

SDCERA

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SAN DIEGO
COUNTY GRAND JURY

August 10, 2007

David R. Higgins
Forman, County of San Diego Grand Jury
Hall of Justice
330 West Broadway, Suite 477
San Diego, CA 92101-3830

Dear Mr. Higgins:

Attached you will find the response to the findings and recommendations detailed in the Grand Jury Report entitled, "San Diego County Employees Retirement Association – The Quest for Alpha."

If you have any questions, please feel free to contact me.

Sincerely,



Brian P. White
Chief Executive Officer

ORIGINAL

San Diego County Employees Retirement Association Response to the San Diego County Grand Jury Report (San Diego County Employees Retirement Association – The Quest for “Alpha”) dated May 11, 2007

Finding (1): While hedge funds are riskier investment vehicles, they are becoming more common and mainstream within the market. According to a *Barron's* article on February 26, 2007, there are over 9,800 hedge funds in existence today, with more than \$1.4 trillion under management. The main thrust of this article was that business-school graduates and MBAs are clamoring for jobs at hedge funds as the place for huge rewards and the absence of “big bureaucracies.” As SDCERA assets continue to grow, it will need to diversify its funds over a wide range of investment opportunities. Over the next 10 years, the fund could easily grow in dollar assets to \$20+ billion, so that supplementing its own expertise with experienced consultants, like Albourne and Ennis Knupp (EK) could take SDCERA to the next level for pension fund investing. However, the key factor in dealing with hedge fund investing is **managing risk** and developing exit strategies when things go wrong.

Response: Agree.

Recommendation 07-24: Hire its **own risk manager** as an officer of the pension fund **reporting to CEO and the Board**. He/she will work with SDCERA's Chief Investment Officer and investment staff, Albourne, and Ennis Knupp to establish a Risk Management Department. The risk manager should monitor existing asset managers and provide risk analysis and weighting to the Board of Retirement, when choosing new fund managers. He/she should also assist the Board in developing appropriate exit strategies when an investment becomes too risky to retain; unacceptable changes occur in the asset management or its stated strategy; and/or, the investment no longer fulfills its original objective.

Response: **This recommendation was previously implemented.** SDCERA hired an investment officer in August 2006 to cover the areas of fixed income and risk management. It was also decided that an additional level of responsibility for oversight was needed. In January 2007 at the Administrative Retreat, the Board discussed the role of a Risk Officer. The role was discussed in subsequent meetings where it was defined, approved and added to the budget. Recruitment for the position was opened early July 2007.

Recommendation 07-25: In the interim period, the SDCERA CIO should work with Albourne America, LLC in implementing the “Alpha Engine Diversification” recommendations made by Cliffwater, LLC on December 18, 2006 (see Appendix C). Such actions would further diversify the dollar amounts of Alpha fund assets in terms of the risk attributable to each manager.

Response: **This recommendation was previously implemented.** Staff has been increasing the diversification of the Alpha Engine since its initial expansion in 1999 from one manager to six managers. Additional managers were added over time and the program contained 11 different mandates in 2006. Two additional managers were recommended at the September 2006 meeting. The diversification that was recommended by Interim Consultant Cliffwater was something that was already being worked on. SDCERA's current Alpha Engine consultant,

Albourne, has worked collaboratively with Staff to design a comprehensive Strategic and Tactical Plan, which the Board adopted at the May 17, 2007 meeting. The Plan recommends continuing on the path of additional diversification and is consistent with the prior diversification plan of Staff and with Cliffwater's diversification recommendation in January 2007.

Recommendation 07-26: Upon the completion of its lawsuit with Amaranth, provide its membership with a complete report providing full disclosure of all the reasons for the Amaranth loss. Nothing should be withheld.

Response: This recommendation will be implemented. At the conclusion of this litigation all non- confidential information will be disclosed.

Recommendation 07-27: Whenever possible, a subcommittee of SDCERA Board Members should accompany staff to on-site visits during the vetting process involved in selecting new managers.

