

PATTI'S NOTES

SDCERS BOARD MEETING, Business & Governance Committee

April 14-15, 2011

(See also Patti's notes on Cheiron and CEO Mark Hovey's presentation to the City Council on March 21, 2011 below the SDCERS April Board notes.)

My Notes are by subject. They are my understanding of what happened.
Thank you to Mark Hovey, SDCERS' CEO, and his staff for checking my facts on the SDCERS Board meeting.

SDCERS Board's next meeting is Friday, May 20, 2011 at 8:30A.M.

Audit Committee- Wednesday, July 6, 2011 at 9:00A.M.

Business and Governance Committee- Thursday, May 19, 10:30 A.M.

Investment Committee- May 19th at 1:30 A.M.

SDCERS is located at 401 West A, Third Floor.

See SDCERS web site for official information.

UPDATE YOUR ADDRESS OR SDCERS CHECKS MAY STOP

A retiree, speaking during non-agenda public comment, said he failed to notify SDCERS of his address change and mail sent to him from SDCERS was returned as non-deliverable. SDCERS' policy was to assume he had died, so they stopped his checks. As a result, he had to prove he was alive in order to have his checks re-instated.

CHANGING SDCERS TRUSTEES

Richard Wilken, was sworn in. Past Trustee Joe Flynn and President Jim Baross of the City of San Diego Retired Employees Association (REA): recognized Dick Wilken for representing retirees on the Board.

Baross also expressed gratitude for Board's service.

A new SDCERS Trustee, elected by Police, will be sworn in at SDCERS' May 20th Board meeting.

Exiting Trustee Susan Gonick will be recognized at SDCERS May Meeting.

In non-agenda comment, Joe Flynn noted: "I want to publicly thank Trustee Susan Gonick for her past service on this Board. She added another dimension to the deliberations and her sage comments and feisty spirit will be missed. We thank her for her service to the City of San Diego, to members of the pension system, and to all citizens of San Diego..."

APPOINTMENT OF SDCERS BOARD VICE PRESIDENT

Trustee Herb Morgan is the new Vice President of SDCERS Board, replacing Trustee Ray Ellis, who is now acting President until the Board elects new officers later in the year.

SDCERS PRESENTS VALUATION TO CITY COUNCIL

Go to the City web site to see Gene Kalwarski of Cheiron and Mark Hovey present SDCERS June 30, 2010 actuarial valuation report to the City Council on March 21, 2011.

(See Patti's City Council notes below.)

SDCERS MARKET VALUATION

Reconciled market valuation (unaudited) of net assets was **\$5,191,689,166 on February 28th**, as reported by the custodial bank.

Staff informally noted an all-time high for SDCERS was reached in April.

SDCERS ACTUARIAL VALUATION

February 2011 Trust Financial Statements -Sara Jimenez
Actuarial value of SDCERS ending February 28, 2011 was \$4,653,950, compared to \$3,865,944 ending February 28, 2010.

INVESTMENT DIVISION UPDATE ON RETURNS

Fourth Quarter 2010 Executive Summary from HewittEnnisKnupp (HEK):

"The U.S. equity market finished 2010 strongly with the Dow Jones U.S. Total Stock Market Index producing total returns of 11.7% during the fourth quarter and 17.5% for the year."

Fixed income's return "Over the entire quarter, however was down only 1.3%, and still gained 6.5% for 2010."

Average investment Return since 12/31/88 for total fund was 9.3%.

Fourth quarter investment earnings were \$326,613,816.

2010 year end investment earnings were \$698, 729,344.

GETTING OUT GOOD NEWS ON RETURNS

Joe Flynn, former SDCERS Trustee representing retirees commented,

"As they say, Bad News Travels Fast, but good news has difficulty making it out of this room.... And for those who criticize SDCERS 7.75% actuarial interest rate as being too high I would point out that since Dec. 31, 1988 the fund's rate of return has averaged 9.3%. Yes, that is since 1988 through good years and bad....

