   a. Appointment of the General Manager;
   b. Selection of legal counsel (internal and external);
   c. Staff compensation and hiring policy (at a minimum, the authority to allocate or reallocate positions without going through the City's Personnel Department);and
   d. Setting the number and timing of board meetings.

   If the City does not have sufficient confidence that the Board will exercise such authority appropriately, it should then consider establishing any necessary safeguards to protect against the improper exercise of such authority; e.g. enhancing the qualifications and independence of the Board. Such added safeguards would be more effective than constraining the Board's ability to administer the System, and would therefore better serve the interests of all stakeholders.

16. LACERS should propose to the City Council that the City Charter be amended to stipulate that an appointed board member may be removed prior to the end of his or her term, but only for cause relating to the board member's fiduciary or statutory duties, and that if an

[29] LACERS also held 17 committee meetings in 2012, although this was more in line with the Cortex Peer Group, which had an average of 20.7 committee meetings for that year.
[30] Under section 1104 of LACERS' governing statute, four of the seven board members are appointed by the Mayor subject to the approval of the Council. During our interviews, we were informed that there was a practice in place whereby the prior Mayor's appointees signed a letter of resignation prior to taking office. Removal was effected by the Mayor accepting the resignation.

appointed board member is removed from office prior to the expiry of his or her term, that the reason(s) for such removal be publicly disclosed.

Documentation of Roles and Delineation of Authority between Board, Board Committee, and Staff

Published standards are unanimous in recommending that the roles and responsibilities of all significant parties involved in governing and managing a public retirement system be clearly defined, documented, and accessible. At a minimum, the board should approve documentation setting out the roles of the following parties:

- The board
- Officers of the board
- Standing committees of the board
- Executive director or comparable position
- Internal Audit Director or Division

In this section, we evaluate how systems have allocated specific duties among these parties. Published standards seldom provide specific guidance as to the optimal delineation of responsibilities within a public retirement system. Some general principles or guidelines, however, have been identified and are noted below:

> *"The [board] is expected to oversee and assume responsibility for the pension plan but is not expected to manage the plan on a day-to-day basis[31]."*
>
> *"The plan should allocate authority in inverse proportion to the importance of the task … thus minor tasks may be completely delegated to staff but extremely important tasks may be restricted to decisions by trustees or require trustee participation.[32]"*

Consistent with the above, we believe that the board's focus should be on policy and oversight. This would include, but is not limited to:

- Approving and reviewing policies pertaining to governance, investments, benefit administration, operations, and human resources, (and delegating to staff the authority to approve procedures that are consistent with, and support, the board's policies);
- Approving organizational goals and objectives in the areas of funding, investments, and member services;
- Approving strategic plans; and
- Approving parameters for measuring and reporting on organizational performance.

The board should also make certain operational decisions, such as:

[31] Canadian Association of Pension Supervisory Authorities (*CAPSA) Governance Guidelines,* Principle #3, page 7.
[32] *The Clapman Report,* Principle E. Delegation of Duties & Allocation of Responsibilities among Relevant Authorities, Principle 3, page 17.

- Selecting the executive director;
- Approving the annual operating budget; and
- Selecting and evaluating certain advisors (e.g. those that directly serve the board such as the auditor and actuary).

Best practices also suggest that boards should not select investment managers, as such decisions are operational in nature and divert the board's attention from more important policy and oversight matters.

We have also examined the committee structure of the Board. Published Standards are for the most part silent on the number and types of committees that a retirement systems should establish. That being said, both the Association of Public Pension Fund Auditors and the American Institute of Certified Public Accountants have established best practice samples for public audit committees.

Observations on Documentation of Roles, Delineation of Authority and Board Committee Structure

Documentation of Roles

The roles of the Board and the General Manager are documented in the *Statement of Governance Principles*, which is the first of the board governance policies found in the LACERS Governance Manual (although in the document the General Manager's position is referred to as the Chief Executive Officer).

The key investment-related responsibilities of the Board and investment staff, however, are documented separately in the *Investment Policy Statement, Part VI: Duties of Responsible Parties*, together with those of investment managers, investment consultants, and custodians. We also noted Board and staff responsibilities documented in other sections of the Governance Manual, such as the *Alternative Investments Policy*.

While there is no distinct charter or mandate for the Board President, the duties of the position are documented under the *Board Procedures* section and the *Committee Rules* section of the Governance Manual.

We recognize that LACERS is in the process of filling the senior internal audit position. A majority of the Cortex Peer Group have established a separate charter for their internal audit director/division, that describes the internal auditor's roles and responsibilities, and his/her reporting relationship with the Board and the General Manager.[33] The internal audit position is unique in an organization as it reports both to the General Manager and to the Board and/or the Audit Committee. A charter for this position can help clarify this complex relationship, and also clarify the Board's and the General Manager's expectations.

Each LACERS committee has its own charter, although the format and content of each varies widely. For example, the Benefits Committee charter contains only three brief bullet points that state the committee's specific responsibilities, while the other two committee charters are much

[33] The charter serves a different purpose from a traditional job description, which is typically used for recruiting purposes.

more detailed (and are approximately two pages in length). As another example, only the Corporate Governance Committee charter specifies the committee composition. We also noted the following issues concerning the committee charters:

1. The Audit and Strategic Planning Committee Charter states that the committee will draft the Departmental Strategic Plan in accordance with the mission statement. Drafting a strategic plan is a time consuming undertaking, better suited to the staff. A more appropriate role for the committee would be to review the strategic plan, provide guidance or input, and once finished, recommend it to the Board.

2. The Governance Manual includes a charter for the Investment Committee (see page 14), even though this committee was disbanded in 2011. The Investment Committee is also referenced in other sections of the Governance Manual (see the *Alternatives Investment Policy*, pages 6-7, the *Specialized, Non-Traditional Alternative Investment Policy*, page 2, Attachment 1, and the *Real Estate Policy*).

Delineation of Authority

LACERS' approach to delineating authority is generally consistent with published standards and best practices; the Board is focused on policy and oversight, while staff is responsible for implementation and day-to-day operations. The Board is also responsible for appointing the key advisors and service providers, including the selection of public market investment managers (but not legal counsel, as pointed out earlier in this report).

The Board has delegated some authority to management with respect to the selection of investment managers and private equity partners/funds. Although the Board appoints its public market investment managers, many aspects of the search and selection process have been delegated to staff, such as identifying potential candidates, conducting due diligence visits, and selecting a finalist candidate for the Board's approval. A similar approach is taken with respect to managers and funds of the real estate and special investment program. The Board has also delegated greater discretion in its private equity program to the private equity investment consultant (Hamilton Lane); under its Alternative Investment Policy – "Discretion in a Box" program, the Board establishes high level parameters (investment policies, procedures, allocation targets, ranges, etc.), within which the private equity consultant operates, and subject to regular reporting and monitoring. The selection of private equity funds within certain limits do not require board approval (board approval is required, however, for allocations over $25 million or greater to new management groups, and $40 million or greater for follow-on partnerships).[34]

There has been a slow shift in industry practices in recent years, with more and more retirement systems delegating the manager selection function to investment staff, within board set parameters and policies. This change in practice has been founded primarily on the view that manager selection is operational in nature and diverts the board's attention from more important policy and oversight matters. At least one third of the Cortex Peer Group (36%) delegated manager selection to staff and/or investment consultants, subject to various parameters and controls. In a later 2012 study of larger retirement plans and investment boards, such practices

[34] As per LACERS Alternatives Investment Policy

were even more common; 55% of that peer group had delegated manager selection to investment staff or management committees.[35]

Board Committee Structure

The Board has delegated some of its oversight and policy-developing responsibilities to three board committees:

- Audit and Strategic Planning
- Benefits Administration
- Corporate Governance

LACERS previously had an investment committee, but it was deactivated in 2011.

There was a wide variety of committees used by the Cortex Peer Group, although a majority of funds had an investment committee (68%) and audit and/or finance committees (64%).[36] In light of the wide range of practices among the peer group, and the (limited) guidance from published standards, we believe the current committee structure is reasonable, subject to one caveat. Staff indicated they will shortly recommend to the Board that the Audit & Strategic Planning Committee be separated into two different committees, as recommended in the 2007 Management Audit Report. Staff indicated this will likely occur after LACERS fills the senior internal audit position. We agree with the 2007 Management Audit recommendation that there be a separate audit committee, given both the importance of the audit committee's role, and the wide range of responsibilities of such committees.[37]

We question, however, the need for a strategic planning committee. Strategic planning is primarily a staff driven initiative (e.g., developing the strategic and divisional plans, preparing updates on progress, implementation). We recognize the need of the Board to be involved in the strategic planning process, (e.g., approval of the strategic plan, monitoring progress, etc.), but believe this should involve the entire Board. None of the Cortex Peer Group members have established a strategic planning committee.

Recommendations on Documentation of Roles, Delineation of Authority and Board Committee Structure

17. **LACERS should establish separate comprehensive charters for the Board, the Board Chair, and the General Manager (i.e., staff), as opposed to having their roles and responsibilities**

[35] A list of the funds in the second Cortex peer group can be found in Appendix A.

[36] The average number of committees among our peer group was four. One fund had as many as eight board committees. A few boards operated without any committees (these were typically smaller boards, i.e., six or seven member).

[37] The sample audit committee charters published by the Association of Public Pension Fund Auditors (APPFA) and the American Institute of Chartered Public Accountants (AICPA) are considerably more comprehensive in scope and detail as that of the typical retirement board committee charter. In our experience, the typical committee charter covers anywhere from five to fifteen distinct duties and responsibilities. The AICPA sample *Audit Committee Charter Matrix* covered 27 distinct duties and responsibilities, while APPFA's *Example Audit Committee Charter* covered over 80 distinct duties and responsibilities.

documented in various governance and investment policies. The use of charters (or terms of reference) was a typical practice among the Cortex Peer Group.

18. **LACERS should establish a charter for the internal audit position that describes the roles and responsibilities of the position, and the internal auditor's reporting relationship with the Board and the General Manager.**

19. **LACERS should remove the Investment Committee charter from the Governance Manual, as well as various references to the committee found throughout the Governance Manual, as the committee was disbanded in 2011.**

20. **LACERS should consider instituting a consistent format and content for each committee charter, such as a general statement as to the role of the committee, committee composition, frequency of meetings, as well as the specific duties and responsibilities of the committee.**

21. **As LACERS investment programs get larger and more sophisticated over time, the Board should consider delegating the entire selection process to management, subject to board-approved parameters, selection criteria, and relevant internal controls. As we noted above, the Board has already moved in this direction.**[38]

22. **The Board should establish a separate audit committee, and in preparing a charter for the committee, should consider the sample charters prepared by the Association of Public Pension Fund Auditors (APPFA) and the American Institute of Certified Public Accountants.**

23. **The Board should consider eliminating the strategic planning committee.**

Governance Policy Framework

A sound, comprehensive policy framework is a central component of a retirement system's risk management system. Published standards are consistent in recommending that policy frameworks be established.

Several of the Published Standards suggested various policy topics to be covered in the framework, including funding, investments, conflicts of interest, trading, personal investments transactions, acceptance of gifts, compensation, and communications, to name a few.[39]

Observations on LACERS' Governance Policy Framework

The LACERS Governance Manual contains a number of important governance and ethics-related policies, including:

[38] We also noted the idea of further delegating manager selection has previously come before the Board; the Board's President suggested this approach at the Board's January 2012 meeting.
[39] See *The Clapman Report*, the Organization for Economic Co-operation and Development *Guidelines for Pension Fund Governance*, the Government Finance Officers' Association *Governance Guidelines,* and the *CAPSA Governance Guidelines*.

- Governance Statement of Principles
- Committee Rules
- Code of Ethics
- Commitment of a LACERS Board Member
- Policy of Outside Communications
- Board Education and Travel Policy
- Conflict Governance Policy
- Marketing Cessation Policy
- Corporate Governance Actions Response Protocol
- Third Party Marketer Compliance Policy[40]

The Board has also established a Board Communications Policy, which addresses key communication issues involving Board and staff, such as establishing a spokesperson, communicating with the media, and communications between the Board and LACERS staff. The policy also includes several relevant appendices, including the Ralph M. Brown Act (open meeting laws) and other LACERS communication policies. We noted, however, that the policy has not been included in the Governance Manual.

We found LACERS policies were relatively clear and comprehensive, with some exceptions noted in other sections of this report.[41] We did note, however, that some policies in the Governance Manual appear to be out of date, such as the Investment Policy Statement, which is included as an appendix to the Governance Manual. The statement is dated June 24, 2008, and contains outdated asset allocation targets and ranges. There are also references to disbanded committees throughout the Governance Manual, namely in the *Commitment of a LACERS Board Member,* and as mentioned above, in the various investment policies.

Recommendations on LACERS' Governance Policy Framework

24. LACERS should establish a formal frequency for the periodic review of its governance policies. Industry standards in this regard range from every 3 to 5 years. The policy review frequency should be documented (this could be done in the Statement of Governance Principles, or in each policy). Ideally, all governance policies should indicate the date the policy was first approved, and last reviewed and/or amended.

25. LACERS should establish other governance policies which we view as best practice, and which were common among the Cortex Peer Group:

   a. A Monitoring and Reporting Policy: this policy would set out the routine reports to be provided to the Board and/or its committees. (This type of policy would satisfy the requirement in section D of the Statement of Governance Principles concerning identifying information needs.[42])

[40] A review of the ethics policies is covered in the next section. They have been listed here to provide the reader with a comprehensive list of LACERS' governance policies.

