CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Office of the City Auditor

Report to the City Council
City of San José

AUDIT OF RETIREMENT SERVICES: GREATER TRANSPARENCY NEEDED IN THE BUDGETING PROCESS, INTERACTIONS AMONG STAKEHOLDERS, INVESTMENT POLICIES, AND PLAN ADMINISTRATION

Report 17-06
October 2017

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Office of the City Auditor
Sharon W. Erickson, City Auditor

October 12, 2017

Honorable Mayor and Members
Of the City Council
200 East Santa Clara Street
San José, CA 95113

Audit of Retirement Services: Greater Transparency Needed in the Budgeting Process, Interactions Among Stakeholders, Investment Policies, and Plan Administration

The Office of Retirement Services administers the City of San José's retirement plans, including the payment of retirement benefits and the investment of plan assets. Two Retirement Boards of Administration oversee the plans: one oversees the Federated City Employees' Retirement System and one oversees the Police and Fire Department Retirement Plan. The City, as the plans' sponsor, is a key stakeholder of the retirement plans and contributes over $300 million to the retirement plans each year.

In February 2017, the Mayor's Office requested and the City Council approved adding to the City Auditor's work plan an audit of the administration of the Office of Retirement Services and the retirement plans. The Mayor's memo expressed concern that although the Retirement Services administrative budget has increased since FY 2005-06, the plans had seen losses in the two fiscal years prior to the memo's publication. The memo specifically requested that the audit should assess expenditures for administering these plans, including analysis of professional expenses such as legal fees, administrative costs such as travel expenses, and staffing levels. The memo also requested that the audit should assess investment performance relative to key industry and policy benchmarks.

This report addresses the request to review the administration of the Office of Retirement Services. A separate report from the Stanford Institute for Economic Policy Research (expected to be issued shortly) will address the Mayor's request for an external review of the investment performance of San José's pension plans.

Finding 1: Retirement Services' Budget Process Is Not Well Defined. Budget documents and financial reports prepared by the City and by Retirement Services show different categories of Retirement Services expenses, revenues, and payments. The City Council approved a $6.6 million budget for personal services in FY 2016-17. The City's Source and Use statements displayed a total of $11.7 million of expenses, as well as revenues and payments to retirees. The budget presentations to the Retirement Boards showed a total of $12.7 million. Preliminary information indicates that the plans' revenues were $901 million, while expenses (including payments for member benefits) were $477 million, of which $42 million were expenses to administer the plans. This resulted in a net gain of $424

million in FY 2016-17. Including expenses shown in the Comprehensive Annual Financial Reports and additional expenses shown in Retirement Services staff's Annual Fee Reports (which provide a more comprehensive estimate of investment manager fees), we estimate the total expense to administer the plans was $73 million.

According to the City Charter, the Retirement Boards shall annually adopt a budget approved by the City Council covering the entire aggregate expense of administration of the retirement plans. However, this process is not well defined. To address the charter requirements, Retirement Services should prepare a comprehensive budget for adoption by the Retirement Boards and approval by the City Council. To ensure that all parties are reviewing the same information, the comprehensive budget should include all revenues and expenses. In addition, the Retirement Boards should establish budget approval policies to formally designate spending authority to Retirement Services management.

Finding 2: Improving Communications Between the Retirement Boards and the Plan Sponsor. The CEO of Retirement Services presents various items to the City Council during the year, but there are limited opportunities for Councilmembers and Board members to learn about each other's costs, forecasts, and relevant decisions. Establishing a process for a joint annual study session to discuss topics relevant to all parties, formal orientations for Councilmembers and Board members, and presentations to the Boards about relevant topics (e.g., the City's budget forecast) would facilitate communication. Additionally, clear expectations regarding the type and frequency of reports to the Council and the Boards would enable the City Council representatives to utilize their role as conduits of information more effectively.

The Retirement Boards have policies that outline the CEO's authority and responsibilities, but they contain limited guidance on the appropriate communications between the CEO and the City. The Retirement Boards should clarify the CEO's role in this area, and work with the City to determine which activities or agenda items the Retirement Board should notify the City about in advance.

Lastly, though Retirement Services presents data on performance and workload in different documents or presentations, it does not centrally present data on performance measures in one report. In the comprehensive budget recommended in Finding 1, we recommend the Retirement Boards establish a comprehensive set of measures that report on all aspects of the Office's performance and workload in a central, accessible format. This would assist both the City and the Boards in assessing the performance of the Office.

Finding 3: Formalizing Policies to Improve Oversight, Transparency, and Delegation of Investment Decisions. The Retirement Boards are tasked with deciding how to invest the plans' assets. As of June 2017, the Federated plan had $2.23 billion in assets and the Police and Fire plan had $3.44 billion in assets – a total of $5.68 billion for both plans (preliminary data, including healthcare trusts). Actuarial analysis as of June 2016 reported that the Federated pension plan was 53.7 percent funded and the Police and Fire pension plan was 75.7 percent funded. Both the Police and Fire and Federated plans ten-year annualized net investment returns were 3.2 percent as of June 30, 2017 (the calculation of net return will differ depending on the time period used). The 20-year assumed rate of return for both pension plans is 6.875 percent. Both plans have performed well below peer plans in recent years.

Like many other public plans nationwide, the retirement plans have increased investments in "alternative assets," which can be more complex and costly. As of Q1 2017, the retirement plans held a majority of assets in actively managed funds. A staff-developed report places total investment fees at $60.21 million for 2016. The Retirement Boards' current investment policies regarding fees do not contain explicit preferences and strategies for controlling fees, compared with leading practices. To provide guidance on fee preferences and strategies, Retirement Services should develop a comprehensive investment fee policy.

During the three-year period between 1st quarter 2014 and 1st quarter 2017, 41 percent of Federated's and 60 percent of Police and Fire's actively managed funds underperformed their quarterly benchmarks for at least 7 quarters. While Retirement Services redeemed or terminated some of those managers, the investment policies do not clearly define the process for evaluating manager performance. Retirement Services should update its investment policy to reflect existing process for evaluating managers and incorporate a more formal "watch list" for underperforming managers.

The retirement plans lack clarity on the definitions and delegation for certain investment decisions. Retirement Services has 10 authorized full time equivalent staff for the investment program. While the Retirement Boards have discussed delegation of investment authorities, some items are still in need of clarification. We recommend the Retirement Boards clarify the different levels of investment decisions and which bodies have the authority to implement or approve them.

Finally, the Retirement Boards should periodically provide copies of the retirement plans' investment policies to the City Council.

Finding 4: San José's Basic Costs to Administer the Plans Were Comparable to Benchmark Jurisdictions. Retirement Services' basic costs to administer the plans were comparable to benchmark jurisdictions in FY 2015-16 at about $8,000 per $1 million in plan assets (not including all investment manager fees). In response to the Mayor's request we also looked in more detail at travel, legal, and consultant services.

Retirement Services spent about $65,000 on travel in FY 2015-16, which was about $12.50 per $1 million in plan assets, and mid-range compared to other jurisdictions. However, a review of Retirement Services travel reports showed that some instances of Retirement Services' acceptance of free registration to vendor-sponsored conferences may not be in compliance with the City's Gift Policy. Retirement Services should decline the free registration and pay for the conferences to ensure compliance with the City's gift and travel policies.

Additionally, Retirement Services spent over $950,000 on legal services in FY 2016-17, or $170 per $1 million in plan assets. A similar comparison for FY 2015-16 showed that the ratio of dollars spent on external legal services per $1 million in plan assets was slightly higher than, but in line with, other jurisdictions. We found that most benchmarked jurisdictions have internal counsel who provide general legal advice.

Finally, Retirement Services spent about $2.75 million on consultant services in FY 2016-17, including $1.4 million on investment consultants. Consultant costs are slightly higher than other jurisdictions and have increased over the past decade. Increased use of investment consultants has been the main driver behind this increase.

Finding 5: The Office of Retirement Services Could Improve Customer Service Through More Efficient Tools. Retirement Services has about 30 authorized full time equivalent staff (FTE) who work on non-investment issues, which is a ratio of about 420 plan members and beneficiaries per noninvestment staff. This ratio is comparable to other jurisdictions.

Retirement Services Benefits staff answer customer requests for service, though requests are not necessarily addressed by the relevant subject matter expert. Retirement Services does not currently have a software solution with workflow routing capabilities. Retirement Services should assess how to use workflow functionality in its pension benefits administration system—which is currently being replaced—for case management, or acquire a separate case management software system.

Retirement Services could also improve access to key plan information for stakeholders and plan members. The Retirement Services website is outdated and does not always provide complete or accurate information to plan members and stakeholders, and the Retirement Services newsletters are not as comprehensive as those of similar plans. The websites for several benchmark jurisdictions have improved functionality that Retirement Services could adopt to improve ease of navigation. Retirement Services should upgrade their website to improve beneficiary education, and post internal policies and audio recordings of committee meetings to its website to improve transparency.

This report includes 25 recommendations. We plan to present this report at the October 19, 2017 meetings of the Public Safety, Finance, and Strategic Support Committee, the Federated Board, and the Police and Fire Audit Committee; followed by presentation to the November 2, 2017 meeting of the Police and Fire Board. We have tentatively scheduled the report to be heard by the City Council on November 7, 2017. We would like to thank the Office of Retirement Services for their time and insight during the audit process. The Office of Retirement Services and the City Manager's Office have reviewed this report. The City Manager's response is shown on the yellow pages; the Office of Retirement Services declined to provide a response at this time. We expect the Office of Retirement Services to prepare a response after the Boards have had a chance to review and discuss the report.

Respectfully submitted,

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City Auditor

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SE:lg

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cc: Board of Administration of the Federated City Employees' Retirement System
Board of Administration of the Police and Fire Department Retirement Plan

City Manager of the City of San José
Chief Executive Officer of the City of San José Office of Retirement Services

This report is also available online at www.sanjoseca.gov/audits.

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Introduction

The mission of the City Auditor's Office is to independently assess and report on City operations and services. The audit function is an essential element of San José's public accountability and our audits provide the City Council, City management, and the general public with independent and objective information regarding the economy, efficiency, and effectiveness of City operations and services.

In accordance with the City Auditor's fiscal year (FY) 2016-17 Audit work plan, we have completed an audit of the Office of Retirement Services. In February 2017, the Mayor's Office requested to add to the City Auditor's work plan an audit of the administration of Retirement Services and the retirement plans for Police and Fire and Federated retirees. This request was approved by the City Council in February 2017.

The objective of our audit was to review the administration and performance of the Office of Retirement Services. A separate report from the Stanford Institute for Economic Policy Research (expected to be issued shortly) will address the Mayor's request for an external review of the investment performance of San José's pension plans.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. We limited our work to those areas specified in the "Audit Objective, Scope, and Methodology" section of this report.

The Office of the City Auditor thanks the management and staff from the Office of Retirement Services, the City Attorney's Office, the City Manager's Budget Office, and the Office of Employee Relations for their time, information, insight, and cooperation during the audit process.

Background

The City of San José (City) offers two[1] defined benefit retirement plans to City employees: the Police and Fire Retirement Plan (for qualifying members of the Police and Fire sworn services) and the Federated City Employees' Retirement System (for qualifying employees not covered by the Police and Fire plan). Some employees,

[1] The City offers a third plan to Executive Management and Professional Employees (Unit 99) staff, which is a defined contribution plan similar to a traditional 401k. That plan – commonly known as Tier 3 – is administered by the City's Department of Human Resources. The City also offers a defined contribution retirement plan for part-time, temporary, or contract (PTC) employees, including council assistants.

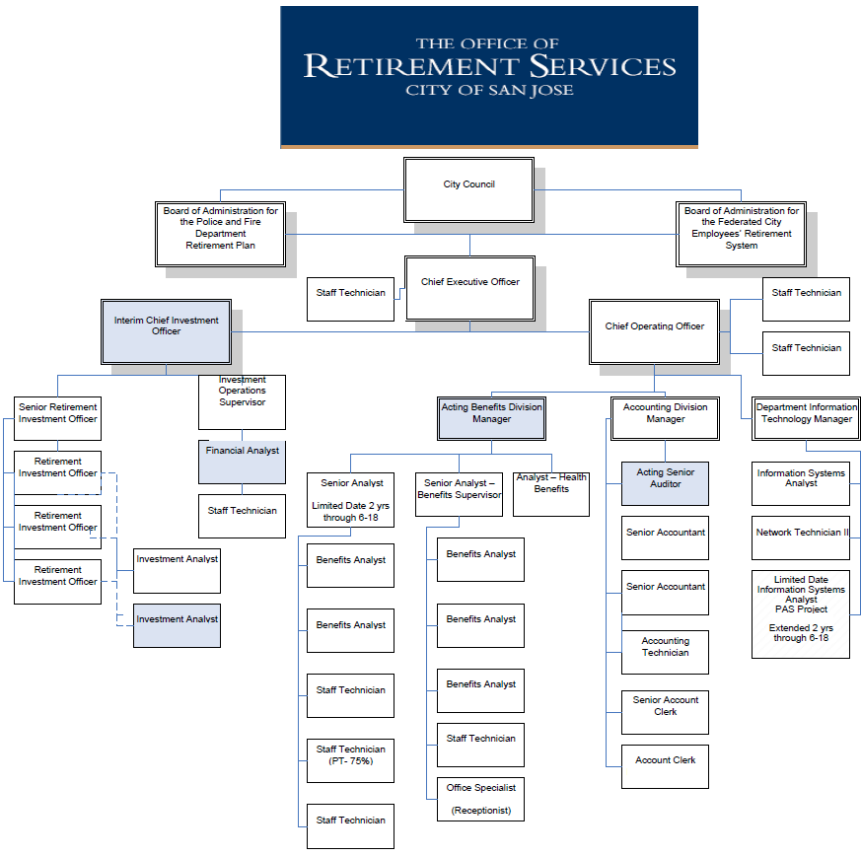
such as part-time unbenefited employees and members of the City Council, are not part of either plan.

The Office of Retirement Services administers the retirement benefits provided by the City. Its mission is to "provide quality services in the delivery of pension and related benefits and maintain financially sound pension plans."

Both the Police and Fire and Federated plans are defined benefit plans, meaning that the City provides stable pension benefits based on retirees' years of service with the City and their final compensation. The City and plan members contribute to the plans at a defined rate, and the City transfers the funds to Retirement Services to manage and pay for benefits. The Retirement Boards and Retirement Services invest contributions to try and meet an expected rate of return that will enable them to make benefits payments. Further information about benefits can be found at the City website here: http://www.sanjoseca.gov/index.aspx?nid=548.

Retirement Services' CEO oversees the entire office, which is split into several divisions, including an investment division overseen by a chief investment officer, as well as a benefits division, accounting division, and information technology division, which are all overseen by the Retirement Services chief operating officer.

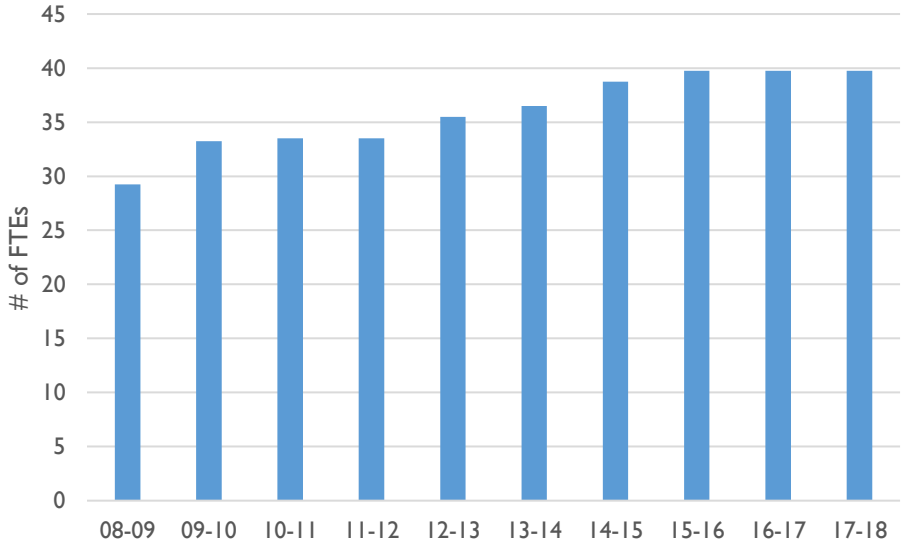
Exhibit 1: Office of Retirement Services Organizational Chart



Source: Office of Retirement Services (Vacant positions or positions filled on interim/acting basis are shaded blue)

In FY 2016-17 and FY 2017-18, Retirement Services had 39.75 budgeted fulltime equivalent (FTE) positions, compared to 29.25 FTE in FY 2008-09.

Exhibit 2: Retirement Services Staffing Has Grown by 36 percent in the Past Decade



Source: City of San José Operating Budgets FY 2008-09 through FY 2017-18

Retirement Services also employs a variety of consultants to provide services including investment consulting and actuarial valuations. (For more information about Retirement Services' use of investment consultants, see Finding 3. Overall consultant costs are discussed further in Finding 4.)

The retirement plans are overseen by two independent boards who have fiduciary responsibility for the retirement funds. The Federated Board consists of seven appointed members: four public members appointed by the City Council, two employee representatives, and one retiree representative. The Police and Fire Board consists of nine appointed members: five public members appointed by the City Council, one Police employee representative, one Fire employee representative, one Police retiree representative, and one Fire retiree representative. Public members appointed by the City Council must have at least twelve years of experience relevant to the administration of a pension plan. Each board also includes one nonvoting City Councilmember.

As part of their fiduciary duties, the Retirement Boards determine the strategic investment policies for their respective plans. As of June 30, 2017, the plans, including the healthcare trusts, had $5.68 billion in total assets under investment.

Nonetheless, as of June 30, 2016, the plans had an estimated unfunded actuarial liability[2] of $4 billion.

- The Federated Plan had an estimated unfunded actuarial liability of $1.75 billion – meaning that they had only 53.7 percent of the assets they would need to pay for benefits already earned.
- For the Police and Fire Plan, the estimated unfunded actuarial liability was $1.06 billion – meaning they had 75.7 percent of the assets they would need to pay for benefits already earned.
- The estimated unfunded actuarial liability for Other Post-Employment Benefits (OPEB) was $538 million for Federated (29.6 percent funded) and $644 million for Police and Fire (17.4 percent funded).

These estimates are prepared annually by independent actuaries hired and directed by the Retirement Boards. These unfunded liabilities totaled almost $270,000 per Federated member, and more than $420,000 per Police and Fire member.

Retirement Services Has Seen Significant Changes in the Past Decade

Over the past several years, there have been numerous notable changes to Retirement Services and the benefits provided by the City.

In 2009, the City hired Cortex Applied Research Inc. to complete a review of pension governance best practices. Their report included recommendations to grant the Retirement Boards greater autonomy and to institute additional safeguards to protect stakeholders.

In August 2010, the City Council adopted a pair of ordinances that restructured the composition of the Retirement Boards. Under the new ordinances, the Police and Fire Board increased from seven members to nine. Additionally, City Councilmembers no longer serve as voting members of the Boards and instead appoint public members who are not connected with the City and have significant banking or investment experience. Each Board has one nonvoting City Councilmember.

In 2012, the Retirement Boards commissioned Cortex to conduct follow-up analysis of the plans' governance models and provide additional recommendations as needed. Key recommendations included granting the Boards full authority to hire and terminate their own staff, determine compensation levels, appoint their own legal counsel, and establish their own procurement policies.

[2] The unfunded actuarial liability is the unfunded pension obligation for prior service costs, measured as the difference between the estimated accrued liability for benefits already earned, and the actuarial value of plan assets. The unfunded liability for OPEB is calculated on a GASB Valuation Basis.

In June 2012, San José voters approved Measure B, which enacted pension reform for the City. In October 2012, the City introduced a tiered system of benefits. For the most part, staff hired after September 30, 2012 are placed into "Tier 2," which receives less generous benefits than "Tier 1," which largely applies to employees hired prior to October 1, 2012. Soon after Measure B was passed, several of the City's bargaining units sued the City, and the Superior Court upheld some provisions of Measure B while striking down others.

In 2014, the San José voters passed Measure G, which implemented some recommendations from the Cortex reports. This included granting the Retirement Boards authority to hire an at-will chief executive, who would have the authority to hire and terminate Retirement Services employees independent of the City Manager's Office. Measure G stipulates that the City Council retains the authority to approve the aggregate expense of administration of the retirement plans. It also stipulates that Retirement Services has the authority to contract with external counsel for legal services, and effectively ended the existing relationship between the Retirement Plans and the City Attorney's Office in favor of exclusively contracting with outside counsel.

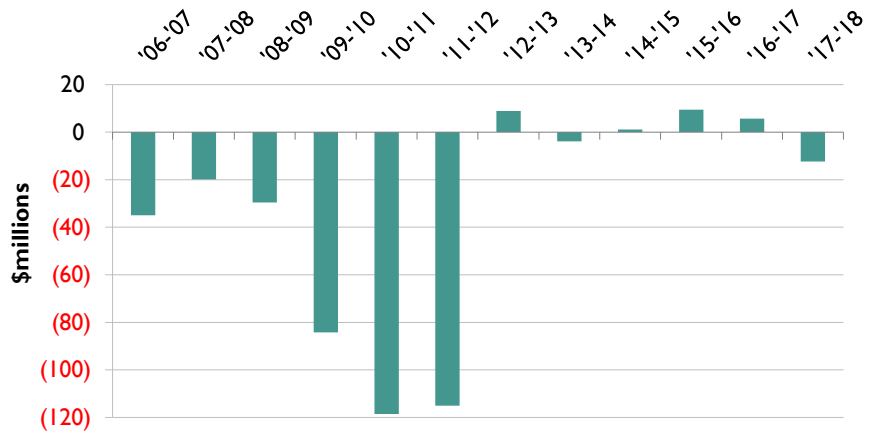
The City and the bargaining units negotiated settlement frameworks to settle the lawsuits related to Measure B in 2015, and the City's voters passed Measure F in 2016 to codify these frameworks and settle the lawsuits brought by the bargaining units.

As of June 30, 2016, the Federated system included 8,506 members – including 2,162 active Tier 1 members, 1,135 active Tier 2 members, 1,206 deferred vested members, and 4,003 retirees and beneficiaries. The Police and Fire plan included 4,048 members – including 1,393 active Tier 1 members, 189 Tier 2 members, 317 deferred vested members, and 2,149 retirees and beneficiaries.

Retirement Costs Have Placed Increasing Pressure on the City

The City has faced significant financial challenges over the last decade as a result of projected revenue shortfalls that have impacted net position and expenses. Between FY 2006-07 and FY 2015-16, the City faced projected General Fund shortfalls in all but three years.

Exhibit 3: The City Faced Eight Years of Projected General Fund Shortfalls Between FY 2006-07 and FY 2017-18



Source: City Manager's Budget Office

In each of those years, the City Council balanced its budget with significant reductions to City services, staffing, and employee pay.

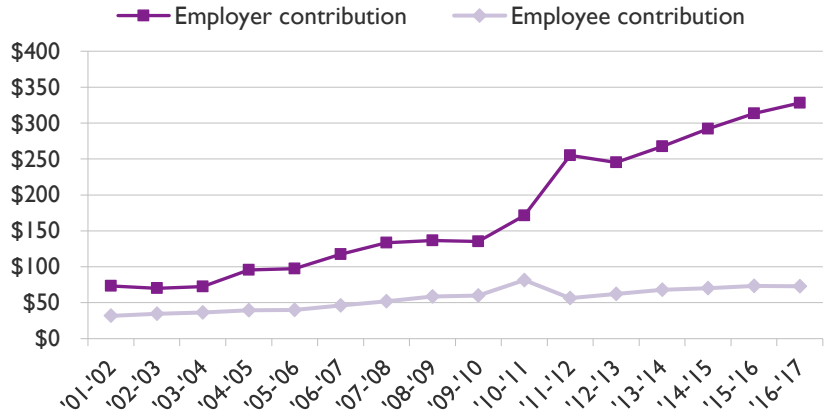
Significant increases in the City's retirement payments have contributed to the City's financial difficulties. The City's contribution rates for FY 2017-18 range from 94 percent to 96.1 percent of payroll for Tier 1 pensions and 6.3 percent to 11.8 percent for Tier 2 pensions. The employees' contribution rates for FY 2017-18 range from 6.6 percent to 11.4 percent of payroll for Tier 1 pensions and 7.7 percent to 16.3 percent for Tier 2 pensions.[3]

In FY 2016-17, the City's contribution was $328 million plus employee contributions of $73 million – for a total contribution amount of $401 million. This included $255.3 million from the City's General Fund. These costs are expected to increase by $42.3 million to a total of $297.6 million in FY 2017-18, which represent 27 percent of the total General Fund base expenditure budget with committed additions.[4]

[3] According to the 2017-18 City Manager's Budget Request and 2018-2022 Five-Year Forecast and Revenue Projections: *In 2010-2011, the Retirement Boards adopted an annual required contribution methodology that established that the City's contribution to the retirement systems be based on a dollar value that is the greater of 1) the employer ARC amount contained in the actuarial valuation (applied in cases where the City's payroll is at or lower than the payroll assumed by the actuary) or 2) the contribution rate contained in the actuarial valuation multiplied by the actual payroll for the Fiscal Year (applied in cases where the City's payroll is above the amount assumed by the actuary). This concept is referred to as the "floor methodology".*

[4] In the City's 2018-2022 Five-Year Forecast, the City's General Fund retirement contributions are forecasted to be $373.1 million by 2021-2022.

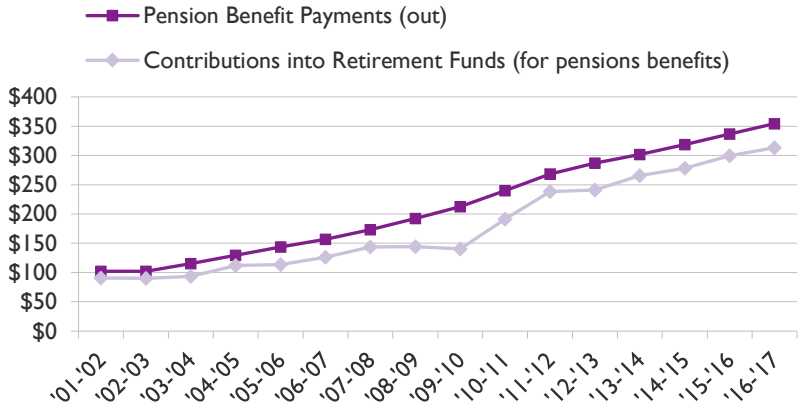
Exhibit 4: The City's Retirement Plan Contributions Have Quadrupled Since FY 2001-02 ($millions)



Source: City of San José Federated City Employees' Retirement System and Police and Fire Department Retirement Plan CAFRs (includes both Defined Benefit Pension Plan and all Post-Employment Healthcare Plan/Trusts)

During this entire period, total pension benefit payments have exceeded employer and employee contributions into Retirement Funds for pension benefits every year. The plans rely on investment income to make up the difference and grow the assets in the plans.

Exhibit 5: Pension Benefit Payments Have Increased Greatly Since FY 2001-02 and Continue to Outpace Contributions ($millions)

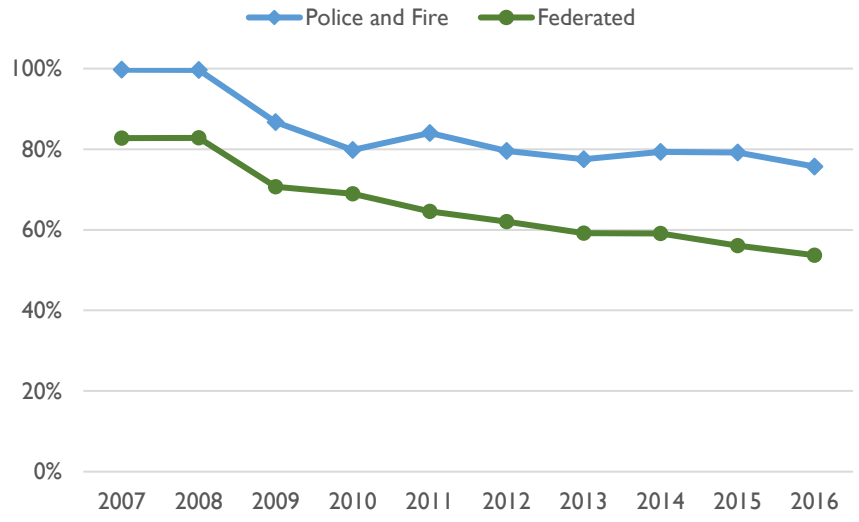


Source: City of San José Federated City Employees' Retirement System and Police and Fire Department Retirement Plan CAFRs

Over the past ten years, the funded status of the Police and Fire pension plan declined from 99.7 percent funded as of June 2007 to 75.7 percent in 2016. The funded status of Federated dropped from 82.8 percent funded to 53.7 percent in 2016. The City's Other Post Employment Benefit (OPEB) plans' funded status is

even lower, as the Federated OPEB was 29.6 percent funded in 2016, and the Police and Fire OPEB was 17.4 percent.