That average rate of return is important, because another rarely reported fact is that of every dollar the pension fund pays out, 70 cents comes from interest earned.

For those viewing these proceedings, you are already better informed than most San Diegans - so tell a friend. The fund is in good hands.... If this information is going to get out, we have to do it ourselves."

INVESTMENTS IN INFRASTRUCTURE

Page 3 of SDCERS Chief Investment Officer Liza Crisafi's Status report for April 1, 2011:

"Staff has begun researching alternatives for implementing the Infrastructure asset class. Staff plans to continue this research and bring forth a recommendation at the July

meeting."

RISK STUDY BEGINS AT INVESTMENT COMMITTEE

The Board previewed, discussed and made suggestions on the development of the Review of Risk Assessment Analysis being overseen by Senior Investment Officer Corey Buuhoan. Buuhoan wrote: "It was ...determined that operational risks were addressed in SDCERS' last performance audit, and investment staff should focus on risks related to the investment portfolio." He noted there are high, medium, and low risk priorities.

In doing comparisons with other retirement system's risk assessments, Buuhoan notes that many of the "...risk management tools being utilized are driven by the need to more closely monitor assets invested by in-house staff, as opposed to 100% of the assets being outsourced to external managers, as is the case for SDCERS." SDCERS' investment staff researches, recommends and oversees the quality and performance of external managers and makes recommendations for SDCERS Board's final decisions.

The report from Hewitt EnnisKnupp (HEK), to SDCERS, lists the objectives as:

- * "Ensure that key risks that could impact SDCERS' investment portfolio were identified and documented."
- "Adequate processes and controls exist to monitor and mitigate these risks."

SDCERS' Investment Officer Amanda Montgomery noted three levels of SDCERS monitoring:

Level 1- Internal controls support work plans.

Level 2- Administrative control under preview of the Investment team reporting to SDCERS' Investment Committee, currently Chaired by Steve Meyer.

Level 3- Internal Auditor control.

In response to Trustee Dick Wilken's question on how monitoring is assured at SDCERS, Bob Wilson (SDCERS' Internal Auditor/Chief Compliance Officer) noted that compliance checks can be put into SDCERS auditing plan for CEO Mark Hovey's use.

Trustee Herb Morgan distinguished the quality differences of risks. As an example, he compared the importance of analyzing "worse-case-scenarios", versus the limited information of SDCERS Board just getting "risk-standard-deviations". Morgan asked for a brief risk education to the Board on the risks of new investments as they arise.

CITY PERFORMANCE AUDIT OF SDCERS

The City will be at SDCERS on July 6th as they continue to do an operational audit of SDCERS. (Patti's Note: There is a meeting of the SDCERS Audit Committee on July 6th, Wednesday at 9:00AM with very limited seating.)

The City Auditor is expected to report the audit results back to SDCERS Audit Committee, most likely in September. Hovey noted the City Audit was asking more than operational questions, with some inquiry into fees, etc.

(Patti's Note: Past President of SDCERS Board, Tom Hebrank is a newest of three outside members on the City Audit Committee, chaired by Council Pro-Tem Kevin Faulconer. Carl DeMaio is the other Council member. See re-plays of the City Audit Committee on the City web site.)

Below is SDCERS' Internal Auditor, Bob Wilson, Status Report to SDCERS Audit Committee:

"In January, the City Auditor's Office kicked off a performance audit of the administrative operations of SDCERS. This audit, requested by the City Council's Audit Committee, was scheduled into the City Auditor's FY 2011 work plan. After gathering a comprehensive package of requested documents, SDCERS staff met with the City staff to review the goals and scope of their audit. During February, the City audit staff met with each of our division managers to review their divisional responsibilities and operations. Field work is in progress now through the April-May timeframe. The focus is on reviewing elements of the SDCERS administrative budget line items, including some attempts at benchmarking, along with selected reviews of operational procedures. Their final report will likely be finalized sometime this summer. I (Wilson) will be planning to ask the City staff to present their report to the SDCERS' Audit Committee at the September meeting if all goes as expected."