Response: This recommendation will not be implemented. It is inconsistent with the management structure for the retirement board established by state law, is inconsistent with Governance Policy No. 4 on the role of the board, would impose an undue burden on board members without compensation, could undermine the policy objectives of the Brown Act, and would unnecessarily increase the expenses of the retirement system

Recommendation 07-28: Should not enter into "side-agreements" with asset managers which restrict the flow of pertinent information, and they should continue their program of eliminating all such outstanding agreements.

Response: This recommendation was implemented in 2006 based upon legislative amendments of the Brown Act and the Public Records Act and the retirement system will continue to conduct business in compliance with state law.

Recommendation 07-29: Board members should periodically review the proposed contracts of new asset managers to better understand the complexities of the agreement. Board members should also receive a copy of the Contract Consultant's report before voting on new asset managers.

Response: The recommendation that Board Members receive a copy of the consultants' report before voting on new asset managers had been previously implemented several years ago. The recommendation that Board Members review manager contracts will not be implemented, because it is inconsistent with the management structure for the retirement board established by state law and is inconsistent with Governance Policy No. 4 on the role of the Board. Managers are reviewed by knowledgeable staff and legal experts.

Finding (2): The Board should not automatically assume its efforts in obtaining "Alpha" results that exceed S & P 500 returns will happen on a long-term basis. Amaranth is the case in point.

Response: This finding is incorrect, since the Board does not automatically assume its active management strategy, which produces returns in excess of the index returns, will exceed the S&P returns on a long-term basis. However, it has been shown with statistical significance that the Fund has added considerable value above the policy benchmark, 148 basis points, for the trailing 10 years. That equates to value above the policy benchmark of over \$600 million dollars.

Recommendation 07-30: Should not substitute its own investment concepts to the methods currently employed by actuaries in the '37 Act counties.

Response: This recommendation is incorrect and cannot be implemented under state law. Actuaries are not investment experts. The Actuary uses a simple average of investment consultants' expected passive returns as the actuary's recommendation. The Board accepted the actuary's passive return assumption. In addition, the Board of Retirement adopted an additional 25 basis points of active returns, well below the 148 basis points over the policy benchmark the fund has been able to produce over the last 10 years. The actuary also agreed that this addition was within the acceptable range of his interest earnings recommendation and has stated, ... "the 8.25% adopted in 2005 and 2006 was in our judgment within the range of reasonable investment earnings assumptions for plans like SDCERA and continues to be within that range for 2007." Government Code section 31453 specifies that the retirement board "may, in its sound discretion, recommend a rate which is higher or lower than the interest assumption rate established by the actuarial survey."

Finding (3): The Tier I and II members are the most vulnerable to the potential loss in health insurance benefits. Many may not qualify for individual plans and those that do may have great difficulty in affording unsubsidized health insurance.

Response: Agree. However, all Tier I and II retirees are eligible for and have access to SDCERA sponsored health insurance plans.

Recommendation 07-31: Adopt the San Diego County's resolution covering Tier I and II retirees.

Response: This recommendation is not necessary given the action that the Board of Retirement adopted on May 3, 2007.

Finding (6): Ultimately, if SDCERA decides to only be responsible for Tier I and II retiree health benefits, then a portion of this five year reserve could be transferred to pay down part of the unfunded liability of \$1.2 billion, thus saving the County money for other programs.

Response: Disagree. Using the five-year reserve to pay down part of the unfunded liability would likely constitute a breach of the terms of the Ellsworth Settlement Agreement.

Recommendation 07-34: Consult with the actuary to determine how much of the health reserve could be used to pay down part of the unfunded liability.

Response: This recommendation will not be implemented because it would be unlawful. This recommendation would likely constitute a breach of the terms of the Ellsworth Settlement Agreement.