Exhibit 6: Police and Fire and Federated Pension Plans' Funded Status Has Decreased Over the Past Ten Years



Source: Federated City Employees' Retirement System and Police and Fire Department Retirement Plan Actuarial Valuations as of June 30, each year

Note: Funded status calculated using the actuarial value of assets, which differs from the market value as gains/losses are recognized over five years to minimize the effect of market volatility on contributions

Thus, in spite of receiving $387 million in contributions from the City and its employees in FY 2015-16, the total estimated unfunded liability as of June 30, 2016 had grown to $4 billion.

Prior Audits

This Office has published several audits that are relevant to Retirement Services and the pension plans.

In 2008, this Office published *An Audit of Retirement Services Travel Expenses*.[5] This report reviewed Retirement Services travel expenditures and policies, and found that some Board members and staff were receiving more in travel reimbursements than they were entitled to receive, that there were numerous instances in which travel expenses were uneconomical, and that the Boards' travel policies were insufficient. The report recommended that Retirement Services adopt the City's Travel Policy, and improve documentation of travel expenses.

[5] https://www.sanjoseca.gov/DocumentCenter/View/3267

In 2009, this Office published an *Audit of Pensionable Earnings and Time Reporting*.[6] This report reviewed the City's calculation of pensionable earnings (i.e., the amount of an employee's pay that is used to calculate their pension contribution and future pension earnings) and noted errors that impacted the City's payroll and retirement systems. These errors resulted in higher pensions to some retirees. Retirement Services and other City departments are currently resolving these errors. As of June 30, 2017, seven of fifteen recommendations from that report are still open, two of which were partially directed to Retirement Services. An audit of pensionable earnings is on the City Auditor's 2017-18 annual work plan.

In 2010, this Office published an *Audit of Pension Sustainability: Rising Pension Costs Threaten the City's Ability to Maintain Service Levels- Alternatives for a Sustainable Future*.[7] This report assessed the long-term sustainability of the City's pension benefits and the potential impact of increases in pension costs on City operations, and provided background on pension reform alternatives being pursued by other retirement systems.

Audit Objective, Scope, and Methodology

The objective of our audit was to review the administration and performance of the Office of Retirement Services. We sought to understand and evaluate the controls over administration of the retirement plans and investment of plan assets. We performed the following to achieve our objectives:

- Interviewed staff from the Office of Retirement Services, Office of Employee Relations, City Attorney's Office, City Manager's Budget Office, and the Mayor's Budget Office;
- Interviewed the two Councilmembers appointed as nonvoting members of the Retirement Boards;
- Interviewed the chairs of the Boards of Administration for both retirement plans;
- Attended select public meetings of the Retirement Boards and the Retirement Board Investment Committees, Audit Committees, and Governance Committees from March 2017 to September 2017;
- Reviewed transcripts, minutes, and recordings of selected past City Council meetings, Retirement Board meetings, and Retirement Board Investment Committee meetings from 2011 to 2017;
- Reviewed the City Charter and Municipal Code, particularly sections outlining the retirement plans, Retirement Board structure, and Retirement Board governance;

[6] https://www.sanjoseca.gov/DocumentCenter/View/3229

[7] https://www.sanjoseca.gov/DocumentCenter/View/3208

- Reviewed the State of California's Pension Protection Act;
- Reviewed the pension plans and benefits administered by Retirement Services;
- Reviewed prior consultant reports, including by Cortex Applied Research and Albourne America, to understand assessments already performed for Retirement Services;
- Reviewed Retirement Services revenue and expense data from 2001 to 2017 from the City's Financial Management System (FMS), the retirement plans Comprehensive Annual Financial Reports (CAFRs), the City's Annual Operating and Proposed Budgets, the annual budget presentations to the Retirement Boards, and the Annual Fee Reports;
- Interviewed Retirement Services staff of the investment division, benefits division, accounting division, and information technology division;
- Reviewed Board and Retirement Services policies, procedures, control memos, and charters;
- Summarized and evaluated cost data for legal services, travel and training, and consultant services over ten years;
- Reviewed a sample of contracts with investment managers, consultants, and legal firms;
- Reviewed examples of travel invoices and legal invoices to understand cost structures;
- Evaluated the staffing of Retirement Services over the past ten years;
- Compiled the number of plan members to evaluate the ratio of plan members to Retirement FTEs;
- Reviewed available education materials for plan members;
- Assessed the information available and accessibility of the current Retirement Services' website;
- Reviewed the use of current Retirement Services software;
- Evaluated Retirement Services' use of performance measures;
- Reviewed bargaining unit Memoranda of Agreement to understand any limitations placed on Retirement Services' costs and related meet and confer requirements;
- Reviewed monthly expense reports and select quarterly reconciliation reports presented to the Boards from 2011 to 2017;
- Reviewed investment consultant quarterly performance reports and monthly flash reports;
- Reviewed the Investment Policy Statements from 2010 to 2017;

- Reviewed investment manager performance from 2007 to 2017 as reported by the investment consultants or the retirement plan's custodian bank (State Street);
- Compiled information regarding the changes in asset allocation from 2006 to 2017 to understand the complexity of the current portfolio;
- Reviewed available guidance on best practices for investment programs;
- Interviewed staff and/or reviewed select policies, procedures, performance information, budget, outreach, and costs of the Alameda County Employees' Retirement Association (ACERA), Contra Costa County Employees' Retirement Association (CCCERA), San Bernardino County Employees' Retirement Association (SBCERA), Orange County Employees Retirement System (OCERS), San Francisco Employees' Retirement System (SFERS), Los Angeles City Employees' Retirement System (LACERS), Los Angeles Fire and Police Pensions (LAFPP), San Diego City Employees' Retirement System (SDCERS), and City of Fresno Retirement Systems (CFRS); and
- Reviewed select policies, performance information, and costs of the California Public Employees' Retirement System (CalPERS).

We should note that many Auditor's Office staff are members of the Federated City Employees' Retirement System.

Mayor's Memo to the City Council

In February 2017, the Mayor's Office requested and the City Council approved adding to the City Auditor's work plan an audit of the administration of the Office of Retirement Services and the retirement plans.

The Mayor's memo expressed concern that although the Retirement Services administrative budget has increased since FY 2005-06, the plans had seen losses in the two fiscal years prior to the memo's publication. The memo specifically requested that the audit should assess expenditures for these plans, including analysis of professional expenses such as legal fees, administrative costs such as travel expenses, and staffing levels. The memo also requested that the audit should assess investment performance relative to key industry and policy benchmarks.

This report addresses the request to review the administration of the Office of Retirement Services. A separate report from the Stanford Institute for Economic Policy Research (expected to be issued shortly) will address the Mayor's request for an external review of the investment performance of San José's pension plans.

The Mayor's memo is included as Appendix A of this report.

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Finding I Retirement Services' Budget Process Is Not Well Defined

Summary

Budget documents and financial reports prepared by the City and by Retirement Services show different categories of Retirement Services expenses, revenues, and payments. The City Council approved a $6.6 million budget for personal services in FY 2016-17. The City's Source and Use statements displayed a total of $11.7 million of expenses, as well as revenues and payments to retirees. The budget presentations to the Retirement Boards showed a total of $12.7 million. Preliminary information indicates that the plans' revenues were $901 million, while expenses (including payments for member benefits) were $477 million, of which $42 million were expenses to administer the plans. This resulted in a net gain of $424 million in FY 2016-17. Including expenses shown in the Comprehensive Annual Financial Reports and additional expenses shown in Retirement staff's Annual Fee Reports (which provide a more comprehensive estimate of investment manager fees), we estimate the total expense to administer the plans was $73 million.

According to the City Charter, the Retirement Boards shall annually adopt a budget approved by the City Council covering the entire aggregate expense of administration of the retirement plans. However, this process is not well defined. To address the charter requirements, Retirement Services should prepare a comprehensive budget for adoption by the Retirement Boards and approval by the City Council. To ensure that all parties are reviewing the same information, the comprehensive budget should include all revenues and expenses. In addition, the Retirement Boards should establish budget approval policies to formally designate spending authority to Retirement Services management.

Retirement Plans Revenues Exceeded Expenses By $424 Million in 2016-17[8]

The retirement plans receive income from three general sources: employer contributions, employee contributions, and investment earnings.[9]

The plans make four types of payments for member benefits: pension payments to retirees, health care premiums for retirees, refunds of contributions (when employees leave the City and take their contributions out of the plans), and death benefits.

[8] Preliminary CAFR data as of 10/4/17 for Federated and as of 10/3/17 for Police and Fire.

[9] Though employer and employee contributions always add to the assets of the plan, investments can lose value and result in a loss to the plans.

In addition to these payments, Retirement Services has five categories of expenses to administer the plans: personal services, non-personal/equipment, professional services, medical services, and investment expenses.

- Personal services are the salaries and benefits of Retirement Services staff.
- Non-personal/equipment includes rent, supplies, and data processing costs.
- Professional services are the costs of consultants and legal professionals used by Retirement Services unrelated to the investment program.
- Medical services relate to the cost of evaluating disability retirement applications.
- Investment expenses include investment manager fees, custodian bank costs, investment consultants, and investment legal fees.

The Retirement Plans Had a Net Increase in 2016-17 Following Two Years of Decreases

Retirement Services prepares Comprehensive Annual Financial Reports (CAFRs) for both retirement plans. The CAFRs present data about income, payments, and expenses for all Retirement Services operations (by each retirement plan, including healthcare trusts).

Following two years of net decreases to the retirement plans' funds in FY 2014-15 and FY 2015-16, the preliminary data indicates that the plans' revenues exceeded expenses by $424 million in FY 2016-17.

- Revenues were $901 million. This included $328 million in employer contributions, $73 million in employee contributions, and $500 million in investment revenue (net of some investment manager expenses as discussed below),
- Expenses were $477 million. This included retirement and other benefit payments of $378 million, $1.6 million refunds of contributions, $56 million health insurance premiums, and $42 million in general and administrative expenses (excluding some investment manager expenses).

The plans' total assets (minus liabilities and restrictions) were $5.68 billion.[10]

[10] Federated total plan net position was $2.233 billion as of June 30, 2017. The Federated plan had a net increase of $148 million and $17 million of expenses reported in the CAFR in FY 2016-17. The Police and Fire total plan net position was $3.443 billion as of June 30, 2017. The Police and Fire plan had a net increase of $276 million and $25 million of expenses reported in the CAFR in FY 2016-17. All data is preliminary, as of 10/4/17 for Federated and 10/3/17 for Police and Fire.

Though Different Reports Present Only Certain Categories of Budget Data, In Total Retirement Services Spent an Estimated $73 Million Administering the Retirement Plans in FY 2016-17

In the past, reports prepared by the City and by Retirement Services have presented only certain categories of revenues and expenses. For FY 2016-17,[11]

- The City's **Adopted Budget** for Retirement Services included only personal services. The FY 2016-17 budgeted amount was $6.55 million; preliminary 2016-17 CAFR data indicates that actual personal services were $6.13 million.[12]
- Retirement Services' **Budget Presentations** included all categories of expenses except investment expenses. The FY 2016-17 adopted amount was $12.73 million.
- The City's **Source and Use of Funds Statements** included revenues, payments for member benefits, and expenses with the exception of investment expenses. Investment expenses are included in the calculation of investment income, but are not listed separately. For FY 2016-17, the budgeted expenses to administer the funds (excluding investment expenses) were $11.68 million; preliminary 2016-17 CAFR data indicates that the actual expenses were $9.44 million.
- The retirement plans' **Comprehensive Annual Financial Reports (CAFRs)** included all categories of revenues, payments for member benefits, and expenses. However, not all categories of investment manager fees are presented as expenses in the CAFRs; some are subtracted from investment returns, and are thus included as investment income.[13] CAFR-reported expenses totaled $42 million FY 2016-17. Of this total, $12.5 million was for expenses other than investment manager fees.
- Retirement Services' **Annual Fee Reports** present expenses only for the investment program. These expenses include estimates for the total cost of investment manager fees, including those not included in the CAFRs as expenses. The investment program expenses totaled $65 million for calendar year 2016, of which $60 million were for investment manager fees.

[11] Data includes both retirement plans, including the health care funds.

[12] There are several City bargaining units that have provisions in their Memoranda of Agreement that set limits on the administrative costs of the retirement plan. For example, the Municipal Employees' Federation (MEF), AFSCME, Local 101 has a side letter limiting the administrative costs to 0.17 percent of plan assets. In the event the costs exceed this amount, the Office of Retirement Services and the Office of Employee Relations are to meet and confer with MEF. The "administrative costs" for this calculation include only personnel expenses.

[13] It is important to note that while the estimated expenses in the Annual Fee Reports are higher than the expenses reported in the CAFRs, this does not render the CAFRs' reported net gains or losses inaccurate since the investment manager fees that are not reported as investment expenses are netted from the manager's investment returns. It is common for some fees not to be separately disclosed in public pension plans' financial statements.

Annual Fee Reports Provide Further Detail on Investment Manager Fees

Retirement Services produced its first Annual Fee Reports (one for each retirement plan) for calendar year 2015. The reports attempt to capture the full cost of investment management fees. This includes information reported in the retirement plans' CAFRs—fees that are separately billed to Retirement Services—as well as fees that are taken out of the investment returns by the fund manager. Though no fees are billed, investment returns are net of fees. Whether an investment manager separately bills fees depends on the type of investment and the fee structure in place in Retirement Services' contract with the manager.

The Annual Fee Reports cover only the cost of the investment program, but indicate that investment manager fees are much higher than what is reported in the retirement plan CAFRs. For calendar year 2016, the non-personal related investment expenses for both plans were estimated at $63 million, including $60 million of investment manager fees. This is double the investment manager fees reported in preliminary 2016-17 CAFR data, which total $29 million.

In addition to more comprehensive fee information, the Fee Reports provide other helpful information regarding fees by asset class and fees as percentages of total assets. The Fee Reports also provide background on fees, summaries of plan portfolios, and year-over-year comparisons that offer context for fee data. This information would be helpful for the City Council to understand as they approve Retirement Services budget information, as discussed later in this finding. As such, Retirement Services should provide the annual fee reports to the City Council for informational purposes.

Recommendation #1: The Office of Retirement Services should forward the Annual Fee Reports to the City Council for informational purposes.

Total Expenses to Administer the Plans Were an Estimated $73 Million

Preliminary 2016-17 CAFR data for all expenses except investment manager fees totals $12.5 million. Investment manager fees from the CY 2016 Annual Fee Report estimate that fees were $60.2 million. Thus, we estimate that the total cost to administer the retirement plans was about $73 million. Because investment manager fees in the Annual Fee Reports are estimated and are reported on a calendar year basis (while the CAFR expense information is reported on a fiscal year basis), the actual expenses may have been slightly higher or lower than $73 million.

Combined with FY 2016-17 payments for member benefits of $435 million, Retirement Services spent an estimated $508 million to pay benefits and expenses.

Retirement Staff Are City Employees Subject to City Authorization

Retirement Services staff, including the CEO and Chief Investment Officer, are City employees whose pay and benefits are controlled within the City's pay plans and benefit structures. The Retirement Boards appoint the CEO and Chief Investment Officer; the CEO has appointing authority over other Retirement Services employees per City Charter Section 810.

Though the structure is unusual within the City organization, historically, the City Council has approved the number and classifications of Retirement Services employees as shown in the City Manager's Proposed Operating Budget. The current process, following that of other City Council Appointed Officials, is that Retirement Services staff work with the Mayor's Budget Office to discuss personnel changes. In the past, some personnel additions have not been approved. The Retirement Services CEO reports a proposed budget to the Boards, noting that personnel additions are subject to approval by the City Council. The decisions are finalized in the City's Proposed Operating Budget, approved by the City Council.

Other plan budgets include detailed staffing plans. For example, the Los Angeles City Employees' Retirement System and the Los Angeles Fire and Police Pension Plan budgets include the proposed FTE for each classification, any change from the prior year, and the salary range of the classification.

Because of the City's involvement in the approval of positions, and keeping in line with the spirit of Recommendation #3 that Retirement Services should produce a comprehensive budget, Retirement Services staff should include in the budget the proposed personal services expenses and staffing plan. This will allow the Retirement Boards to review and adopt the proposal prior to City Council approval.

Recommendation #2: The Office of Retirement Services should include its proposed personnel budget and staffing plan for City Council approval as part of the comprehensive annual budget outlined in Recommendation #3.

Retirement Services Should Prepare a Comprehensive Annual Budget

The City Charter (as a result of Measure G) states:

> *Each retirement board shall annually adopt a budget approved by the City Council covering the entire aggregate expense of administration of the retirement plan or plans that the retirement board has been*

> *designated to administer for the ensuing fiscal year, using the same fiscal year as the City pursuant to Section 1200 of this Charter.*[14]

Retirement Budget Adoption Consisted of a PowerPoint Presenting Personal and Non-Personal Expenses for Administering the Plans

During the annual budget preparation cycle, Retirement Services provides a budget presentation to each Retirement Board. These budget presentations contain information about Retirement Services personal services, non-personal/equipment, professional, and medical expenses. The presentations provide detail about the types of expenses within each category, and descriptions of changes to expenses. They do not provide information regarding investment expenses, payments for member benefits, or investment income.

The City's Approval Was Only of Personal Services Costs

The City's Operating Budget only presents Retirement Services personal services costs and authorized staff for City Council approval, totaling $6.55 million in FY 2016-17 (budgeted). This is because the City's budget accounts for all City positions, but the City does not establish appropriations for Retirement funds. Thus, non-personal/equipment and professional expenses are presented for display only in a separate section of the budget (as discussed later in this Finding).

A Comprehensive Budget Document Is Needed

A comprehensive budget containing revenues, expenses, and payments promotes transparency, provides important controls over spending, and measures financial results. As described by the San Bernardino County Employees' Retirement Association (SBCERA) budget policy: *"A budget should provide information that is valuable, understandable, and enables the Board to rely upon the information contained therein when making future decisions about the organization."* As a reference, revenue, payment, and almost all expense information is reported in the City's Source and Use statements.

Other jurisdictions we surveyed prepare more comprehensive budget documents for their retirement plans.[15] Some of these budgets include both revenues (e.g., plan sponsor contributions, employee contributions, and earnings on investments) and expenses. Plan budgets range from about 25 pages to over 90 pages, and may include discussion about major changes to the budget from the prior year. Some jurisdictions provide breakdowns by division (e.g., benefits, investment). Several

[14] City Charter Section 810

[15] For examples, see: Los Angeles City Employees' Retirement System, Los Angeles Fire and Police Pensions, Orange County Employees Retirement System, Alameda County Employees' Retirement System, San Bernardino County Employees' Retirement Association, City of Fresno Retirement Systems, San Francisco Employees' Retirement System, and Contra Costa County Employees' Retirement Association.

jurisdictions provide short descriptions of the type of work that each division covers and may present goals for the year by division.

A number of jurisdictions also budget for investment expenses, including investment manager fees. For example, the Board of the Los Angeles City Employees' Retirement System adopts a budget that includes 13 basic categories of revenues and expenditures that are similar to the 11 categories of revenues and expenditures San José's plans include in their CAFRs. The Los Angeles system's budget also contains a specific line item for investment management expense.

The Retirement Services' chief investment officer (CIO) policies state: "The CIO shall: b) Develop and recommend an annual budget for the investment program to form part of the total operating budget of the Plan [or System]." To this end, the comprehensive budget prepared by Retirement Services should include the annual budget for the investment program.

To best promote transparency and provide complete, reliable information, San José's retirement plans' budget should include both past revenue information and projected revenues as well as past and projected expenses and payments for all Retirement Services programs, including investment expenses. To ensure that the information is verifiable and can be traced to other financial reports, the comprehensive budget should budget for all revenues, payments, and expenses included in the CAFR. This would include payments for retirement and health benefits and investment manager expenses, as described earlier in this Finding. In addition to payments for member benefits, revenue and expense information could be presented either:

- With revenues gross of fees and all investment manager fees listed as expenses; or
- As reported in the CAFRs, with revenues net of some investment manager fees and the remaining investment manager fees listed as expenses, accompanied by explanatory note regarding the inclusion of some expenses in net revenue.

To ensure a common understanding of what the budget is, we recommend that all parties receive a full, comprehensive budget.

Recommendation #3: The Office of Retirement Services should prepare a comprehensive annual budget document covering the entire aggregate expense of administering each plan.

City Council Approval of Retirement Plan Expenses

San José differs from other jurisdictions surveyed in that the City Council has approval authority over the plans' budgets. This authority is contained in Section

810 of the City Charter (resulting from the passage of Measure G in 2014), cited previously. A process to address this could be:

- Retirement Services prepares a comprehensive annual budget document as recommended above (while continuing to consult with the Mayor's Office as appropriate) and presents it to the Retirement Boards.
- The Boards review the budget and forward it to the City Council for their approval.
- The Boards then adopt the budget that was approved by the City Council.

It should be noted that the language in the charter, "entire aggregate expense of administration of the retirement plan," could be interpreted in different ways. Specifically, the definitions of "aggregate" and "administration" could be subject to multiple interpretations. To ensure a common understanding of what the budget is, we recommend that all parties review the same annual budget document.

Recommendation #4: In compliance with the City Charter, the Office of Retirement Services should formally request each retirement board annually adopt the annual budget document that has also been approved by the City Council.

The Boards Should Establish Formal Policies to Delegate Authority to Staff to Spend Plan Resources

The Retirement Boards have contracted with an external consultant to develop several *charters* to establish policies and delegate responsibilities for Retirement Services. These charters include: the Boards of Administration, the Investment Committees, the CEO, and the Chief Investment Officer.

The CEO charters[16] state:

> *The CEO shall have the authority to make all necessary expenditures for the sole benefit of the members and beneficiaries of the Plan [or System], to manage the operations of the Plan [or System] and implement the policies and decisions of the Board, subject to applicable legislation, board policies, controls, and approved budgets.*

Though this authorizes the CEO to expend plan assets within the approved budget, it does not provide clarity as to whether the CEO is authorized to change spending within the broader top-line categories or if the Board authorizes the spending for each detailed line item.

[16] The Federated Board and the Police and Fire Board each adopt charters and policies for their respective plans.

Other jurisdictions have detailed budget policies, sometimes included in their budget documents. For example, San Bernardino County Employees' Retirement Association's (SBCERA's) budget policy states:

> *[T]he Board approved the Expenditure Budget Approval Policy (Budget Policy), which provides the Board and the CEO with a clear process for establishing its annual budget, covering all expenditures of SBCERA. The Budget Policy ensures the annual budget is presented and adopted in a timely and transparent manner, and meets the statutory requirements as stated in the Budget Appropriations and Statutory Limit section on the next page. The budget presented herein was prepared in accordance with the Budget Policy. The Budget Policy also grants the CEO authority to transfer funds within each of the four broad categories of the budget (Personnel Costs, Professional Services, Operational Services and Supplies, and Capital Expenditures) to accomplish the goal of administering the operations of SBCERA. However, funds may not be moved from one budget category to another without approval from the Board.*

San Bernardino County's budget policy goes on to describe how expenditures and payments will be included in the budget; how the budget will be adopted, amended, and reviewed; and the basis of accounting.

The City of Fresno Retirement Systems also has an Administrative and Professional Budget Policy in its budget. The policy dictates what level of authority the board has to approve spending and what authorities are delegated to the Retirement Administrator. The policy also outlines how performance and actual spending should be reported to the board and how budget appropriations may be amended.

Orange County Employees Retirement System has a budget approval policy in addition to the budget policies and process outlined in their annual budget. The policies dictate that the CEO presents the budget to the board and the process describes the timeline of budget preparation and approval. The policies also specify what should be included in the budget and the process by which the CEO can request amendments to the budget.

Recommendation #5: The Retirement Boards should establish formal budget adoption policies and procedures that include clear delegation of authority to staff to spend plan assets subject to certain limits defined by the Boards.

The City's Budget Documents Could More Clearly Present the Total Income and Expenses of the Retirement Plans

Although contributions to the retirement plans comprise a significant percentage of the City's operating budget, descriptions of this financial burden and a summary of

the costs were not included in the City Manager's 2017-18 Adopted Operating budget. To calculate the full contributions, a reader would have to add the contributions from various Source and Use of Funds statements, as described in the following section. The City's Five-Year Forecast includes several pages about the retirement plans, including descriptions of the benefits provided, a brief history of changes to benefits, data about the percent of the General Fund spent on retirement contributions, and five-year expenditure forecasts. This information would be helpful in the summary or historical sections of the City's operating budget.

To Reduce Confusion, the City's Operating Budget Should Cross Reference the Retirement Plans' More Comprehensive Budget

The City's Operating Budget presents some information about Retirement Services payments and expenses in both the Retirement Services chapter and in several Source and Use of Fund statements. This information is provided by Retirement Services staff as requested by the City Manager's Budget Office.

The Retirement Services chapter shows data for only one category of expense—personal services. This information is included because Retirement Services staff are City employees. The chapter also includes descriptions of any personnel changes for the year and performance measures for the Office. In FY 2016-17, the budget presented in this chapter totaled $6.55 million for both retirement plans. Though there is a line item for "Non-Personal/Equipment," this line item has a $0 value shown. Beneath the cost data in the FY 2017-18 Adopted Operating Budget, there is a note that reads: *"The budget figures represent the Personal Services costs associated with civil service positions only. The other operating costs are budgeted separately as reflected in the Source and Use Statements, which are provided for display purposes only."* Appendix B shows the FY 2017-18 Proposed Operating Budget Retirement Services chapter.

Approval of Retirement Services' chapter of the budget has, by default, constituted the City's approval of the plan's expenditures. Following the implementation of Recommendation #3, when Retirement Services prepares a comprehensive budget, we recommend that the Retirement Services chapter references the more complete expense and revenue information contained in that separate document.

The Source and Use Statements in the City's Operating Budget Should Show the Investment Expenses Presented in the CAFR

In addition to the Retirement Services chapter, the City's Operating Budget includes five Source and Use of Funds statements (two for each pension funds and three for the health care funds). These Source and Use statements include expense information for personal services expenses, non-personal/equipment expenses, and professional services (which includes medical services). The FY 2016-17 budgeted expenses listed across the five funds totaled $11.68 million. However, the Source and Use statements contain disclaimers that the information is for display only.

Appendix C shows the FY 2017-18 Proposed Operating Budget Source and Use of Funds statements for the defined benefit funds and retiree health trusts.

Like the CAFRs, the Source and Use statements show other sources of income and payments in addition to line item expenses, but not in the same categorization or by the same name.[17] Chiefly, as depicted in these statements, the investment income category is a combination of what the retirement plans gained or lost on their investments for the year, other income categories such as revenue from interest or dividends, and the investment expenses of the plans.[18] As such, investment expenses are included in the Source and Use statements as part of the overall gain or loss of plan investments, but are not separately listed.

Going forward, we recommend that the investment expenses be listed separately from investment income. By doing so, readers can understand how the plans fared in their investment returns separately from the cost of investment operations.

Recommendation #6: The City Manager's Office should update the City's Operating Budget to:

a) include total employee and employer retirement contributions in the City's operating budget as summary or historical information,

b) cross-reference its separate approval of the Retirement budget, and

c) modify the presentation in the Operating Budget's Source and Use statements to display investment expense.