SDCERS AUDIT COMMITTEE

The Board continued suggestions to update and adopt the Revised Audit Committee Charter to the next SDCERS Audit Committee on July 6th..

There was a suggestion to add: "With the assistance of the external auditor, review and approve the quality of the internal audit function, consistent with the Institute of Internal Auditors' Standards for the Professional Practice of Internal Auditing."

Chair Marilyn Brown also recommended:

- 1) Proposed revisions covering the quality of interior and exterior audit staff.
- 2) What needs to be done in Closed Sessions versus open sessions.
- 3) Developing a SDCERS' policy on no-revenge to outside companies if one of their staff is a whistleblower on a problem doing business with SDCERS staff (a popular state-wide topic due to past conflicts at CalPERS).

INFORMAL BENCHMARK OF OPERATING COSTS OF COMPARABLE CALIFORNIA PUBLIC PENSION SYSTEMS

SDCERS' Chief Financial Officer Robert Buscher and CEO Mark Hovey are still sorting out apples from oranges as they review the various budget styles of pension systems. They have been informally using the most recent Comprehensive Annual Financial Reports (CAFRs) available on other California pension systems, including SDCERS , Alameda County, Contra Costa County, Sacramento County, San Bernardino County, San Diego County and San Jose City. Their preliminary review excluded outside legal and actuary costs. At this stage, Buscher focused on over-all-cost, total membership and net asset size.

In this preliminary review, Buscher notes that SDCERS has "Generally higher legal,

insurance, actuary and rent costs..." and "Generally lower relative investment fees than other systems."

Cost differences are driven by scale and options. Buscher further noted that "Funding level greatly impacts results." SDCERS' was the fifth most efficient system of seven given current funding levels, but putting all systems at equal funding, SDCERS was the third most efficient system of seven. was 5th from the top funded, out of 7 systems. Hovey pointed out that the Government Standard Board is considering changing the footnote location of the Unfunded Actuarial Liabilities (UAL) in the CAFR.

As systems vary on how they report legal and investment expenses, the Board expressed interest in re-looking at legal and investment comparisons when they were listed separately from pension systems' administration costs.

The section of the report called "Proforma" took out legal, investment, and actuarial expenses. SDCERS' combined insurance, rent, legal and actuarial costs totaled \$3.5 million. Hovey noted that some other pension systems are housed by the plan sponsors, cover the system's technology expenses and/or legal costs.

Trustee Patrick Lane asked for a comparison of technology capital expenses. Trustees Richard Tartre and Wayne Kennedy said comparing trends in expenses over a long time period were most helpful.

ACTUARIAL COSTS AND PROPOSED PENSION PROPOSITION

Patricia Karnes, as V.P. Advocacy, City of San Diego Retired Employees Association(REA), commented that the retiree association would like to request that SDCERS study the actuarial impact of the proposed pension proposition and communicate the impact on SDCERS funding ratio that would affect retirees. What would be the impact if the City Attorney won his "Substantially Equal" lawsuit, and if the pension plan closed under the proposition, except for police?

Later, Trustee Dick Wilken asked the Board to be pro-active. SDCERS owes our plan sponsor and members information on what is coming down the track, he said. He asked if SDCERS FY2012 budget included the cost of a work plan to do an actuarial study of Substantially Equal, the pension proposition, and the sufficiency of SDCERS' funding.

CEO Mark Hovey said details from the plan sponsor were needed before the actuary would be able to do a complete analysis. Hovey pointed out that SDCERS is not a pay-as-you-go system. Each member's rates are calculated separately and do not cover others' retirement benefits. He noted that the proposed proposition initiative was by public signature, and not proposed by the City.

SDCERS acting President, Ray Ellis, encouraged individuals in the City to come to SDCERS for correct information.

