

SAN DIEGO COUNTY EMPLOYEES RETIREMENT ASSOCIATION THE QUEST FOR “ALPHA”

SUMMARY

On August 29, 2006, the 2006-2007 San Diego County Grand Jury undertook an investigative study of the San Diego County Employees Retirement Association (SDCERA). SDCERA was founded in 1938, when the County Board of Supervisors adopted the provisions of the State of California’s “County Retirement Act of 1937” (’37 Act) to establish a pension system for its employees. The provisions contained in the ’37 Act, as it is called, delineate the organizational structure, rules of eligibility, and payment formulas to be used by a county retiree association. The Act vests the management of each pension plan in a board of retirement consisting of nine members, one of whom shall be the County Treasurer. The other members are chosen either by election from association members or appointment by the County Board of Supervisors. The division between these two methods of selection is four members each, and the Board of Supervisors may appoint a sitting member of its own board. This prescribed selection process can, at times, result in a divided Board in matters of divergent interest between the County (plan sponsor) and the members served by the plan.

According to the Constitution of California (Article XVI, section 17), the retirement board of a public pension system shall have the sole and exclusive fiduciary responsibility for the assets of the plan. This article establishes a board of retirement as an independent entity, and it goes on to state that the members of the board shall discharge their duties solely in the interest of, and for the exclusive purposes of providing benefits to participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system. Hence, the Board of Retirement acts as the trustee of all the funds held for current and future retiree pension payments. It is a vested “defined benefit plan” for county employees whose current membership as of January 1, 2007, includes 17,622 active general and safety members, 4,841 deferred members, and 12,346 members or their beneficiaries now receiving benefits. Total membership is 34,809.

In recent years (see Appendix A), the pension fund has grown substantially in dollar value, and as of the end of the 2006 fiscal year (6/30/06), the audited value of the fund was \$7,330,948,000. This growth is directly related to the **excellent investment results** generated during the last five years with an average return of 9.8%. A second reason for this rapid increase in net assets has been the County’s infusion of \$1.2 billion from the proceeds of pension obligation bonds issued in fiscal years 2003 and 2004. This was necessitated by the funding deficiencies (see unfunded ratio, Appendix A) caused by the Board of Supervisor’s granting enhanced benefits to a new tier (Tier A) of employees

retiring on or after March 8, 2002. The benefit formula changed, wherein general members could earn a retirement check at age 60 based on 3% of their highest yearly earnings multiplied by the number of years of service. Those members working in the field of public safety also became eligible for the same formula, except they can retire at age 50. Thus, an employee with 30 years of service could expect to receive 90% of his/her salary at age 60 (age 50 for public safety). This action paralleled similar changes in other California government entities, but it did create a serious under-funding of the pension system since it was tantamount to a 50% increase in benefits for many members without a similar increase in county contributions. Today, the unfunded ratio, as determined by the actuary, stands at 83.6%. Anything less than 80% is considered a concern for the viability of the plan to pay the future benefits of its active members.

In addition to pension benefits, the Board of Retirement has authorized each year since 1974, the payment of health insurance premiums for current retirees from “excess earnings” generated from investments over the Assumed Rate of Return determined by the actuary for the particular fiscal year. In order to qualify this payment for tax exempt status, the Board of Retirement entered into an agreement with the Board of Supervisors in 2000 to develop a method of compliance with the Internal Revenue Code (IRC) for a 401(h) health plan. This will be discussed later in the report. In 1998, the Board of Retirement authorized another monthly benefit called Supplemental Targeted Adjustment for Retirees Cost of Living Adjustment (STAR COLA) to eligible retirees that supplements the loss in purchasing power not otherwise compensated by regular cost of living adjustments (COLA) made each year. Neither of these supplemental benefits is vested, and there is no guarantee of future funding participation by either Board. **This report was completed on April 30, 2007, and it does not reflect any changes or actions taken by the San Diego County Employees Retirement Association Board of Retirement and/or the San Diego County Board of Supervisors after that date.**

PURPOSE

SDCERA is an independent board. Although bound to the County of San Diego by the '37 Act, it is not subject to the County's oversight. Nor are the actions of the Retirement Board subject to any review or monitoring by its members, other than their Brown Act opportunity to speak at open meetings and the election process by which members can vote for the board candidate representing their category of membership (General, Safety, or Retiree). Hence, depending on a member's status, he /she can only vote for one or two board members on a biennial basis. In view of the above, this study was crafted by the Grand Jury as an opportunity to look into how effectively SDCERA manages its affairs to meet its obligation to guarantee a pension for current and future retirees and/or their beneficiaries. Association members should have a high level of confidence that their pension is secured for the future. It should be noted that there have not been any major Grand Jury studies on SDCERA. Since SDCERA is a large operation, and due to time constraints, the Grand Jury focused its review on the following areas:

- Fund Investments
- Actuarial Determinations
- Retiree Health Insurance Benefits (401h)
- Conduct of Board Meetings
- Use of Outside Consultants and Auditors

The goal and objective of the Grand Jury study is to ensure that SDCERA is operating within the provisions of the '37 Act and other applicable laws, and that every effort is being made to safeguard pension benefits and minimize costs ultimately borne by tax payers.