[41] Earlier in this section of the report we identified some issues with the Statement of Governance Principles, and in the next section we have comments concerning LACERS' ethics policies.

[42] See *Statement of Governance Principles, Section D - Other Board Responsibilities* which states: Identify information needs and determine how, when and in what form information is to be delivered to Board members so as to enable the Board to meets its responsibilities, having regard for time available.

b. **A strategic/business planning policy: LACERS has established a rigorous strategic planning process, which involves regular reporting to the Board and its committees. We suggest that there would be value in documenting the parameters of this process in a board policy or staff procedure.**

c. **A General Manager Performance Evaluation Process: the only documentation we received concerning the evaluation of the General Manager was a memorandum to the Board dated August 8, 2006 which briefly described the evaluation process, and incorporated the City's General Manager Performance Evaluation form. (The memorandum referred to an Executive Evaluation Committee, which we understand no longer exists.) The Board should establish a formal evaluation policy and evaluation tool for the General Manager. It may use the August 2006 memorandum as a starting point but should also explore best practices in the industry.**

26. **LACERS should review and update its Investment Policy Statement and other investment policies, and include the latest versions in its Governance Manual.**

27. **LACERS should add the Board Communications Policy to the Board's Governance Manual.**

28. **LACERS should update the *Commitment of a LACERS Board Member* document, which references committees and subcommittees that no longer exist (e.g., Audit and Risk Control Committee, Private Investment Committee, etc.)**

Ethics Policies

A core tenet of fiduciary practice is that fiduciaries owe a strict duty of loyalty to their beneficiaries and must at all times act in the best interests of the beneficiaries when administering a retirement system. Fiduciaries must also act with utmost honesty and integrity in carrying out their duties. To help fiduciaries successfully meet these duties, published standards suggest that every system establish one or more policies addressing ethical conduct. In practice, this typically takes the form of a conflict of interest policy and a code of conduct/ethics, or combination of the two.

Published standards have also addressed in some detail the elements of such policies. The Organization for Economic Cooperation and Development (OECD) Governance Guidelines states as follows under section 9 - Risk-Based Internal Controls:

> *The governing body should also develop a code of conduct and a conflicts of interest policy for them and the staff of the pension entity as well as for any party with operational responsibilities. There should also be appropriate controls to promote the independence and impartiality of the decisions taken by the governing body, to ensure the confidentiality of sensitive information pertaining to the fund and to prevent the improper use of privileged or confidential information.*

The GFOA Governance Guidelines also recommends the establishment of a Code of Ethics, providing standards of conduct for board members and plan staff, and which address the following:

- Loyalty to system participants;
- Fair, honest and open (transparent) decision-making;
- Other aspects of personal conduct, such as avoiding improper influence and fully understanding applicable ethics-related laws.

The Clapman Report covered the topic of conflicts of interests in considerable detail, and identified four key principles regarding addressing conflicts of interest and related disclosure policies, which include (but were not limited to) the following requirements:

1. A fund should establish and publicly disclose its policy for dealing effectively and openly with situations that raise either an actual conflict of interest or the potential for the appearance of a conflict of interest.
2. A fund should clearly identify the persons subject to its conflict policy ("covered persons") and should provide appropriate training to those covered persons.
3. A fund should establish a regular, automatic, process that requires all covered persons to report and disclose actual or potential conflicts of interest.
4. Trustees and staff should periodically affirm and verify compliance with conflict rules, regulatory reporting requirements, and other policies intended to protect the fund against the actuality or appearance of interested transactions and conflicts.

Observations on LACERS' Ethics Policies

The scope and content of LACERS' ethics policies and applicable ethics legislation appear generally consistent with published standards, as well as the prevailing practices of the Cortex Peer Group, although some exceptions were noted.

(Note: In examining the scope and content of a retirement system's ethics policies, we also considered applicable ethics laws. We often find that important ethics rules that are not covered in the system's ethics policies are addressed in the applicable ethics laws.)

The LACERS Governance Manual contained several ethics-related policies, including the following:

- Code of Ethics
- Conflict Governance Policy
- Marketing Cessation Policy
- Third Party Marketer Compliance Policy

The Board Education Policy also contains requirements for board ethics training, and there are some ethical and conduct-related statements in the Governance Principles Statement.[43]

[43] Page 3 of the Statement of Governance Principles states "At all times [the Board will] meet high ethical standards that exceed legal minimums"; page 4 states "the Board strives to achieve a governing style that emphasizes… ethical conduct of Board business to avoid even the appearance of impropriety".

Applicable Legislation on LACERS' Ethics Policies

LACERS is also subject to thorough and rigorous ethics laws, including the *California Political Reform Act of 1974* (the "Political Reform Act") and other state laws (e.g., Government Code, section 1090), as well as the City's ethics laws, including those set out in the City Charter (section 222), the City's Governmental Ethics Ordinance (i.e., Municipal Code Chapter IV, Article 9.5), the City of Los Angeles Code of Ethics, the Mayor's Executive Directive No. 1: Ethics in Government, and the Mayor's Executive Directive No. 7: Departmental Liaison, Training, and Compliance.

Under the Political Reform Act and the City's ethics laws, LACERS board members and staff are subject to routine financial reporting and disclosure requirements. Actual disclosure requirements vary depending on their respective level of decision-making authority, and the specifics of such are set out in LACERS' Conflict of Interest Code – Schedule A, which we understand requires approval by the City's Ethics Commission. Commonly reportable interests include:

(a) investments in business entities (e.g., stocks, businesses, partnerships);
(b) real estate interests;
(c) sources of income, including gifts and loans; and
(d) business positions.

The Political Reform Act and the City's ethics laws also regulate the receipt of certain gifts by City officials and employees. These laws set annual limits on the amount of gifts a City official may receive, depending on the source of a gift. In some cases, the law prohibits certain gifts. Gifts directed to an official's family member may also be subject to these same restrictions. Gifts are reportable on a City official's Statement of Economic Interests, CA Form 700.

We also understand that, pursuant to the Mayor's Executive Directive #1, LACERS' Commissioners and the General Manager are required, upon appointment, to sign an Ethics Pledge, acknowledging their commitment to abide by certain ethics principles and restrictions as set out in the Directive. The acknowledgement is filed with the City, and not LACERS. This requirement is similar to a practice recommended by *The Clapman Report*, which suggests that board members annually affirm familiarity and compliance with the board's governance rules and principles, and that board members and staff periodically affirm and verify compliance with conflict rules and regulatory requirements.[44]

LACERS' Gifts Policy

Several years ago, LACERS established a separate gifts policy for staff. The staff gifts policy was a zero tolerance policy, and thus was more restrictive than both State and City requirements, both of which allow gifts up to a certain dollar value, depending on the source of the gift. Due to practical implementation challenges with the gifts policy, it was recently amended to allow the receipt of certain perishable gifts up to $50, provided the gift is donated to LACERS for a general employee purpose (e.g., department-wide employee raffle, general consumption or enjoyment).

[44] See *The Clapman Report*, pages 6, 13 and 14.

Only a few funds in the Cortex Peer Group have adopted a zero tolerance gifts policy for board members and/or staff. Our experience has been that zero tolerance policies can be impractical to implement, or lead to awkward social interactions (such as refusing a cup of coffee while on an on-site due diligence visit). Most of the Cortex Peer Group funds have adopted gifts policy that allow for a nominal gift or expression of appreciation, often expressed as a certain dollar value from any one source in a particular year (and which is consistent with the approach taken by State and City ethics laws). Their policies often also require disclosure of such gifts.

Ethics Training and Advice

Under the City's ethics laws, Commissioners and LACERS employees had previously been required to attend a City Ethics Commission (CEC) training session every two years. We were informed that the on-site ethics training has recently been replaced by an on-line training module. The CEC, rather than LACERS staff, monitors compliance with completion of ethics training.

Staff has raised concerns about the adequacy of resources made available to the Board by the CEC, given the complexity of applicable ethics legislation and of the high fiduciary standard to which public fund trustees are held. In 2010, the CEC had prepared a handbook for LACERS' board members, which provided useful guidance on navigating the City's ethics legislation. The CEC has since informed LACERS that the handbook is outdated, and has removed it from its website.

Staff have requested additional support from the CEC, including the delivery of an annual presentation for the Board on recent changes to the City's ethics laws. LACERS has not received a timely response to this request, and has not been able to secure anyone from the CEC to provide this training, which was targeted for January 2012 and 2013.

Service Providers

The Political Reform Act and the City's ethics laws also extends to certain LACERS consultants, requiring them to file statements of economic interest, additional disclosure requirements as set out in the regulations of the CEC, and a requirement to attend an ethics training program conducted or sponsored by the CEC (see Municipal Code 49.5.6.G). This is consistent with a practice recommended by *The Clapman Report*, that suggests ethics policies be extended to cover key consultants (i.e., a consultant from whom material advice is requested or received, or to whom material responsibility is delegated).[45]

The Board has established a Marketing Cessation Policy, the purpose of which is to prevent, and avoid the appearance of, undue influence on the Board or any of its members in the award of investment related and other service contracts. The policy restricts service providers from contacting board members when the service provider is being considered for a contract, or from providing gifts of any type to board members and staff. The policy also requires firms that are interviewed by the Board to submit a statement listing all contact with board members, staff, and consultants during the search period.

[45] See Principle #2, on page 17 of *The Clapman Report*.

Recommendations on LACERS' Ethics Policies

Collectively, LACERS policies and applicable ethics laws addressed all of the key ethic-related topics that were typically addressed by the policies of the Cortex Peer Group, and/or recommended by the Published Standards. Nevertheless, we did identify several improvement opportunities concerning the documentation of LACERS' ethics policies, and the level of ethics training and support it receives from the City:

29. **LACERS should reorganize the Governance Manual so that its ethics-related policies are all contained in the same section of the Manual to assist board members in maintaining familiarity with them.**

30. **LACERS should amend its Governance Manual so that it includes a comprehensive list of all applicable ethics legislation, for easy reference by board members and staff (such as, the City's Governmental Ethics Ordinance, and the Mayor's Executive Directives No. 1 and No. 7). The City Ethics Commission or the City Attorney's Office should assist LACERS in this regard.**

31. **LACERS should establish an annual attestation to be completed by board members, in which they affirm that they have reviewed and are familiar with LACERS' governance and ethics policies. The affirmation could also be extended to staff, with respect to applicable ethics policies.**

32. **Public fund trustees are subject to the highest level of fiduciary duty that exists in law, as well as complex ethics legislation and policy at the state, city and board level. Accordingly, the City should work together with the CEC and the City Attorney's Office to ensure that the LACERS Board receives at least annual in-person training on the City's ethics laws.**

Board Education Practices

Published Standards are unanimous in recommending that public retirement systems provide education for their board members. The standards, however, typically provide only general guidance in this regard. For example, *The Clapman Report* recommends that "*trustees, on a regular basis, should obtain education that provides and improves core competencies, and that assists them in remaining current with regard to their evolving obligations as fiduciaries.*" The *CAPSA Governance Guidelines* state, *"The plan administrator should be provided with appropriate training and ongoing education, as required".*

Cortex recognizes that boards differ significantly in terms of board composition and skill sets, board and staff time availability, and financial resources. Nevertheless, we believe best practices require retirement systems to develop board education programs that incorporate most, if not all, of the elements listed below, tailoring them to their particular circumstances:

a) A board education policy that sets out what is expected of board members with respect to education;
b) A new board member orientation program;

c) Continuing in-house education delivered by staff, advisors, or other third parties;
d) Opportunities to attend conferences, seminars, or courses;
e) A board member reference manual or handbook;
f) Periodicals, books, and other literature that board members may use for self-study purposes;
g) An education needs assessment process.

Observations on LACERS' Board Education Policies

LACERS' education practices and policies are comprehensive and rigorous, and are generally consistent with Published Standards and the prevalent practices of the Cortex Peer Group. Our review of LACERS Board and committee reports from the Review Period showed that the Board undertook a redesign of its education program and policies as part of its strategic planning activities, and that considerable work and improvement was done in this area.

Specifically, we found that LACERS' *Board Education and Travel Policy* is comprehensive, and contains provisions and requirements that we consider best practice, and which were common among the Cortex Peer Group, including the following:

- Education objectives
- Trustee orientation
- In-house education program
- External education (conferences, seminars)
- Reporting to the Board
  - Quarterly travel expenditure reports
  - Monthly report on seminars and conferences attendance
- Detailed travel expense reimbursement policies
- Appendices containing the following information:
  - A list of approved educational seminars and schedule
  - A Board travel reimbursement checklist
  - A Board member education evaluation form

We also found that the trustee education practices were comparable to best practices and the prevalent practices of the Cortex Peer Group. Some relevant details are as follows:

- Over a 12 month period, LACERS board members in the aggregate participated in 69 days of external education, which was higher than the peer group average of 60.3;
- LACERS had a rigorous internal education program, which included seven internal education sessions in 2011, and three internal sessions in 2012; and
- The Board has an ample education budget of $10,000 per board member, as compared to the peer group average which was $3,600.[46] In fiscal year 2012, the Board used only approximately 57% of this budget, or approximately $4,800 per board member.

[46] LACERS data was from 2012, while the peer group data was from 2010.