PROPOSED FY 2012 \$45,442,000 BUDGET

The budget is still in process. A revised budget will be presented at SDCERS Board's

May meeting, largely focusing on investments. Then it will go to the City Council in May for their information. The City Council "accepts" it and does not approve it.

Board comment:

Trustee Mark Oemcke recommended strategic long-term budget planning, which Hovey is projecting for next Fall or Spring.

Currently, there was a \$2.5 million reduction in investment expenses by the move to passive investment, however there was a \$3.5 million increase in investment expenses due to new areas of investment.

Trustee Alan Arrollado asked how administrative expenses were funded, and was told it does not come directly from Plan Sponsors, but rather is deducted from plan assets and goes into a 15 year amortization schedule.

Trustee Gregory Bych noted:

- 50% of SDCERS budget is not staff.
- 20% goes to rent and insurance.
- SDCERS is currently carrying the cost of the old technology system, as well as, the transition to the new technology
- 20% goes to legal expenses. He recognizes the need for fiduciary attorneys for lawsuits, etc.

Outside fiduciary counsel is expected to be \$500,000 in FY 2012.

Trustee Patrick Lane wanted to see staff succession planning beyond the executive level.

The Board also learned that less actuarial work would be required in FY2012 and a reduction in the need for outside labor due to completion of the PSC correction process.

(See Tab 29, also see Tab 35 in SDCERS Board Packet)

CFO Bob Buscher reports on page 1:

"At \$15.3 million, Administration expenses represent 33.6% of the total SDCERS FY 2012 budget, continuing a declining percentage-of-total-budget trend dating back six years."

"At \$30.2 million, Investment Management expenses represent 66.4% of the total SDCERS FY 2012 budget, compared to 64.6% of the FY 2011....primarily due to increased allocation of investments to real estate, the implementation of an allocation to infrastructure in FY 2012 and the assumed 7.75% investment return on equities and fixed income."

Page 3:

"Investment management fees are projected to increase by \$1,515,000 (5.3%) from the FY 2011 budget, which is approximately 2.5% less than the projected growth in the asset base."

In his March 31, 2011 Finance and Benefits Administration report (Tab 35) Buscher wrote: "Notably, no new staff additions have been proposed for the coming year and there is no provision for a general salary increase."

DROP BENEFIT ELECTION.

SDCERS conducted an election in which Active members voted on proposed changes to DROP.

Communication Manager Robyn Bullard's report states there were 119 Yes votes and 3,286 No votes. "The proposed measure failed for lack of a majority vote of the members of the System."

REVISED STATEMENT OF POLICY UNDER PROPOSITION 162 AND CITY CHARTER.

"The California Pension Protection Act of 1992 enacted by California's voters as Proposition 162 in November, 1992, amended ...the California Constitution to state that: '...the retirement board of a public pension or retirement system shall have plenary authority and fiduciary responsibility for investment of monies and administration of the system....'

SDCERS Board policy notes that the Board "...will take all appropriate actions, consistent with its fiduciary responsibilities, to maintain its constitutional independence...." Areas of responsibilities: Investments, Budget, Actuarial, Fund Accounting and Payment Processing, Legal Services, Plan Interpretation and Administration, Contracting, Information Technology, and Human Resources. Under Investments: "SDCERS' participants' and beneficiaries' interests will take precedence over all other interests in the management of the investment program to ensure that sufficient assets are available to provide them with all benefits due as specified in SDCERS plan document."

REVISED OVERPAYMENT AND UNDERPAYMENT POLICIES.

This policy change will return at a later Board meeting for a vote.

Changes to this Board policy do not apply to PSC corrections as the Court said the member must pay all the cost.

Discussion of changing interest rates for varying circumstances, as well as, IRS tax compliance. Contact SDCERS for further information.

UPDATE ON PSC CORRECTION PROCESS - SDCERS' CEO MARK HOVEY See SDCERS WEB SITE FOR LATEST NEWS!

Trustee Alan Arrollado stressed the importance of affected members attending SDCERS' seminars on the correction process.