PROCEDURES

Reviews:

- Read and reviewed all the minutes of the SDCERA Administrative Board Meetings held on the first Thursday of each month and the Board's Investment Committee meeting held on the third Thursday of each month from January 1, 2000 to April 2007.
- Reviewed and analyzed the 1937 Governance Act and applicable articles from the State of California Constitution.
- Read the *Kroll Report* and *Navigant Study* pertaining to the City of San Diego Employees Retirement System (SDCERS).
- Read, reviewed, and analyzed three multi-strategy hedge fund contracts for D. E. Shaw, Amaranth, and Silver Point.
- Read, reviewed, and analyzed the consulting contract for Albourne LLC.
- Read and reviewed investment articles written during this period concerning Amaranth and hedge fund investing found in *Barron's*, *Wall Street Journal*, *Business Week*, *Fortune*, and other financial publications
- Read, reviewed, and analyzed SDCERA's *Comprehensive Annual Financial Report* (CAFR) for fiscal years 1999, 2000, 2001, 2002, 2003, 2004, 2005, and 2006.
- Read and reviewed miscellaneous documents and letters obtained from SDCERA and the Board of Supervisors

Visits:

- Attended fifteen Administrative or Investment Board meetings from August 2006 to April 19, 2007.
- Watched video tapes of the July 21, 2005 and March 1, 2007 meetings.
- Attended meetings where the Kroll Report and Navigant Study were presented to the San Diego City Council and the San Diego City Employee Retiree System Board.

Interviews:

- Interviews and sworn testimony taken from 14 witnesses
 - Three officials from SDCERA staff
 - Three current members of the Retirement Board
 - Four outside consultants in the areas of actuarial determinations, auditing financial reports, and contract review for investments.
 - Four follow-up interviews were also conducted with persons listed above

DISCUSSION

INVESTMENT OF FUNDS

General Comments

The State Constitution of California specifies that the retirement board of a public pension shall diversify the investments in its system so as to minimize the risk of loss and maximize the rate of return. At the beginning of each fiscal year, the General Consultant for the fund recommends to the Board of Retirement different target portfolio strategies associated with different levels of risk. Once adopted by the Board, it becomes the model for the allocation of funds to different asset classes (see Appendix B). In addition to a general consultant, there is a separate consultant for the portfolio of hedge funds. SDCERA invests all of its assets with individual managers who are hired based on the recommendations and due diligence completed by one of the consultants. Both consulting positions were held by Rocaton Investments prior to October 2006. A new consultant, Albourne America, LLC has been selected out of four competing firms for the position with the Alpha portfolio of hedge funds. Albourne is an investing consultancy firm that has focused solely on the evaluation of the hedge fund spectrum since 1994. Its eighty-six clients have more than \$150 billion invested in hedge funds. Its contract with SDCERA calls for the firm to produce research reports in five primary advisory areas: due diligence, manager screening, portfolio construction, risk management, and strategy research. The Board recently approved the appointment of a new General Consultant, a Chicago based firm called Ennis Knupp (EK). In addition to corporate clients, EK serves twenty-six public funds with aggregate assets of \$750 billion. During its normal course of operations, SDCERA relies on these consultants to give them the type of research and assessment of potential managers to sustain a more sophisticated investment program compared to its peers in California. SDCERA also places strong reliance on consultants to monitor the individual asset manager's ongoing performance and suitability to remain in the fund.

In terms of risk and reward, SDCERA manages a higher risk/higher return fund than most of its contemporaries. According to management, the record of performance has

been “excessively rewarded for the risk taken.” In this regard, the investment program has been controversial with some of SDCERA’s constituents and critics, because of the allocation of 20% of fund assets to hedge funds. The program is under intense scrutiny, and staff and board of SDCERA have come to the defense of this investment strategy in public meetings and through its published performance reports to the extent that there is an active advocacy on behalf of hedge fund investing. The expression “Alpha Engine” is the mathematical term for **beating the market**. One of their primary arguments is that hedge funds provide the opportunity to exploit uncorrelated investment sources that add value (i.e. Alpha) to the fund irrespective of the direction of the broad market of stocks, such as the Standard and Poors Index (S & P 500). In a down market, hedge funds can be a buffer against and reduce market losses. However, hedge funds:

- Operate in environments of illiquid assets;
- Use leverage to enhance their positions;
- Require lengthy “lock-up” periods where investors do not have access to their money;
- Charge high fees;
- Engage in short-selling;
- Are subject to rapid changes in market conditions;
- Often place no limitations on the strategies employed by the manager; and
- Are a higher risk vehicle for investor.

For these reasons, hedge funds are more volatile, and the investor is more dependent on the manager’s ability to handle rapidly changing market conditions.