LACERS has also established a supervisor training program and tuition reimbursement program for staff. The education budget for staff for fiscal year 2012 was $20,000, and approximately 75% of that budget was utilized.

Recommendations on LACERS' Board Education Policies

33. LACERS should develop an education needs assessment process for the Board, which would serve as input into a Board or trustee education plan. This is an emerging practice, which involves periodically surveying individual board members on certain education-related issues, including:

   a. Educational topics for further study that relate to the duties of the trustees. (We often find that staff is in a good position to identify a list of potential topics for the Board's consideration.)

   b. Trustee preferences as to how best to obtain that education (e.g., internal versus external education, amount of education per year, educational tools, etc.).

<u>Public Disclosure Practices</u>

Published standards universally promote full and clear disclosure of relevant information to all stakeholders of a public retirement system. *The Clapman Report*, however, had the most detailed recommendations in this regard, namely the following:

1. A fund should clearly define and make publicly available its governance rules.
2. A fund should identify and disclose its leadership structure and all persons in positions of senior responsibility.
3. A fund should establish and publicly disclose its policy for dealing effectively and openly with situations that raise either an actual conflict of interest or the potential for the appearance of a conflict of interest (i.e., its conflict of interest policy).
4. Trustees and staff periodically affirm and verify compliance with conflict rules, regulatory reporting requirements, and other policies intended to protect the fund against the actuality or appearance of interested transactions and conflicts[47]; and
5. A fund should publicly disclose necessary information to ensure that trustees and staff are fulfilling their fiduciary duties to beneficiaries.[48]

These latter two items involve very rigorous verification and disclosure requirements, which have not been largely adopted by public retirement systems in the U.S. (as evidenced by the practices of the Cortex Peer Group and our discussions with other public retirement systems). Accordingly, we have not evaluated LACERS against these more rigorous criteria. They are, however, available in Appendix B for the Board's consideration.

[47] This is the same *Clapman Report* recommendation that we noted in the "Ethics" subsection; we have also included it in this subsection as it has both a verification component and a public disclosure component.
[48] See Part D of *The Clapman Report*, pages 13 to 15.

Observations on LACERS' Public Disclosure Practices

LACERS routinely discloses plan information in a manner consistent with the prevalent practices of the Cortex Peer Group. Such information is routinely posted on the LACERS website, and includes the Governance Manual, the Comprehensive Annual Financial Report, board meeting minutes, investment reports, and actuarial valuation reports. While LACERS also posts its committee meeting minutes on its website, they are accessible in different manners (e.g., the Benefits Committee meeting minutes are more easily accessible than those of the other two board committees).[49] 72% of the Cortex Peer Group routinely publishes committee meeting minutes.[50]

We also examined LACERS' practices against several of the disclosure practices recommended by *The Clapman Report* (specifically items 1 to 3 noted above under *Published Standards*). LACERS meets these requirements by routinely disclosing the following:

- Governance rules (which are set out in LACERS' Governance Manual, available on LACERS' website);
- Leadership structure and all persons in positions of senior responsibility (which is available on LACERS' website);
- Conflicts of interest policies (which are set out in LACERS' Governance Manual, available on LACERS' website).

Recommendation on LACERS' Public Disclosure Practices

34. LACERS should establish consistent accessibility to the meeting minutes of all its board committees.

<u>Monitoring and Reporting Practices</u>

Published standards are unanimous in recommending that boards and staff be provided ongoing reporting on the performance of the system and on compliance with policies, rules, and legislation. They do not, however, specify details of such reporting; e.g. frequency.

We analyzed LACERS' practices against those of the Cortex Peer Group. The LACERS Board received many of the reports commonly provided to the boards of the Cortex Peer Group, and with comparable frequency, including:

a. Quarterly investment performance reports
b. Reports from the General Manager and the CIO at each meeting
c. Report on department operations at each meeting
d. Benefits payment reports at each meeting
e. Strategic planning updates, at least annually
f. Reports on travel expenses, on a quarterly basis

[49] The Audit and Strategic Planning Committee and the Corporate Governance Committee minutes can only be accessed through links contained in the board meeting agendas, and these links do not work for all web browsers.
[50] This understandably excludes the minutes of disability hearing committees, as well as other committee business conducted in executive session.

g. Monthly reports on upcoming educational conferences and seminars
h. Regular reports from legal counsel

We also examined the content of LACERS' quarterly investment performance reports against the performance reports of the funds covered in our 2012 benchmarking study.[51]

Observation on Monitoring and Reporting Practices

We found that the content of the LACERS' performance reports is consistent with that of the peer group. The reports of LACERS and the peer group typically included the following:

a. Total fund performance relative to asset mix policy benchmark
b. Total fund performance relative to peer groups (i.e. other pension funds)
c. Asset class performance relative to passive market benchmark returns
d. Manager performance relative to passive market benchmark returns
e. Investment performance attribution analysis, although this analysis only appears in one investment performance report during the review period (the quarter ending June 30, 2012, only shows total fund attribution results for the latest quarter)

Recommendation on Monitoring and Reporting Practices

While LACERS' practices were generally consistent with the Cortex Peer Group, we had the following suggested practice for its consideration:

35. **LACERS should consider conducting fund attribution on a regular basis. In doing so, although not a common industry practice, LACERS should discuss with its investment consultant the feasibility of obtaining attribution data on a broader time horizon (i.e., quarterly, annually, every 3 years, 5 years and 10 years). In the June 2012 investment performance report, attribution data is provided only for the latest quarter.**

Governance Compliance

As part of our review, we examined the consistency of the Board's practices against a listing of key responsibilities as set out in the Governance Manual, namely the *Statement of Governance Principles.* In performing this review, we examined Board meeting minutes over a 12 month period ending June 30, 2012.

Observation on Governance Compliance

We found the Board completed most of the duties set out in the *Statement of Governance Principles.* See Appendix C for a detailed summary of our observations. We also noticed some exceptions, which are detailed below (references are to section numbers in the *Statement of Governance Principles*):

[51] This study contained a peer group of public investment boards and larger public retirement systems. See Appendix A for a list of those funds.

1. Section D states that the Board will have in place policies and guidelines concerning the following topics: proposed legislation (state and federal); adoption/amendment of administrative code, rules and regulations. We did not find any policies or guidelines in this regard.
2. Section D.4 states that the Board will periodically evaluate its own performance. The last such evaluation has not been conducted since January 2010, when it was facilitated by the Board's governance consultant. Some board members indicated a preference to not continue with this practice.

We have provided recommendations to address the exceptions, where appropriate.

Recommendation on Governance Compliance

36. **The Board should review Section D of the *Statement of Governance Principles* with respect to the following requirements, and decide whether to reaffirm them or remove them from the policy statement:**

    a. **Have in place policies and guidelines concerning proposed legislation (state and federal); adoption/amendment of administrative code, rules and regulations; and**
    b. **The periodic evaluation of the Board's performance.**

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VI. Long-term Strategic and Financial Planning

Objective 13: Does LACERS have effective procedures for long-term financial planning to enable appropriate financial strategies and decisions to be made timely by the System and the plan sponsor?

The City directed us to assess the effectiveness of LACERS' long-term strategic and financial planning procedures in enabling the System and the City to set appropriate and timely financial strategies and decisions.

Observations on Long-term Strategic and Financial Planning

Long-term strategic and financial planning and management processes and documents exist to assist LACERS and the City in determining future financial requirements. To enhance the monitoring, review and implementation of these processes, LACERS should consider incorporating the primary objectives of the separate processes into an overall Long Term Strategic and Financial plan that includes a summary description and timeline of the key activities.

Annual actuarial valuations are performed timely and the City is informed of annual contribution requirements in a timely manner. Actuarial assumptions are formally assessed every three years following a triennial Actuarial Experience Study (discussed above) but are reviewed and assessed more frequently as dictated by LACERS' Board. The inputs into the annual actuarial valuation include actuarial assumptions approved by LACERS' Board with input from the City and budgeted and actual salary information is provided timely by the City to the actuary for each valuation.

The projected salary expense assumption utilized in the annual actuarial valuation is deemed to be reasonable; however, the assumption utilized does not currently conform to LACERS' Peer Group. In addition, LACERS' Board adopted in April 2013 a "true-up mechanism" to adjust the City covered payroll budgeted amount (utilized in the annual LACERS' actuarial valuation in determining the City's annual contribution) to actual covered payroll incurred which is deemed a best practice.

The cash management process effectively enables LACERS to meet its benefit obligations to its members. Historically, LACERS has not transacted an unplanned investment liquidation to meet its cash needs for operations.

The City does not have an active role in LACERS' strategic and financial planning processes, however, any analysis performed on behalf of LACERS or by LACERS' staff regarding the City's funding of LACERS or the City's duties as the Plan Sponsor of LACERS is communicated timely to the City. LACERS need for financial resources is communicated to the City effectively; however, a co-developed and formalized communication process between the staff of LACERS and the City would ensure LACERS and the City's stakeholders are specifically informed about and updated on the various planning strategies and initiatives.

LACERS' long-term strategic and financial planning policies and procedures are adequate and comparable to policies and procedures utilized by the Project Peer Group. LACERS could enhance their strategic planning process by further developing the individual strategic and financial management goals and initiatives with specific objectives, actions and measurements of success for each identified outcome.

LACERS does not have a formal timeframe to review and update the Investment Policy or Actuarial Policy which is a best practice among similar policies of LACERS' Project Peer Group. To ensure that LACERS' financial planning goals and objectives are consistently communicated in its financial planning documents in a timely manner we recommend that LACERS consider instituting a formal frequency to review these policies. (LACERS considers these policies to be living, rolling documents that are constantly being reviewed and updated.)

As the Board establishes and approves the policies and procedures for LACERS, it is critical for the Board to be continuously educated on financial planning and management best practices. We would like to encourage LACERS to continue to emphasize the importance of Board education sessions related to this topic to ensure that the Board is well equipped to interpret, communicate, and ultimately adopt financial management best practices on an on-going basis.

We identified the key strategic and financial planning processes and documents utilized by LACERS that were in effect for the review period as follows:

1) Annual Actuarial Valuation;
2) Triennial Actuarial Experience Study;
3) Board's Actuarial Funding Policy;
4) Strategic Plan;
5) Cash Management Procedure;
6) Board Investment Policy; and
7) Asset-Liability 10 year Optimization Study of Risk, Return, and City Contribution.

Other ancillary and supporting processes and documents are also part of LACERS' long-term financial planning.

We reviewed each process and document to determine what type of information was obtained, how the information was utilized by LACERS in determining future financial requirements and strategic and long-term financial management and decision making, and whether the information was acted upon timely. In addition, we considered the interaction between LACERS and the City throughout the various strategic and financial planning processes.

We also interviewed LACERS' staff and the City personnel regarding financial management and how financial resource needs are communicated to the City in a timely manner. We specifically inquired as to the following:

- Is the City involved in LACERS' financial planning processes and is the City able to review LACERS' plans?

- Are actuarial valuations conducted and completed timely and is the City advised of changes in contributions resulting from these valuations? Is the actuarial assumed projected salary expense reasonable?

- Does LACERS maintain adequate cash reserves to meet unexpected increases in benefits without having to incur unplanned liquidation of plan investments?

- Are LACERS' strategic and financial planning policies and procedures adequate; are there enhancement opportunities; and, is there proper communication between LACERS and the City on financial planning matters?

Assessment of LACERS' Long Term Strategic and Financial Planning Processes

Annual Actuarial Valuation

LACERS utilizes the annual actuarial valuation to determine a point in time status of the funding of LACERS' future plan obligations. Using reasonable actuarial assumptions LACERS' actuarial consulting firm projects future liabilities and discounts them back to the date of its report. The valuation report establishes an annual required contribution (ARC) based on the assumptions used. The actuarial valuation is commissioned as part of the annual actuarial audit process and is generally completed in the fall of each year prior to the completion of the Comprehensive Financial Annual Report. The actuarial assumptions selected for the valuation are approved by LACERS' Board with the input of the City. The City's Administrative Officer ("CAO") provides timely information to LACERS' actuary regarding budgeted and historic salaries of City employees for use in the valuation. Once the valuation is complete, the City is provided a copy timely and the result of the valuation is posted to the web site.

Triennial Actuarial Experience Study

The purpose of the experience study is to review the economic and demographic actuarial assumptions used by LACERS and to compare the actual experience with that expected experience under the current assumptions during a three year period (as discussed in the sections above). The actuary takes the study's results and expected near-term experience and recommends changes in the actuarial assumptions to be utilized in future valuations. LACERS' Board takes this information and based on input from the City determines the actuarial assumptions to be utilized going forward. The most recent triennial experience study was completed as of June 30, 2011.

Board's Actuarial Funding Policy

The Board's actuarial funding policy seeks to achieve long-term full funding of the cost of benefits provided by LACERS; to establish reasonable and equitable allocation of the cost of benefits over time; and to minimize volatility of the City's contribution to the extent reasonably possible. The policy stipulates funding by setting the actuarial cost method (currently established as the entry age normal method), the asset smoothing method for recognizing investment gains/losses (currently set generally over a seven year period), and the amortization policy in terms of duration and pattern for systematically allocating the difference between the actuarial accrued liability and the actuarial value of assets (currently amortized over periods determined by how the unfunded accrued actuarial liability arose). [52]

Five Year Funding Illustration

To assist in the City's budgeting process and five year outlook for the City's contribution, the CAO obtains the most recent plan funding data (determined using various actuarial assumptions) from the actuary who performed the valuation and provides this information to the City on an annual basis for this purpose. Per discussion with LACERS' staff, this is a CAO process and the information

[52] Per LACERS Actuarial Funding Policy (Modified October 23, 2012) included as part of the Board Governance Policies (updated: January 8, 2013)

is not utilized by LACERS for long-term planning as the projections have historically been unable to predict investment performance with any degree of precision which is the largest component of the Plan's funding.