[17] The Source and Use statements show: contributions from the employer (City contributions and transfers between funds) and employees (participant income), benefit payments (including pension payments, death benefits, and refunds of contributions), and investment income.

[18] CAFR Statements of Changes in Plan Net Position line items that comprise the "investment income" category are: net depreciation/appreciation in fair value of investments, interest income, dividend income, net rental income, and investment expenses.

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Finding 2 Improving Communications Between the Retirement Boards and the Plan Sponsor

Summary

The CEO of Retirement Services presents various items to the City Council during the year, but there are few opportunities for Councilmembers and Board members to learn about each other's costs, forecasts, and relevant decisions. Establishing a process for an annual study session, formal orientations, and presentations to the Boards about the City's budget forecast would facilitate communication. Additionally, clear expectations regarding the type and frequency of reports to the Council and the Boards would enable the City Council representatives to the Retirement Boards to utilize their role as conduits of information more effectively.

The Retirement Boards have policies that outline the CEO's authority and responsibilities, but they contain limited guidance on the appropriate communications between the CEO and the City. The Retirement Boards should clarify the CEO's role in this area, and work with the City to determine which activities or agenda items the Retirement Board should notify the City about in advance.

Lastly, though Retirement Services' presents data on performance and workload in different documents or presentations, it does not centrally present data on performance measures in one report. In the comprehensive budget recommended in Finding 1, we recommend the Retirement Boards establish a comprehensive set of measures that report on all aspects of the Office's performance and workload in a central, accessible format. This would assist both the City and the Boards in assessing the performance of the Office.

The City and the Retirement Plans Lack Sufficient Opportunities to Communicate with Each Other

Increasing communication between the City and the retirement plans would provide both the City Council and the Retirement Boards with the ability to make more informed decisions. While the Boards are the fiduciaries responsible for investment of plan assets and payment of plan expenses, the City Council has duties to establish employee benefits, pay annual required contributions, and represent the taxpayers.

In 2010, the City Council approved ordinances changing the structure of the Retirement Boards to replace City Councilmembers with public members. The public members are required to meet certain eligibility requirements to ensure financial expertise.

In 2014, the voters approved Measure G to further separate the governance of the retirement plans from the City Council. Measure G authorized the Retirement Boards to appoint the CEO and Chief Investment Officer. While the City Council appoints Board members, the current governance structure provides for relative independence of the Boards to complete their fiduciary duties.

Currently, the CEO of Retirement Services generally presents to the City Council:

- upon receipt of actuarial valuations,
- following the issuance of the retirement plan CAFRs,
- during the City's budget hearing process, and
- to the Public Safety, Finance, and Strategic Support Committee in December regarding the investment program.

Retirement Services staff also occasionally present other information about the retirement plans to the City Council. For example, in November 2016 the CEO and the Chief Investment Officer presented to the City Council about the investment program.

The City Council holds study sessions, in which no decisions are made, throughout the year about topics relevant to City business. The City Council held several study sessions about retirement costs in the past.

However, despite presentations between to the Council or to the Boards, the Council and the Boards do not hold public joint meetings in which members are presented the same information and can hear each other's discussions.

Retirement Boards and the City Council Should Meet in an Annual Study Session

Both the Retirement Boards and City officials have requested further information over the past year. In February, the Mayor formally requested this audit be performed to understand Retirement costs and retirement plans' performance. During the 2017 asset allocation process, one Board member requested that the City provide input about its risk tolerance. This resulted in the CEO requesting City staff to attend Retirement Board meetings to observe and provide insight during the asset allocation process. City staff informed the Boards that they may respond to the requests for information formally, but this response would require coordination between City departments and presumably review by the City Council.

The timing of requests for City input do not always allow for City staff to attend the meeting or to organize a message to convey to the Boards. City staff reported that short lead times led to difficulties in rearranging their schedules last minute and an inability to provide comprehensive feedback, particularly if communications would have to be approved by the City Council.

More Formalized Communications Are Common in Other Jurisdictions

Other jurisdictions have more formalized communication processes between the plan and the plan sponsor(s). Alameda County Employees' Retirement Association (ACERA) holds annual joint meetings with the Retirement Board and the Alameda County Board of Supervisors. The ACERA CEO has standing bi-monthly meetings with the County administrator and ACERA staff hold quarterly meetings with plan sponsors. Orange County Employees Retirement System (OCERS) has monthly meetings between staff and plan sponsors to keep them apprised of what is presented to the Board and to recap the decisions of the Board. Additionally, Orange County system's senior management meets annually with the executive teams of the plan sponsors to share what has happened with the system and to ask for input about how plan decisions affect plan sponsors.

An Annual Joint Study Session Would Enhance Communications

Improved communication between the Retirement Boards and the City Council could enable the Boards to make decisions with more complete information and provide the Council with better foresight regarding service level increases or staffing increases. In addition to the current presentations from Retirement staff to the City Council and requests for City staff to attend Retirement Board meetings, an annual meeting with the City Council and both Retirement Boards would allow these bodies to discuss issues and understand that challenges that each is facing. To facilitate the interactions between the City and the retirement plans, the first meeting could include a discussion regarding the roles and responsibilities of the City and the Boards.

Recommendation #7: The City Council and the two Retirement Boards should hold a joint annual study session to review topics relevant to all parties, such as:

a) forecasts for the City's expected revenue and budget,

b) City and employee retirement contribution rates,

c) actuarial assumptions of the retirement plans,

d) the plans' investment returns, and

e) the plans' funded status.

Formal Orientation for City Councilmembers and the Boards Would Facilitate Decision-Making

Though the Retirement Boards are independent in many ways from City governance, the City Council is responsible for appointing and reappointing Board members, approving the Retirement Services budget (see Finding 1), and approving the City's contributions to the retirement plans. In early 2015, when a number of Councilmembers were new to the Council, there were presentations about the retirement plans in study sessions. This type of orientation would be helpful for all new Councilmembers to help inform their decisions.

The Retirement CEO reports that he frequently offers to provide presentations to Councilmembers or hold meetings with Councilmembers upon request. Additionally, the Director of the Office of Employee Relations (OER) reports that she meets with new Councilmembers to brief them on the retirement plans.

On the other hand, Retirement Board members have asked for further information about the City's risk tolerance. Board members are oriented by Retirement Services staff but may not have the opportunity to learn about the City's fiscal health or City services from City staff members. Retirement Services staff report that they have recently updated the orientation materials provided to Board members.

Regular meetings between the Council and the Boards will ensure ongoing communication channels are opened, as recommended in Finding 1. For new Councilmembers and Board members, however, an annual study session may be held after they are responsible for making decisions about appointments, prefunding, asset allocation, or contribution rates. A formal orientation process, including presentations on the retirement plans and continuing to have one-on-one meetings with the Director of OER, would also enable new Councilmembers and Board members to have better informed participation in the annual study session discussions.

Recommendation #8: The City should structure a formal process to orient new City Councilmembers about the Retirement plans.

Recommendation #9: The Retirement Boards should structure a formal process to periodically orient Board members to the City's budget and service level solvency.

Presentations on the City's Budget

Information about the City's budget forecast, proposed and adopted budgets, and Mayor's budget messages are relevant to retirement plan decision-making. For example, knowing if the City expects to face a loss in revenue over the coming years would provide context as the Retirement Boards determine contribution rates and make investment decisions.

City staff have said that they have presented to the Retirement Boards about budgetary information as requested, and that the Boards reportedly found the information helpful. Reporting this information on a regular basis will increase Board awareness of the City's fiscal situation as the plan sponsor between the annual meetings as recommended in Finding 1.

Recommendation #10: The City as the plan sponsor should provide the Retirement Boards, on a regular basis, with relevant budget documents, such as the City's 5-year budget forecast, the Mayor's budget messages, and the City's proposed operating budget.

City Councilmembers Could Better Define the Role of the Nonvoting Board Member

Two City Councilmembers sit on the Retirement Boards as nonvoting Board members – one on each Board. The purpose and responsibilities of the Council representative are described in Municipal Code Section 2.08.170 as follows:

> *The council representative to the board of administration of federated city employees' retirement system [or the police and fire department retirement plan] serves to advise the city council of the background, attitudes and reasons behind decisions and recommendations of the board, and to advise the board of policies, procedures and decisions of the council that may bear on matters under discussion by the board.*
>
> *The council representative may attend the meetings of the board of administration of the federated city employees retirement plan [or the police and fire department retirement plan] and may fully participate with the voting members of the board in all matters pending before the board, with the exception of quasi-adjudicatory matters and closed sessions. The council representative shall be provided with a copy of the board's public agenda packet at the same time as agenda packets are distributed to board members, but shall not receive closed session material. The council representative shall have no power to vote on any matter pending before the board, nor shall the council representative be counted as a board member for the purpose of determining what constitutes a quorum of the board. The council representative shall receive no additional*

> *compensation for serving as a nonvoting member of the board. The council representative shall not identify or represent himself or herself as a member of the board of administration of the federated city employees retirement plan [or the police and fire department retirement plan] except in meetings of the city council and the board of administration of the federated city employees retirement plan [or the police and fire department retirement plan].*

In practice, there is no clear guidance as how the Council representative is to advise the City Council. In the past, the Council representative frequently reported on Retirement topics at City Council meetings. There is still a standing consent calendar item on the City Council's weekly agenda for a report by the City Council representative (generally item 2.6),[19] but it was used only once in the first six months of this year.

The Retirement Boards view the nonvoting Board member as a communication channel with the City. For example, the Police and Fire Plan's communication policy states: *"The Board shall provide timely public notice to the City Council and the city administration of relevant issues on the Board's agenda. Additional communications may be provided through the non-voting board member and spokespersons."* This communication channel is aided by consistent attendance at Board meetings and active engagement in discussions.

The Council representatives could be a more active conduit of information between the City Council and the Boards to open communication between these governing bodies. Structuring a more formal communication process, such as through periodically scheduled (perhaps monthly or quarterly) reports to the City Council and to the Retirement Boards, would clarify the role of the Council representatives as an active conduit of information. With these periodic reports, the Council representatives could provide to the Council written reports or copies of presentations provided to the Boards, such as the annual fee report, asset allocation changes, plan risk analysis, and analyses of assets and liabilities. Notification about any recent reports would provide the City Council the opportunity to see the information and hear a brief update from the representative about the Board discussions.

On the other hand, City operations and City Council discussions may be relevant for many Board decisions. A periodic report in which the City Council representatives briefly inform the Board about any recent Council discussions about relevant topics would be helpful to inform Board decisions in a timely manner. Similarly, relevant reports could be provided to the Boards, such as the 5-year budget

[19] The Council representatives ask for the item to be separated from the rest of the consent calendar if they have a report to give; otherwise, there is no discussion.

forecasts, the Mayor's budget message, and the adopted budgets. Topics could also include discussions regarding service levels, financial reports, or staffing changes.

Recommendation #11: The City Council should clarify their expectations of the Council representatives to the Retirement Boards, including the type of report and frequency of reporting that would be most useful to the Council.

Recommendation #12: The Retirement Boards should clarify their expectations of each Council representative, including the type and frequency of reporting that would be most useful to the Board.

Retirement Boards Should Provide Clearer Guidance on Communications with the City

The Boards' CEO charters describe the duties and responsibilities of the CEO, including Board governance, vendors, human resources, finance and accounting, and stakeholder communication. The stakeholder communication duties read:

> *Stakeholder Communications*
>
> *The CEO will support and advise the Board with respect to stakeholder communications. This shall include but is not limited to:*
>
> *a) Providing the Board with advice and recommendations in connection with all communication plans, policies, frameworks, and related decisions requiring Board approval or action.*
>
> *b) Implementing any communication-related policies, strategies, or initiatives.*
>
> *c) Keeping the Board informed of material communication issues and developments.*
>
> *As directed by the Board, the CEO will:*
>
> *a) Notify the City Council of any Board concerns with respect to positions on legislation at the state and federal level that relate to the retirement system, consistent with the process set out in Council Policy 0-4, Involvement in the Legislative Process.*
>
> *b) Provide the City Council with any recommendations of the Board concerning proposed ordinances amending the Police and Fire Department Retirement Plan [or Federated City Employees' Retirement System].*

The Boards also each have a communication policy that includes information about the Boards' approach to communicating with the City. Each policy states the Boards' intentions to keep the City informed about relevant activities and agenda items.

However, neither the policy nor the CEO charter provide specific guidance about what types of activities or items would require notification to the City beyond proposed ordinance changes and positions on state and federal legislation. In practice, however, the CEO does have other communications with the City. These include periodic meetings with the Mayor's Office staff, attendance at the City Manager's weekly senior staff meetings, and email communications with City staff. Some of these emails have been requests for staff attendance at meeting or requests for information and presentations. As noted previously, when requests are made, City staff report difficulties in providing comprehensive answers due to quick turnaround times.

To ensure that the Boards alert the City in a timely manner regarding action items of interest to the City, the Boards should work with City staff to determine what types of agenda items or Board decisions are appropriate to notify the City about. This should include a consideration about the time required for City staff or the City Council to provide input, if requested. Additionally, the Boards should provide further guidance to the CEO regarding their expectations of his communication with City staff.

Recommendation #13: To facilitate communication of relevant activities to the City, the Retirement Boards should:

a) Work with City staff to determine what types of activities or agenda items are appropriate to notify the City about in advance and update relevant charters and/or policies accordingly, and

b) Modify the CEO charter to clarify the CEO's role in communicating with the City.

The City Should Designate a Retirement Services Liaison

Retirement Services communicates with City staff from several departments, including: the Office of Employee Relations (OER), the City Attorney's Office, the City Manager's Budget Office, the Finance Department, and the Mayor's Office. Staff in all these departments and offices may be the best points of contact for Retirement Services, depending on the issue at hand.

However, designating a City staff member to be the liaison to Retirement Services would streamline some communications and may help with the timeliness of receiving and responding to Retirement Services' requests. A monthly meeting between the CEO of Retirement Services and a City staff liaison to discuss upcoming Board meeting topics, any issues the City would need to be aware of, and results of

previous discussions or requests would help keep the City aware of Retirement Services activities. Ongoing, regular meetings would also help Retirement Services communicate to the City of upcoming agenda items that the City should be notified about, as stated in Recommendation #13.

Currently, employees from OER attend Retirement Board meetings for agenda items relevant to OER proceedings. However, there is not necessarily a City staff member present for the entirety of Board meetings. The City staff liaison to Retirement Services should coordinate with current City staff meeting attendees to improve on current communication efforts.

Recommendation #14: The City Administration should designate a City staff member as the liaison to Retirement Services and provide guidelines for the liaison's role (e.g., monthly meetings with the Retirement CEO and attendance at Retirement Board meetings).

Centralizing Retirement Services' Performance Measure Reporting Could Better Communicate Performance, Workload, and Compliance

Retirement Services currently has three performance measures and four activity and workload highlights in the City's Operating Budget. These are:

1) Percent of active members that feel that Retirement Services had a positive impact on their ability to make decisions to achieve retirement goals;
2) Percent of portfolios analyzed for compliance with investment policy;
3) Percent of members (active and retired) that rate department services as very good or excellent based on accuracy and usefulness of work;
4) Number of active and retired members surveyed;
5) Number of portfolios analyzed annually;
6) Number of agendized Board meetings; and
7) Investment committee work plan projects.

Additionally, Retirement Services staff present comparisons to other pension plans of personnel services expenses and administrative costs as part of the budget presentations to the Boards. Additional reports and presentations to the Boards may include other measures of costs or workload. For example, a recent dashboard report to the Police and Fire Board included data on the cost of the City's retirement contributions compared to the City's budget. However, these measures are not presented in a central location to facilitate review of all programs within Retirement Services.

In the past, Retirement Services has reported on other measures in the City's operating budget. Prior to FY 2011-12, there were two other activity and workload highlights: "Number of portfolios" and "Administrative cost per $1 million of assets." There were also two additional performance measures: "Administrative cost of City plans compared to similar plans" and "Information needed by the Boards and members is delivered in the agreed upon time frame."

The City's operating budget document notes that Retirement Services discontinued the use of administrative cost comparisons because of variations in pension plans administrative cost reporting and difficulties in obtaining meaningful data. One limit on access to meaningful data is that Retirement Services does not currently track the timeliness of customer requests or questions. With the new software solution (discussed further in Finding 5), tracking of timeliness and workflow should be utilized.

Retirement Services Should Have Performance Measures Covering Range of Programs in Their Comprehensive Budget

In our opinion, Retirement Services should incorporate additional performance metrics on their full range of programs, including the investment program, into their comprehensive budgets (as recommended in Finding 1). The San Francisco Employees' Retirement System (SFERS) budget reports on investment returns through the measure "Return on investment ranking of 50th percentile or better among public pension plans with assets in excess of $1 billion, using 5-year average return." This information shows stakeholders how the plan is performing compared to peer plans.

Retirement Services' performance measures should cover the range of the Office's activities, including plan administration and the investment program. Possible performance measures to include in the retirement plans' budgets could be:

- customer service timeliness,
- administrative costs per plan member,
- ratio of active members to beneficiaries,
- funded status of each plan,
- the plan's 20-year actual rate of return,
- returns by asset class,
- annualized returns compared to policy benchmark and assumed rate of return,
- percent likelihood of portfolio meeting assumed rate of return,
- percent of quarters that portfolio met the target allocation within a set margin, and

- percent of investment managers who met or exceeded benchmark goals over the past four quarters.[20]

Retirement Services already tracks data for some of these performance measures, particularly for the investment program. However, the information is not all readily accessible to the City Council and other stakeholders, nor is it reported in a central location. For example, the annualized returns compared to policy benchmarks are in the consultant reports, but these reports are lengthy and may not be accessible to the lay reader.

By reporting measures of performance and workload for both member services and the investment program in the annual retirement plan budgets (see Finding 1), Retirement Services can better keep stakeholders informed about critical aspects of the retirement plans. To ensure the communication of performance and workload is effective, Retirement Services should provide the City Council and other stakeholders the opportunity to review and provide comment on the newly established performance measures.

Recommendation #15: The Retirement Boards should adopt a formal set of performance measures to be included in the retirement plans' budgets for both plan administration and the investment program. The Retirement Boards should provide the City Council with the opportunity to review and provide comment on the adopted performance measures.

[20] Though Retirement Services staff may use a longer time period to evaluate managers for actions such as probation or termination, presenting investment manager performance over four quarters enables continual monitoring and early reporting on potential problems.

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Finding 3 Formalizing Policies to Improve Oversight, Transparency, and Delegation of Investment Decisions

Summary

The Retirement Boards are tasked with deciding how to invest the plans' assets. The Boards delegate some responsibility for decision-making and implementation to various parties, such as the Board Investment Committees, internal investment staff, investment consultants, and investment managers. As of June 2017, the Federated plan had $2.23 billion in assets and the Police and Fire plan had $3.44 billion in assets – a total of $5.68 billion for both plans (preliminary data, including healthcare trusts). Actuarial analysis as of June 2016 reported that the Federated pension plan was 53.7 percent funded and the Police and Fire pension plan was 75.7 percent funded. Both the Police and Fire and Federated plans' ten-year annualized net investment returns were 3.2 percent as of June 30, 2017 (the calculation of net return will differ depending on the time period used). The 20-year assumed rate of return for both pension plans is 6.875 percent. Both plans have performed well below peer plans in recent years.

Like many other public plans nationwide, the retirement plans have increased investments in "alternative assets," which can be more complex and costly. As of Q1 2017, the retirement plans held a majority of assets in actively managed funds. A staff-developed report places total investment fees at $60.21 million for 2016. The retirement plans' current investment policies regarding fees do not contain explicit preferences and strategies for controlling fees, compared with leading practices. To provide guidance on fee preferences and strategies, Retirement Services should develop a comprehensive investment fee policy.

During the three-year period between 1st quarter 2014 and 1st quarter 2017, 41 percent of Federated's and 60 percent of Police and Fire's actively managed funds underperformed their quarterly benchmarks for at least 7 quarters. While Retirement Services redeemed or terminated some of those managers, the investment policies do not clearly define the process for evaluating manager performance. Retirement Services should update its investment policy to reflect existing process for evaluating managers and incorporate a more formal "watch list" for underperforming managers.

The retirement plans lack clarity on the definitions and delegation for certain investment decisions. Retirement Services has 10 authorized full time equivalent staff. While the Retirement Boards have discussed delegation of investment authorities, some items are still in need of clarification. We recommend the Retirement Boards clarify the different levels of investment decisions and which bodies have the authority to implement or approve them.

Finally, the Retirement Boards should periodically provide copies of the retirement plans' investment policies to the City Council.

Changes over Time in the Pension Plan Portfolios Have Led to Greater Investment in Complex, Expensive Assets

The retirement plans, including the healthcare trusts, consist of $5.68 billion in combined assets. The Federated plans make up $2.23 billion and the Police and Fire plans make up $3.44 billion. Each Retirement Board is tasked with deciding how to invest its plans' assets. This decision is called the strategic asset allocation, and it is considered the Boards' most important investment decision. The goal of an asset allocation is generally to meet both risk and return objectives, so that enough assets will be available long term to fund retirement benefits.

The Retirement Boards are also tasked with setting the assumed rate of return, or the discount rate.[21] For both plans, it is currently 6.875 percent. When developing the asset allocation, the Boards take their assumed rate of return into consideration.

Both Plans' Ten-Year Annualized Net Investment Returns Were 3.2 Percent, Below Their Policy Benchmarks

Over the past decade, many public plans increasingly diversified their portfolios – investing more in *alternative assets*,[22] often as part of an effort to meet return assumptions. Some plans also sought alternative investments that were less correlated with the stock market, after suffering significant losses during the 2008 financial crisis. It is in this context that the Retirement Boards engaged in a diversification effort for the plans during the past decade. This process has affected actual investment performance since then.

The retirement plans have experienced fluctuating investment returns over the past several years, including net losses on investments totaling over $120 million for all plans[23] in FY 2014-15 and FY 2015-16. As of the end of FY 2016-17, the Police and Fire plan's ten-year annualized net investment return was 3.2 percent, and the Federated plan's ten-year annualized net investment return was also 3.2 percent. This compares to policy benchmark returns[24] of 3.7 percent for the Police and Fire

[21] The annual rate used to discount pensions expected to be paid in the future to current dollars. For pension plans, it is often based on expected investment returns.

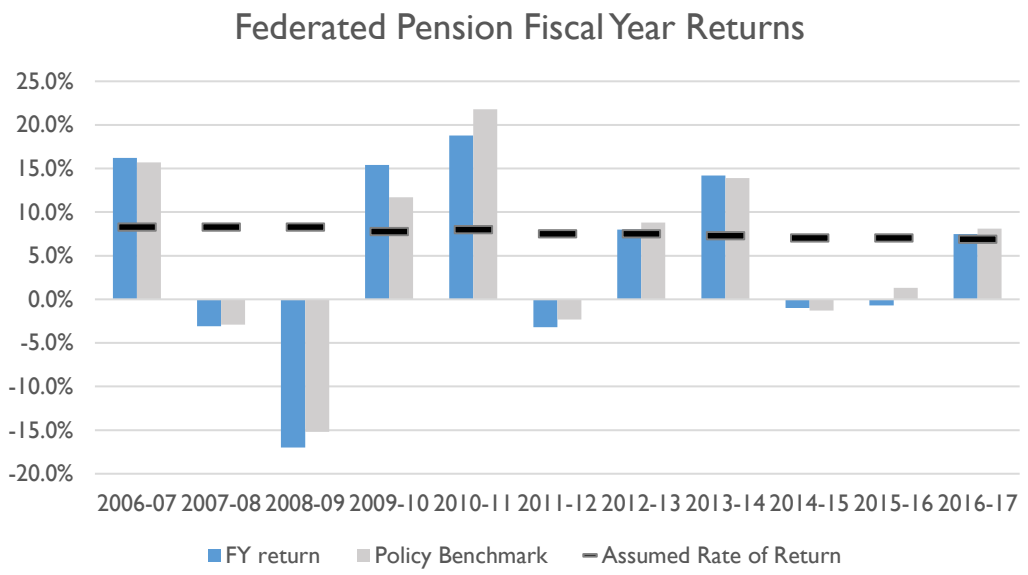
[22] Alternatives (alternative assets; alternative investments) are a broad category of investments outside of traditional equities (stocks) or fixed income (bonds or credit). They often include real assets (e.g., commodities, real estate), private market funds, and hedge funds. Alternatives are considered more complex and expensive than traditional assets.

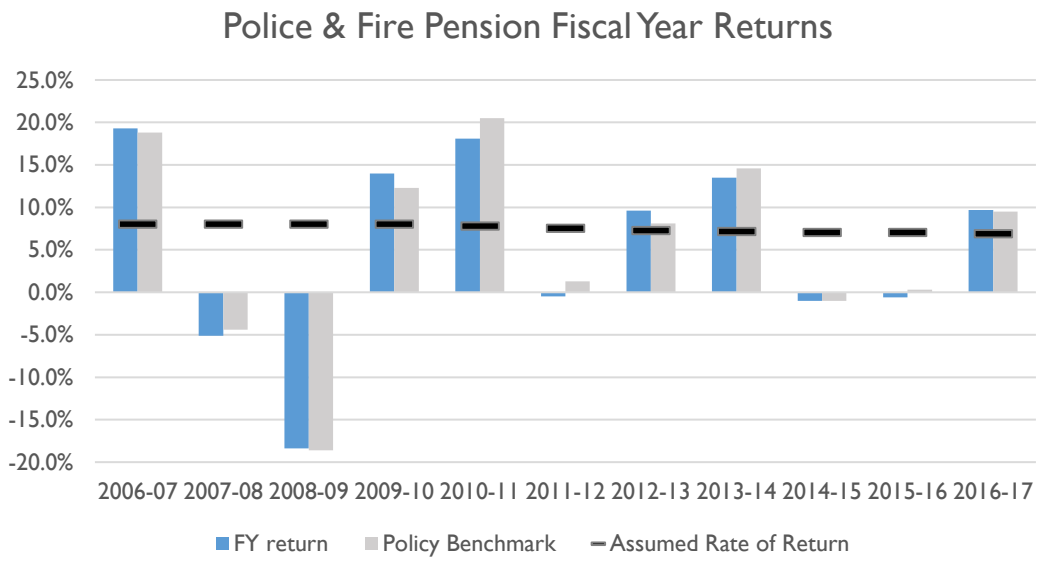
[23] Pension and healthcare plans

[24] Portfolio returns are generally measured against benchmarks, such as a broad market index. The pension and healthcare plans use "policy benchmarks" composed of a mix of market indexes, weighted according to their target asset allocations. Each asset class, asset sub-class, and investment manager is held to its own benchmark, depending on the nature of the investment. Investment manager benchmarks are usually specified beforehand in their respective investment manager agreements.

plan and 3.9 percent for the Federated plan for that ten-year period. The assumed rate of return of 6.875 percent is based on a 20-year time horizon.[25]

Exhibit 7: The Retirement Plans Have Experienced Fluctuating Investment Returns[26]





Source: Retirement Services CAFRs

[25] As of June 30, 2017, the plans' investment consultant does not report 20-year net returns. The investment consultant does report returns since inception. As of June 30, 2017 these are 6.7 percent for Federated (since Jan. 1994) and 8.5 percent for Police and Fire (since Mar. 1971).

[26] Plan returns for FY 2006-07 and FY 2007-08 are gross of fees; otherwise returns are shown net of fees. FY 2016-17 returns for both plans come from preliminary CAFR data as of October 3, 2017 (Police and Fire) and October 4, 2017 (Federated).

Investment returns have critical impacts on the City's contribution rates going forward, the employee contributions (particularly for Tier 2 employees),[27] and the overall funded status of the plans. As described in the background, the Federated pension plan is 53.7 percent funded and the Police and Fire pension plan is 75.7 percent funded. However, it is helpful to view investment returns compared to benchmarks and to peer plans to provide greater context. For example, in FY 2008-09, negative investment returns would not be surprising in comparison to stock market returns overall.