Finding (7): One of the SDCERA officials interviewed informed the Grand Jury that the Board of Retirement may adopt this new change in the Brown Act, which implied the Board would begin to discuss investment matters in closed session. Another witness stated this revision of the Brown Act was too broad, and the Board should continue to restrict closed sessions to legal and personnel matters, with exception made for real estate transactions. Use of closed sessions for investment decisions could also cause association members to lose confidence in the Board's commitment to openness in the management of its investments.

Response: Disagree. The adoption of a ban on closed session discussions of investment transaction would be imprudent and would arbitrarily limit the range of investment opportunities available for the retirement board's consideration. The determination of whether to conduct a closed session should be as to specific investments as authorized by Government Code section 54956.81. When the retirement board deems closed session to be appropriate, it is unlikely to diminish the confidence of the members or the public in the work of the board as information regarding the investment will be publically available. Consistent with Government Code section 6254.26(b), the retirement system provides detailed information, such as the name and address of investment funds, the dollar amount of the commitment, investment strategy and objectives, fiscal year cash distributions, the rate of return of the investment fund and the fund's management fees and costs.

Recommendation 07-35: Should not adopt the amended provisions of the Brown Act and continue to make its investment decisions at open meetings.

Response: This recommendation will not be implemented. This recommendation would limit investment opportunities and potentially adversely impact the performance of the SDCERA investment fund.

Finding (8): The acoustics in the room make it difficult to hear the speakers addressing the Board. In addition, SDCERA Board members cannot be heard by the audience when they do not speak directly into their microphones.

Response: Agree. The Retirement Association just moved into their new building in late 2006. While there may have been some technical difficulties these are part of the adjustments required when implementing a new electronic system.

Recommendation 07-36: The SDCERA CEO should consider improving acoustics in the room by possibly installing overhead speakers. Also, since those making presentations are of different heights, they should have the option of using a hand microphone.

Response: Agree. The Retirement Association is working with their vendors to fine tune the system. Changes will be made as recommended and required.

Finding (9): There have been many meetings where asset managers have had to wait for hours to speak to the board. This causes shorter presentations and little time for question and answer sessions. In some instances, SDCERA has paid the travel expenses of speakers.

Response: Disagree. The time devoted to investment matters was expanded several years ago by implementing a schedule for two retirement board meetings per month. Previously, administrative and investment agenda items were addressed at one monthly meeting. Consultants, investment managers and speakers are all informed prior to meetings about the agenda structure and the nature of the public meeting process. Avoiding time certain scheduling minimizes agenda gaps which waste the time of the retirement board and the public. The retirement board does not set time limits for presentations by consultants and investment managers and does not limit the time for questions and answers. The agenda materials distributed in advance of board meetings are an aid to efficient consideration of agenda items.

Recommendation 07-37: Investment Committee meetings should focus on investments and not include non-related agenda items. These interfere with the time allotted for presentations from new asset managers and regular reports from current investment consultant(s).

Response: This recommendation will not be implemented because this arbitrary agenda limitation would probably require the scheduling of special meetings, which does not facilitate public participation. The Board of Retirement meets twice a month. The first meeting has an emphasis on administrative matters and the second has an emphasis on investment matters. However, neither agenda is exclusive. Any matter, which needs to be discussed, must be put on the agenda in a timely fashion. Utilizing regular meetings to timely address board business benefits members and the public who wish to plan for meeting attendance.

Finding (10): The efforts of the Grand Jury were, at times, impeded by SDCERA.

Response: Disagree. SDCERA made all requested documents and witnesses available without the necessity of subpoenas, made out of town consultants available at SDCERA's expense, made its legal counsel available, made witnesses available for multiple interviews and the length of the interviews was at the pleasure of the Grand Jury. Pursuant to Evidence Code section 910, a witness may not be compelled by the Grand Jury to disclose privileged matter. It is improper for the Grand Jury to make an assumption of fact or to draw an adverse inference from the exercise of a privilege not to disclose a matter. Some aspects of the Grand Jury's inquiry involved matters which were and are the subject of pending claims or litigation and consequently are exempt from disclosure pursuant to the attorney-client privilege, the attorney work product doctrine, the Brown Act and the Evidence Code.