Strategic Plan
LACERS' strategic plan summarizes short- and long-term goals and objectives, the process to achieve those objectives and how to measure its success in achieving the predefined goals. Furthermore, the strategic plan allows LACERS to allocate its resources methodically to the most critical areas of its operations. LACERS updates the strategic plan every three years and quarterly updates are provided to the Board to monitor progress. On an annual basis new strategic initiatives are presented to the Board's Audit and Strategic Planning Committee for approval and if the new initiative is approved, a formal approval request is made to the full Board for adoption and inclusion in the annual budget process. LACERS' strategic plan includes the following as two of its seven goals: "Maximize value and minimize costs of our health and welfare program" and "Achieve long-term, sustainable, risk adjusted returns." As a result LACERS' management is seeking as part of its on-going operations to achieve these goals in accordance with the strategic plan.

Cash Management Procedure
The Cash Management Procedure serves to ensure that LACERS has sufficient cash to meet its immediate liquidity needs. LACERS' investment management staff is currently responsible for following this policy. The average minimum end-of-month cash balance stipulated in the Cash Management Procedure is sufficient to cover the monthly benefit payments, capital calls, and other departmental operational needs. In addition, if LACERS reaches a pre-determined floor cash balance or is projected to reach the floor amount, per the policy, the Investment Division is required to transfer amounts from the investment portfolio to the cash account.

Board Governance Policies – Investment Policy
As discussed in the sections above, the Investment Policy attempts to define and clarify the Board's investment objectives, tolerance for risk, liquidity needs and permissible (impermissible) investment strategies, asset classes, and instruments. This policy serves as the governing document for the ongoing supervision and management of the investment program. LACERS' Investment Policy addresses the overall investment objective, the long-term strategic asset allocation, risk management, standards and measures of investment performance, investment manager selection criteria, and investment guidelines.

The asset allocation policy provides for diversification of assets in an effort to maximize the investment return consistent with market conditions (see sections above). LACERS utilizes asset allocation modeling in identifying the asset classes it will utilize and the percentage that each class represents of the total fund. LACERS's Board reviews the asset allocation policy strategically approximately every three years and on a tactical basis more frequently. [53]

Asset-Liability 10 Year Optimization Study of Risk, Return and City Contribution
During 2012, LACERS worked with its investment consultant to evaluate its investment portfolio using an asset-liability rolling 10 year analysis model (as discussed in sections above). The model

[53] Per the LACERS' Investment Policy revised June 24, 2008 included as part of the Board Governance Policies (updated: January 8, 2013)

projected LACERS' unfunded liability (including assumptions for new plan retirees), changes in capital market assumptions, investment returns, benefit costs, and future City contributions to develop an optimal asset allocation policy.

LACERS expects this optimization process and resulting asset allocation policy structure to enhance the System's ability to achieve its funding goals and ultimately minimize the City's contributions to LACERS. LACERS' Board adopted a revised asset allocation policy target weights and ranges as a result of the study. This study included the 7.75% actuarial rate of return assumption utilized in the most recent actuarial valuation, a lower inflation rate, and revised asset class return, risk, and correlation assumptions.

Communication of Financial Resources Needed for Effective Planning

We considered how LACERS' need for financial resources to effectively plan and make timely decisions with respect to actuarial valuations, the actuarial assumed projected salary expense, and the adequacy of cash reserves in meeting unexpected benefit payments were communicated to the City.

Actuarial Valuation

As discussed above, LACERS has an annual actuarial valuation performed and an actuarial experience study performed every three years. We believe that these actuarial studies represent standard industry practice for financial planning and decision making purposes for LACERS and the City. The results of these reports and studies are communicated timely to the City.

Reasonableness of Actuarial Projected Salary

LACERS' actuary obtains employee salary information from the City to utilize in the annual actuarial valuation which is based on the City's current budget for the upcoming year. As discussed in the interim report, the actuary assumed a wage and a price inflation component in determining the salary-increase assumption which was deemed to be reasonable and comparable to the Project Peer Group. In addition, the actuary utilized a promotional and merit increase assumption structured as a function of an employee's age (based on the most recent triennial actuarial experience study performed as of June 30, 2011). The promotional and merit increases are determined by measuring the actual salary increases by employees, net of wage and price inflation by age group.

In the triennial study as of June 30, 2011 for LACERS, the actuary indicated that the promotional and merit increase for similar public retirement systems was structured to more closely correlate to years of service versus age which is utilized by LACERS. Per review of the Project Peer Group actuarial assumption for promotional and merit increase, the increase for promotional and merit also correlated generally to years of service. However, due to the decrease in the number of active LACERS' members (from 30,236 as of 6/30/2008 to 25,449 as of 6/30 2011) utilized in LACERS' triennial actuarial experience study, the actuary recommended and LACERS' Board agreed to maintain the previous age-based structure in determining the promotional and merit increase component of projected salary expense as the declining member data since June 30, 2008 was not deemed to reflect a reliable basis for setting a new structure based on employee years of service.

In addition, in April 2013, LACERS' Board adopted a Plan Sponsor contribution true-up mechanism for LACERS' and the City's accounting and budgetary processes with respect to the actual vs. budgeted covered City payroll amount utilized by the actuary in determining City annual contributions. The true-up process ultimately enhances the computation of the Tier 1 and Tier 2 employee contributions to LACERS by adjusting the City's covered payroll amount to actual amounts paid each year and by reflecting the full impact of the difference in the subsequent year's City contribution amount .

Without the true-up process, the differences in the budgeted versus actual covered payroll each year would be amortized over a number of years (currently 15 years) as an actuarial gain or loss. This true-up process is considered an actuarial best practice in matching Plan Sponsor and employee contributions to actual covered payroll amounts as they are incurred.

Cash Flow and Cash Reserve Planning

Based on our discussions with LACERS' staff and our review of the Cash Management Procedure for paying monthly benefit payments, LACERS' cash management process during the review period (discussed above) was sufficient to meet required pension or benefit payments and to avoid untimely investment asset liquidations. However, all benefits are set by the City. Therefore, the City could in the future set benefits at a level that could create the need for untimely liquidation of assets.

The City's Input into LACERS' Various Planning Processes and Communication with the City

The City has access to LACERS' planning process documents and financial planning instruments either online or following specific request to LACERS for access. There was no formal communication process as it relates to financial planning or processes; however, both LACERS and the City are responsive to requests for information from each other and provide the requested information timely. Although we have been assured by both LACERS and the City that critical information is being shared in a timely manner, without an established formal process for communication, an opportunity exists to forgo the historical practice of communicating regularly.

The ultimate purpose of a specific communication process is to ensure desired communication exists for all of LACERS's and the City's stakeholders in the development and implementation of the various policies and procedures for the upcoming year. Developing the communication process invites feedback from LACERS' and the City's staff in developing a cooperative approach to ensure stakeholders are properly informed which further strengthens the quality of the initiatives being developed. Once implemented, stakeholders will more fully understand the factors driving the policy or procedure and ensure they understand how implementation will occur.

Comparison to the Project Peer Group

Finally, we addressed whether LACERS' long-term strategic and financial planning policies and procedures were deemed adequate and whether there were enhancement opportunities in the policies and procedures. Overall, LACERS' strategic plan and financial planning documents and procedures are in line with the Project Peer Group.

We reviewed the strategic and financial planning process and documents for nine of LACERS' peers. Only six of the nine Peers had strategic plans available for review. Three out of the six strategic plans did not contain language regarding long-term financial planning. Out of the three Strategic Plans that referenced long-term financial planning, two Plans had a more developed and detailed financial planning strategy than LACERS's current financial planning strategy and process.

LACERS' strategic plan includes two long-term financial management goals focused on achieving satisfactory risk adjusted investment returns and reducing costs. In contrast another Peer Retirement System has long-term financial management goals that not only include achieving satisfactory investment returns and reducing costs, but were expanded to include: maximizing a fully funded status with regard to the actuarial liability of the system, clear policy guidance from the Board, establishing updated and written procedures to ensure continuity and best practices, ensuring adequate staffing and resources, and ensuring efficiency and transparency in investment management.

In focusing its strategic plan on achieving more immediate results, LACERS has successfully used it as an effective tool for getting things done. LACERS may be able also to leverage this success further by using the tool to develop its longer-term goals and initiatives**.** A longer-term strategic and financial plan could also enhance communication to the City and its stakeholders regarding LACERS' future financial funding and operational requirements.

Overall LACERS has adequate long-term strategic and financial policies and procedures in place to allow for timely and effective financial strategies and decisions to be made, including adjustments for financial market behavior and benefit structure changes.

Recommendation on Long-term Strategic and Financial Planning

37. **While the components of long-term strategic and financial planning exist and are in place, the City and LACERS should formalize that part of its communication process.**

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VII. Review of the Status of Prior Management Audit Recommendations

Status Choices

Chose Not to Implement
Fully Implemented
Partially Implemented
Not Yet Implemented
Not Empowered to Implement
Not Applicable

	Task Area, Topic, Page in Original Report, #, Recommendation	Implementation Status	Details
	Task Area 1 - Governance		
	1a. Governance Standards		
1	1 So as not to conflict with the Board's plenary authority, yet recognizing the need for transparency, the City, supported by LACERS, 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 1160 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.	Not Empowered to Implement	No legislative changes were made in response to the 2007 report. This was largely beyond the control of LACERS, as it required a City Charter amendment.
2	24 2 The City, supported by LACERS, 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 and the pay schedule for its staff.	Not Empowered to Implement	No legislative changes were made in response to the 2007 report. This was largely beyond the control of LACERS, as it required a City Charter amendment.

	Task Area, Topic, Page in Original Report, #, Recommendation	Implementation Status	Details
3	25 3 The Board should review its current delegation of authority to the General Manager, as set forth in the Board's Governance Policies, and make changes where appropriate.	Partially Implemented	Review of the Governance Manual was listed as a strategic priority throughout the review period. However, we did not notice a thorough review of delegation authority, with the exception of strategic initiative #3.2 - Optimization of Asset Allocations within Asset Classes, in which management was recommending that within-asset class reviews across public traded asset classes become a management function. We did not however, note any ultimate changes to the Board's policy on this matter.
4	26 4 The City, supported by LACERS, should seek through appropriate legislative processes, an amendment to the Brown Act to explicitly exclude from coverage individual or specific investments (e.g., information related to private equity investments, information that could result in front running, etc.) so that the current legal interpretation employed by LACERS will be embedded permanently in law.	Chose Not to Implement	Not required/applicable. There is a provision in the Ralph M. Brown Act, s. 54956.81, which allows the "legislative body of a local agency" to meet in closed session to "consider the purchase or sale of particular, specific pension fund investments."
	Task Area 2 - Organizational Structure and Resources		
	2a. Board Governance - Policies, Practices & Procedures		
5	36 1 LACERS should add educational training sessions to the agenda for its annual off-site meetings.	Partially Implemented	Education sessions were added to the 2009 and 2010 off-site retreats. The Board discontinued off-site retreats in 2011, but added education to its regular Board meetings. Ten education sessions were delivered to the Board over 2011 and 2012.

	Task Area, Topic, Page in Original Report, #, Recommendation	Implementation Status	Details
6	36 2 With a view towards developing a more comprehensive formal governance document(s) that incorporates the concepts and principles discussed above, the Board, in conjunction with the City Attorney and/or fiduciary counsel, should (1) collect and review all of LACERS' investment-related governance policies and procedures; (2) determine what revisions need to be made and revise the documents accordingly; (3) determine where new policies are required, (4) develop appropriate policies, and (5) review legal statements made in the Governance Policies (such as those pertaining to liability of Board members) to ensure that the statements are legally correct.	Partially Implemented	Review of the Governance Manual was listed as a strategic priority. Our review of the Governance Manual and of strategic plan updates shows the following policies were reviewed and changed during the Review Period : Board Education and Travel Policy (and appendices), Board committee structure, the Corporate Governance Committee charter, the Third Party Marketer Compliance Policy, the Actuarial Funding Policy. We also understand that a Departmental Communications Policy was developed and approved by the Board in June 2011, but it does not appear in the Governance Manual. We also understand that there was considerable staff, City attorney and consultant efforts undertaken on reviewing and updating the ethics policies. The Board however chose not to approve the proposed ethics changes. In summary, it appears that the review of the Governance Manual was not completed during the Review Period, although we understand considerable efforts have been undertaken on this initiative in 2013.