The Retirement Plans' Investment Performance Ranks Well Below Peer Plans

The retirement plans have persistently underperformed peer plans in recent years. The investment consultants use databases containing investment returns, and other data, for public pension plans with assets over $1 billion.

Exhibit 8: Retirement Plans' 5-Year Investment Returns Rank Well Below Peer Plans[28]

Fiscal Year	Federated Pension (rank/*quartile*)	Police & Fire Pension (rank/*quartile*)
2011-12	*3rd quartile*	72 of 100
2012-13	*4th quartile*	83 of 100
2013-14	*4th quartile*	84 of 100
2014-15	*4th quartile*	96 of 100
2015-16	99 of 100	96 of 100
2016-17	94 of 100	94 of 100

Source: Investment consultant performance reports

It should be noted that underperformance of key benchmarks was cited in the Mayor's audit request as a reason for initiating this review. As discussed in a later section, the retirement plans' investment managers have also underperformed their benchmarks in recent years.

[27] Tier 2 employees are responsible for paying up to 50 percent of the unfunded liability. Per the City Charter, "in the event an unfunded liability is determined to exist, employees will contribute toward the unfunded liability in increasing increments of 0.33% per year, with the City paying the balance of the unfunded liability, until such time that the unfunded liability is shared 50/50 between the employer and employee."

[28] The plans' general investment consultant did not report a percentile ranking for the Federated plan prior to 2015-16, but reported the quartile returns. Quartiles are listed where a ranking was not available. In the consultants' universe rankings, "1" represents the 1st percentile, or the highest ranking. Rankings based on gross returns for all plans.

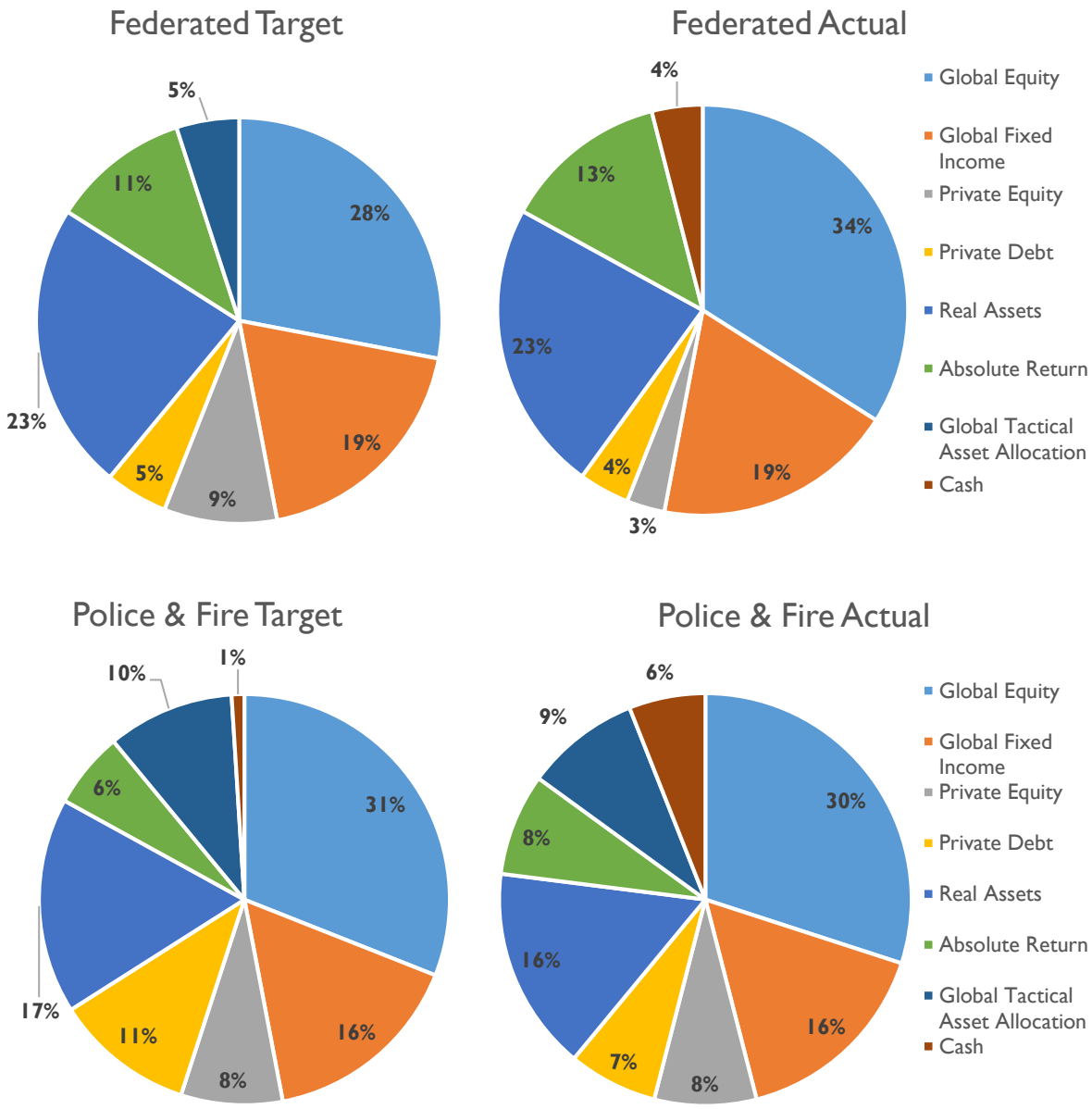
The Plans' Asset Allocations Have Shifted Dramatically Over the Last Ten Years

The target asset allocation determines how retirement plan assets will be invested by type of investment (i.e., by asset classes). The Retirement Services CAFRs, as of FY 2016-17, list 8 different asset classes for each plan: global equities, global fixed income, private equity, private debt, real assets, absolute return, global tactical asset allocation, and cash.

Target Versus Actual Allocations

While the Boards adopt target asset allocations, the actual asset allocation at a given time may differ somewhat for various reasons, including changes in the market. The target and actual asset allocations as of June 30, 2017 for the pension plans are as follows:

Exhibit 9: The Retirement Plans Invest in a Variety of Asset Classes, as of June 30, 2017



Source: Federated and Police and Fire CAFRs

The retirement plans' asset allocations (both target and actual) have changed over time. A growing portion of investments are in alternatives, while the plans have fewer investments in fixed income and public equities than ten years ago.[29] As mentioned previously, this is in line with a nationwide trend among public plans to invest more in alternatives.

A Growing Allocation to Alternative Investments

Between 2005 and 2015, the allocation to alternatives among public plans increased from 9 percent to 24 percent.[30] By comparison, the Federated pension plan increased its alternatives allocation from 6 percent to 43 percent between fiscal years 2006-07 and 2016-17.[31] During the same period, the Police and Fire pension plan increased its alternatives allocation from 9 percent to 48 percent. Alternatives have gained notoriety in recent years for being generally obscure, illiquid, and costly. While this is often the case, alternatives can also include mutual funds which use some alternative strategies and investments, such as with global tactical asset allocation funds.

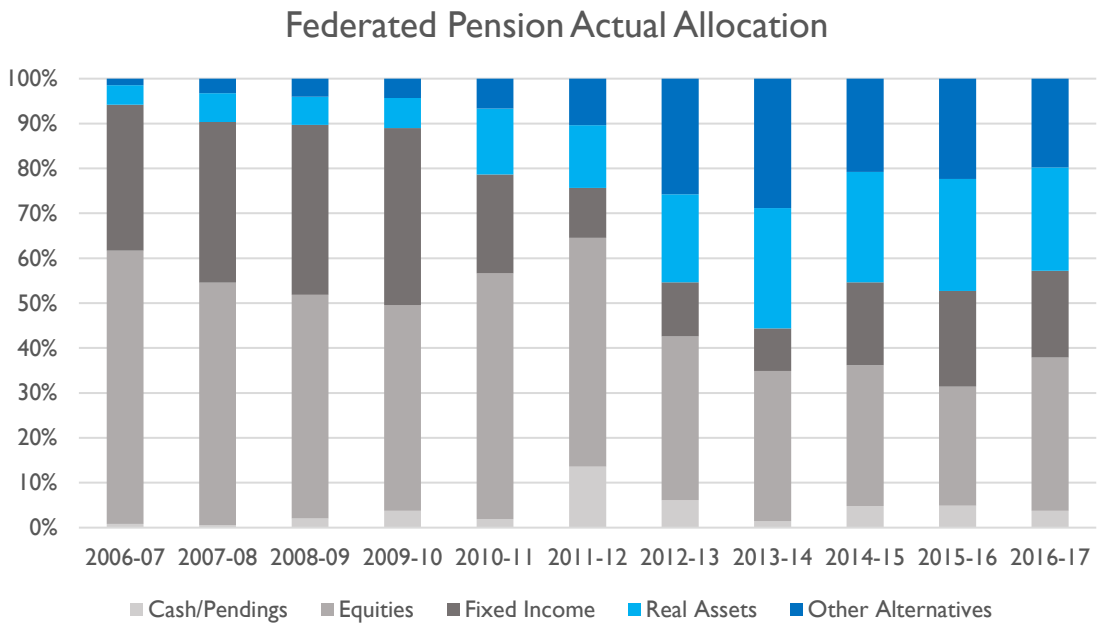
Over time, Retirement Services has used different names or definitions for different asset classes. For simplicity, the asset classes have been placed into four general categories: equities, fixed income, real assets, and other alternatives. Exhibit 10 shows how the pension plans' actual asset allocations have changed over the last eleven years.

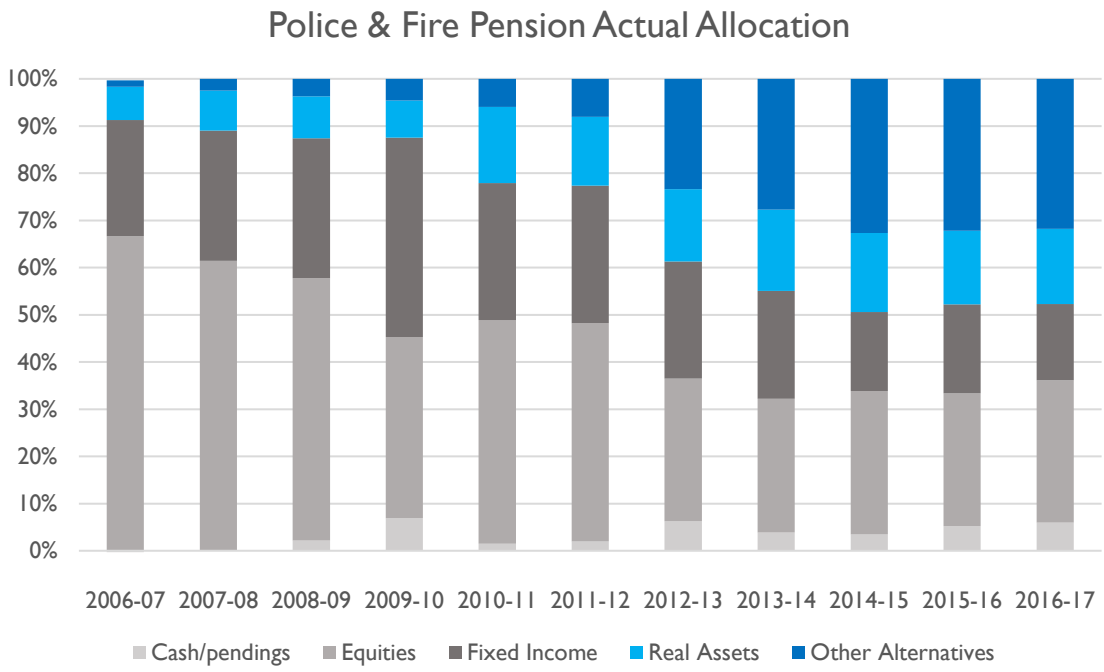
[29] For reference, see Appendix E for each plan's largest disclosable stock holdings over time.

[30] Center for Retirement Research, July 2017. Alternatives defined as investments which are "not traditional stocks, bonds, and cash – held directly or in mutual funds." The report specifically looked at private equity, hedge funds, commodities, and real estate.

[31] Calculated based on actual asset allocations for each plan from Retirement Services CAFRs. Alternatives defined for this report to include the following asset classes: private equity, private debt, real assets, absolute return, and global tactical asset allocation (GTAA). The alternatives allocations for both plans do not include equity or credit hedge funds, which are contained within the plans' respective global equity and global fixed income asset classes.

Exhibit 10: The Retirement Plans Have Increased Investments in Alternative Assets Over Time[32]





Source: Federated and Police and Fire CAFRs

[32] "Cash/pendings" includes the net sum of categories labeled "short-term" and "pendings" in the CAFR investment summaries. This sum is negative in some fiscal years.

With Increasingly Complex and Expensive Investments, Retirement Services Should Develop a Comprehensive Fee Policy

In 2017, Retirement Services investment staff prepared two reports on total investment fees for calendar year 2016 – one report for each system. The intention was to capture the fees normally deducted from investment income, or net investment returns. This includes performance fees, which staff refer to as incentive fees. Retirement Services issued their first such fee reports in 2016, for calendar year 2015. The retirement plans are among the few public plans to have a report disclosing performance fees or other indirect investment fees. CalPERS and Orange County (OCERS) have undergone efforts to fully disclose investment fees.

Different Fund Types and Fee Structures

Based on the asset allocation, Retirement Services contracts with external fund managers to invest the plans' assets. The fund managers can be categorized into four broad fund types, or strategies: passive, active, hedge, and private. Retirement Services describes the fund types as follows:

> ***Passive management*** *strategies are those strategies that are intended to generate a return that emulates a passive index.* ***Active strategies*** *are those strategies where investment managers make specific investments in an attempt to outperform an index.* ***Hedged strategies*** *refer to those strategies where long and short investments are employed. Hedged strategies generally seek to achieve an absolute return ("alpha") in all market environments regardless of market returns ("beta").* ***Private strategies*** *are those strategies which employ managers who utilize a diverse set of approaches to invest directly in non-exchange listed companies or to take listed companies private. Private strategies also include managers who invest in the credit of companies or provide loans to companies and invest in non-exchange listed real estate.*[33]

Each asset class can be invested in one or several fund types. For example, public equities could be invested entirely in passive funds or could be distributed among passive, active, or hedge funds. The same is true for fixed income and real assets – the latter can also be invested in private market funds.

The different fund types generally have different fee structures. **Passive funds** charge fees as a percentage of assets under management.[34] These are called

[33] 2015 Annual Fee Reports, emphasis added.

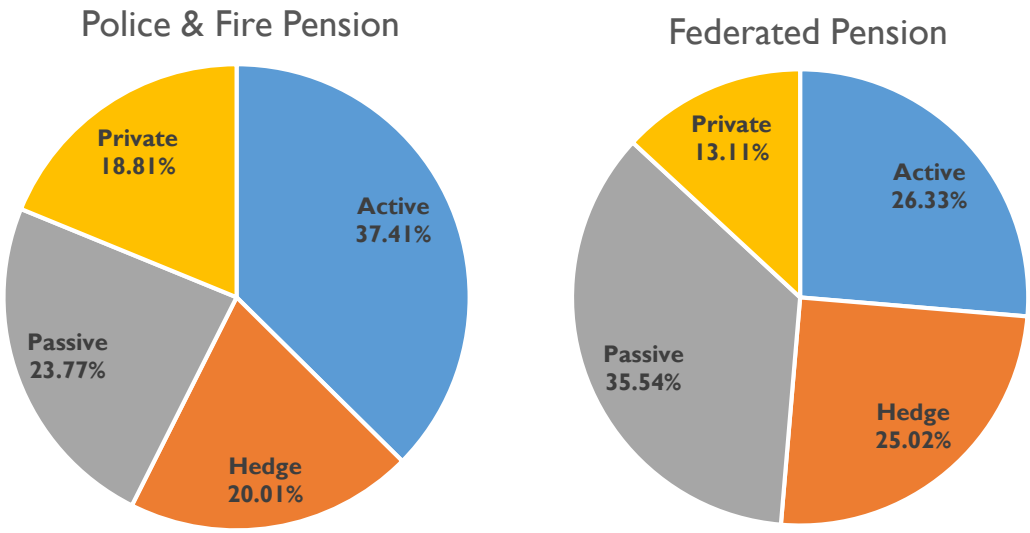
[34] Assets under management is the total market value of assets the firm manages on behalf of all its clients. Management fees are determined by the total market value of assets an investment management firm manages on behalf of a single client or investor.

management fees. **Active funds** usually charge higher management fees than passive funds. **Hedge funds** charge a management fee that is generally higher than what active funds charge, as well as a performance fee. The performance fee is calculated as a percentage of net profits, or the return exceeding a benchmark return. For example, a typical hedge fund fee structure is the "2-and-20," or 2 percent of assets under management and 20 percent of net profits. Private market funds use a similar fee structure as hedge funds. Because of this, private market and hedge funds tend to be more expensive than traditional active or passive funds.[35]

A Majority of Assets in Actively Managed Funds

As of the 1st quarter of 2017, assets for the Federated pension plan and the Police and Fire pension plan were distributed as follows:

Exhibit 11: Retirement Plans Have the Majority of Assets in Actively Managed Funds, as of Q1 2017[36]



Source: State Street performance data

Retirement Services staff compiled total management and performance fees paid for the year by asset class and by fund type. Staff used a combination of invoices and custom reporting templates for fund managers to capture as much information as was available. The fee totals gathered in this process represent an approximation to actual paid totals. It can be difficult to account for total fees paid when it comes to

[35] Hedge funds and private market funds are, by default, types of "actively managed funds."

[36] Total market value as of Q1 2017 was $2.0 billion for Federated and $3.3 billion for Police and Fire. The charts in Exhibit 11 total to $1.8 billion for Federated and $3.1 billion for Police and Fire. These totals do not include manager transition accounts, terminated manger accounts, currency hedging accounts, or overlay accounts.

private market funds and hedge funds since performance fees tend to be subtracted from the fund's investment income.

Retirement Services Staff Estimated $60.21 Million in Investment Fees

According to Retirement Services staff's calculations, the Federated pension paid out $16.25 million in management fees and $4.9 million in incentive fees. The Police and Fire pension paid out $28.72 million in management fees and $9.5 million in incentive fees. This makes a total of $59.37 million in fees paid out for both pensions. Adding the fees associated with the healthcare plans, the total fees for 2016 were $60.21 million.

These are the total fees for each retirement plan broken down by fund type:

Exhibit 12: Hedge Funds Had the Highest Total Fees for Both Plans in 2016[37]

Fund Type	Federated	Police & Fire	Total
Passive	$ 771,000	$ 764,000	$ 1,535,000
Active	$ 2,817,000	$ 8,270,000	$ 11,087,000
Hedge	$ 11,921,000	$ 17,500,000	$ 29,421,000
Private	$ 6,290,000	$ 11,900,000	$ 18,190,000
Total	**$ 21,850,000**	**$ 38,355,000**	**$ 60,205,000**

Source: Federated and Police and Fire 2016 Fee Reports (totals may not add due to rounding).

Investment Fees Totaled 1.07 Percent of Assets for Federated and 1.21 Percent for Police and Fire

The *average balance*[38] in 2016 for the Federated pension was $1.99 billion and for the Police and Fire pension was $3.15 billion. Total investment fees (calculated on the average balance) were 1.07 percent of assets for Federated and 1.21 percent for Police and Fire.

The 2016 1-year net return for the Federated pension was 6.3 percent and for the Police and Fire pension was 6.2 percent. This compares to policy benchmark returns of 8.0 percent for Federated and 7.4 percent for Police and Fire. The overall fund

[37] Staff stated in the report that numbers may not match totals due to rounding

[38] Per the fee report, average monthly balances were provided by the custodian bank.

policy benchmark returns are a combination of the benchmark goals for each asset class, net of fees.

New Legislation Will Impact Public Plan Fee Disclosure

Assembly Bill 2833 was signed into California law on September 14, 2016 as Section 7514.7 of the California Government Code. It was intended to increase transparency of private equity fees for public investment funds, and was later expanded to include fees for all investments in "alternative investment vehicles." The law defines alternative investments to include private equity funds, venture funds, hedge funds, and absolute return funds. Section 7514.7 requires every public investment fund's alternative investment vehicles to make certain annual disclosures, particularly regarding their share of net profits (i.e., performance fees).

The fee reports compiled by Retirement Services investment staff capture some of the required disclosures implied by this legislation, particularly in relation to management and performance fees. However, Retirement Services staff have suggested that the new legislation's requirements are stricter than what was requested from the plans' fund managers for creating the fee reports. This may potentially enable Retirement Services to collect complete fee data more easily in the future.

Retirement Services Policies on Investment Fees Could Be More Comprehensive

A detailed investment fee policy communicates to staff, investment managers, and stakeholders the Boards' preferences on the use and structure of investment fees. The Government Finance Officers Association (GFOA) developed a set of recommendations for public pensions to design an investment fee policy – shown in Appendix D. The retirement plans currently do not have fee policies as comprehensive as GFOA guidance or as the Orange County Employees Retirement System's (Orange County) Investment Fee Policy. More comprehensive fee guidance would increase the transparency of investment decisions.

Retirement Services Investment Policies

Per the Board of Administration policies, each Retirement Board will "approve a Statement of Investment Policy and all other material investment policies of the Plan." The Boards adopted Investment Policy Statements for each plan, which were most recently updated in 2017. The policies each contain different language regarding investment costs. The Federated policy's "Investment Costs" section states the intention of the Boards to control investment costs. It includes as examples that "professional fees will be negotiated" and "where appropriate, passive portfolios will be used to minimize management fees."

The "Investment Costs" section for the Police and Fire policy also states an intention to control costs, and includes a consideration for management and performance fees, as well as administrative expenses, when deciding the plan's asset allocation. A footnote calls out for monitoring the costs of alternative investments. Both the Federated and Police and Fire Investment Policy Statements specify that the Boards will receive annual reports of the plans' investment expenses.

The Investment Committee Charter and the CIO Charter also contain language regarding investment costs. The Investment Committee is responsible for monitoring "all material aspects of the investment program," which includes the "cost effectiveness of the investment program including portfolio transitions." Likewise, the Chief Investment Officer is responsible for monitoring "the cost-effectiveness of the Fund."

The Government Finance Officers Association Recommends a Robust Investment Fee Policy

The GFOA recommends more robust fee policies for public plans, citing the trend toward greater investments in alternative assets (see Appendix D). In practice, Retirement Services staff follow some of these recommendations. For example, we found Retirement Services **does** include *most favored nations clauses*[39] in their contracts, and staff **do** receive some assistance from consultants in determining if fees compare to peers. This is in line with part of GFOA's recommendation, but these practices are not currently written into the retirement plans' investment policies.

Authority to Negotiate Fees

The GFOA also recommends investment fee policies include explicit delegation of authority for negotiating fees. In the case of the retirement plans' policies, it is not clear which party is primarily responsible for the negotiation of professional fees. According to a review of investment staff processes by the plans' absolute return consultant, a staff person (the "Deal Lead") leads the step involving preliminary negotiation of fees. Other staff, investment consultants, legal counsel, and the Chief Investment Officer play a supporting role in this step. However, current policy would suggest the Chief Investment Officer, Investment Committees, or the Boards could be responsible for fee negotiation.

Fee Structures

Unlike Federated, the Police and Fire policy directly mentions types of fees, such as performance fees, and a footnote specifically calls out alternative investments. However, GFOA recommendations suggest, when dealing with alternatives, the

[39] A most favored nation clause is a provision in a contract where the seller agrees to provide the buyer with the best terms it provides to other buyers. In this case, the investment manager agrees to provide the investor with the best terms it provides to its other investors.

policies contain preferences for certain fee structures, particularly during manager selection. One example is stating a preference for performance fees with a hard hurdle.[40] The Police and Fire policy only suggests the different fee structures will be considered when deciding the asset allocation. The Federated plan is also heavily invested in alternatives, but its policy does not address this type of investment with regards to costs.

Also, given similarities in asset allocation between the two plans, as well as the sharing of staff and consultant resources, it may make sense to have consistent "investment costs" sections in each plan's policy.

The Orange County Employee Retirement System's Investment Fee Policy

The Orange County Employees Retirement System is one of the few retirement systems besides San José's that developed some form of comprehensive fee study. Apart from this, the Orange County's retirement board has adopted an Investment Fee Policy that provides guidelines on managing investment fee expenses. The GFOA used the Orange County fee policy as a reference for its own recommendations. It is a multi-page document that contains an organizational philosophy on the importance of controlling fees,[41] an explicit set of preferences for certain fee structures, responsibilities for the chief investment officer and investment staff, roles for the investment consultants in controlling fees, and even expectations for prospective and incumbent investment managers for controlling fees. While Orange County's Investment Policy Statement, like the San José plans, also contains a short section on investment costs, their Investment Fee Policy supplements this by elaborating on the strategies, preferences and leading practices Orange County intends to use in controlling against excessive investment fees.

The "Administration and Accountability" section of the policy provides some detail on the CIO's responsibility to administer fees. For example, "fees for investment-related services shall be negotiated by the Chief Investment Officer (CIO) with appropriate staff and legal support." It is made clear who is primarily responsible for negotiating investment fees, and who provides support.

Per the policy, other CIO responsibilities include scheduling "an annual fee-review study session with the Committee," which includes reviewing "the prevailing fee

[40] A hurdle rate is a benchmark return which a fund must meet before it can charge performance fees. A "hard" hurdle indicates that a fund can only charge performance fees on the return in excess of the hurdle rate.

[41] The objectives of the policy are as follows: 1) "reducing the costs of investment operations to the lowest sustainable level available in competitive markets for top investment managers;" 2) "aligning the interests of OCERS and its stakeholders with the selected investment management firms we retain, as well as their key professionals who manage our portfolios and provide superior research;" 3) "securing the best available combination of skill, performance expectations, risk and cost for a given investment discipline;" and 4) "minimizing potential appearances of excessive fees to address the optics of public-sector investment funds that operate in a highly transparent community."

structures of incumbent managers." It should be noted that Orange County's fee report also calculates fees by individual investment managers.

There are also sections outlining duties for the investment consultants and the "Fee Review Process," with expectations for both staff and consultants. As part of this process, "prospective managers shall be given a copy of (or excerpts from) the Orange County fee policy and such further guidance regarding preferred fee structures as the CIO shall deem appropriate." This implies that the fee policy may be considered a guideline document for prospective investment managers as well.

The Orange County fee policy also contains a section titled "Preferences on Fees." It provides a list of potential features of a prospective manager's fee structure that would be considered favorable. Some items specifically address performance fees, including an explicit preference for performance fees over fixed fees and potential controls on performance fees, such as hurdle rates, clawbacks,[42] caps, and high-water marks.[43]

There is an additional appendix attached to the fee policy elaborating on "Performance-fee Hurdles." It focuses on investment managers in alternative assets, which the policy defines to include hedge funds and other managers that use performance fees.

Retirement Services Should Adopt a More Comprehensive Fee Policy

The GFOA considers the use of an Investment Fee Policy as a best practice and offers recommendations for what to include when drafting one. The GFOA states this is especially important for public plans with increasing investments in alternative assets, as is the case for both San José plans. An Investment Fee Policy can serve to increase transparency for San José's retirement plans by providing to stakeholders and prospective fund managers, as well as staff and trustees, a clear set of objectives, strategies, and preferences employed for the management of investment fees, including those of alternative investments.

In particular, the fee policies should include clear and specific delegation of responsibilities for implementing cost controls, such as a fee negotiation. Such policies should include a reasonably detailed set of preferences for certain fee structures, and certain features within fee structures (e.g., hurdles, high water marks). Preferences should be addressed for traditional assets as well as alternatives.

[42] A "clawback provision" allows the investor the right to reclaim some performance-based fees from the manager if later investment losses lead to the manager holding too high a share of the fund's profits.

[43] A high water mark is the highest value reached by an investment fund since inception. Funds using a high water mark can only begin charging performance fees if the fund surpasses the high water mark value.