Cynthia Queen, Membership Services, noted many members are inquiring what the tax would be if they took refunds.

In the worse case, people who fail to respond to SDCERS' letters, do not have service credits necessary to retire, and who do not the PSC to retain eligibility, will have their checks terminated.

Hovey recommends monitoring SDCERS web site for updates if you are interested.

See also Hovey's report to the Audit Committee under Tab 42 under the SDCERS Board Packet on the web site, as well as Elaine Reagan's Legal Services Report Tab 30, Bob Wilson's Compliance report Tab 33 and Tab 45, and Robert Buscher's report on Tab 35.

* Court hearing on April 22nd at 2:30PM, to clarify application of PSC correction action

for 240 active DROP members who entered DROP after November 20, 2007.

* Internal Auditor/Chief Compliance Officer Bob Wilson's report to the Audit Committee:
"...the staff team has diligently worked to compute to the numbers for over 2,000 members who had affected PSC contracts."

"Nearly 500 of the 2,000 affected members are retired or in DROP, so their calculations also involve retroactive calculations of benefits and possible recovery of overpaid benefits."

The IRS has not yet assigned an agent to review SDCERS' voluntary correction program application for court ordered PSC pricing corrections.

Buscher wrote in his report, that SDCERS' Finance and Benefits Administration is "...developing the procedures necessary to handle the significant increase in staff workload once the Members elect their respective PSC correction option."

PUBLIC RECORDS ACT POLICY

No changes to this Board policy.

LEGAL SERVICES - Elaine Reagan

Substantially Equal: Court of Appeals has requested a briefing from the City Attorney on his challenge changing the venue to Los Angeles County.

Barton Case: "The City filed a Notice of Appeal on January 7, 2011."

Italiano Case: "City advises it will appeal final judgement when entered."

Saathoff Case: "12-29-10: Plaintiffs corrected Notice of Appeal lodged.
4-8-11: Respondents' Briefs due.

PATTI'S NOTES

CITY COUNCIL- SDCERS PRESENTATION ON ARC AND VALUATION

AT 2:00PM MARCH 21, 2011

This is my understanding of the presentation. See the City web site for official recording.

SDCERS CEO Mark Hovey and SDCERS outside actuary, Cheiron, presented SDCERS June 30, 2010 Valuation and ARC (City's annual required contribution) for budget year 2011-2012 at \$231.2 million to the City Council Meeting 2:00p.m., March 21, 2011. Hovey announced review of SDCERS assumptions used to prepare the ARC would be ready this summer for presentation to the SDCERS Board

DeMaio said if other pension systems were having problems also, then police would not leave for better benefits elsewhere. He noted that as lower level employees are laid off, leaving higher paid employees, that the average pension goes up, and demanded the

Council cap the amount allowed for a pension.

DeMaio also argued with Cheiron, saying SDCERS Board could close the pension system on their own terms, and not use government rules. He noted that SDCERS was already aggressive in the amortization for year 17 in a 20 year period so he did not see the ARC going up if the system was closed. Brief discussion of SDCERS Board rule against negative amortization, less about public approval of 15 year amortization. Council President Young verified that if employees go for 401Ks, and stop paying into the pension system, then the payment for the UAL goes up.

But the City Attorney had a plan to deal with an increased \$2-plus billion UAL debt with his Substantially Equal Lawsuit. Apparently employees are already leveraged to leave for 401K plans in the City Attorney's eyes.

DeMaio asked Hovey to send him how much the Substantially Equal lawsuit would reduce the ARC, as DeMaio announced that the City could go through bankruptcy several times before the ARC payments drops after 2024.

Gloria asked Goldsmith if the City was near bankruptcy? Goldsmith said "No".

Hovey noted the Purchase of Service Credit correction was still in process. Cheiron included 50% of the estimated PSC underpayments as a credit in the City's actuarial valuation, and noted this was their best estimate of the ultimate amount the City would recover.