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7	39 3 The Board should develop and adopt a Standard Operating Manual that describes the fund's internal policies, procedures, and practices, as well as the functional position descriptions of the fund's staff.	Fully Implemented	In response to this recommendation, Staff indicated that LACERS' staff policies and procedures were posted to the intra net, organized by division. Management is tasked with the review and update of the policies and procedures, as needed.
8	39 4 The Board should develop committee charters for all of its standing and ad hoc committees identified in the Fiscal Year 2006/07 committee structure.	Fully Implemented	The Governance Manual contains charters for all three standing committees. The Charter for the investment committee should be removed from the Governance Manual, as it has been disbanded.
9	39 5 Once the Governance Document is completed, the Board should hold a general educational training session on its governance policies, procedures and practices.	Not Yet Implemented	Review and amendments to the Governance Manual are still in progress.
10	39 6 The Board should direct staff to develop, in conjunction with the Board's general investment consultant, more educational seminars on investment strategies and products and risk management, as directed by the Board.	Fully Implemented	Eight educations sessions on these topics were delivered by the general investment consultant to the Board over 2011 and 2012.
11	39 7 The Audit Committee should be a separate standing committee.	Not Yet Implemented	The Board has yet to split the Audit and Planning Committee. Staff indicated this may happen once the internal auditor position is filled.

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12	39 8 The Board's Governance Policies need to be updated and revised to reflect the current committee and sub-committee structures. Once that task is completed, staff should develop conforming committee charters for Board approval, consistent with the Fiscal Year 2006/07 committee structure.	Partially Implemented	Governance Manual contains charters for all three standing committees. The Charter for the investment committee should be removed from the Governance Manual, as it has been disbanded. There are also references to disbanded committees throughout the Governance Manual, namely in the Commitment of a LACERS' Board Member, and in various investment policies (see the Alternatives Investment Policy, pages 6-7, the Specialized, Non-Traditional Alternative Investment Policy, page 2, Attachment 1, and the Real Estate Policy).

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13	39 9 The formal statement of governance principles should identify the roles and responsibilities of key staff (including the Chief Investment Officer and the pension fund's portfolio managers) and the pension fund's service providers (including the general investment consultant and legal counsel).	Not Yet Implemented	The Statement of Governance Principles does not identify the roles and responsibilities of key staff, other than the General Manager (referred to in the Statement as the Chief Executive Officer), and does not address the role of the pension fund's service providers (including the general investment consultant and legal counsel). The role of the CIO and investment officers is documented elsewhere, but not in the Governance Manual. (Staff provided us with a document entitled "Responsibilities of the Chief Investment Officer". There is a job description for the Investment Officer II position; however this description and corresponding role of the Investment Officer III are not in the Governance Manual.) The duties of the General Investment Consultant are set out in the Investment Policy Statement, which is an appendix to the Governance Manual. Duties of Legal Counsel are not set out in the Governance Manual. We understand, however, that the review of the Governance Manual is still ongoing.

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14	39 10 To facilitate periodic review and update of the Board's policies, the Board's Governance Policies should include the date of adoption and include the dates of any subsequent amendments of the Policies.	Partially Implemented	The Governance Manual has an amendment date on the cover, although we agree that each policy within the Governance Manual should have its own date. We found that many of the documents in the Governance Manual contain approval and/or amendment dates, although there were a number of gaps which should be addressed as part of the current review (for example, see Board Procedures, or the Audit and Strategic Planning Committee charter). We also noted that the Investment Policy Statement included in the Governance Manual is out of date (it is dated 2008).
15	39 11 LACERS 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.	Chose Not to Implement	We were informed by staff that the Board felt that this recommendation was not necessary.
16	42 12 The Board should adopt a formal evaluation process that sets forth the process, guidelines and criteria that will be used by the Board in its annual review and evaluation of the General Manager.	Not Yet Implemented	No formal evaluation policy has been established. The only document addressing this that we received was a report to the Board from June 2006 (predating the 2007 Management Audit), which describes the process and includes a survey tool.

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17	42 13 The LACERS' Board should institutionalize the Board self-evaluation process and commit to performing a Board self-evaluation annually. We encourage full Board participation in the self-evaluation process. The Board should conduct the Board self-evaluation immediately prior to conducting its annual review of the General Manager.	Not Yet Implemented	There is no documented process for a Board self-evaluation. The Board has not undertaken a self-evaluation since 2010; we understand there is little support for this process at the Board level, but there does appear to be support at the staff level.
18	43 14 To facilitate the ability to monitor with the Board's and staff compliance with the rules regarding travel, and the members ability to select appropriate conferences for their knowledge level, the LACERS' list of conferences should be expanded to identify the educational level of the conference (e.g., fundamental, intermediate, advanced); the number of the Board member(s) and staff that attended, the names of the attendees, and the total amount of expenses incurred in connection with participation at each conference should be reflected in the report; and consideration should be given to limiting the number of conferences an individual trustee can attend in a given year.	Fully Implemented	All the required information is provided to the Board on a regular basis.
19	49 15 The Board should periodically hold compulsory educational sessions (for current and new trustees) for the purpose of becoming more knowledgeable about the governing documents applicable to the administration of the pension fund and the investment of pension fund assets, including but not limited to the provisions of Proposition 162, the City Charter, as amended, the Brown Act, the Board's Investment Policy Statement, and any reporting and disclosure requirement applicable to the Board.	Fully Implemented	The Board's fiduciary counsel holds an annual fiduciary education session every other year - sessions were held in 2008, 2010, and 2012.

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20	51 16 The LACERS' Board should develop and conduct, in conjunction with fiduciary counsel, a formal training program for new Board members and a training regimen for ongoing education and training of Board members.	Fully Implemented	New Board members undergo a rigorous orientation, the scope of which is set out in Board policy. Staff provided us with orientation agenda and materials for trustees. The new investment consultant provided the Board with eight education sessions in 2010 and 2011. The Board's fiduciary counsel holds an annual fiduciary education session every other year.
21	51 17 The LACERS' Board should adopt a Travel and Travel Reimbursement Policy that is sufficiently detailed to provide guidance to the Board members in both of these areas.	Fully Implemented	The Board approved a Board Education and Travel Policy, with a comprehensive appendix on Travel Reimbursement Procedures, in 2009, and reviewed and amended the documents in 2010 and 2011.
22	52 18 The LACERS' Board should continue to treat its Strategic Plan and its Ethics Code as top priorities and make every effort to complete these documents as soon as possible.	Fully Implemented	LACERS has established a 3 year- Strategic Plan, and updates the plan on an annual basis, and provides regular progress reports to the Audit and Strategic Planning Committee and the Board. In 2009 and 2010, the Audit and Strategic Planning Committee reviewed reports from staff and legal counsel on potential changes to its various ethics policies. The Committee did not approve the recommended changes, and instead chose to continue with the policies as currently worded.

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23	52 19 The Code of Ethics should be revised to, among other things, clarify 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 and clarify terms used in the Code of Ethics; clearly delineate prohibited activities; add annual reporting and disclosure requirements; and add oversight and monitoring requirements.	Partially Implemented	In 2009 and 2010, the Audit and Strategic Planning Committee reviewed reports from staff and legal counsel on potential changes to its various ethics policies. The Committee did not approve the recommended changes, and instead chose to continue with the policies as currently worded. The Board has established a Conflicts Governance Policy (date unknown), which partially addresses the first item in recommendation 52.19, by identifying some of the State and City's legal and regulatory ethics requirements, including the Political Reform Act, Government Code section 1090, and the City Charter.
24	52 20 The LACERS' Board should, with the assistance of the City Attorney, develop a comprehensive conflict of interest and disclosure policy for its service providers and incorporate an annual certification requirement into the policy. The Board may also wish to clarify in the policy whether the City's lobbying laws apply to service providers. Note: The 2007 Management Audit Report included, as an exhibit: A sample conflict of interest protocols for third-party consultants, sample guidelines for internal review of conflicts, sample guidelines relating to provisions (for inclusion in contracts and requests for proposals) and sample disclosure forms for third-party investment consultants and managers.	Partially Implemented	See above. Also, LACERS established a Third Party Marketer Compliance Policy, most recently revised in December 2010. It requires certain disclosures from investment managers and other investment partners concerning the use of placement agents. It also makes reference to the City's lobbying disclosure requirements, but only with respect to placement agents. There is no annual requirement for an annual certification, as recommended in the prior management audit.

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25	52 21 The LACERS' Board should establish a formal written securities litigation policy that memorializes the Board's philosophy regarding the necessary course of action that should be followed relating to all aspects of the securities litigation case review, evaluation and ongoing monitoring of potential cases. The policy should include procedures for filing proofs of claim and monitoring securities litigation claims. Finally, the policy should also include a protocol for determining whether or not to opt out of a securities litigation case.	Chose Not to Implement	No policy was established. LACERS' staff indicated they prefer to address each situation on an individual basis. The General Manager is in the process of developing a new strategy for dealing with securities litigation.
	2b. Organizational Structure		
26	54 1 Since there is generally only one staff per asset class, we believe the Board could reduce risk of failure to properly monitor the portfolio by hiring additional qualified investment staff to provide back up in the case of prolonged absence of one or more investment officers. However, we note that this risk is mitigated by the extensive use of external management.	Fully Implemented	Additional Investment Officers have been added to the staff.
27	57 2 LACERS should evaluate whether the lead manager of the Benefits Processing section should be viewed primarily as a "process management" role or as more of one with an operational (i.e., operational responsibilities with subject matter expertise) focus.	Fully Implemented	
28	61 3 LACERS should review the benefits administration organizational structure to determine whether the current layers of management practices offer the most efficient	Fully Implemented	Additional Senior Management Analyst II position was created & filled May 2010. The structure has been reviewed and continues to be reviewed periodically pursuant to the

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	use of resources.		Strategic Plan.
29	61 4 LACERS should continue to expand the member database system (PensionGold) capabilities as an opportunity to restructure the organization (i.e., relocate staff or combine units) to gain the full benefit of the IT investment.	Fully Implemented	Initiative to replace the Pension Accounting System (PAS) was adopted. System implementation will begin March 2013 and Go-Live June 2016. Process reengineer efforts are inclusive of the PAS Implementation project.
	2c. Organizational Efficiency and Effectiveness		
30	61 1 LACERS should develop a performance dashboard for management that includes measures of work efficiency as well as timeliness.	Fully Implemented	Tracking work efficiency is done in part through semiannual workload and monthly statistics. LACERS conducts customer service surveys to the recently retired. A report of the survey results will be provided to the Board on a periodic basis. In addition, staff will be exploring whether the firm CEM is capable of developing meaningful benchmarking. This is also cost-effective.
31	66 2 LACERS should continue to document all major work processes and procedures performed in the organization, especially the Retirement Services division.	Fully Implemented	
32	66 3 LACERS should pay special attention to capturing and sharing the knowledge of the experienced, albeit inform-mal subject matter experts (SMEs) in the Retirement Services division on whom many of its employees rely for key information.	Fully Implemented	

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33	66 4 LACERS should include expanded individual and organizational performance metrics as a priority in the next iteration of the Strategic Plan.	Fully Implemented	Metrics focusing on meeting milestones was established in SP adopted in April 2009. January 2013 senior staff discussions reached consensus that LACERS would continue to focus on milestone metrics at this time.
34	66 5 LACERS should evaluate how regularly managers and staff receive formal performance evaluations and ensure that this process occurs annually per guidelines of the employment charter.	Fully Implemented	
35	66 6 LACERS should encourage its leadership team to evaluate the "trade-offs" between operational efficiency versus organizational effectiveness and provide performance guidelines that establish clearer priorities for the Department.	Fully Implemented	
	2d. Staffing Adequacy		
36	661 The current level of investment staffing is just adequate and allows little to no margin of safety should there occur multiple or extended absences. The Board should consider hiring additional qualified staff, especially in asset classes that have increasing allocations and transactions. However, we note that the risk here is mitigated somewhat by the extensive use of external management.	Fully Implemented	Significant changes in this area: CIO salary range increased; Investment Officer III position added; additional Investment Officer I positions have been developed to team up with Investment Officer IIs.
37	69 2 LACERS should continue efforts to update the position descriptions for the benefits administration-related	Fully Implemented	This has been done each time a position is backfilled

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	divisions, paying special attention to guidelines for percentage of time allocated to tasks as well as to supervisory responsibilities.		and/or created in the budget process.
38	69 3 LACERS should evaluate the training needs of all staff with the objective of improving the organization's performance by enhancing the capability of current employees to execute their job responsibilities and understand new investment strategies.	Chose Not to Implement	LACERS evaluated the training and do not believe any Board action is required.
39	69 4 LACERS should communicate the rationale for hiring decisions as it pursues the staffing strategy. Such communication can help clarify potential misconceptions of rationale for building a balanced, appropriately staffed organization.	Fully Implemented	
40	69 5 LACERS should re-evaluate recruiting strategy to reduce the high percentage of vacancies in key areas of the organization.	Fully Implemented	
	2e. Use and Sufficiency of Resources		
41	69 1 LACERS should review policies regarding the protection of sensitive information about members and issue clear, standardized procedural guidelines for treatment of such material throughout the organization.	Fully Implemented	
42	71 2 LACERS should continue leveraging scanning technology to reduce the use of paper-based records and implement "continuous improvement" practices to identify	Chose Not to Implement	

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	new opportunities to improve the efficiency of operations.		
	2f. Use of Investment Consultants and Provision of Contractual Services		
43	71 1 The Board should review the IPS and investment consultant contract for consistency and solidify vague requirements as noted in our report.	Not Yet implemented	LACERS' staff indicated that this initiative will be addressed as contracts come up for renewal. Estimated completion date 1-3 years.
44	7 2 The Board should include an annual or bi-annual asset allocation study as a specific task in the consultant's contract.	Fully Implemented	It was determined that a comprehensive asset allocation study will be conducted every three years. This is provided for in the Wilshire contract; see section C.1 on page 2.
45	77 3 The Board should clarify and document whether the investment consultant is involved in the compliance monitoring responsibility.	Fully Implemented	Stated in the Investment Policy Statement (IPS), Page 19.
46	77 4 The Board should include the requirement in the IPS and investment consultant contract that the consultant submit their Form ADV Part II annually.	Partially Implemented	See Wilshire's contract, section XII. SECURITIES AND EXCHANGE COMMISSION FORM ADV (Uniform Application for Investment Adviser Registration), which states as follows: "LACERS acknowledges receipt of the Contractor's Form ADV, Part II and will provide LACERS a copy of any updates without further written request." Although the requirement is in the Wilshire contract, it has not been placed in the IPS.