Recommendation #16: The Retirement Boards should incorporate in their respective Investment Policy Statements, or establish in a separate document, more comprehensive guidance in line with the Government Finance Officers Association's recommendations on fee policies for public plans, containing at least the following:

a) **Delegation of responsibility to negotiate, monitor, and report on fees;**

b) **The respective roles of trustees, staff, consultants, and investment managers in controlling fees;**

c) **Strategies that will be employed to seek the lowest reasonable fees in traditional asset classes; and**

d) **Strategies that will be employed to ensure the plans are not paying excessive fees for alternative assets.**

The Retirement Plans Lack Specific Policies Regarding the Process for Monitoring Investment Manager Performance

As described earlier, Retirement Services contracts with external fund managers[44] to invest the plans' assets. There is currently no direct investment performed internally by department staff. Internal investment staff are tasked with implementing board investment policies, providing recommendations, and conducting manager due diligence.[45]

The Plans Are Invested in Almost 100 Unique Funds

As of the quarter ending March 31, 2017, the Federated pension plan was invested in 56 investment funds, and the Police and Fire pension plan was invested in 81 investment funds. As a cost-saving measure, both pensions sometimes contract with the same fund managers, so there are 38 investment funds in common between the two pension plans. This makes 99 total unique funds across the two pension plans.

Of these investment funds, the Federated pension plan was invested in 20 hedge funds, 19 private funds, 8 traditional active funds, and 9 passive funds. The Police and Fire pension plan was invested in 23 hedge funds, 38 private market funds, 15 traditional active funds, and 5 passive funds. The number of funds in each fund type does not necessarily indicate the amount of plan assets invested in each fund type.

[44] Also *investment managers;* include external private companies that manage public or privately traded assets, transition managers, hedge fund managers, and fund-of-funds managers.

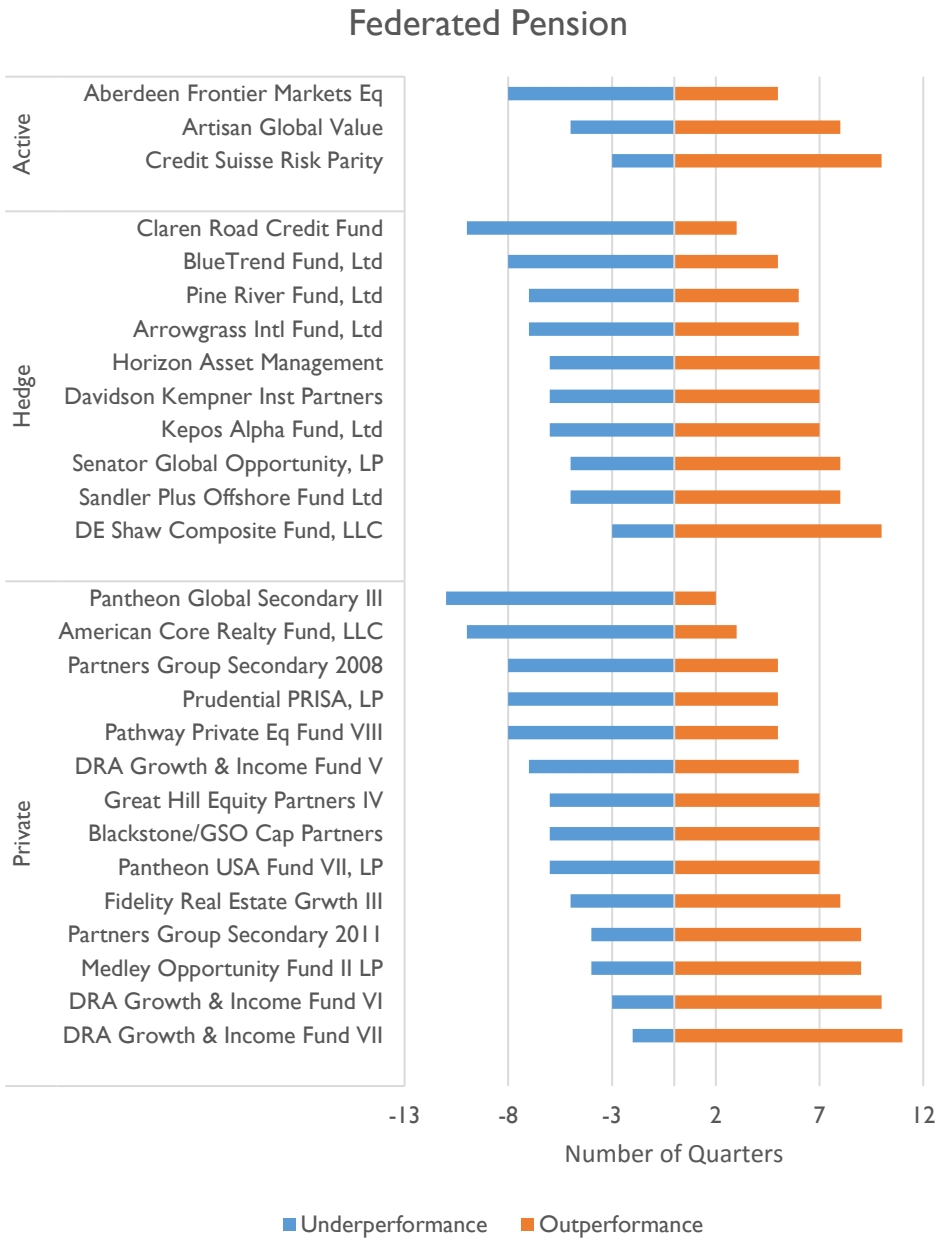
[45] Manager due diligence pertains to the selection and recommendation of fund managers, subsequent contract negotiations, general monitoring of funds including performance, and resolution of any conflicts which arise (including redemptions or terminations)

Actively Managed Funds Underperformed Their Quarterly Benchmarks

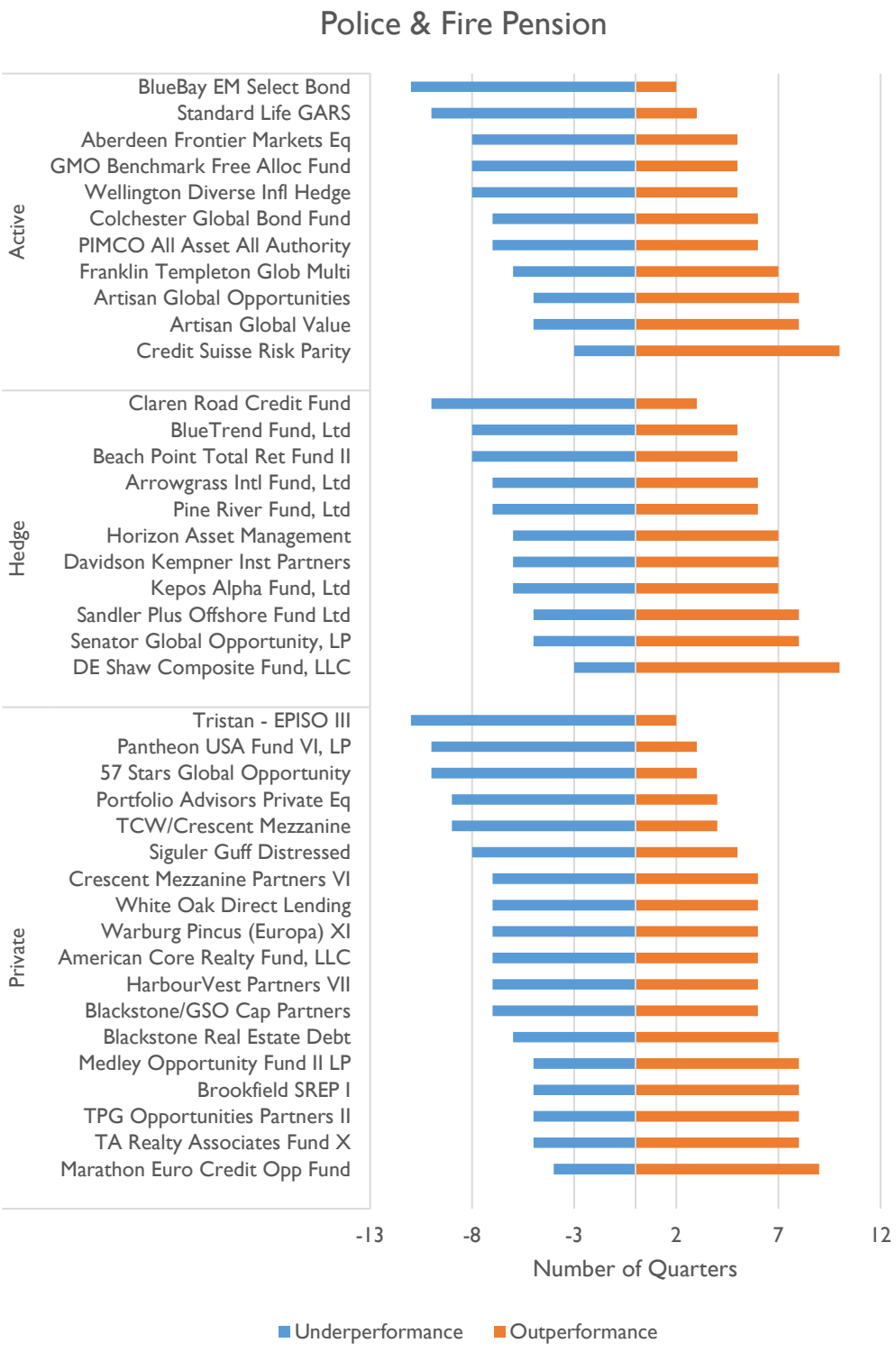
Over the 13-quarter period covering Q1 2014 through Q1 2017, based on performance data calculated by the plans' custodian bank, 41 percent of Federated's and 60 percent of Police and Fire's actively managed funds (including private and hedge) underperformed their quarterly benchmarks in at least 7 out of the 13 quarters. For both funds combined, this constituted a majority of fund managers.[46]

[46] This averages to 52 percent of actively managed funds for both plans combined.

Exhibit 13: As of March 31, 2017, 41 Percent of Federated and 60 Percent of Police and Fire Pension Plan Actively Managed Funds Underperformed Quarterly Benchmarks in at Least 7 of Prior 13 Quarters[47]



[47] This analysis only includes pension plan funds which had quarterly return data for all 13 quarters, and it does not include any passively managed funds. The 3-year period between 2014 and 2017 was chosen because the average tenure of all funds for each pension plan was less than 4 years. Also due to this, quarterly returns were available for a greater number of the funds analyzed than rolling 1-year returns or rolling returns on greater time horizons. Fund managers are generally evaluated on longer time horizons. Private market funds generally require much longer time horizons from inception to evaluate, often more than 5 years. As noted later, some underperforming funds in these charts have already been redeemed or terminated.



Source: Custodian bank performance data, provided by investment staff

Persistent Underperformance Indicates a Formal "Watch List" May Be Necessary

Retirement Services investment staff, who perform much of the manager due diligence work, have redeemed assets from or terminated some of the most underperforming managers in Exhibit 13.[48] Nonetheless, the 27 Federated funds shown in Exhibit 13 above represented $726 million, or 36 percent, of plan assets as of Q1 2017. The 40 Police and Fire funds shown represented $1.58 billion, or 48 percent, of plan assets as of Q1 2017.

From Q1 2014 through Q1 2017, of the Federated funds that were held for the entire period, 70 percent underperformed quarterly benchmarks for at least 3 consecutive quarters. In the same period, of the Police and Fire funds that were held for the entire period, 78 percent underperformed quarterly benchmarks for at least 3 consecutive quarters.

Although quarterly benchmarks are not the ideal metric for evaluating investment managers, this consecutive underperformance suggests a more formal "watch list" may be necessary. Some funds[49] underperformed quarterly benchmarks for as many as 8 consecutive quarters in this same period.

One of the Plans' Consultants Conducted Review of Manager Due Diligence Processes

Prior to our audit the Retirement Boards asked one of their consultants to conduct reviews of the manager due diligence processes for the department's investment staff. These reviews were conducted between 2016 and 2017, covering staff processes for the absolute return program, as well as public and private market asset classes.

The reviews resulted in 14 recommendations for the absolute return process and 15 recommendations for both the public market and private market processes.

The reports summarized Retirement Services staff's current manager due diligence process in four main steps: evaluation of prospective managers, negotiation of contract terms, execution (i.e., actual transfer of funds to manager), and managing (i.e., monitoring, reporting, and resolving any issues).

For each step's stages, the report summarized the lead staff and supporting parties, resources available, and expected outputs or deliverables. According to interviews with staff, some of the recommendations by the consultant have been implemented.

[48] Based on interviews with staff, the reasons for terminating or redeeming from a fund are not necessarily based on performance, and they can include many factors, from organizational or personnel changes in the investment management firm, legal or compliance issues, significant changes in the fund's investment strategy or style, or anything about the investment management firm that may be considered a significant risk to plan assets.

[49] This includes some private market funds, which often require longer time horizons to properly evaluate.

Investment staff are currently working on completing other outstanding recommendations and formalizing internal manager due diligence procedures.

The Federated and Police and Fire Investment Policy Statements Lack a "Watch List" or Performance Criteria for Investment Managers

While the Investment Policy Statements have some guidance regarding the hiring, monitoring, and termination of investment managers, clearer performance criteria would improve the transparency of manager evaluation.

The 2017 Investment Policy Statements for the two plans each have sections titled "Hiring & Terminating Investment Managers" and "Monitoring Investment Managers." The section pertaining to hiring and terminating managers requires the preparation of staff-level procedures containing "additional criteria and processes" for manager due diligence. Retirement Services staff or consultants must provide reports to support recommendations for hiring or terminating managers. This section also delegates certain authorities to the Chief Investment Officer and the Investment Committees. For example, the Chief Investment Officer may terminate a manager without prior approval given potential "imminent impairment to assets." The Investment Committees have authority to hire or terminate managers under a certain threshold size of investments.[50]

The section regarding monitoring states that managers "will be monitored on an ongoing basis" and can be terminated "at any time due to performance or other developments." Regarding performance evaluation, the policy states the following:

> *Quarterly performance of investment managers will be measured and evaluated relative to appropriate long-term performance benchmark and objectives, though it is understood that investment managers will, from time to time, underperform their benchmarks and objectives. Persistent underperformance by an investment manager, however, will be viewed as the basis for an extraordinary review of that manager and the manager's potential termination.*

The monitoring section also lists some qualitative criteria that would lead to the "extraordinary review" mentioned above, including breach of contract terms, significant operational changes in the investment management firm, or regulatory compliance issues.

Performance Criteria for the "Extraordinary Review" Process Undefined

The above sections of the Investment Policy Statements are not clear on what performance criteria is being used for the various fund managers. For example, managers are understood to underperform benchmarks "from time to time," but

[50] For Federated, only authorizes terminating managers up to $50 million by unanimous vote; For Police and Fire, authorizes hiring *and* terminating of managers up to $75 million

"persistent underperformance" could lead to "an extraordinary review." There is not currently a definition or set of criteria to explain what persistent underperformance looks like, nor elaboration on what the extraordinary review process entails or which parties are responsible for conducting it.

According to the plans' Vendor Selection Policy, the Investment Committee is responsible for recommending the appointment or termination of an investment manager, and the Board makes a final decision. Staff and the investment consultant are responsible for conducting due diligence. However, as noted previously, the Investment Policy Statements state that staff and the investment consultant must provide recommendations to appoint or terminate an investment manager, with accompanying analysis. Further, said policies authorize the Chief Investment Officer to terminate an investment manager without an Investment Committee recommendation or Board approval under certain circumstances, including "uncharacteristic performance."

Many Benchmark Jurisdictions Specify an Investment Manager Watch List and Quantitative Performance Criteria as Part of Investment Policy

A number of benchmarked plans have investment policies which establish an investment manager "watch list," or a list of managers which require heightened due diligence. The policies also detail the process for placing a manager on a watch list, as well as the parties responsible for maintaining, monitoring, and acting upon the watch list. For these plans, there are specific quantitative criteria[51] for manager performance that would lead to being placed on a watch list. Exhibit 14 below summarizes the features of the watch lists and performance criteria for some of the benchmarked plans' investment policies, including the San José plans' for comparison.

[51] "Quantitative criteria" (for a watch list) is taken to mean a threshold or maximum length of time (i.e., number of quarters) an investment manager is allowed to underperform their benchmark of a certain time-horizon (e.g., rolling 3 years or 5 years) before being placed on the watch list. This differs from "qualitative criteria," which deal with the investment manager's operational, regulatory, or investment strategy issues, among others, that would be a cause for concern.

Exhibit 14: Both San José Plans' Policies Lack a Manager Watch List or Quantitative Performance Criteria, Compared to Benchmark Plans

System	Watch List?	Quantitative Criteria?
San José Police & Fire and Federated Plans	No; undefined "extraordinary review" process	No; only qualitative criteria listed for "extraordinary review"
Orange County (OCERS)	Yes; for public market funds[52]	Yes, for public market funds *Example*: Manager placed on watch if in bottom half of peer-universe, or below benchmark, over a rolling 3 years for 3 consecutive quarters
Alameda County (ACERA)	Yes; watch list and probation list for US Equities, International Equities, and Fixed Income managers	Yes; attached tables specify criteria by asset class *Example*: International equity managers are placed on watch list if returns below benchmark or peer ranking below median over rolling 5 years for 2 consecutive quarters
Los Angeles City	Yes; "Good Standing" and "On Watch" lists	Yes; includes tables for quantitative and qualitative criteria *Example*: Manager placed "On Watch" if returns below benchmark over rolling 3 years for 8 of 12 previous quarters

Each of the above benchmarked jurisdictions also include other nuances in their policies that that differ from one another. The Orange County system's policy provides separate termination procedures for hedge funds and private market funds, given that these funds may be more illiquid or have different risks associated with them. The Alameda County system's investment guidelines document describes their "Contract Review Process" for investment managers in detail, specifying the three stages for the process ("Watchlist," "Probation," and "Termination."); the steps leading up to initiation of the review and the recommendation for one of the stages; and which party carries out each step in this process. For the Los Angeles City system, the investment policy has tables for both quantitative and qualitative criteria. The quantitative criteria go beyond manager returns, and includes

[52] Orange County's policy specifies three categories of funds: 1) Publicly Traded Equities, Fixed Income and Commodities, Individually managed Real Estate and Timberland, Real Estate Securities and Open End Real Estate Commingled Funds; 2) Closed-End commingled funds (private equity, real estate, energy and diversified credit); and 3) Direct Hedge Funds, Global Asset Allocation Managers, Diversified Credit (Multi-Strategies), and other Investment Managers legally structured as hedge funds.

measurements such as tracking error[53] or the information ratio[54] to evaluate placement in the "On Watch" category.

The Need to Clarify San José Policies on Investment Manager Evaluation

Retirement Services investment staff have existing procedures for monitoring investment managers, which have been reviewed by one of their consultants. The Retirement Plans' Investment Policy Statements contain language specifying qualitative criteria for placing investment managers under "extraordinary review," but the extraordinary review process is not clearly defined. Further, there is no language on quantitative criteria for "persistent underperformance," or what kind of underperformance by investment managers would also trigger an extraordinary review.

In our opinion, the retirement plans' Investment Policy Statements should better reflect existing processes for investment manager evaluation, clearly define the "extraordinary review" process, and establish a formal "watch list" of underperforming managers. This would improve the transparency of the manager evaluation process and ensure that the process is formalized into policy.

Recommendation #17: The Retirement Boards should incorporate in their respective Investment Policy Statements a policy on investment manager evaluation that reflects existing manager due diligence process and procedures, and includes the following:

a) Defining the "extraordinary review" process;

b) Establishment of a "watch list" and/or "probationary status" for underperforming managers;

c) Process by which managers of concern are identified, placed under "extraordinary review," and given a final decision;

d) Quantitative criteria for underperformance which would trigger placement under "extraordinary review" and/or on a "watch list;"

e) Potential actions resulting from the "extraordinary review" process;

f) Delegation of authority for implementing each step in this process; and

g) As necessary, incorporating into the policy nuances of different asset classes or fund types.

[53] Measures the standard deviation of differences between actual returns and benchmark returns.

[54] The ratio of actual returns above a benchmark to the volatility of those returns. Used for measuring risk-adjusted return.

The Retirement Plans Lack Clarity on the Definitions and Delegation of Authority for Certain Investment Decisions

Retirement Services has made clarifications to some of the different levels of investment decision-making in the last few years. However, there remain discrepancies in their current policies and outstanding items in need of clarification. For example, as described later, there should be some formal definition for *tactical decisions*, how they are categorized, and which parties have discretion over these types of decisions.

The Investment Program Staff Has Grown Over the Last Few Years

The Retirement Services investment program consists of 10 budgeted FTE, including a Chief Investment Officer, Investment Officers, Investment Analysts, and Investment Operations staff. Currently, there are 3 vacancies, with an interim chief investment officer in place and one temporary operations staff. This compares to FY 2011-12, when the program budgeted for 11 FTE but had 7 vacancies, including the Chief Investment Officer and the Deputy Director of Investments.

For comparison to some benchmarked jurisdictions, Orange County (OCERS) budgeted 6 positions for investments, with plan assets valued at $12.9 billion.[55] San Bernardino County's system (SBCERA) budgeted 8 FTE for investments, with plan assets valued at $8.2 billion.[56] As noted previously, both San José plans were valued at $5.68 billion.

The investment program also uses three investment consultants: a general consultant, an absolute return consultant, and a risk consultant. The Federated and Police and Fire plans now share the same general consultant, whereas before 2017, they had separate consultants.

The Retirement Boards Engaged in Discussion on Investment Decision-making Authority Following Measure G

Following the passage of Measure G in 2014, the Chief Investment Officer and the Police and Fire Investment Committee engaged in discussion on how the investment program uses discretion, and the boundaries on its decision-making authority. According to a June 2015 memo from the Chief Investment Officer, Investment Program decisions are placed in two categories: "large scale tactical decisions" and "smaller scale tactical decisions."

[55] As of December 31, 2016

[56] As of June 30, 2016

The "large scale" decisions were described as including "multi-manager transitions and/or redeployment of over $100 million in Plan assets." The Chief Investment Officer noted that the Investment Committee approved all these decisions.

The memo defined "small scale" decisions as those not requiring conferral with the Investment Committee, on the basis that the CIO Charter authorizes the CIO to "administer the day-to-day operations of the Investment Program." Per the memo, these decisions fall into the following topics: "risk mitigation," "resizing of an existing approved manager," "reallocating among approved managers within sub asset classes," and "partial liquidations of managers for cash flow purposes." One example is with "risk mitigation," where the Chief Investment Officer described a case of redeeming some assets from a manager that had undergone significant operational changes.

The Retirement Boards Sought to Clarify Investment Discretion

Following the memo by the Chief Investment Officer, both Retirement Boards initiated a series of discussions and retreats regarding the governance structure of the retirement plan. The plans' fiduciary counsel gave a presentation titled "Who Decides? Clarifying Investment Discretion" to the Federated Investment Committee in October 2015, which sought to consolidate various governance documents and regulations, along with existing practices from other systems, to assist in the discussion of how to structure investment decision-making authorities. The same presentation was given at the September 2015 Police and Fire Investment Committee retreat. It found common elements in the governance structures of the two San José plans with other systems, including:

- *Board has ultimate authority over IPS [investment policy statement], asset allocation, policies, hiring/firing managers; many participate in manager due diligence*
- *Consultants selected by and report to the Board*
- *Investment Committee of Board, makes recommendations only*
- *Staff supports and reports; implements program; limited authority to rebalance within range; conduct manager due diligence*

One exception was that in San José the Investment Committee has additional limited $50 million or $75 million[57] authority to hire and/or terminate managers.

The presentation also defined the "areas needing clarification" for the Federated plan:

- *Increasing, decreasing existing allocations to managers, and under what circumstances*

[57] Only terminate managers up to $50 million for the Federated Investment Committee by unanimous vote; $75 million for the Police and Fire Investment Committee with authority to hire *and* terminate managers

- *Reallocating among managers within sub-class*
- *Liquidating positions to meet cash flow needs*
- *Risk monitoring and mitigation*
- *Cost administration*

Discussion Resulted in Some Delegation of Authority to the Chief Investment Officer

Following a Police and Fire Board retreat in March 2016, a series of discussions followed, concerning, among other governance topics, the delegation of investment authority to the Chief Investment Officer. These discussions resulted in an updated 2017 Investment Policy Statement for both the Federated and Police and Fire plans. The items incorporated into the Investment Policy Statements generally addressed the "areas needing clarification" from the fiduciary counsel's presentation and the Chief Investment Officer's June 2015 memo. There were 3 remaining actions items set to be "brought forward at a future date." They are as follows:

1. *Clarifies existing rebalancing language;*
2. *Delegates authority to the CIO to select/terminate managers below $50 million;*
3. *Delegates tactical authority to the CIO to overweight/underweight allocations to react to market forces within preapproved ranges, with later reporting to the IC;*
    a. *Requires deviations outside of those ranges have prior IC/Board approval.*

Despite the recent updates, the Investment Policy Statements still include language regarding "tactical allocation" without explicitly defining what "tactical allocation" entails, or which party has the authority to authorize tactical decisions.[58]

[58] For example, under the section "Rebalancing", the policy states the following: "The Retirement Plan will be rebalanced to tactical rather than long-term target allocation in circumstances where the Board of Trustees have approved a tactical allocation…" The need to "clarify existing rebalancing language" likely refers to this section of the policy, as "tactical allocation" appears nowhere else in the Investment Policy Statements. The implication from the current language is that the Board may approve a tactical allocation, and that the plan(s) will be rebalanced per that approved tactical allocation. The word "tactical" does appear once more in the "Investment Philosophy" section of the policy as follows: "The Investment Program seeks to add value over time through careful selection of active and passive investment managers as well as tactically adjusting portfolio risk factor exposures." However, there is no clarification in the policy on the differences between "tactical allocation" and "tactically adjusting portfolio risk factor exposures," or if such differences exist. Further, there is a lack of clarity on the approval process for either of these decisions, as the investment policy implies that the Investment Program, or staff, are authorized to make tactical decisions regarding "risk factor exposures." According to interviews with staff, tactical decisions are understood to involve changing the weights to asset sub-classes within an asset class.

The Retirement Boards Should Revisit and Clarify Existing Policy

Given that the retirement plans have budgeted a large internal investment team relative to their total assets, there are opportunities for the Boards to reassess how they delegate authority for investment decisions while retaining reasonable oversight. Clarifying existing policy would not only be necessary for improving the efficiency of the investment program, but also for improving the transparency of the investment decision-making process.

Recommendation #18: **The Retirement Boards should clarify the different levels of investment decisions and which bodies have the authority to implement or approve them. The Boards should incorporate these clarifications into updates to the Investment Policy Statements, and if necessary, the Investment Committee Charter and Chief Investment Officer Charter.**

The Retirement Boards Should Provide the City Council with the Investment Policy Statements Periodically for the Council's Review and Comment

Because the overall investment policies express the Boards' long-term investment strategies; describe investment decision-making processes; and provide Board views on costs, risks, and management of investments, they are crucial documents for providing reassurance to the City and other stakeholders. As discussed above, the retirement plans' investment policies and performance have a direct impact on City services. This report includes several recommendations to improve the transparency of the plan's investment policies. In the spirit of those recommendations, we also recommend Retirement Services periodically provide City Council with copies of the Investment Policy Statements.

Recommendation #19: The Retirement Boards should periodically provide copies of the retirement plans' investment policies to the City Council.

Finding 4 San José's Basic Costs to Administer the Plans Were Comparable to Benchmark Jurisdictions

Summary

Retirement Services' basic costs to administer the plans were comparable to benchmark jurisdictions in FY 2015-16 at about $8,000 per $1 million in plan assets (not including all investment manager fees).

Retirement Services spent about $65,000 on travel in FY 2015-16, which was about $12.50 per $1 million in plan assets, and mid-range compared to other jurisdictions. However, a review of Retirement Services travel reports showed that some instances of Retirement Services' acceptance of free registration to vendor-sponsored conferences may not be in compliance with the City's Gift Policy. Retirement Services should decline the free registration and pay for the conferences to ensure compliance with the City's gift and travel policies.