Recommendation 07-38: Advise its trustees, staff, and outside consultants of the necessity to cooperate with legally constituted investigations.

Response: **This recommendation was followed at all times.** Witnesses scheduled through SDCERA were informed of the confidential nature of the Grand Jury's investigative process and that he/she should not discuss their testimony with anyone except legal counsel. SDCERA's legal counsel conferred with the Office of County Counsel concerning the appropriate scope and form of questions pertaining to pending legal matters and understood that the Grand Jury concurred that witnesses were not at liberty to respond to questions, which fell within the scope of privileged matters. It is also improper to criticize a witness for limiting testimony to non-privileged matters within the scope of his or her personal knowledge or expertise as to the retirement system. The stated perception that the Grand Jury's study was thwarted is belied by the factual and technical detail of the report itself. It is irresponsible and unfair to make such an assertion in the absence of clear and convincing support.

SUBJECT: RESPONSE TO 2006-2007 GRAND JURY REPORTS (District: All))

**County of San Diego Response to Grand Jury Report:
“San Diego County Employees Retirement Association, The Quest for ‘Alpha’”
Issued May 15, 2007**

FINDINGS AND RESPONSES:

Finding: It may be difficult for Tier A retirees to switch policy coverage or enter a new health insurance plan that restricts open admission to a specific time period.

Response: Disagree. Nothing in the December 5, 2006 action of the Board of Supervisors deprived Tier A retirees from access to SDCERA sponsored health plans. Although there was some concern expressed that those plans might not be available if a specified percentage of retirees did not have part of their premium paid through the SDCERA health care allowance, that concern was speculative. In any event, pursuant to the actions of the San Diego County Employees Retirement Association (SDCERA) Board on May 3, 2007 and the San Diego County Board of Supervisors on June 19, 2007, Tier A retirees should continue for the foreseeable future to be eligible for and have access to SDCERA sponsored health insurance plans.

Finding: The SDCERA Board, in effect, became the plan sponsor, a role normally reserved for the actual employer, which in this case was the County. Later, the plan was tinkered with to create an IRC 401(h) plan in order for the pension board to comply with rules governing its 401(a) tax exempt status. Thus, the County became the sponsor in name only, as SDCERA operates and pays for the actual plan. This role reversal has created irreversible problems between and County and the Retirement Board that appear to be unsolvable.

Response: Agree

RECOMMENDATIONS AND RESPONSES:

The 2006-2007 San Diego County Grand Jury recommends that the San Diego County Board of Supervisors:

Recommendation 07-32: By separate action, give Tier A retirees a one-year moratorium and earmark their funding in the 401(h) until June 30, 2008. It would also give more time for the Board of Retirement and the Board of Supervisors to sort through all the issues.

Response: This recommendation will not be implemented. The actions of the San Diego County Employees Retirement Association (SDCERA) Board on May 3, 2007 and the San Diego County Board of Supervisors on June 19, 2007, make this action unnecessary.

Recommendation 07-33: Establish a new retiree health plan for its active members (Tier A). This plan could be set up as a part of the normal salary benefits negotiated between the County and its employee groups and unions. By taking this position, the County could remain competitive in the labor market and still control its costs. Then, the County could decide whether

SUBJECT: RESPONSE TO 2006-2007 GRAND JURY REPORTS (District: All))

or not to include the Tier A members who have retired between March 8, 2002 and June 30, 2007, in their plan or “grandfather” them into SDCERA’s 401(h) plan covering existing Tier I and II retirees.

Response: **This recommendation will not be implemented.** Pursuant to the actions of the San Diego County Employees Retirement Association (SDCERA) Board on May 3, 2007 and the San Diego County Board of Supervisors on June 19, 2007, Tier A members of the retirement system will not lose health insurance coverage from SDCERA.