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47	77 5 PCA's contract should be expanded 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.	Not Applicable	Although there were amendments to the PCA contract in 2010 and 2011, these did not include the services described in this recommendation. PCA was ultimately terminated by the Board in 2011. Note: The contract with the new general investment consultant, Wilshire, does include in its scope of services assistance with custodial and other vendor searches, including securities lending, and other vendors of investment related operations, but it does not address the review of such service providers.
48	79 6 The Board should periodically review LACERS'' retainer consultants on their timeliness, depth of research, understandability of their material, and their overall availability.	Partially Implemented	Staff informed us that there is no formal review process for its investment consultants. Currently, consultant review is on an ongoing basis as consultants are assigned tasks. Timeliness, depth of research and availability are continually monitored. Staff will bring options back to the Board for consideration of a more formal review of consultant performance. As well, LACERS intends to undertake an RFP process for each consultant over the next 3 years.
49	79 7 The Board should organize and document its periodic review of the consultant to include checking all contractual deliverables and services to ensure that the consultant performed on all requirements.	Partially Implemented	See above.

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50	79 8 The Board should ensure that the consultant provides periodic education to ensure that LACERS' current investment practices remain valid.	Fully Implemented	Wilshire has provided eight investment related education sessions during 2011 and 2012. This is also a requirement of its service contract - see page 1 of the Wilshire contract.
51	79 9 The LACERS' Board should specify the standard of care and fiduciary responsibility of the General Investment Consultant in their contract.	Fully Implemented	Provided for on page 4 of the Wilshire contract.
52	81 10 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.	Chose Not to Implement	Staff confirmed that none of its service providers are required to submit an annual certificate regarding conflicts of interest. Under the Wilshire Contract, the consultant is required to comply with LACERS' investment, ethical and fiduciary policies, but does not explicitly include an annual certification requirement.
53	84 11 The Board should continue to employ a private equity specialist to provide a comprehensive range of alternative investments advisory services.	Fully Implemented	The Board continues to retain Hamilton Lane to advise it on private equity matters.
	2g. Use of Legal Counsel		

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54	87 1 The LACERS' Board should seek authority to hire its own internal legal counsel, who should report to the General Manager. The autonomy we contemplate would include the authority to decide to use the City Attorney for certain issues that do not raise potential conflicts, and as to which familiarity with California law would render reliance on the City Attorney prudent.	Not Empowered to Implement	LACERS informed us that it did communicate to the Chief Legislative Analyst in August 2011 that it supports the concept of acquiring the additional authority over legal services. These changes in authority, however, would require revisions to the City Charter, and thus require overall City support. As an alternative to seeking a change in the Charter, LACERS has implemented various methods to increase services from the City Attorney.
55	93 2 Prior to hiring its own attorney, the Board should evaluate the responsibilities and legal skill sets required and then evaluate the economics of hiring an in-house lawyer versus the shared expense cost of maintaining the current arrangement.	Not Yet Implemented	See above.
56	93 3 If the Board hires its own attorney, the Board should establish in its Governance Documents the scope and limits of that attorney's authority, as well as the relationship between the LACERS in-house attorney and the City Attorney's Office.	Not Yet Implemented	See above.
57	93 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.	Chose Not to Implement	City Attorney's Office confirmed no document exists, and that they instead follow State professional guidelines for dealing with conflicts.
58	93 5 If the status quo is maintained, then the current allocation should be reviewed by LACERS and established in a written document. In addition, procedures should be in place at LACERS 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	Chose Not to Implement	No such document or procedures appear to have been prepared. However, we understand that LACERS does track legal fees from both internal and external counsel.

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	related costs and expenses.		
59	94 6 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), LACERS should request that it be billed on that basis rather than an outdated allocation formula.	Fully implemented	Confirmed by staff and the City Attorney.
60	94 7 LACERS should 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.	Fully implemented	Staff informed us that as an alternative to seeking a change in the Charter, LACERS has implemented various methods to increase services from the City Attorney. This includes: - Bi-weekly meetings with the City Attorney - The City Attorney attends Board Debriefing Meetings (which are senior staff planning meetings held after each Board meeting). - LACERS established a Procedure for Legal Review / Requests for Signatures, as documented in an Intra-Departmental Correspondence dated August 2012, to standardize the submittal and tracking of items for legal review and requests for signature.
61	95 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.	Partially Implemented	No written procedures were established in this regard, and the Board does not play a role in the number of attorneys assigned to LACERS, nor does it have any authority or control in this matter, due to City legislation. Staff informed us, however, that various methods were implemented to increase services from the City Attorney, and that LACERS is proactive in its use of outside counsel when these types of services are required.

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62	95 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.	Fully Implemented	We understand that the Board approves RFP's for legal services, and that LACERS' staff serve on the search panel with staff from the City Attorney's office.
63	96 10 The LACERS' 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 Documents.	Chose Not to Implement	No memorandum has been established.

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64	96 11 The Board should explore with the City Attorney procedures for allowing staff to discuss business/legal issues directly with outside counsel. There should be clarity as to who will have access to outside counsel with respect to investment-related issues.	Fully Implemented	No written procedures were established in this regard. Staff informed us, however, that various methods were implemented to increase services from the City Attorney, and that LACERS is proactive in its use of outside counsel when these legal services are required. Staff and City Attorney have also indicated that LACERS' staff is permitted to communicate directly with external legal counsel, as needed.
65	96 12 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.	Fully Implemented	See above.
66	96 13 If the current structure is maintained, the Board's Governance Policies 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 LACERS.	Chose Not to Implement	The Board's governance policies do not identify the roles and responsibilities of the City Attorney.
67	97 14 The Board should direct the City Attorney to develop a model investment contract to improve efficiency and streamline the contract review process. A number of public pension funds make use of model contracts for this very reason.	Fully implemented	Staff confirmed that the legal contract template has been established.

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68	97 15 The Board should conduct a legal compliance review with the City Attorney's Office. Alternatively, LACERS might consider establishing an internal compliance function and hire a staff to perform such responsibilities.	Partially Implemented	Staff informed us that LACERS' plans to establish an internal compliance staff to perform such responsibilities. However, LACERS does obtain legal compliance services when appropriate. For example, legal compliance services were provided for the recently adopted technical Administrative Code changes and for Internal Revenue Service tax compliance issues.
	2h. Appropriateness of Staffing Skill Sets and Review of Position Descriptions		
69	97 1 LACERS should review position descriptions for managers in the Retirement Services and Health Benefits Administration divisions to ensure they accurately reflect the work being performed.	Chose Not to Implement	
70	99 2 LACERS 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. LACERS should require the CFA professional designation for senior investment officers and the CIO. LACERS should increase salary levels commensurate with required upgraded job specs. LACERS should take steps to reclassify the CIO and senior in-vestment officer positions to 'exempt' titles in order to accomplish this recommendation.	Partially Implemented	LACERS has taken appropriate action to include CFA as a desired credential given that it is a represented position.

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71	99 3 LACERS should expand the position description content to include the educational level required to hold a given role within the organization. Although this information may be contained in the City's job bulletin, it should also be included in LACERS' documentation.	Chose Not to Implement	
72	100 4 LACERS should specify any relevant subject matter expertise that is germane to the job responsibilities at LACERS to enhance the quality of the applicant pool.	Chose Not to Implement	
	2i. Span of Control (Reporting Relationships)		
73	100 1 LACERS should review the ratio of supervisors to employees in the Retirement Services division to determine which units may have inefficient spans of control. This holds especially true for units in which vacancies at the supervisor level are to be anticipated for the near/medium term.	Chose Not to Implement	
74	102 2 LACERS should analyze the volume and complexity of work performed in the Benefits Processing section of the Retirement Services division to determine if an additional senior management resource is warranted.	Chose Not to Implement	
75	102 3 LACERS should continuously monitor reporting relationships to ensure that the span of control ratios remain near the 1:5 benchmark for "high performing" organizations.	Chose Not to Implement	

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	2j. Joint Opportunities with LAFPPS for Enhanced Efficiency and Effectiveness		
76	102 1 With the primary objective of creating cost savings through new economies of scale, the City should consider, through appropriate legislative and administrative processes, consolidation of LACERS and LAFPPS, either in whole or in part. Consolidation would not reduce benefits or dissolve the current pension fund Boards.	Not Empowered to Implement	Outside LACERS' purview. The Board did not adopt these recommendations as it had been determined that, based on the City Charter, the decision to consolidate lies with the Plan Sponsor.
77	104 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.	Not Empowered to Implement	See above.
78	104 3 The City should consider the eventual creation of a combined benefits administration function as a second step in the consolidation process.	Not Empowered to Implement	See above.
	3b. Appropriateness of Investment Performance Benchmarks		
79	104 1 LACERS should consider using a broader benchmark, such as the Lehman Intermediate Aggregate Index, for their intermediate fixed income managers currently benchmarked to the LB Intermediate Government/Credit Index.	Chose Not to Implement	LACERS is still using the successor to the Lehman Brothers Intermediate Government/Credit index (provided now by Barclays Capital).
80	127 2 Going forward, if LACERS decides to make any changes to its asset class benchmarks, a subsequent change should be made to the Total Fund Policy Index as	Not yet implemented	The IPS statement is out of date, and has not been changed since 2008, to reflect changes in investment policy and benchmarks. Staff are aware of this, and

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	well.		will work with the investment consultant to update the policy.
	3c. Asset Allocation, Diversification, Risk and Return		
81	128 1 LACERS should request that the consultant provide more discussion on how proposed asset allocation policies will likely impact funding ratios and contribution levels.	Fully Implemented	The January 2012 Asset Allocation presentation from Wilshire does discuss the impact of asset allocation to contributions and funding.
82	131 2 LACERS should consider conducting a complete asset liability study every ten years.	Fully Implemented	LACERS conducted an asset liability study in 2011, and presented the results to the Board at its January 2012 meeting. The service agreement with the current investment consultant requires the investment consultant to conduct a "comprehensive asset/liability analysis" once every three years (see section C.1, page 2 of the Wilshire Contract.)
83	131 3 LACERS should ensure that Board members have access to and are satisfied with training on investment issues such as asset allocation and risk metrics.	Fully Implemented	The Board has revised its Board Education and Travel Policy; Board members are provided with conference lists; and internal education sessions have been provided by Wilshire, including eight sessions over 2011 and 2012, including sessions on asset allocation and a session on risk management. Board members that we spoke with indicated a satisfaction with the current education program.
84	144 4 LACERS should consider working with the General Consultant to develop and implement an annual risk budget for the Total Fund and each asset class.	Fully Implemented	A risk budgeting program was approved by the Board on January 24, 2012.

	Task Area, Topic, Page in Original Report, #, Recommendation	Implementation Status	Details
	3d. Asset Allocation Process and Re-Balancing Process		
85	144 1 LACERS should consider adopting a SMART rebalancing strategy to rebalance the asset allocation.	Fully Implemented	The intent of the recommendation is completed. LACERS did consider using SMART, but opted for another, similar strategy.
	3e. Investment Policy Statement (IPS) and Guidelines		
86	150 1 LACERS should perform a comprehensive review and edit of the IPS for consistency and clarity.	Partially Implemented	Staff indicated that this has been completed and ongoing. Additionally, LACERS has submitted the Investment Policy Statement to its consultant for further review and potential feedback. However, we noted that the IPS which was provided to us, and which is included in the on-line Governance Manual, is dated June 24, 2008, and certain parts of the policy (including the asset allocation) have not been updated as per allocation changes approved by the Board.
87	152 2 LACERS should include in the IPS "meeting or exceeding the actuarial rate over the long-term" as an additional long-term investment objective.	Chose Not to Implement	Not included in the objectives on page 2 of the IPS.
88	154 3 LACERS should include in the IPS an objective "to achieve total returns in excess of the policy index" as an additional long-term investment objective.	Chose Not to Implement	Not included in the objectives on page 2 of the IPS.
89	154 4 LACERS should insert a discussion on risk in the IPS to describe and clarify the Board's risk tolerance, including reference to the LACERS' time horizon, liquidity needs, etc.	Fully Implemented	See Investment Objective #3 on page2 of the IPS.