Additionally, Retirement Services spent over $950,000 on legal services in FY 2016-17, which was almost $170 per $1 million in plan assets. A similar comparison for FY 2015-16 showed that the ratio of dollars spent on external legal services per $1 million in plan assets was slightly higher than, but in line with, other jurisdictions. We did find that most benchmarked jurisdictions have internal counsel who provide general legal advice.

Finally, Retirement Services spent about $2.75 million on consultant services in FY 2016-17, including over $1.4 million on investment consultants. Consultant costs have increased over the past decade, and increased use of investment consultants has been the main driver behind this increase.

Retirement Services Expenses to Administer the Plans per $1 Million in Assets Were Mid-Range Compared to Similar Plans in 2016

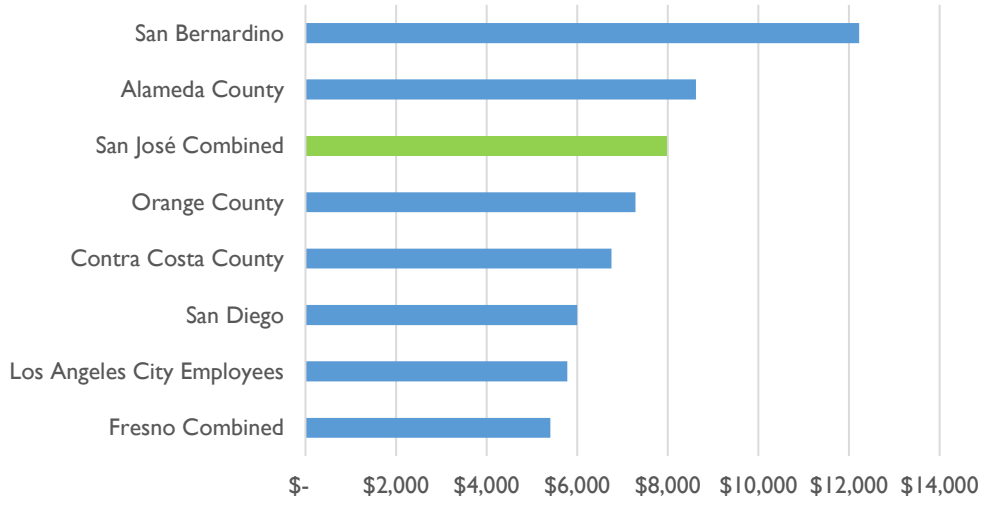
The combined San José Retirement Plans assets (including health trust assets) totaled $5.23 billion in FY 2015-16. Based on the $42 million in basic administrative expenses reported in the FY 2015-16 CAFRs,[59] Retirement Services spent almost $8,000 on expenses per $1 million in assets[60] in FY 2015-16. This is comparable to

[59] Because FY 2016-17 CAFR data is not available for other jurisdictions, we used FY 2015-16 data for comparisons. The $42 million reported in San José's FY 2015-16 retirement plan CAFRs does not reflect all investment manager fees, as described in Finding 1. However, because few other jurisdictions have done comprehensive fee analyses like San José, we did not include the cost of investment manager fees reflected in the Annual Fee Reports for purposes of comparison.

[60] We normalized expenses for Retirement Services and the benchmark plans per $1 million of assets listed in the Retirement Service and benchmark plan 2015-16 CAFRs. Subsequent comparisons in this Finding are also normalized per $1 million in plan assets.

benchmarked jurisdictions, which ranged from almost $5,500 in expenses per $1 million in assets in FY 2015-16 to over $12,000.[61]

Exhibit 15: Combined Retirement Services Expenses per $1 Million in Plan Assets Were Mid-Ranged Compared to Similar Plans in FY 2015-16



Source: Auditor analysis of Federated and Police and Fire CAFRs and the CAFRs of benchmark jurisdictions

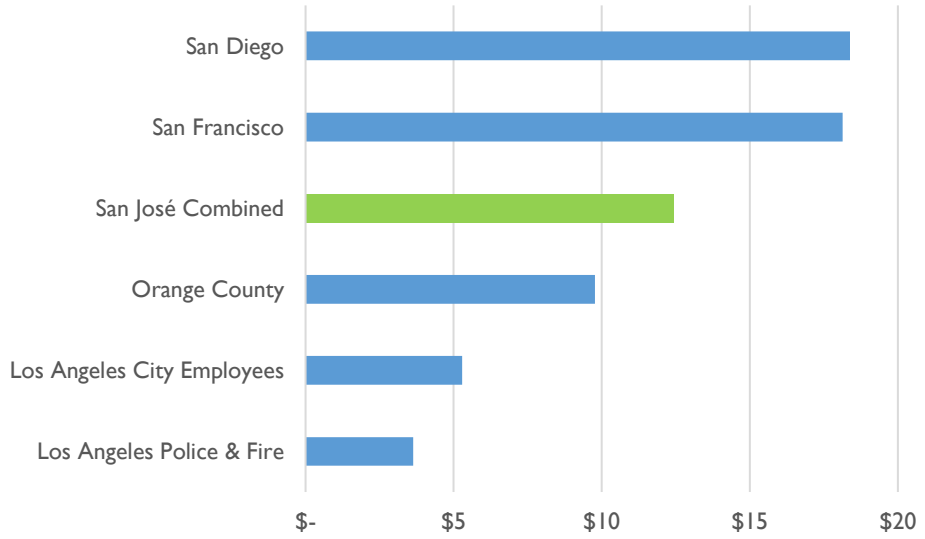
Retirement Services Travel Expenditures Are Mid-Range Compared to Benchmarked Jurisdictions

Staff and Board trustees travel for conferences and training and to conduct due diligence as part of their professional responsibilities.

According to the City's Financial Management System (FMS), the Office of Retirement Services spent almost $700,000 on travel from FY 2006-07 through FY 2015-16. During this period, the Police and Fire Plan generally spent slightly more on travel than the Federated Plan. However, in FY 2015-16, Retirement Services only spent about $65,000 on travel for both plans, which is about $12.50 per $1 million of total assets. Compared to surveyed jurisdictions, Retirement Services had about mid-range expenses for travel per $1 million in assets in FY 2015-16.

[61] Of the seven jurisdictions, LACERS, SBCERA, SDCERS, and CFRS CAFRs report based on a fiscal year ending on June 30, while OCERS, CCCERA, and ACERA CAFRs report based on the calendar year.

Exhibit 16: Combined Retirement Services Travel Expenses per $1 Million in Plan Assets Are Mid-Range Compared to Similar Plans in FY 2015-16[62]



Source: Auditor analysis of FMS data, FY 2015-16, Federated and Police and Fire CAFRs, FY 2015-16 benchmark plan CAFRs and annual reports, and FY 2015-16 travel reports for benchmarked plans.

Retirement Services' Acceptance of Registration at Vendor-Sponsored Conferences May Not Be Compliant with the City's Travel and/or Gift Policies

A review of quarterly and monthly travel reports showed some instances in which Retirement Services may not, in spite of their good intentions, have been in compliance with the City's Gift Policy and/or the City's Travel Policy.

For example, the Federated quarterly travel report[63] for April 1, 2016 – June 30, 2016 notes that two individuals associated with Retirement Services traveled to the Pension Bridge conference in San Francisco from April 5, 2016 through April 6, 2016. This conference was hosted by Pension Bridge, which holds conferences that connect money managers with pension funds for networking and educational purposes. Though the conference was hosted by Pension Bridge, investment manager firms can sponsor individual talks and meals associated with the conference as well as the overall conference. Per the quarterly travel report, Retirement Services paid $231.75 to cover the expense of meals for each of the travelers over the two days of the conference, but did not include the cost of attending the conference, which was provided free to associates of public pension plans. This

[62] Of the five jurisdictions, SFERS, SDCERS, LACERS, and LAFPP use fiscal years ending in June for their CAFRs and annual reports, while the OCERS CAFR reports based on calendar year.

[63] http://sjrs.legistar.com/gateway.aspx?M=F&ID=d7cf4989-7eac-45a3-9094-132e45eaba2c.pdf

exceeded the maximum allowable meal per diem expense under the City's Travel Policy.[64]

Retirement Services explained that their internal policy has been to pay for the meals associated with conferences sponsored by vendors to avoid the appearance of conflicts of interest. This policy is consistent with the **intention** of the City's Gift Policy,[65] which states that:

> *Elected officials and City employees shall not accept money or other considerations or favors from anyone other than the City for the performance of an act which they would be required or expected to perform in the regular course of their duties; nor shall such persons accept any gifts, gratuities, or favors of any kind which might be perceived or interpreted as an attempt to influence their actions with respect to City business. Gifts may not be accepted unless they are done so in accordance with this policy.*

Because members of the Retirement Boards are appointed by the City Council and because Retirement Services staff are City employees, the Gift Policy applies to them. Because Section 12.08.020 of the City's Municipal Code defines gifts to include meals and limits gifts to $50, the attendees were not allowed to accept them.[66] Since the meals associated with the Pension Bridge Conference were valued at more than $50, the Office covered the cost.

However, the City's Gift Policy applies not only to the meals associated with the conferences, but the conferences themselves. Under this policy Retirement Services staff and Board members cannot accept a gift of free admission to vendor-sponsored conferences unless they are speakers or participating on a panel. The City Gift Policy allows staff and Board members to attend these conferences if Retirement Services pays for the cost of the conference. In order to stay compliant with the City Gift Policy, the simplest solution may be for Retirement Services to pay the cost of Retirement Services staff and Board members to attend vendor-sponsor conferences.

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[64] The City's Travel Policy (Section 1.8.2 of the City Administrative Policy Manual) states that "All meals and incidental expenses are reimbursed on a per diem basis. Per diem meal expenses are determined by the applicable CONUS rates." Per diem rates (referred to in the City Travel Policy as CONUS rates) are established by the United States General Services Administration, and are based on the location of travel. For example, GSA established a $64 per diem rate for meals and incidental expenses in San José for travel in 2017. GSA's website shows that the established Meals and Incidental Expenses per diem rate for San Francisco in 2016 was $74. Since the GSA CONUS per diem rate was $74, the maximum allowable meal expenses under the travel policy should have been $148, which is less than the $231.75 that Retirement Services paid.

[65] The City Council is currently considering amending the City Gift Policy.

[66] The Policy does allow City staff and officials to accept free admission and food at an event in which that individual speaks, participates in a panel or seminar, or performs a similar service.

Recommendation #20: The Office of Retirement Service should ensure compliance with the City Gift Policy by paying for the total cost of attendance at vendor-sponsored conferences.

A Stricter Gift Policy for the Retirement Boards

Retirement Services has drafted an updated gift policy, which is intended to be stricter than the City Gift Policy and set a gift limit of zero dollars, but the Boards have not yet adopted it. Retirement Services staff said that a stricter gift policy is needed to clarify potential conflicts of interest for trustees and staff who are involved in outside organizations as well. Rather than drafting a new a gift policy in addition to the City's policy, we recommend the Boards reaffirm the existing City Gift Policy and adopt an addendum that further limits gifts if desired.

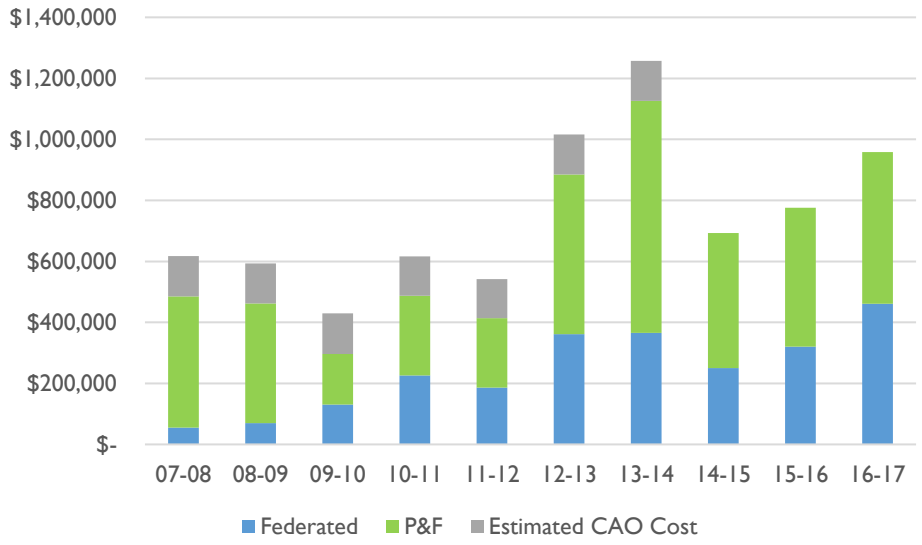
Recommendation #21: If the Retirement Boards would like to establish a more stringent gift policy, they should reaffirm the City Gift Policy and pass an addendum that further limits gifts to Retirement Board Members and Retirement Service Staff.

Retirement Services' Use of Attorneys Appears to Be in Line with Benchmarked Jurisdictions, Though It Does Not Have Internal Counsel

Over the past ten years, Retirement Services' legal costs fluctuated from over $600,000[67] in FY 2007-08 to over $950,000 in FY 2016-17, with a peak of over $1.25 million in FY 2013-14. Retirement Services staff said that much of the increase in legal costs in FY 2012-13 and FY 2013-14 can be attributed to litigation related to the passage of Measure B in 2012 and subsequent ballot measures.

[67] As discussed earlier in this report, CAO provided legal services to Retirement Services prior to the passage of Measure G in 2014. After Measure G was implemented, CAO no longer provided legal services to Retirement Services. Exact figures for the value of the legal services City Attorney's Office (CAO) provided to Retirement Services prior to the passage of Measure G are unavailable. We estimated the cost of legal services based on FY 2009-10 cost estimates that CAO prepared for the Federated Board and historic shares of legal cost by the Federated and Police and Fire Boards between FY 2013-14 and FY 2016-17.

Exhibit 17: The Cost of Legal Services Have Increased Since FY 2007-08



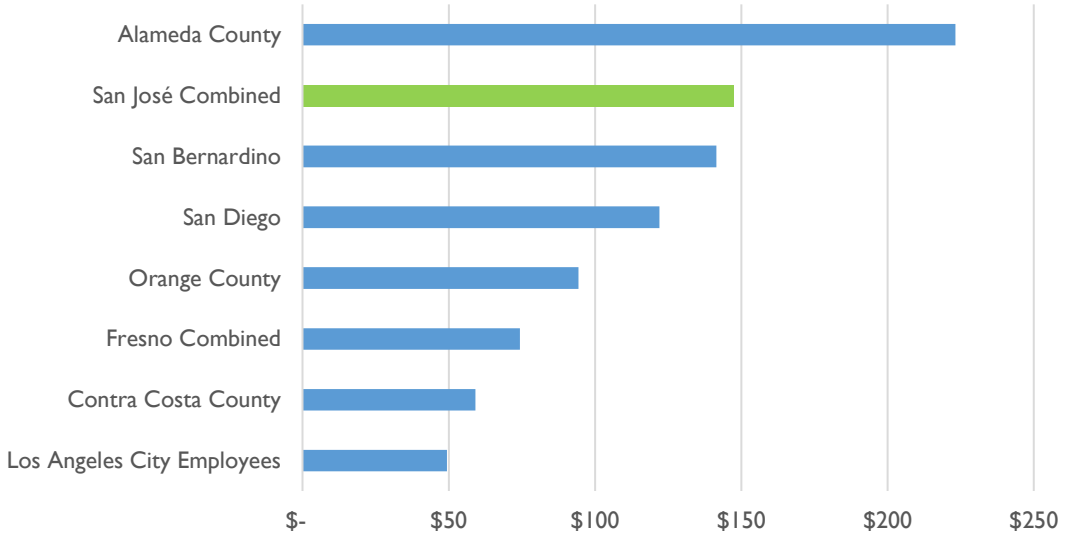
Source: Auditor analysis of Federated and Police and Fire CAFRs and estimated City Attorney's Office (CAO) cost of services provided

Retirement Services legal costs per $1 million in plan assets were comparable to benchmarked jurisdictions in 2016.[68] Retirement Services spent about $147 on legal expenses per $1 million in assets in FY 2015-16 compared to $49 for Los Angeles City Employees' Retirement System (LACERS) and $223 for Alameda County (ACERA). However, contract extensions may result in further increasing costs.[69] Retirement Services may consider the use of internal counsel if the cost of contracted legal services becomes prohibitive.

[68] Not every jurisdiction has published FY 2016-17 CAFRs, so we benchmarked based on the FY 2015-16 CAFRs.

[69] For example, the Retirement Services contract for general counsel authorizes rates of $625 per hour for senior partners, $565 for partners, and $495 for counsel. The City is currently considering a contract to increase these rates.

Exhibit 18: San José Combined Retirement Services Legal Expenses for External Counsel per $1 Million in Plan Assets Are Slightly Higher Than but in Line with Similar Plans in 2016[70]



Source: Auditor analysis of Federated and Police and Fire CAFRs,[71] and benchmark jurisdiction CAFRs

Retirement Services currently uses the services of four firms for different types of legal counsel: one for general counsel and investment counsel, one for tax counsel, one for domestic relations orders, and one primarily for investment counsel. Benchmarked jurisdictions generally employ outside counsel to fill similar roles. For example, both Los Angeles City Employees' Retirement System (LACERS) and San Diego (SDCERS) employ outside counsel for litigation, taxes, and fiduciary assistance.

As discussed in earlier sections of this report, the citizens of San José voted to pass Measure G, which reformed the governance of the retirement plans. Among other provisions, Measure G amended the City Charter to state that:

> *Each retirement board may retain or employ, by contract, attorneys to assist the retirement board on matters reasonably necessary to carry out their fiduciary duties in the administration of the retirement plan or plans that the retirement board has been designated to administer.*

[70] Of the seven jurisdictions, LACERS, SBCERA, SDCERS, and CFRS CAFRs report based on a fiscal year ending on June 30, while OCERS, CCCERA, and ACERA CAFRs report based on the calendar year.

[71] The Federated CAFRs for FY 2009-10 through FY 2011-12 included cost figures for these legal services, and the CAO presented a memo estimating costs to the Federated Board in 2009. The Police and Fire Board refused to pay for CAO legal services, so their costs did not appear in the Police and Fire CAFRs. Other than the memo provided to the Federated Board, neither CAO nor Retirement Services staff knew how to estimate the cost of CAO services to Retirement Services.

Prior to the passage of Measure G, the City Attorney's Office provided legal counsel to the retirement boards and managed their contracts with outside counsel. After Measure G, the Retirement Boards were granted the authority to directly contract with outside counsel without going through the CAO. The Boards now have a firm that fills the role of general counsel and advises the Boards on proceedings with the City.

Many Benchmarked Jurisdictions Employ Internal Counsel

Of the benchmarked jurisdictions, every system except for the City of Fresno (which is the smallest benchmarked system by number of beneficiaries) either employs attorneys that directly work for the plan or use legal services provided by the plan sponsors. For example, Los Angeles Fire and Police Pensions (LAFPP) uses legal counsel from the Los Angeles City Attorney's Office, while ACERA directly employs its own legal counsel.

Benchmarked plans noted that external counsel is useful for providing specialized expertise for issues such as investment legal support. Benchmarked plans often use internal counsel for more general purposes, such as managing plan documents, compliance issues, and managing contracts with external counsel. The Retirement Boards may be paying more for general legal services from outside counsel than it could be receiving from internal counsel.

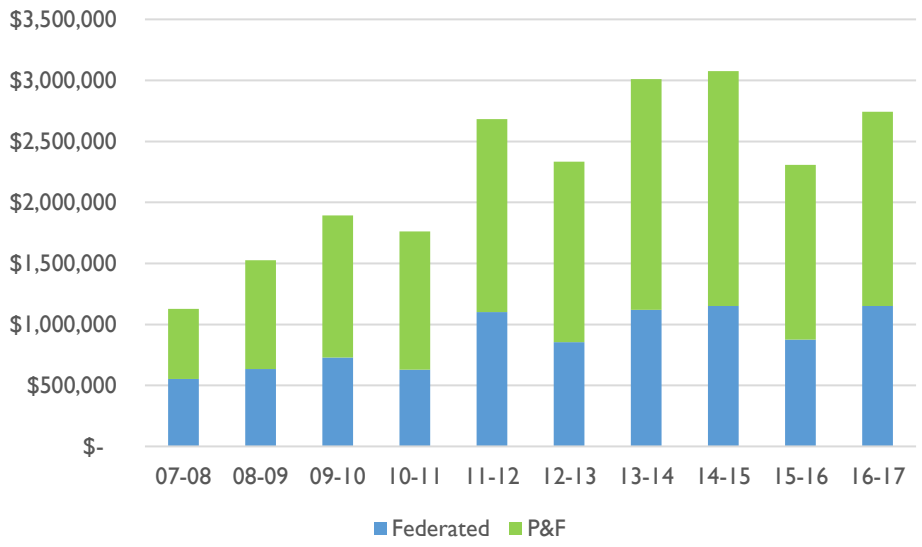
CAO staff noted that the billable rates that external counsel is charging Retirement Services appear to be reasonable. However, when CAO processes invoices from external counsel that have contracted to provide legal services to the City, an attorney from CAO reviews the number of billable hours and uses their expertise to gauge if these figures are reasonable. Retirement Services does not have any attorneys on staff to assess whether the number of billable hours used by external counsel is reasonable. Retirement Services currently reviews bills sent from external counsel by having the staff who requested their services sign off on invoices which include the number of billable hours at a contracted hourly rate. Retirement Services could benefit from having internal counsel with the expertise to assess if the number of billable hours invoiced by external counsel is reasonable for the services provided.

Retirement Services' Use of Consultants Comparable to Similar Jurisdictions

The Police and Fire and Federated Plans used a variety of consultants, including an actuarial consultant, IT consultant, investment consultants, and a consultant to identify beneficiary deaths. The two plans generally used the same consultants, though prior to 2017, they employed separate general investment consultants.

Retirement Services' use of consultants (not counting legal services) increased from about $1.13 million in FY 2007-08 to almost $2.75 million FY 2016-17, with a peak of almost $3.1 million in FY 2014-15.

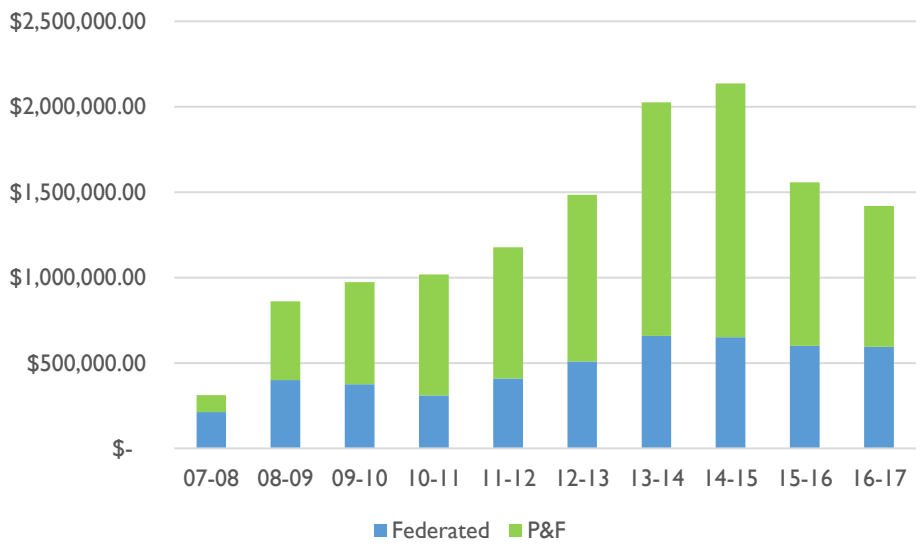
Exhibit 19: Retirement Services Spent About $2.75 Million on Consultants in FY 2016-17



Source: Auditor analysis of Federated and Police and Fire CAFRs

Increasing investment consultant costs over the past decade has been the biggest driver in increasing consultant costs for the two plans overall.

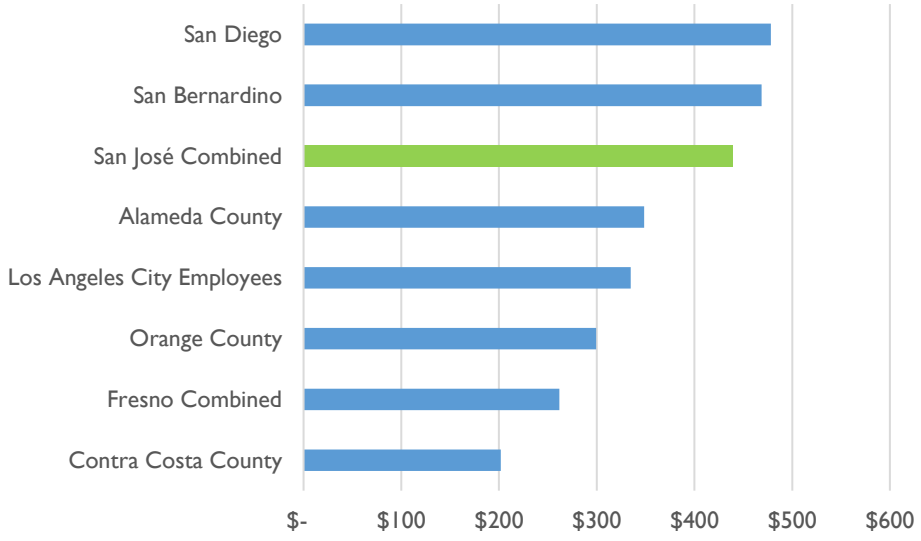
Exhibit 20: Investment Consultant Costs Have Increased Greatly Since FY 2007-08



Source: Auditor analysis of Federated and Police and Fire CAFRs

Retirement Services spent about $439 on consultant costs per $1 million in assets in FY 2015-16.[72] This was mid-range compared to benchmark jurisdictions.

Exhibit 21: Combined Retirement Services Consultant Expenses per $1 Million in Plan Assets Are Mid-Range but in Line with Similar Plans in 2016[73]



Source: Auditor analysis of Federated and Police and Fire CAFRs and benchmark jurisdiction CAFRs

Retirement Services should continue to monitor the costs of consultants, and ensure that consultants are providing services in accordance with the scopes of their contracts.

[72] Not every jurisdiction has published FY 2016-17 CAFRs, so we benchmarked based on the FY 2015-16 CAFRs.

[73] Of the seven jurisdictions, LACERS, SBCERA, SDCERS, and CFRS CAFRs report based on a fiscal year ending on June 30, while OCERS, CCCERA, and ACERA CAFRs report based on the calendar year.

Finding 5 The Office of Retirement Services Could Improve Customer Service Through More Efficient Tools

Summary

Retirement Services has about 30 full FTE who work on non-investment issues, which is a ratio of about 420 plan members and beneficiaries per noninvestment staff. This ratio is comparable to other jurisdictions.

Retirement Services Benefits staff answer customer requests for service, though requests are not necessarily addressed by the relevant subject matter expert. Retirement Services does not currently have a software solution with workflow routing capabilities. Retirement Services should assess how to use workflow functionality in its pension benefits administration system—which is currently being replaced—for case management, or acquire a separate case management software system.

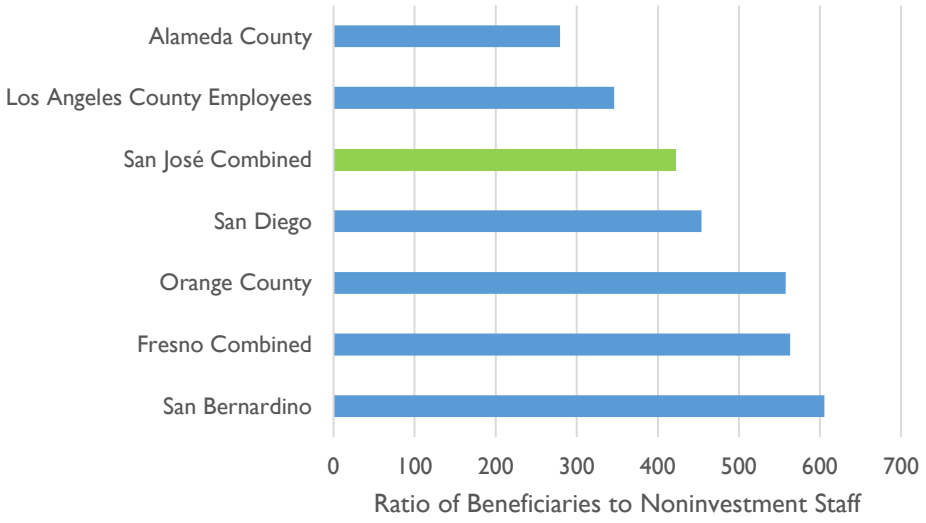
Retirement Services could also improve access to key plan information for stakeholders and plan members. The Retirement Services website is outdated and does not always provide complete or accurate information to plan members and stakeholders, and the Retirement Services newsletters are not as comprehensive as those of similar plans. The websites for several benchmark jurisdictions have improved functionality that Retirement Services could adopt to improve ease of navigation. Retirement Services should upgrade their website to improve beneficiary education, and post internal policies and audio recordings of committee meetings to its website to improve transparency.