	Task Area, Topic, Page in Original Report, #, Recommendation	Implementation Status	Details
90	156 5 The IPS should acknowledge LACERS' level of risk with some discussion of how its risk level was developed, and include specific guidelines on how to identify and measure risk.	Partially Implemented	See Risk Management, page 4 of the IPS.
91	157 6 LACERS should consider developing a detailed practical risk management policy/procedure document.	Fully Implemented	See Investment Risk Management Policy, approved December 27, 2011.
92	157 7 LACERS should clarify the standard of care assignments in the Investment Policy Statement.	Fully Implemented	Provided for on page 3 of the IPS.
93	157 8 The documented roles and responsibilities in the Investment Policy Statement should be checked by LACERS for accuracy (such as the documentation regarding compliance monitoring responsibility).	Fully Implemented	Staff indicated a review was completed, and that LACERS has submitted the Investment Policy Statement to its consultant for further review and potential feedback.
94	157 9 LACERS should specify in the Investment Policy Statement the timeframe for performing analysis and executing a new asset allocation study.	Fully Implemented	See page 3 of the IPS.
95	158 10 LACERS should consider specifying the rebalancing timing and process in the IPS.	Fully Implemented	Rebalancing ranges are specified on page 21 of the IPS. IPS (page 10) requires rebalancing when ranges are exceeded.
96	159 11 LACERS should insert a section regarding portfolio measurement and monitoring for the Total Fund as well as for the asset class and manager levels, and include a schedule of minimum required performance metrics.	Fully Implemented	See the Manager Monitoring Policy, approved by the Board on August 9, 2011.
97	161 12 LACERS should consider designating an Asset Allocation Index as an additional Total Fund evaluation tool and document the Policy Benchmark and Asset Allocation Index in the IPS.	Chose Not to Implement	LACERS continues to use only the Policy Benchmark.

	Task Area, Topic, Page in Original Report, #, Recommendation	Implementation Status	Details
98	161 13 LACERS should specify in the Proxy Policy which party has been delegated the responsibility of voting proxies.	Fully Implemented	See the table in the Proxy Voting policy.
99	166 14 LACERS should expand the discussion of securities lending to include the broad parameters of the program.	Fully Implemented	Securities lending policy was established in 2011.
100	166 15 LACERS should expand the IPS to define how transactions costs such as brokerage commissions should be monitored.	Fully Implemented	Provided for on page 9 of the IPS, which states "Investment managers are requested to submit quarterly reports to monitor brokerage activity and transaction costs."
101	167 16 LACERS should include in the IPS a requirement for periodic Board review of the IPS.	Fully Implemented	Provided for on page 15 of the IPS, section VI.A.2.
	3f. Compliance with Investment Guidelines and Monitoring		
102	170 1 LACERS' IPS should reference a written policy for monitoring investment manager guideline compliance. The policy should specify all of the procedures, including identifying responsible parties and detailing a method to document monitoring activity.	Fully Implemented	The IPS includes as Appendix IX the Manager Monitoring Policy, approved by the Board on August 9, 2011.
103	173 2 LACERS should update its manager guidelines to explicitly state the fiduciary standard of care and to include proxy voting policy direction.	Chose Not to Implement	Cortex reviewed a sample of manager guidelines, including those for Franklin Templeton, Capital Guardian, Aaronson Johnson. The guidelines do not explicitly state the fiduciary standard of care of the manager, and do not provide direction concerning proxies. Staff confirmed the same, but indicated that proxy voting direction is set out in the Proxy Voting policy.

	Task Area, Topic, Page in Original Report, #, Recommendation	Implementation Status	Details
	3g. Investment Management Structure		
104	176 1 The Board should continue to monitor its overexposure to small cap equities and consider using an all-cap or mid-cap manager for a portion of the overexposure.	Chose Not to Implement	No all-cap or mid-cap investment managers are being used by LACERS.
105	184 2 The Board should work with its consultant to determine if it can reduce the number of domestic equity managers.	Not Yet Implemented	Staff indicated that this will be done as part of the risk budgeting process.
106	184 3 IFS concurs with previous recommendations that LACERS should increase the active management portion of the international equity portfolio.	Partially implemented	The active portion of the international equity portfolio was initially increased from 70% to 80% between 2007 and 2009, but has since been lowered to 55%, as of December 2012.
107	195 4 The Board should review the performance of the internally managed cash portfolio on a regular basis. If the Board is willing to devote the necessary resources in terms of staff and technology, they could consider expanding the internally managed cash portfolio to other types of fixed income securities in the future.	Not Applicable	LACERS currently does not manage assets internally. All cash is managed by LACERS' custodian and portfolio managers.
	3h. Investment Transaction Costs		
108	198 1 LACERS should measure whether the cost of trading negates commission recapture savings to assess the value of the program. This is related to the overall issue of measuring transactions costs and not merely relying on the managers to do so.	Chose Not to Implement	
	3i. Custody Relationships and Fees		

	Task Area, Topic, Page in Original Report, #, Recommendation	Implementation Status	Details
109	201 1 LACERS should develop a detailed set of operational procedures and standards for custody operations and incorporate it into the custody agreement.	Chose Not to Implement	The Board did not adopt these recommendations as operational procedures are already in place.
110	205 2 If Northern is replaced, LACERS should include in the transition plan some mechanism whereby LACERS can have access to historical data.	Chose Not to Implement	Completed in 2008 contract. LACERS chose not to implement in the contract that existed during the management audit. A new contract was executed in 2008 that considered the recommendation.
111	205 3 LACERS should address preservation and access to historical data in the custody agreement.	Fully implemented	Completed in 2008 contract.
112	205 4 If the current process is the only means through which non-investment income can be folded into total return within Northern's performance reporting and analytics systems, that fact should be clearly reported to LACERS staff so that no one misinterprets the data.	Chose Not to Implement	
113	206 5 If the Board desires, cash returns should be recalculated correctly by omitting the income that does not belong in order to get a true measure of performance. Going forward, LACERS should work with Northern or its replacement to analyze the manner in which non-investment income is reported in performance as well as accounting reports and be sure that the process and systems provide clear data not subject to possible misinterpretation.	Fully Implemented	

	Task Area, Topic, Page in Original Report, #, Recommendation	Implementation Status	Details
	3j. Securities Lending Program and Fees		
114	206 1 LACERS should discuss with their consultant ways in which the securities lending program may be more thoroughly evaluated given more detailed comparative information, discuss with Astec the types of information available at the lender and the agent level, and discuss with their securities lending information additional reporting of relative performance that can be used to evaluate whether the program is yielding a competitive return.	Fully Implemented	Included in custodian's compliance monitoring.
115	211 2 Given that the risk of loss in cash collateral is borne by LACERS and that the return on securities loans collateralized by cash is driven primarily by the return earned investing the cash collateral, LACERS should monitor securities lending holdings, investment activity, portfolio structure, and periodic returns with the same diligence as any other investment account.	Fully Implemented	Included in custodian's compliance monitoring.
	Task Area 4 - Benefits Administration		
	4a. Reasonableness of Actuarial Methods		
116	213 1 Although the funded status of the Plan is considered fair at 77%, LACERS has taken steps to improve the	Fully Implemented	These recommendations were reviewed and, as

	Task Area, Topic, Page in Original Report, #, Recommendation	Implementation Status	Details
	contribution percent. The experience studies performed periodically help LACERS to 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 levels approach an accepted percent.		interpreted by LACERS, the status is completed and ongoing assumptions, as would be appropriate for a plan settlement calculation. The LACERS funded ratio is an ongoing measure including the value of future pay increases, valued using LACERS' long term earnings assumptions. As of June 2007, LACERS was 81.7% funded on retirement benefits and funded at 68.5% for health benefits at a time when most pension systems were 0% funded on health benefits. LACERS will continue to conduct experience studies every 3 years.
117	219 2 LACERS should change the due dates of the valuation reports in future RFPs for actuarial services.	Fully implemented	Implemented in the 2010 RFP.
	4b. Benefit Payment Testing		
118	222 1 Although, as mentioned, the benefit calculations are shown to be done correctly and the data is in the preferred paperless format, LACERS should make an attempt to put the scanned data into additional sub categories. Some existing categories are over 90 pages long. In addition, on a go forward basis, there is a need for the plan document to be onsite, updated promptly with any amendments, and to provide the definitive answer to any questions that arise about the administration of the plans. Currently there is a well written Summary Plan Description (SPD), but these should be for the employees' use to educate them about their basic retirement principles. The SPD should not be	Chose Not to Implement	The indexing function has been in place, and in use, since the implementation of the EDMS system 3 years ago. Older electronic files in the IDMS system may not be indexed. The City Charter and Administrative Code are considered LACERS' "Plan documents". The City Clerk is responsible for updating, maintaining these documents. The most current version is made available on-line to all City employees and the public. LACERS will continue to produce reference documents in form of policies, procedures , board rules, information sheets, and the Summary Plan

	Task Area, Topic, Page in Original Report, #, Recommendation	Implementation Status	Details
	used in place of a plan document. LACERS should make certain that every legislative and administrative change to LACERS benefit is reflected in the plan document.		
	4c. Disability Pension Application, Review, Approval and Appeal Procedures		
119	226 1 LACERS 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 are destroyed.	Chose Not to Implement	There was a major risk of loss to the mainly paper process in the event of a man-made or natural disaster. LACERS has provided for sufficient redundancy and business continuance planning in the event of a disaster. They considered the recommendation to be inefficient.
120	232 2 LACERS should evaluate the need for additional staffing if re-examinations are required more frequently than annually.	Chose Not to Implement	There were 3 staffers and there was a need to add additional staff to ensure a more efficient process or alternatively use an automated process to improve the efficiency of the process. The prior schedule reviewed cases in an annual year at the beginning of the year of the review. The goal was to gain on efficiencies in scale, and perhaps streamline the process. Breaking this up into smaller review batches can be done (from annual to quarterly) and will be implemented.
121	232 3 LACERS should evaluate the benefits of conducting more frequent re-examinations of disability retirees.	Chose Not to Implement (See Above)	Disability Section planned to conduct quarterly re-examinations. According to the staff in the Disability Section, they rarely do re-examinations as they are returning to work.
122	232 4 LACERS should consider negotiating a formal contract relationship with Permanent Disability Evaluation	Not Yet Implemented	An RFP needs to be developed if it is determined that

	Task Area, Topic, Page in Original Report, #, Recommendation	Implementation Status	Details
	- outside vendor who assigns examining doctors.		this needs to be pursued.
	4d. Reasonableness of Calculations and Actuarial Methods Used for Projecting Future Retiree Health Benefits		
123	232 1 The assumption for deferred vested members should continue to be monitored and, possibly a set of stratified rates by age should be considered.	Fully Implemented	The actuarial assumptions can be divided into two segments, demographic assumptions and health-specific assumptions. Each has to be individually analyzed and reasonableness of each has to be determined.
124	236 2 LACERS should maintain the current marriage assumptions [76% and 50%, respectively].	Fully Implemented	No change was necessary.
125	236 3 Data on marital status at retirement and age difference of spouses should be examined more closely by LACERS. This can be a more significant factor in an OPEB valuation than in a retirement valuation.	Fully Implemented	
126	236 4 LACERS should consider a table which includes expected improvement in life expectancy, or even a generational table which automatically incorporates expected improvements in life expectancy.	Not Applicable	The table is reviewed every three years as part of the Experience Study therefore the improvement in life expectancy is captured.
127	237 5 Typically mortality will begin to approach "standard" after a number of years of disablement, and a table incorporating this type of approach may be more	Chose Not to Implement	The current LACERS practice of using a substandard table throughout the disabled member's life is the most common approach among public sector plans.

	Task Area, Topic, Page in Original Report, #, Recommendation	Implementation Status	Details
	appropriate and should be considered by LACERS.		
128	237 6 Additional data with regard to retirement during the third year of the three-year period should be examined. Depending on this experience, it is possible that a higher incidence of early retirement should be included, although it may be appropriate to wait for the next three year experience study.	Chose Not to Implement	Staff and Segal believe the data actually points to a trend towards later retirement during 2003 to 2005. LACERS will continue to monitor this assumption.
129	238 7 Comments made above with regard to the disability assumption (no assumed rate after age 60) and the eight year set forward of ages for disabled life mortality should be considered.	Chose Not to Implement	The current assumption is common practice for public pension systems and the impact of changing this assumption would be de minimis. LACERS will continue to monitor this assumption.
130	238 8 Segal should clarify the assumption that was used for the June 30, 2006 actuarial valuation.	Fully Implemented	
131	239 9 LACERS should consider the impact of a higher trend scenario on the cost of the plan. We estimate that changing the grading from 1% per year to 0.5% per year to the same ultimate 5.0% increases the cost by over 2% of payroll.	Not Yet Implemented	
132	240 10 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 LACERS.	Fully Implemented	
133	240 11 Additional analysis of experience should be	Chose Not to Implement	Reviewed, not implemented, continue to monitor.

	Task Area, Topic, Page in Original Report, #, Recommendation	Implementation Status	Details
	undertaken by LACERS in the areas of election of medical coverage and percentage of spouses who will be covered.		
134	241 12 If assets are tracked separately, it would provide useful information to include these exhibits for OPEB separately.	Chose Not to Implement	
135	243 13 Segal should clarify the amortization policy and it should be adopted by the Board, if it has not already done so.	Not Yet Implemented	
136	244 14 One measure of contribution rates should be developed and shown in the report based on actual practice, i.e., based on either (1) contributions paid at the beginning of the year, or (2) contributions paid at the end of each pay period.	Chose Not to Implement	LACERS provides both rates at the request of the plan sponsor to allow them to determine which payment option would be most financially appropriate to them for a given fiscal year.
137	244 15 Additional information should be obtained to enable consideration of the lag in contributions and its effect on the methodology used to amortize the UAAL.	Fully Implemented	
138	244 16 Segal should confirm that the 3,147 retirees and surviving spouses noted as not receiving a subsidy are paying the full cost of the Plan, and that there is no AAL included in the valuation for them.	Fully Implemented	
139	244 17 Segal should provide an analysis by source of the $163.7 million net gain, and explain the increase in the	Fully Implemented	

	Task Area, Topic, Page in Original Report, #, Recommendation	Implementation Status	Details
	medical inflation assumption in light of this gain.		
140	245 18 Additional information should be obtained to enable consideration of the experience gain in relation to the change in trend assumption for this valuation.	Fully Implemented	
	Task Area 5 - Administration		
	5a. Significant Expense Analysis		
141	245 1 LACERS 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.	Fully Implemented	
142	263 2 LACERS' staff should review with each manager its process and controls over use of LACERS' trading soft dollar credits.	Fully Implemented	

Appendix A
Governance Analysis - Criteria, Published Standards, and Peer Group Funds

In assessing this objective:

a) We reviewed LACERS' enabling legislation to determine what fiduciary duties and responsibilities are required under that legislation. We also reviewed job descriptions, charters, MOUs, and terms of reference the Board has established for itself, its committees, senior staff, and key advisors to determine if it clearly set out the roles and responsibilities of the various decision-making bodies.
b) We assessed the content of the role-related documentation to determine if the duties and responsibilities have been appropriately assigned consistent with best practices (e.g. separation of policy and operational duties), and whether proper accountability has been established.
c) We reviewed Board policies with respect to conflict of interest, code of conduct and ethics and compared them against those of other public retirement systems, as well as our knowledge and understanding of what would constitute best practice with respect to such policies.
d) We reviewed other policies or guidelines the Board has established with respect to governance concerning issues such as Board operations, trustee education, travel, planning, board performance evaluation, general manager performance evaluation, etc.
e) We reviewed samples of reports and documents submitted to the Board to determine if it is fulfilling its responsibilities with respect to monitoring and oversight of LACERS as set out in legislation and in its charter and policies.
f) Finally, we reviewed Board meeting minutes over a 12 month period (we used fiscal year 2012) to assess whether the LACERS' Board has carried out key duties set out in their governance policies.

Published Standards

The Published Standards were drawn from the works of a number of bodies around the world including:

- *The Committee on Fund Governance Best Practice Principles,* issued by the Stanford Institutional Investor's Forum, and also known as *The Clapman Report* (hereinafter the "Clapman Report").
- *Governance of Public Employee Post-Retirement Benefits Systems,* issued by the Government Finance Officers Association (hereinafter the "GFOA Governance Guidelines").
- *OECD Guidelines for Pension Fund Governance,* issued by the OECD Working Party on Private Pensions (hereinafter the "OECD Governance Guidelines").
- The Canadian Association of Pension Supervisory Authorities' *Pension Governance Guidelines* (hereinafter the "CAPSA Governance Guidelines").

On issues not addressed in the above works, Cortex has provided where possible its own view as to what constitutes best practice, based on its experience working with over 100 pension systems over the last 20 years.

Peer Group Funds used for the Governance Analysis Section

We relied on two different Cortex peer groups in the Governance Analysis section of our Report (Audit Objective 11). The first Cortex Peer Group, and which most often referenced, consisted of 25 public retirement systems, including 15 state-wide systems, 6 county systems, and 4 municipal systems.[54] The data was gathered primarily in 2010 and 2011. California systems are shown in bold.

Retirement System (As of Dec. 31, 2009)	**Assets Size ($M)**	**Retirement System** (As of Dec. 31, 2009)	**Assets Size ($M)**
Teacher Retirement System of Texas	$94,500	Indiana State Teachers' Retirement Fund	$8,163
Illinois Teachers' Retirement System	$38,000	Wyoming Retirement System	$5,983
Colorado Public Employees' Retirement Association	$35,037	**Alameda County Employees' Retirement Association**	**$4,700**
Los Angeles County Employees Retirement Association	**$34,565**	Missouri Local Government Employees Retirement System	$3,700
Public School and Education Retirement System of MO	$26,484	Fire & Police Pension Association of Colorado	$3,069
Arizona State Retirement System	$24,112	**Ventura County Employees' Retirement Association**	**$2,716**
Public Employees' Retirement System of Nevada	$21,503	**Fresno County Employees' Retirement Association**	**$2,610**
Public Employees' Retirement System of Mississippi	$19,204	**Kern County Employees' Retirement Association**	**$2,400**
San Francisco Employees' Retirement System	**$15,100**	**San José Police and Fire Department Retirement Plan**	**$2,300**
Indiana Public Employees' Retirement Fund	$14,025	**San José Federated Employees Retirement System**	**$1,700**
Los Angeles Fire and Police Pensions	**$12,904**	MoDOT & Patrol Employees' Retirement System	$1,339
Kansas Public Employees Retirement System	$12,355	**Sonoma County Employees' Retirement Association**	**$1,333**

[54] One retirement system made its data available, but requested that its identify not be disclosed. Accordingly the above table lists only 24 systems.

For certain issues, we included relevant data from a second Cortex peer group, comprised of larger retirement systems and investment boards. Data for this group was gathered in 2012, and includes the following systems and boards. This peer group consisted of seven state investment boards and councils and four public retirement systems. There was one California fund, which is shown in bold.

Fund	**Asset Size ($M)** (As of June 30, 2011)
Teacher Retirement System of Texas	$132,209
New Jersey State Investment Council	$88,685
State of Wisconsin Investment Board	$87,864
Washington State Investment Board	$79,639
The Oregon Investment Council	$75,507
Virginia Retirement System	$54,562
Massachusetts Pension Reserves Investment Management Board	$50,677
Alaska Permanent Fund Corporation	$45,240
Los Angeles County Employees Retirement Association	**$42,729**
Arizona State Retirement System	$30,537
West Virginia Investment Management Board	$12,850

Appendix B

Compliance and Verification Requirements recommended by *The Committee on Fund Governance Best Practice Principles,* issued by the Stanford Institutional Investor's Forum (the "Clapman Report")

Principle D.3

Trustees and staff should periodically affirm and **verify compliance** with conflict rules, regulatory reporting requirements, and other policies intended to protect the fund against the actuality or appearance of interested transactions and conflicts. Accordingly, trustees and executive staff should at least annually verify and publicly report on the following as relevant:

a) Compliance with regulatory requirements (SEC, CFTC, state agencies, etc.);
b) Compliance with the fund's own governance standards, policies and procedures;
c) Compliance with the fund's Code of Ethics;
d) Compliance with standards governing the reporting of performance and, where applicable, funded status of defined benefit plans;
e) Compliance with rules governing gathering and retaining appropriate records and documents;
f) Compliance with rules governing personal investment transactions; and
g) The suitability of all investments made by the fund in the current or previous year given the fund's fiduciary standard, investment objectives, and investment policies.

Principle D.5

A fund should **publicly disclose necessary information** as specified below to ensure that trustees and staff are fulfilling their fiduciary duties to beneficiaries. Accordingly, the fund should publicly disclose:

a) The fund's trading policies and procedures including commissions paid;
b) Any referral fees paid by the fund;
c) The role of any external entities in setting policy and strategy for the fund or for any external investment manager used by the fund;
d) An annual summary of actual or potential conflicts of interest that were identified and how they were managed or controlled (e.g., situations involving recusals);
e) A detailed annual statement of risks to the fund in the nature of a risk factors disclosure that might be contained in a registration statement filed with the United States Securities and Exchange Commission;

f) A statement and quantification, based on realistic economic and financial assumptions, of the fund's liabilities and description of how investment practices are structured to satisfy those obligations over the long-term.
g) The fund's policy on personal investment transactions as well as a statement that all covered persons have complied with rules governing personal investment transactions, together with a description of any exceptions from compliance;
h) The fund's policy on receipt of gifts and entertainment for covered persons as well as an annual statement that the gifts and entertainment policy has been complied with together with a description of any exceptions from compliance;
i) An annual statement of the fund's holdings and performance;
j) An annual statement describing whether and how the fund and its trustees have fulfilled the best practices as set forth herein;
k) An annual report of the fund's contracting process and of material contracts let; and
l) A description of proxy voting policies and proxy votes cast, including those by external managers with respect to fund investments, to the extent not otherwise disclosed by the fund.

Appendix C

Compliance Review with the Board Duties as set out in the Statement of Governance Principles

Board's Role	Status	Notes
A. Develop and Adopt Policies		
A.1. Set the long-term strategic direction and annual business plan for LACERS, focusing on the goals of LACERS against which its performance is measured and monitored.	In compliance	Consider changing "annual business plan" to "strategic business plan" to reflect current LACERS terminology.
A.2. Set policies for LACERS focusing on: • Asset allocation • Unfunded liabilities • Risk adjusted rates of return • Potential future risks	In compliance	
B. Review and Evaluate Performance		
B.1. Monitor performance and regularly review results as compared to: • LACERS mission/vision statement • Strategic plan and other long-range goals • Annual business plans	In compliance	
B.4. Review, approve, and monitor actuarial data and assumptions.	In compliance	
C. Risk Control		
C.1. Review and approve the annual budget, including budget change proposals, financial standards and policies.	In compliance	
C.2. Ensure the integrity of the financial control and reporting system.	Implementation in progress	Limited review of controls by external audit firm. Full review to be undertaken by internal audit director, once the position is filled.
C.3. Oversee all audits, including approve the outside auditor, the annual internal audit plan, and provide that financial controls and reporting systems are set forth.	Implementation in progress	No internal audit plan currently; expected once the internal audit position is filled.
D. Other Board Responsibilities		
D.1. Have in place Board policies and guidelines regarding proposed legislation (state and federal), corporate governance, shareholder voting, and the adoption/amendment of administrative code, rules and regulations.	***Exception noted***	Missing policies and guidelines regarding: - proposed legislation - adoption/amendment of administrative code, rules,

Board's Role	Status	Notes
		and regulations
D.3. Organize the board of trustees; organize its Committees; and approve charters and delegations to Committees and the General Manager.	In compliance	
D.4. Periodically evaluate the Board, its performance and take any steps necessary to improve Board operations.	***Exception noted***	Evaluation has not been conducted since 2010.
D.6.c. Conduct member hearings and decide appeals.	In compliance	
Election		
The election of the Board President and Vice-president shall be held at the second meeting of July each year. The Board shall elect one of its members President and one Vice-president, which officers shall hold offices for one year and until their successors are elected, unless their membership on the Board sooner expires.	In compliance	

Appendix D – Project Peer Group

Peer Group Members	Net Investment Assets ($Millions)	Metro Area CPI Average 5 Years
1. San Francisco Employees' Retirement System	$ 15,631.54	225.8
2. Employees' Retirement System of Georgia	$ 13,764.60	205.7
3. Los Angeles Fire and Police Pensions	$ 13,366.76	221.3
4. Arkansas Teacher Retirement System	$ 11,817.30	210.3
5. Public Employee Retirement System of Idaho	$ 12,027.01	220.5
6. School Employees Retirement System of Ohio	$ 9,413.33	198.1
7. Orange County Employees Retirement System	$ 8,787.35	221.3
8. San Diego County Employees Retirement Association	$ 8,527.81	221.3
9. Sacramento County Employees' Retirement System	$ 6,105.28	220.5
Peer group – average net investment assets	**$11,049.00**	**215.4**
Los Angeles City Employees' Retirement System	**$ 9,132.23**	**221.3**

Data generally as of June 30, 2012.

Appendix E – Management Audit of LACERS Interim Report issued June 27, 2013 is incorporated herein by reference.

The Interim Report can be accessed at the LA City Controller's web site:
http://controller.lacity.org/stellent/groups/electedofficials/@ctr_contributor/documents/contributor_web_content/lacityp_026044.pdf

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Attachment 2

LACERS
LOS ANGELES CITY EMPLOYEES'
RETIREMENT SYSTEM
Securing Your Tomorrows

January 7, 2014

The Honorable Ron Galperin, Controller
City of Los Angeles
200 North Main Street, Suite 300
Los Angeles, CA 90012

Attention: Farid Saffar, Director of Auditing

Re: Response to Final Management Audit Report

Dear Controller Galperin:

Thank you for the opportunity to provide our response to the Final Management Audit Report (Report).

We also would like to thank P2E Consulting for noting many positive aspects relating to LACERS including:

- That our System "operated in a reasonably efficient and economical manner";
- That "LACERS Board and staff were diligent in their consideration of the prior management audit recommendations";
- That LACERS operations are "very transparent"; and
- That "everyone at LACERS had a great attitude of cooperation".

The greater than 70% reduction in recommendations compared with the 2007 management audit attests to the commitment and diligence of our Board and staff in administering the retirement system.

We generally agree with the analysis and recommendations in the Report and look forward to further reviewing the recommendations with our Board.

202 West First Street, Suite 500, Los Angeles, CA 90012-4401 | (800) 779-8328 | TDD (888) 349-3996 | Fax (213) 687-4174
www.lacers.org | lacers.services@lacers.org

Attachment 2

Should you have any questions or require further information, please do not hesitate to contact me at (213) 473-7280.

Sincerely,

Thomas Moutes
General Manager

TM:bc

cc: Zara Bukirin, Joint Administrator, Mayor's Office
Karen E. Kalfayan, Joint Administrator, City Council
Steven M. Harding, President and CEO, P2E Consulting
LACERS Board of Administration