Retirement Services Would Benefit From Software with Workflow Functionality

Retirement Services employs about 30 full time equivalent staff who work on noninvestment issues, such as benefits. The plans had over 12,500 active members and beneficiaries as of June 2016, which is a ratio of about 420 plan members and beneficiaries per noninvestment staff. This ratio is comparable with estimates from benchmarked jurisdictions, which ranged from about 280 plan members and beneficiaries per noninvestment staff to 605.[74]

[74] The number of noninvestment staff for benchmark jurisdictions used for these ratios was obtained via conversation with staff from these jurisdictions.

Exhibit 22: Retirement Services' Ratio of Plan Members and Beneficiaries per Noninvestment Staff Is in Line with Similar Jurisdictions

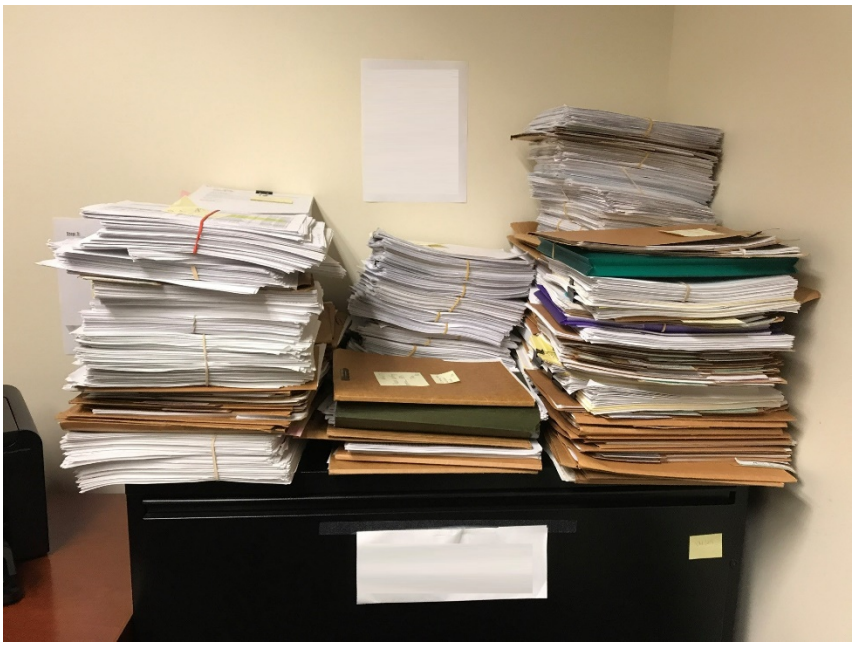


Source: Retirement Services and benchmark jurisdiction CAFRs and adopted budgets

Retirement Services has a Benefits Division under the Chief Operating Officer which provides customer service to plan members and beneficiaries. Benefits staff generally develop subject matter expertise for issue areas such like domestic relation orders (DROs), Medicare payments, or pensionable earnings corrections.

In addition to developing subject matter expertise to respond to plan member requests, Benefits staff spend about half of their time responding to phone calls from plan members, or staffing the front desk and handling requests from plan members who walk into the Retirement Services office. However, when staff handle phone duty or staff the front desk, they are expected to respond to the member inquiry regardless of their subject matter expertise. For example, if a Benefits staff member who specializes in processing Fair Labor Standards Act corrections were handling phone duty but receives an inquiry related to DROs, she would attempt to answer the member question herself rather than forward it to the relevant subject matter expert unless she needed additional expertise. Some Benefits staff expressed concern that staffing the front desk or responding to calls impaired their ability to work on tasks associated with their subject matter expertise.

Exhibit 23: Picture of Retirement Services Document Backlog



Source: City Auditor's Office Photograph

Retirement Services Is Replacing Its Pension Benefits Administration System, But Does Not Have a Case Management Software System

Retirement Services uses PensionGold Version 2 software as its pension benefits administration system, and is currently in the process of replacing the software with Version 3, which has an anticipated implementation date of 2019.

Retirement Services does not have a software solution or case management system to centrally track member requests. PensionGold Version 2 allows staff to place notes about certain cases in the system, but notes are siloed and unable to be routed. PensionGold Version 3 should possess workflow functionality that Version 2 does not have.

Several of the jurisdictions surveyed have workflow software, either PensionGold Version 3 or other systems that offer workflow functionality. For example, San Diego (SDCERS) has its own system, called IRIS, which includes case management functionality in addition to the benefits administration functionality that PensionGold Version 2 offers. San Bernardino County (SBCERA) noted that they have PensionGold Version 3, which has workflow functionality, and they use it to manage member inquiries and requests, and Los Angeles City Employees' Retirement Systems (LACERS) said that they intend to use workflow functions once they are done installing PensionGold Version 3. San Diego noted that the improved functionality from IRIS increased efficiency to the point that they could eliminate eight FTE through attrition while still increasing service output.

Benefits staff also noted that they have some backlogs that they attributed to reliance on manual systems. They expressed that a lack of self-service capabilities add workload, as members must make requests to Benefits staff for services that could be offered online. Greater automation could also improve Retirement Services Benefits workload internally. For example, PensionGold Version 2 cannot calculate salaries for determining pension benefits, and the process must be done manually, which is time-consuming. This functionality will be added in PensionGold Version 3.

Having workflow functionality would help Benefits staff route cases to the relevant subject matter expert as needed, freeing up staff time to address cases relevant to their subject matter expertise. There is also a risk that staff who are not subject matter experts on an issue may not know the information they need to address a member request, and could accidentally provide the wrong advice because they are not currently able to route requests to the relevant subject matter expert through an automated system.

Retirement Services does not currently track how long it takes to complete member requests. Existing performance measures collected by Retirement Services include customer satisfaction metrics, but do not gauge timeliness. Some of the benchmarked jurisdictions do not explicitly track the time it takes to complete requests, but some do in a limited capacity. Alameda County (ACERA) tracks phone response time, and reports the results to its board. Orange County (OCERS) reported that they track and report timeliness.

Recommendation #22: The Office of Retirement Service should assess how to use workflow functionality in PensionGold Version 3 for case management, including routing beneficiary requests to subject matter experts or staff familiar with the case, and to track workload statistics (such as time to complete requests), or acquire a separate case management software system.

Retirement Services Should Improve Access to Information for Stakeholders and Plan Members

Retirement Services disseminates information for plan members and stakeholders through a variety of means, including newsletters and plan websites.

Newsletters Are an Important Means of Communication

Retirement Services publishes newsletters on a quarterly basis. The plan websites show that Retirement Services regularly published these newsletters online from 2003 to 2010, and discontinued their production before resuming publication in 2016. From about 2007 to 2010, the newsletters were about 10 pages each, and included articles about healthcare and retirement as well as some information about upcoming events and board meetings. Since the newsletters were brought back in

2016, they have been about two pages, and generally include information about upcoming events, or about the retirement plans themselves, such as the actuarial valuations. Of the four newsletters published since their publication was resumed in 2016, two only address information about the plans themselves, and only two include information about workshops or upcoming events, while none include informational articles.

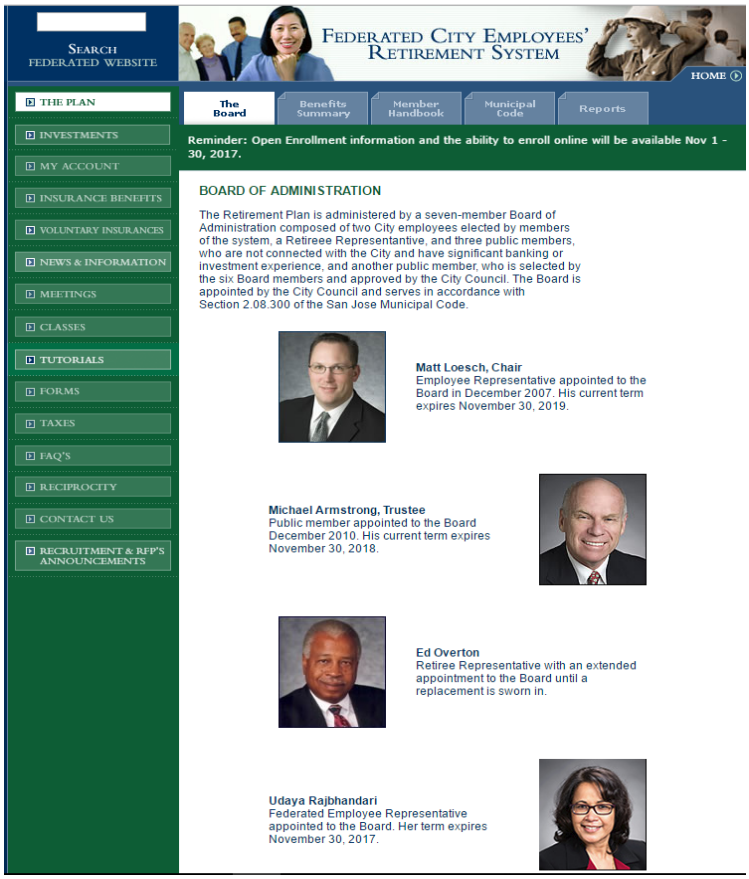
The member newsletters of most benchmark plans, including Los Angeles Fire and Police Pensions (LAFPP), California Public Employees Retirement System (CalPERS), Los Angeles City Employees Retirement System (LACERS), San Bernardino County (SBCERA), Alameda County (ACERA), Contra Costa County (CCCERA), and Orange County (OCERS) feature content that may be of practical use and interest to plan members and stakeholders, such as articles on how divorce impacts member benefits or the impact of withholding federal income tax, as well as updates on key dates and some general interest topics. The newsletters that Retirement Services currently publishes are shorter than those of benchmarked jurisdictions and do not provide as much information.

Recommendation #23: The Office of Retirement Services should expand its newsletters to include more information about the plans, upcoming events, and information about retirement.

The Retirement Services Plan Websites Should Be Improved

Retirement currently operates a website for each of the plans. These websites provide plan members and stakeholders with information about benefits, educational resources, and documents about plan governance. The landing page for each website includes pictures of the board members as well as links to pertinent information such as classes and reciprocity.

Exhibit 24: Federated Plan Front Page



Source: Federated Plan website

However, the websites' current design and organizational structure impede the ability of plan members and stakeholders to easily find information. Some types of information that would be useful for plan members to find is not available, and other pertinent information that is on the website can be difficult to find due to an unintuitive layout.

Missing information: For example, although the City offers benefits to both Tier 1 and Tier 2 beneficiaries, the Police and Fire Plan website frequently asked questions (FAQ) page only includes information for Tier 1 beneficiaries, while the Federated FAQ page does not provide much information for Tier 2 beneficiaries. Further, the website for the Police and Fire Plan includes a retirement benefits handbook for Tier 1 members, but does not have a similar handbook for Tier 2 members. The Federated Plan website has noted that its member handbooks have been under construction since 2012.

Ineffective search feature: The search feature on both plan websites does not provide search results based on relevance. For example, searching "tier 2" on the Police and Fire Plan website returns a list of PDF and Word documents that include the words tier 2 in them, but the results do not have clear title names or provide

detailed information about the links. Retirement Services could consider using a Google search feature to improve the search functionality on its website for stakeholders and plan members who are trying to find documents.

Outdated information: Some of the information on the websites appears to be out of date, and though the plans have changed significantly over the past several years, information on the plan websites has not kept pace with these changes. The Police and Fire Plan website FAQ includes a question about the Supplemental Retirees' Benefit Reserve, which was eliminated over four years ago as part of Measure B. Outdated or insufficiently updated information on the websites and elsewhere may confuse plan members who might make detrimental decisions due to having incomplete or inaccurate information.

The Websites of Benchmarked Jurisdictions Have Features Retirement Services Could Adopt

Websites of benchmarked jurisdictions feature systems that facilitate navigation and accessibility of information, many of which the Retirement Services' plan websites do not have. These design choices, based on a review of ten comparable plan websites, include:

- Seven of ten benchmark jurisdictions have a link on their homepage to a page with aggregated links to popular services and resources that plan members and stakeholders commonly look for, such as a change of address form and health plan rates. Accessing this information is easier as it can be found with just one click rather than by navigating through multiple pages.
- Nine of ten benchmark websites had separate central pages for active plan members and retirees.
- Similarly, Los Angeles (LACERS and LAFPP) and San Francisco (SFERS) have separate FAQ pages for active and retired plan members, while CalPERS' FAQ is searchable by keyword and allows the list of questions to be narrowed down by category. These design choices enable plan members to find information that is pertinent to them more easily.

Retirement Services published some educational tutorials on its website, but these tutorials are in PowerPoint format, and must be downloaded before they can be viewed. These tutorials are not available as videos, and interested plan members or stakeholders cannot view them without having PowerPoint software. CalPERS, Los Angeles (LACERS and LAFPP), Orange County (OCERS), and San Bernardino County (SBCERA) also publish educational videos that help plan members learn, among other content, how to navigate their websites, how to use online benefits calculators, and how to sign up for a member account. These plans publish video content on YouTube or on their websites, which can be viewed in a web browser rather than requiring download.

Despite these issues, Retirement Services has not substantively upgraded the plan websites since at least 2004. In fact, the current front page for the Retirement Services website is essentially identical to how it appeared in 2004.

Exhibit 25: San José Retirement Services Website, 2004

Exhibit 26: San José Retirement Services Website, 2017

Source: Retirement Services website and archive of Retirement Services website

Retirement Services said that they are aware that the website needs an upgrade, but have not had the resources to prioritize upgrading the website until after the PensionGold Version 3 implementation, which will not be completed until 2019.

If stakeholders and plan members cannot navigate the websites to find information they need, the workload for Retirement Services Benefits staff may increase. If plan members are not able to find information themselves on the websites, they may need to contact Benefits staff with requests for basic information. Time spent responding to these requests could consume staff time that could be better used helping members with more personalized queries.

Recommendation #24: The Office of Retirement Service should upgrade their website to promote transparency and ease of navigation for stakeholders and plan members to find information.

Retirement Services Should Post Plan Policy and Governance Documents and Meeting Recordings Online

Retirement Services does not currently post many policy and governance documents on the plan websites. There is a reports page with links to the popular annual financial reports (PAFRs), CAFRs, and actuarial valuations. However, the plan websites do not include important documents relevant to Retirement Services governance, such as the board charters or internal policies.

Other jurisdictions such as Orange County (OCERS) and Alameda County (ACERA) post their policies online. Having access to these policies increases transparency for stakeholders and plan members.

The Retirement Boards hold publicly accessible meetings at City Hall, and televise their meetings for stakeholders and beneficiaries to view online live. Video and audio recordings of Board meetings are posted on the City's website afterwards. Retirement Services posts agendas and minutes for Board meetings and committee meetings online.

However, few of the audio recordings for committee meetings have actually been posted on the City's public information and legislation database (called Legistar). For example, audio recordings are only available for two of the last eight Joint Investment Committee Meetings.

Exhibit 27: Audio Recordings of Committee Meetings Are Generally Not Being Posted Online

Name	Meeting Date	Meeting Time	Meeting Location	Meeting Details	Audio File	Agenda	Minutes
Joint Investment Committee	9/26/2017	12:00 PM	1737 N. First Street, Suite 580 5th Floor Board Room, San Jose, CA 95112 *or immediately following the Federated Board Meeting*	Meeting details	Not available	Agenda	Not available
Joint Investment Committee	8/22/2017	12:00 PM	1737 N. First Street, Suite 580 5th Floor Board Room, San Jose, CA 95112 *CANCELED*	Meeting details	Not available	Agenda	Not available
Joint Investment Committee	6/27/2017	12:00 PM	1737 N. First Street, Suite 580 5th Floor Board Room, San Jose, CA 95112 *or immediately following the Federated Investment Committee meeting.*	Meeting details	JOINT IC 6-27-2017	Agenda	Minutes
Joint Investment Committee	5/23/2017	12:00 PM	1737 N. First Street, Suite 580 5th Floor Board Room, San Jose, CA 95112 *or immediately following the Federated Investment Committee meeting.*	Meeting details	Joint IC Minutes 5-23-2017	Agenda	Minutes
Joint Investment Committee	4/25/2017	12:00 PM	1737 N. First Street, Suite 580 5th Floor Board Room, San Jose, CA 95112 *or immediately following the Federated Investment Committee meeting.*	Meeting details	Not available	Agenda	Minutes
Joint Investment Committee	3/28/2017	12:00 PM	1737 N. First Street, Suite 580 5th Floor Board Room, San Jose, CA 95112 *or immediately following the Federated Investment Committee meeting.*	Meeting details	Not available	Agenda	Not available
Joint Investment Committee	2/28/2017	11:15 AM	1737 N. First Street, Suite 580 5th Floor Board Room, San Jose, CA 95112 *or immediately following the Federated Investment Committee meeting.*	Meeting details	Not available	Agenda	Minutes
Joint Investment Committee	12/20/2016	12:00 PM	1737 N. First Street, Suite 580 5th Floor Board Room, San Jose, CA 95112 *or immediately following the Federated Investment Committee meeting.*	Meeting details	Not available	Agenda	Minutes
Joint Investment Committee	11/22/2016	12:00 PM	1737 N. First Street, Suite 580 5th Floor Board Room, San Jose, CA 95112 *REVISED or immediately following the Federated*	Meeting details	Not available	Agenda	Minutes

Source: City of San José Retirement's Legistar Website

The City's Open Government Resolution established that the meetings of every "City Board, Commission and Committee and Decision-Making Body shall be audio-recorded and the audio recordings shall be retained for at least two (2) years". Since Retirement Services already posts recordings of the Board meetings and is required to retain audio recordings for committee meetings, they should post the audio files online in a timely manner.

Having plan policy and governance documents and audio recordings of meetings available online would improve transparency for plan stakeholders who want to learn more about Board and committee decisions.

Recommendation #25: To improve transparency, the Office of Retirement Services should post plan charters and policies, as well as audio recordings of committee meetings, online.

Conclusion

The total cost to administer the retirement plans was approximately $73 million in FY 2016-17, though budget and financial documents report different categories of this total amount. Retirement Services should improve the current approval process of retirement plan spending, including preparation a comprehensive budget and establishment budget adoption policies. Beyond the budget transparency, more formalized communication between the City and the retirement plans would enable both bodies to better carry out their responsibilities.

The retirement plans have been performing below benchmarks over the past few years with increasingly complex and expensive investments. To provide clear guidance on investment cost controls and performance evaluation, the Retirement Boards should establish more detailed policies.

The basic costs of administering the retirement plans are comparable to other jurisdictions, but Retirement Services should clarify the approvals of travel and gifts. Lastly, updating the pension administration software and the information on the Retirement Services website would improve customer service.

RECOMMENDATIONS

Recommendation #1: The Office of Retirement Services should forward the Annual Fee Reports to the City Council for informational purposes.

Recommendation #2: The Office of Retirement Services should include its proposed personnel budget and staffing plan for City Council approval as part of the comprehensive annual budget outlined in Recommendation #3.

Recommendation #3: The Office of Retirement Services should prepare a comprehensive annual budget document covering the entire aggregate expense of administering each plan.

Recommendation #4: In compliance with the City Charter, the Office of Retirement Services should formally request each retirement board annually adopt the annual budget document that has also been approved by the City Council.

Recommendation #5: The Retirement Boards should establish formal budget adoption policies and procedures that include clear delegation of authority to staff to spend plan assets subject to certain limits defined by the Boards.

Recommendation #6: The City Manager's Office should update the City's Operating Budget to:

a) include total employee and employer retirement contributions in the City's Operating Budget as summary or historical information,

b) cross-reference its separate approval of the Retirement budget, and

c) modify the presentation in the Operating Budget's Source and Use statements to display investment expense.

Recommendation #7: The City Council and the two Retirement Boards should hold a joint annual study session to discuss topics relevant to all parties, such as:

a) forecasts for the City's expected revenue and budget,

b) City and employee retirement contribution rates,

c) actuarial assumptions of the retirement plans,

d) the plans' investment returns, and

e) the plans' funded status.

Recommendation #8: The City should structure a formal process to orient new City Councilmembers about the Retirement plans.

Recommendation #9: The Retirement Boards should structure a formal process to periodically orient Board members to the City's budget and service level solvency.

Recommendation #10: The City as the plan sponsor should provide the Retirement Boards, on a regular basis, with relevant budget documents, such as the City's 5-year budget forecast, the Mayor's budget messages, and the City's proposed operating budget.

Recommendation #11: The City Council should clarify their expectations of the Council representatives to the Retirement Boards, including the type of report and frequency of reporting that would be most useful to the Council.

Recommendation #12: The Retirement Boards should clarify their expectations of each Council representative, including the type and frequency of reporting that would be most useful to the Board.

Recommendation #13: To facilitate communication of relevant activities to the City, the Retirement Boards should:

a) Work with City staff to determine what types of activities or agenda items are appropriate to notify the City about in advance and update relevant charters and/or policies accordingly, and

b) Modify the CEO charter to clarify the CEO's role in communicating with the City.

Recommendation #14: The City Administration should designate a City staff member as the liaison to Retirement Services and provide guidelines for the liaison's role (e.g., monthly meetings with the Retirement CEO and attendance at Retirement Board meetings).

Recommendation #15: The Retirement Boards should adopt a formal set of performance measures to be included in the retirement plans' budgets for both plan administration and the investment program. The Retirement Boards should provide the City Council with the opportunity to review and provide comment on the adopted performance measures.

Recommendation #16: The Retirement Boards should incorporate in their respective Investment Policy Statements, or establish in a separate document, more comprehensive guidance in line with the Government Finance Officer's Association recommendations on fee policies for public plans, containing at least the following:

a) Delegation of responsibility to negotiate, monitor, and report on fees;
b) The respective roles of trustees, staff, consultants, and investment managers in controlling fees;
c) Strategies that will be employed to seek the lowest reasonable fees in traditional asset classes; and
d) Strategies that will be employed to ensure the plans are not paying excessive fees for alternative assets.

Recommendation #17: The Retirement Boards should incorporate in their respective Investment Policy Statements a policy on investment manager evaluation that reflects existing manager due diligence process and procedures, and includes the following:

a) Defining the "extraordinary review" process;
b) Establishment of a "watch list" and/or "probationary status" for underperforming managers;
c) Process by which managers of concern are identified, placed under "extraordinary review," and given a final decision;
d) Quantitative criteria for underperformance which would trigger placement under "extraordinary review" and/or on a "watch list;"
e) Potential actions resulting from the "extraordinary review" process;
f) Delegation of authority for implementing each step in this process; and
g) As necessary, incorporating into the policy the nuances of different asset classes or fund types.

Recommendation #18: The Retirement Boards should clarify the different levels of investment decisions and which bodies have the authority to implement or approve them. The Boards should incorporate these clarifications into updates to the Investment Policy Statements, and if necessary, the Investment Committee Charter and Chief Investment Officer Charter.

Recommendation #19: The Retirement Boards should periodically provide copies of the retirement plans' investment policies to the City Council.

Recommendation #20: The Office of Retirement Service should ensure compliance with the City Gift Policy by paying for the total cost of attendance at vendor-sponsored conferences.

Recommendation #21: If the Retirement Boards would like to establish a more stringent gift policy, they should reaffirm the City Gift Policy and pass an addendum that further limits gifts to Retirement Board Members and Retirement Service Staff.

Recommendation #22: The Office of Retirement Service should assess how to use workflow functionality in PensionGold Version 3 for case management, including routing beneficiary requests to subject matter experts or staff familiar with the case, and to track workload statistics (such as time to complete requests), or acquire a separate case management software system.

Recommendation #23: The Office of Retirement Services should expand its newsletters to include more information about the plans, upcoming events, and information about retirement.

Recommendation #24: The Office of Retirement Service should upgrade their website to promote transparency and ease of navigation for stakeholders and plan members to find information.

Recommendation #25: To improve transparency, the Office of Retirement Services should post plan charters and policies, as well as audio recordings of committee meetings, online.

APPENDIX A

Mayor's Memo to the City Council

COUNCIL AGENDA 02/14/2017
ITEM 3.4

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: CITY COUNCIL **FROM:** Mayor Sam Liccardo

SUBJECT: FY 2015-2016 RETIREMENT PLANS' COMPREHENSIVE ANNUAL FINANCIAL REPORT **DATE:** February 14, 2017

APPROVED: L.W 2-14-2017

RECOMMENDATION

Add to the City Auditor's workplan to include the performance of administration of Retirement Services of the Plans for Police & Fire and Federated retirees. This audit should focus on the following areas, with an eye to maximizing net assets and reducing administrative costs of the Plans:

1) Expenditures for these Plans, with some context of expenses of peer public Plans of this size:
   - professional expenses, including but not limited to legal/attorney fees;
   - administrative costs, including such expenses as travel; and,
   - staffing levels

2) Investment Performance relative to key industry and policy benchmarks, within the context of the Board's sound direction to reduce volatility/risk.

DISCUSSION

Over the last ten years, the City and our retirees have benefitted considerably from the restructuring of the retirement plan boards, which has populated the Boards with members possessing greater professionalism and expertise. During that time, we have decided to take the management of Retirement Services away from the City Manager's purview, remove Councilmembers from the Plan boards, and allow Retirement Services and the Plans to operate as largely independent administrative entities. Of course, the Plans continue to financially depend upon the contributions of their sponsor, the City.

Over that decade, staffing in the Office of Retirement Services has increased dramatically. Since FY 2005-2006 the budget has increased 151% while the Full-Time Employees has doubled, while virtually every other department in the City has shrunk. We have also seen puzzling activity and expenses

independent of staff, for example, on today's agenda, in a February 10, 2017 letter, we see the Board's outside counsel asserting vested rights on an issue that had been long been resolved through extensive legal research with counsel and negotiation with representatives of our 11 unions months ago.

The Plans' investment losses of the last two years, and the more dramatic failure to meet actuarial assumed rates of return, have substantially added to both the Plans' unfunded liabilities and the General Fund's burdens.

Nonetheless, the real source of my concern does not simply focus on negative returns. I appreciate that a deliberate investment strategy exists to reduce the volatility of the Plans, by reducing exposure to higher-return (but higher-risk) asset classes, such as public equities. There is a risk-return tradeoff, about which we are all cognizant.

Yet after substantial taxpayer investment in staffing that would improve the professional supervision of our investment portfolio, we see that investment returns appear to consistently underperform key benchmarks. For example, over the past five years, the Police and Fire Plan (p. 84) and the Federated Plan (p. 107) underperform both the policy benchmark and the returns of other public funds with at least $1 billion in assets. More recent returns do not show any improvement, as last year's returns in the Federated (-0.7%, see p. 87) and Police & Fire (-0.4%, see p. 103) Plans, and Health Care Trusts (-2.7% for Federated, 0.6% for Police & Fire) underperformed policy and custom benchmarks. Our own Department of Finance—admittedly with dramatically different investment strategies, needs, and asset classes—takes a very conservative approach to savings and investment, yet has achieved better returns with the same market conditions in recent years.

I appreciate that the City Auditor's office is not intended to be a final arbiter for financial investment expertise, and so would welcome the Auditor's input about whether there might be third parties who might contract with the City or the Boards to perform this review. Some of the issues about which it would be helpful to gain insight include:

- While the reports suggest that merely eliminating the variance between asset allocation and policy targets would close the gap between our returns and the benchmarks, we would benefit from testing that conclusion.
- Given the deliberately risk-averse strategy, it seems worth knowing whether we are achieving the best returns possible within that framework.
- Both Plans appear to hold large amount of Plan assets in cash. It would be helpful to know how this compares to other similarly-situated public Plans.
- From the standpoint of the City of San Jose, as the Plans' sponsor—whose taxpayers remain the "backstop" for Plan losses—it would also be helpful to gain insight about whether the current asset allocation strategy represents the optimal risk-return trade-off, particularly in light of the current rate of return assumptions.

APPENDIX B

Source and Use of Funds Statements

The following pages are excerpted from the City's 2017-18 Proposed Operating Budget. They are the Source and Use of Funds statements relevant to the retirement plans and are presented for display purposes only.

Source: City of San José 2017-18 Proposed Operating Budget Source and Use of Funds Statements

FEDERATED RETIREE HEALTH CARE TRUST FUND (124)*

STATEMENT OF SOURCE AND USE OF FUNDS

	2015-2016 Actual	2016-2017 Adopted	2016-2017 Modified	2016-2017 Estimate	2017-2018 Proposed
SOURCE OF FUNDS					
Beginning Fund Balance					
Claims Reserve	125,892,000	157,176,707	168,605,000	168,605,000	224,041,987
Total Beginning Fund Balance	125,892,000	157,176,707	168,605,000	168,605,000	224,041,987
Transfers					
City Contributions	26,035,000	30,715,000	26,344,538	26,344,538	29,233,648
Total Transfers	26,035,000	30,715,000	26,344,538	26,344,538	29,233,648
Revenue from Use of Money/Property					
Investment Income	(1,142,000)	2,061,456	12,935,071	12,935,071	18,498,783
Participant Income	17,881,000	18,308,902	16,212,378	16,212,378	15,852,586
Total Revenue from Use of Money/Property	16,739,000	20,370,358	29,147,449	29,147,449	34,351,369
TOTAL SOURCE OF FUNDS	**168,666,000**	**208,262,065**	**224,096,987**	**224,096,987**	**287,627,004**
USE OF FUNDS					
Expenditures					
Professional Fees	61,000	55,000	55,000	55,000	55,000
Total Expenditures	61,000	55,000	55,000	55,000	55,000
Ending Fund Balance					
Claims Reserve	168,605,000	208,207,065	224,041,987	224,041,987	287,572,004
Total Ending Fund Balance	168,605,000	208,207,065	224,041,987	224,041,987	287,572,004
TOTAL USE OF FUNDS	**168,666,000**	**208,262,065**	**224,096,987**	**224,096,987**	**287,627,004**

* This Statement of Source and Use is for display purposes only. The Federated City Employees Retirement Plan Board of Administration approved the annual administrative budget on 4/20/17.

FEDERATED RETIREMENT FUND (134)*

STATEMENT OF SOURCE AND USE OF FUNDS

	2015-2016 Actual	2016-2017 Adopted	2016-2017 Modified	2016-2017 Estimate	2017-2018 Proposed
SOURCE OF FUNDS					
Beginning Fund Balance					
Claims Reserve	2,009,643,000	1,883,058,925	1,916,121,513	1,916,121,513	1,943,446,839
Total Beginning Fund Balance	2,009,643,000	1,883,058,925	1,916,121,513	1,916,121,513	1,943,446,839
Transfers					
1980 COLA	1,448	2,500	2,500	498	525
1990 COLA	35,968	37,000	37,000	32,582	33,000
City Contributions	133,886,000	142,856,000	135,478,362	135,478,362	157,269,000
Total Transfers	133,923,416	142,895,500	135,517,862	135,511,442	157,302,525
Revenue from Use of Money/Property					
Investment Income	(36,315,000)	20,119,408	88,312,701	88,312,701	129,559,508
Participant Income	15,920,000	16,353,544	16,353,573	16,353,573	17,721,593
Total Revenue from Use of Money/Property	(20,395,000)	36,472,952	104,666,274	104,666,274	147,281,101
TOTAL SOURCE OF FUNDS	**2,123,171,416**	**2,062,427,377**	**2,156,305,649**	**2,156,299,229**	**2,248,030,465**
USE OF FUNDS					
Expenditures					
1980 COLA	1,448	2,500	2,500	498	525
1990 COLA	35,968	37,000	37,000	32,582	33,000
Benefits	173,318,000	186,994,799	179,449,810	179,449,810	197,394,791
Health Insurance	29,577,000	31,593,575	27,500,000	27,500,000	30,250,000
Professional Fees	529,654	1,266,000	1,270,500	1,270,500	1,381,200
Retirement Non-Pers/Equip	656,984	1,212,000	1,484,000	1,484,000	1,369,800
Retirement Pers Svcs	2,930,849	3,278,598	3,278,598	3,115,000	3,539,687
Total Expenditures	207,049,903	224,384,472	213,022,408	212,852,390	233,969,003
Ending Fund Balance					
Claims Reserve	1,916,121,513	1,838,042,905	1,943,283,241	1,943,446,839	2,014,061,462
Total Ending Fund Balance	1,916,121,513	1,838,042,905	1,943,283,241	1,943,446,839	2,014,061,462
TOTAL USE OF FUNDS	**2,123,171,416**	**2,062,427,377**	**2,156,305,649**	**2,156,299,229**	**2,248,030,465**

* This Statement of Source and Use is for display purposes only. The Federated City Employees' Retirement Plan Board of Administration approved the annual administrative budget on 4/20/17 It should be noted that the personal services costs reflected in this statement can vary from the budget presented to the Board due to revised salary, retirement, and benefit costs when compared to those that were projected in March.

FIRE RETIREE HEALTH CARE TRUST FUND (126)*

STATEMENT OF SOURCE AND USE OF FUNDS

	2015-2016 Actual	2016-2017 Adopted	2016-2017 Modified	2016-2017 Estimate	2017-2018 Proposed
SOURCE OF FUNDS					
Beginning Fund Balance					
Claims Reserve	19,420,000	26,660,421	27,079,000	27,079,000	35,733,572
Total Beginning Fund Balance	19,420,000	26,660,421	27,079,000	27,079,000	35,733,572
Transfers					
City Contributions	8,100,000	8,201,000	8,036,765	8,036,765	9,105,907
Total Transfers	8,100,000	8,201,000	8,036,765	8,036,765	9,105,907
Revenue from Use of Money/Property					
Investment Income	(420,000)	348,414	640,907	640,907	3,081,126
Total Revenue from Use of Money/Property	(420,000)	348,414	640,907	640,907	3,081,126
TOTAL SOURCE OF FUNDS	**27,100,000**	**35,209,835**	**35,756,672**	**35,756,672**	**47,920,605**
USE OF FUNDS					
Expenditures					
Professional Fees	21,000	20,000	23,100	23,100	23,100
Total Expenditures	21,000	20,000	23,100	23,100	23,100
Ending Fund Balance					
Claims Reserve	27,079,000	35,189,835	35,733,572	35,733,572	47,897,505
Total Ending Fund Balance	27,079,000	35,189,835	35,733,572	35,733,572	47,897,505
TOTAL USE OF FUNDS	**27,100,000**	**35,209,835**	**35,756,672**	**35,756,672**	**47,920,605**

* This Statement of Source and Use is for display purposes only. The Police and Fire Retirement Plan Board of Administration approved the annual administrative budget on 4/6/17.

POLICE AND FIRE RETIREMENT FUND (135)*

STATEMENT OF SOURCE AND USE OF FUNDS

	2015-2016 Actual	2016-2017 Adopted	2016-2017 Modified	2016-2017 Estimate	2017-2018 Proposed
SOURCE OF FUNDS					
Beginning Fund Balance					
Claims Reserve	3,161,406,000	3,052,037,246	3,090,401,299	3,090,401,299	3,273,478,778
Total Beginning Fund Balance	3,161,406,000	3,052,037,246	3,090,401,299	3,090,401,299	3,273,478,778
Transfers					
1970 COLA	534	1,000	1,000	534	530
1980 COLA	12,619	14,000	14,000	11,581	11,500
1990 COLA	5,125	5,500	5,500	5,125	4,445
City Contributions	133,869,000	137,477,000	134,752,086	134,752,086	159,886,480
Total Transfers	133,887,278	137,497,500	134,772,586	134,769,326	159,902,955
Revenue from Use of Money/Property					
Investment Income	(29,671,000)	30,513,214	231,165,477	231,165,477	222,296,039
Participant Income	39,515,000	38,934,030	38,934,211	38,934,211	41,630,579
Total Revenue from Use of Money/Property	9,844,000	69,447,244	270,099,688	270,099,688	263,926,618
TOTAL SOURCE OF FUNDS	**3,305,137,278**	**3,258,981,990**	**3,495,273,573**	**3,495,270,313**	**3,697,308,351**
USE OF FUNDS					
Expenditures					
1970 COLA	534	1,000	1,000	534	530
1980 COLA	12,619	14,000	14,000	11,581	11,500
1990 COLA	5,125	5,500	5,500	5,125	4,445
Benefits	186,940,000	201,450,427	191,676,795	191,676,795	210,844,475
Health Insurance	23,449,000	24,323,543	24,000,000	24,000,000	24,323,542
Professional Fees	758,565	1,331,950	1,488,500	1,488,500	1,529,200
Retirement Non-Pers/Equip	639,287	1,220,200	1,494,000	1,494,000	1,364,000
Retirement Pers Svcs	2,930,849	3,273,386	3,273,386	3,115,000	3,537,691
Total Expenditures	214,735,979	231,620,006	221,953,181	221,791,535	241,615,383
Ending Fund Balance					
Claims Reserve	3,090,401,299	3,027,361,984	3,273,320,392	3,273,478,778	3,455,692,968
Total Ending Fund Balance	3,090,401,299	3,027,361,984	3,273,320,392	3,273,478,778	3,455,692,968
TOTAL USE OF FUNDS	**3,305,137,278**	**3,258,981,990**	**3,495,273,573**	**3,495,270,313**	**3,697,308,351**

* This Statement of Source and Use is for display purposes only. The Police and Fire Retirement Plan Board of Administration approved the annual administrative budget on 4/6/17 should be noted that the personal services costs reflected in this statement can vary from the budget presented to the Board due to revised salary, retirement, and benefit costs when compared to those that were projected in March.

POLICE RETIREE HEALTH CARE TRUST FUND (125)*

STATEMENT OF SOURCE AND USE OF FUNDS

	2015-2016 Actual	2016-2017 Adopted	2016-2017 Modified	2016-2017 Estimate	2017-2018 Proposed
SOURCE OF FUNDS					
Beginning Fund Balance					
Claims Reserve	38,865,000	49,458,118	49,599,000	49,599,000	62,179,546
Total Beginning Fund Balance	38,865,000	49,458,118	49,599,000	49,599,000	62,179,546
Transfers					
City Contributions	11,576,000	12,477,000	11,455,063	11,455,063	11,819,178
Total Transfers	11,576,000	12,477,000	11,455,063	11,455,063	11,819,178
Revenue from Use of Money/Property					
Investment Income	(798,000)	619,621	1,173,883	1,173,883	5,084,085
Total Revenue from Use of Money/Property	(798,000)	619,621	1,173,883	1,173,883	5,084,085
TOTAL SOURCE OF FUNDS	**49,643,000**	**62,554,739**	**62,227,946**	**62,227,946**	**79,082,809**
USE OF FUNDS					
Expenditures					
Professional Fees	44,000	27,000	48,400	48,400	48,400
Total Expenditures	44,000	27,000	48,400	48,400	48,400
Ending Fund Balance					
Claims Reserve	49,599,000	62,527,739	62,179,546	62,179,546	79,034,409
Total Ending Fund Balance	49,599,000	62,527,739	62,179,546	62,179,546	79,034,409
TOTAL USE OF FUNDS	**49,643,000**	**62,554,739**	**62,227,946**	**62,227,946**	**79,082,809**

* This Statement of Source and Use is for display purposes only. The Police and Fire Retirement Plan Board of Administration approved the annual administrative budget on 4/6/17.

APPENDIX C

Excerpts from 2015-16 Retirement Plan CAFRs

Federated City Employees Retirement System:

Basic Financial Statements *(Continued)*

STATEMENTS OF CHANGES IN PLAN NET POSITION
For the Fiscal Years Ended June 30, 2016 and 2015 (In Thousands)

	2016		
	Defined Benefit Pension Plan	Postemployment Healthcare Plan	Total
ADDITIONS			
Contributions:			
Employee	$ 15,920	$ 17,881	$ 33,801
Employer	129,456	30,465	159,921
Total Contributions	**145,376**	**48,346**	**193,722**
Investment income / (loss)			
Net depreciation in fair value of investments	(57,268)	(6,600)	(63,868)
Interest income	21,199	1,172	22,371
Dividend income	12,198	3,702	15,900
Less: investment expense	(11,139)	(721)	(11,860)
Net Investment Loss	**(35,010)**	**(2,447)**	**(37,457)**
TOTAL ADDITIONS	**110,366**	**45,899**	**156,265**
DEDUCTIONS			
Retirement benefits	160,499	-	160,499
Healthcare insurance premiums	-	29,577	29,577
Death benefits	11,530	-	11,530
Refund of contributions	1,289	-	1,289
Administrative expenses and other	3,940	237	4,177
TOTAL DEDUCTIONS	**177,258**	**29,814**	**207,072**
NET (DECREASE) / INCREASE	**(66,892)**	**16,085**	**(50,807)**
PLAN NET POSITION - RESTRICTED FOR PENSION AND POSTEMPLOYMENT HEALTHCARE BENEFITS:			
BEGINNING OF YEAR	**1,925,774**	**209,761**	**2,135,535**
END OF YEAR	**$ 1,858,882**	**$ 225,846**	**$ 2,084,728**

See accompanying notes to basic financial statements. *(Continued)*

Police and Fire Department Retirement Plan

Basic Financial Statement *(continued)*

STATEMENTS OF CHANGES IN PLAN NET POSITION
For the Fiscal Years Ended June 30, 2016 and 2015 (In Thousands)

	2016				
	Defined Benefit Pension Plan	Post-employment Healthcare 401(h)	Police Department Healthcare Trust	Fire Department Healthcare Trust	Total
ADDITIONS					
Contributions					
Employee	$ 21,508	$ 18,007	$ -	$ -	$ 39,515
Employer	132,480	1,389	11,576	8,100	153,545
Total contributions	**153,988**	**19,396**	**11,576**	**8,100**	**193,060**
Investment income / (loss)					
Net depreciation in fair value of investments	(45,378)	(775)	(1,829)	(935)	(48,917)
Interest income	22,011	410	4	2	22,427
Dividend income	13,494	242	1,071	535	15,342
Net rental income	1,748	30	-	-	1,778
Less: investment expense	(21,081)	(372)	(44)	(22)	(21,519)
Net Investment Loss	**(29,206)**	**(465)**	**(798)**	**(420)**	**(30,889)**
TOTAL ADDITIONS	**124,782**	**18,931**	**10,778**	**7,680**	**162,171**
DEDUCTIONS					
Retirement benefits	176,029	-	-	-	176,029
Healthcare insurance premiums	-	23,449	-	-	23,449
Death benefits	10,083	-	-	-	10,083
Refund of contributions	828	-	-	-	828
Administrative expenses and other	4,254	74	44	21	4,393
TOTAL DEDUCTIONS	**191,194**	**23,523**	**44**	**21**	**214,782**
NET (DECREASE) / INCREASE	**(66,412)**	**(4,592)**	**10,734**	**7,659**	**(52,611)**
PLAN NET POSITION - RESTRICTED FOR PENSION AND POSTEMPLOYMENT HEALTHCARE BENEFITS					
BEGINNING OF YEAR	**3,110,065**	**51,341**	**38,865**	**19,420**	**3,219,691**
END OF YEAR	**$ 3,043,653**	**$ 46,749**	**$ 49,599**	**$ 27,079**	**$ 3,167,080**

See accompanying notes to basic financial statements *(Continued)*

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Sources: Federated City Employees Retirement System 2015-16 CAFR and the Police and Fire Department Retirement Plan 2015-16 CAFR

APPENDIX D

Summary of Government Finance Officers Association's Investment Fee Policy Recommendations

The Government Finance Officers Association (GFOA) developed a set of recommendations for public pensions to design an investment fee policy. They are as follows:

1. *Staff and consultants should negotiate the lowest competitive fees using measures and techniques such as:*
    - *Determining what fees similar investors are paying and making these peer comparisons part of the negotiation process.*
    - *Including a most favored nation clause (ensuring that the type and size of fees are at the level that is being made available to other similar investors) in the agreement.*
    - *Leveraging the consultant's knowledge of the marketplace to minimize fees for contracted services, keeping in mind that fees are a key component of the competitive procurement process*
2. *Give a specific individual or group of employees explicit responsibility for negotiating fees, and require that they report on the status of negotiations before the management agreement is executed. Consult with retirement system trustees to determine their interest in alternate fee structures (e.g., a fixed fee versus a performance fee that may have a higher or lower expected cost, based on performance).*
3. *Identify where the importance of competitive fee ranks among the multiple factors analyzed when selecting investment managers:*
    - *The primary factors to consider are demonstrated track records, proven investment talent, repeatable investment processes, competitive and strategic investment advantages, and other qualitative factors.*
    - *When screening investment managers, make sure fees are reasonable. Future returns are uncertain, while fees can be determined in advance. When one manager's fees are higher than another's, analyze the track record to determine whether the additional cost is necessary and appropriate.*
    - *Because fees for active management can be dramatically higher than fees for passive management, examine the fees, the investment process, and historical performance of active managers to determine the likelihood that their performance will be better than the index return, after fees.*
4. *When investing in traditional investments, ensure that the pension system is paying a reasonable, competitive fee by implementing the following strategies:*
    - *When using a separate account structure (whereby professional investors manage a portfolio solely for the system), establish fee break points as the manager's mandate grows.*
    - *Explore the possibility of excluding uninvested cash from management fees, where possible. If exclusions aren't possible, consider a refunding arrangement.*
    - *When investing in commingled and mutual funds (investment vehicles that pool assets of multiple investors), ask the manager to identify and quantify all levels of fees.*
        - *Any fee that aren't directly related to the management of the portfolio should be considered for elimination.*
        - *Seek access to the lowest-cost share class and require that any fees related to services provided to retail investors be refunded to the retirement system.*

- *Ask the investment manager to consider all the accounts it handles for your organization when determining fees.*

5. *When investing in alternatives, ensure that the retirement system is not paying excessive fees by implementing the following additional strategies:*

   - *Identify all fees. Paying a base fee is usually appropriate, but the fee policy should specify a preference for performance-based fees, where applicable. Focus on aligning the interests of the retirement system and the investment manager through the performance fee structure, potentially including fulcrum fees, hurdle rates, fee caps, and clawback provisions.*
   - *The fee policy should state a preference for performance fees that compensate the manager for alpha rather than beta, and it should include a hard hurdle. Alternative investment managers commonly use carried interest, participation fees, which are expressed as a percentage of net returns over a specified minimum return.*
   - *Rather than entering into direct partnerships with alternative investment managers, investigate the possibility of group purchasing arrangements such as an alternative investment fund of a P-share class. These options allow retirement systems to realize pricing concessions based on their meaningful economies of scale and their long-term investment horizon.*
   - *Look for ways to piggyback on other institutional investors to maximize economies of scale and increase negotiating leverage. One way of piggybacking is through a cooperative pool, in which an investment manager makes available a separate pool that provides lower pricing, based on the combined assets in the pool. Such break points are employed by mutual funds and commingled investment trusts and can be replicated through investment pools established for public pension funds.*
   - *Hire an attorney to oversee alternative investment contracts.*

APPENDIX E

Largest Disclosable Stock Holdings (by Market Value) for Federated and Police and Fire Pension Plans, FY 2011-12 to FY 2015-16

Federated Pension

	2012-13	2013-14	2014-15	2015-16	2016-17
1	Vanguard Russell 3000 Index*	Monsanto Co	Kinder Morgan Inc	National Grid PLC	Monsanto Co
2	Vanguard Developed Markets Index*	Oracle Corp	National Grid PLC	American Tower Corp	Exxon Mobil Corp
3	Monsanto Co	National Grid PLC	Oracle Corp	Monsanto Co	Samsung Electronics Co Ltd
4	TE Connectivity Ltd	Bank of New York Mellon Corp	Monsanto Co	Exxon Mobil Corp	National Grid PLC
5	Exxon Mobil Corp	Williams Cos Inc	Enbridge Inc	Enbridge Inc	Vinci SA
6	Potash Corp of Saskatchewan	Enbridge Inc	Royal Bank of Scotland Group	Oracle Corp	Transcanada Corp
7	AON PLC	Microsoft Corp	Bank of New York Mellon Corp	Kinder Morgan Inc	Citigroup Inc
8	BHP Billiton Ltd	BHP Billiton Limited	American Tower Corp	Crown Castle Intl Corp	Archer Daniels Midland Co
9	Google Inc Cl A	Royal Bank of Scotland Group	Williams Cos Inc	Syngenta Ag Reg	Bank of New York Mellon Corp
10	Compass Group PLC	Johnson + Johnson	Exxon Mobil Corp	Transcanada Corp	Oracle Corp

Police and Fire Pension

	2012-13	2013-14	2014-15	2015-16	2016-17
1	Exxon Mobil Corp	Oracle Corp	Oracle Corp	Oracle Corp	Samsung Electronics Co Ltd
2	Apple Inc	Bank of New York Mellon Corp	Royal Bank of Scotland Group	Bank of New York Mellon Corp	Citigroup Inc.
3	Vangaurd Total World Stock Index*	Microsoft Corp	Bank of New York Mellon Corp	Medtronic PLC	Bank of New York Mellon Corp
4	Microsoft Corp	Royal Bank of Scotland Group	Citigroup Inc.	Samsung Electronics Co Ltd	Oracle Corp
5	Johnson & Johnson	Johnson & Johnson	Arch Capital Group Ltd	Microsoft Corp	Arch Capital Group Ltd

	2012-13	2013-14	2014-15	2015-16	2016-17
6	Google Inc Cl A	Medtronic Inc	Medtronic Inc	Arch Capital Group Ltd	ABB Ltd Reg
7	General Electric Co	Arch Capital Group Ltd	Samsung Electronics Co Ltd	Johnson & Johnson	Marsh & McLennan Cos
8	Chevron Corp	Novartis AG Reg	Microsoft Corp	Marsh & McLennan Cos	Medtronic PLC
9	Proctor & Gamble Co/ The	TE Connectivity Ltd	Qualcomm Inc	Telefonica Brasil ADR	Baidu Inc. Spon ADR
10	Pfizer Inc	Compass Group PLC	Tesco PLC	Citigroup Inc	Microsoft Corp

*Indicates healthcare trust investment

Source: City of San José Retirement Plan CAFRs

PSFSS AGENDA: 10/19/2017
ITEM:

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: SHARON ERICKSON
CITY AUDITOR

FROM: Jennifer Schembri

SUBJECT: **SEE BELOW**

DATE: October 10, 2017

Approved Jennifer A Maguire

Date 10-10-17

SUBJECT: RESPONSE TO AUDIT REPORT – AUDIT OF RETIREMENT SERVICES: GREATER TRANSPARENCY NEEDED IN THE BUDGETING PROCESS, INTERACTIONS AMONG STAKEHOLDERS, INVESTMENT POLICIES, AND PLAN

The Administration has reviewed the ***Audit of Retirement Services: Greater Transparency Needed in the Budgeting Process, Interactions Among Stakeholders, Investment Policies, and Plan*** and is in agreement with the recommendations identified in the report. The following is the Administration's responses to Recommendation Numbers 6, 8, 10, 11 and 14. The Office of Retirement Services will be providing responses to the other Recommendations.

BACKGROUND

The Office of Retirement Services administers the City of San Jose's retirement plans, including the payment of retirement benefits and the investment of plan assets. Two Retirement Boards of Administration oversee the plans: one oversees the Federated City Employees' Retirement System and one oversees the Police and Fire Department Pension Plan (collectively, "retirement plans"). The City, as the plans' sponsor, is a key stakeholder of the retirement plans and contributes over $300 million to the retirement plans each year. And while the Retirement Services administrative budget has increased since FY 2005-2006, the retirement plans have experienced losses in FY 2014-2015 and FY 2015-2016.

The Mayor's Office requested, and the Rules and Open Government Committee approved, adding an audit of the administration of the Office of Retirement Services and the retirement plans to the City Auditor's work plan. The purpose of the audit was to assess the expenditures for the two retirement plans, including an analysis of professional expenses such as legal fees, administrative costs such as travel expenses, and staffing levels.

RECOMMENDATIONS AND ADMINISTRATION'S RESPONSE

Finding 1: Retirement Services' Budget Process is Not Well Defined

Recommendation #6: The City Manager's Office should update the City's Operating Budget to:

(a) Include total employee and employer retirement contributions in the City's operating budget as summary or historical information,
(b) Cross-reference its separate approval of the Retirement budget, and
(c) Modify the presentation in the Operating Budget's Source and Use statements to display investment expense.

Administration's Response to Recommendation #6:

The Administration agrees with this recommendation. Budget documents, including but not limited to the City's Operating Budget and Five Year Forecast have been and will continue to be routinely published and posted on the City's website to ensure accessibility to relevant budget information. However, it is noted that certain retirement expenditures could be more easily accessed if they were referenced in other budget documents. The Department will update the City's Operating Budget to provide a summary section related to employee and employer retirement contributions, cross-reference the City's approval of the Retirement budget and modify the Operating Budget's Source and Use statements to display investment income.

Finding 2: Improving Communications Between the Retirement Boards and the Plan Sponsor

Recommendation #8: The City should structure a formal process to orient new City Councilmembers about the Retirement Plans.

Administration's Response to Recommendation #8:

The Administration agrees with this recommendation. The Director of Employee Relations and the Budget Director meet with all new Councilmembers to brief them on the City's retirement plans as well as other issues related to budget, retirement, employee relations and collective bargaining. The City Manager's Office of Employee Relations and Budget Office will expand this orientation to provide a more detailed explanation of the City's retirement systems. It is recommended that the Office of Retirement Services also provide an orientation to new City Councilmembers about the Retirement Plans.

Recommendation #10: The City as the plan sponsor should provide the Retirement Boards, on a regular basis, with relevant budget documents, such as the City's 5-year budget forecast, the Mayor's budget messages, and the City's proposed operating budget.

Administration's Response to Recommendation #10:

The Administration agrees with this recommendation. As noted above, relevant budget documents, including the City's 5-year budget forecast, Mayor's budget messages, and the City's proposed operating budget have been and will continue to be routinely published and made available to the public on the City's website. The City Manager's Budget Office will ensure the Director of Retirement Services receives copies of these documents to provide to the Retirement Boards.

Recommendation #11: The City Council should clarify their expectations of the Council representatives to the Retirement Boards, including the type of report and frequency of reporting that would be most useful to the Council.

Administration's Response to Recommendation #11:

The Administration agrees with this recommendation. Council representatives provide a vital link between the City Council and the Retirement Boards and clarifying their role will foster better communication.

Recommendation #14: The City Administration should designate a City staff member as the liaison to Retirement Services and provide guidelines for the liaison's role (e.g. monthly meetings with the Retirement CEO and attendance at Retirement Board meetings.)

Administration's Response to Recommendation #14:

The Administration agrees with this recommendation. The City Manager's Office of Employee Relations has been and will continue to regularly monitor and attend Retirement Board meetings. The City Administration will discuss their role further, while being mindful that the Retirement Boards are council appointees and that the CEO of Retirement Services reports directly to the Retirement Boards.

COORDINATION

This report had been coordinated with the City Manager's Budget Office.

CONCLUSION

The audit report provides recommendations to improve communication between the City and the Retirement Boards as well as make information related to the City's retirement plans more accessible. The Administration values these recommendations for opportunities to improve. The Administration would like to thank the City Auditor and staff for this audit.

JENNIFER SCHEMBRI
Director of Employee Relations

For questions, please contact Jennifer Schembri, Director of Employee Relations at 408-535-8154.