With the implosion and collapse of Amaranth Advisors, LLC on September 19, 2006, SDCERA’s use of hedge funds has been further called into question. The anticipated loss from this venture will be in excess of \$150,000,000 based on an auditor’s footnote in the 2006 SDCERA CAFR. To date, \$63,000,000 has been recovered and approximately \$15,000,000 more is pending the final dissolution of Amaranth’s remaining assets. A lawsuit against Amaranth and its key executives was filed on March 31, 2007, in the New York courts to recover the original investment of \$175,000,000. The outcome of the lawsuit will not be known for some time.

Multi-Strategy Hedge Funds: D. E. Shaw, Amaranth, and Silver Point

A multi-strategy hedge fund is one where the manager simultaneously invests in multiple strategic investments and is free to shift assets within the fund at his own discretion. At the July 21, 2005, Investment Committee Meeting, Rocaton consultant, Robin Pellish, presented two hedge fund managers, Nicholas Maonis of Amaranth LLC. and Trey Beck of D. E. Shaw to the Board of Retirement. Each fund had been vetted by both staff and consultant, Rocaton, and board approval was sought for a \$175,000,000 investment in each manager’s hedge fund. The Board had already been in session for four hours on matters not relating to investments. Each manager cut his presentation short limiting the

amount of information available to the Board. Mr. Maounis listed about eight strategies in which his firm was currently invested, but did not mention natural gas trading as an activity of his fund. Directional trading in natural gas energy contracts would later cause the collapse of his hedge fund firm. One Board member questioned Maounis about the addition of a 2% yearly fee for fund expenses on top of the normal 1.5% fee charged by hedge funds. This Board member stated this is the “biggest fee structure” used by any hedge fund. These fees are paid monthly and at the end of the year 20% of the investor’s profits are deducted by the fund manager. The addition of a 2% fee made Amaranth a much riskier fund simply on the basis that the manager would be under pressure to take on higher risk for greater gain to satisfy and retain investors. The Amaranth contract signed by SDCERA is also replete with 17 pages devoted to a wide variety of risks that could cause the investor to lose all or part of his money, and this contract in particular, highlighted the risks involved in energy trading. Both fund managers received approval of the Board at this meeting. Silver Point was subsequently approved for a \$125,000,000 investment at a later meeting.

Another problem that occurred at the outset of entering into these three multi-strategy contracts was that each fund manager required SDCERA to sign a confidential side-agreement limiting access to fund information. Due to concerns with California freedom of information laws, hedge fund managers viewed SDCERA as a “disclosure risk” for proprietary information that they did not want competitors having access to. The side agreements established what is termed as a “Chinese Firewall”(this term refers to the internet firewall established to screen out information contained in Google, Yahoo, and other search engines that the Chinese government deems objectionable) wherein confidential information would not be provided directly to SDCERA, but could be available to SDCERA’s consultant, Rocaton. This has limited SDCERA’s monitoring and due diligence capabilities and placed the burden on the outside consultant. Legislative changes in 2006, which amended the California Government Code Section 2654.26 on Investment Disclosures, now permit public pension funds to limit release to the public of certain types of information regarding their hedge fund holdings. The amended act spells out more clearly what the public can have access to and what the pension fund can retain as confidential information.

The contracts for all three multi-strategy hedge funds are very “dense” in the use of legal language, which often defies understanding of basic terms and conditions. This is particularly true in determining what the withdrawal provisions are in each contract. The SDCERA Contract Consultant reviewed the withdrawal provisions and provided reports on the D. E. Shaw and Silver Point contracts to the Grand Jury. Each contract is a maze of details on such things as advance notice required for withdrawals, percentage of capital that can be withdrawn at specific times, withdrawal penalty fees, authority of the manager to change a withdrawal request, and the percentage of the asset fund which is illiquid and not subject to withdrawal. All three contracts delegate immense discretionary authority to the manager to change the conditions and rules, and to place

limitations on distributions. They offer almost no opportunity for early withdrawal of SDCERA fund assets.

As a part of his duties, the Contract Consultant reviews each new asset manager's contract and provides SDCERA's investment staff with a written legal evaluation highlighting significant terms in each contract.

FACTS/FINDINGS/RECOMMENDATIONS

Fact: SDCERA currently invests up to 20% of its fund assets (\$1.5+ billion) in hedge funds in its "Alpha Engine" portfolio. It believes that alternative investments enhance value over time, and based on staff estimates, \$750 million has been added to the fund over the last ten years from these investments alone.

Finding: 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.

Recommendations

The 2006-2007 San Diego County Grand Jury recommends that the San Diego County Employees Retirement Association (SDCERA):

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.

- 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.
- 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.
- 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.
- 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.
- 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.

ACTUARIAL DETERMINATIONS

General Comments:

The broadest statement of actuarial requirements appears in the California Constitution (Article XVI, Section 17 (e)) which provides:

“The retirement board of a public pension or retirement system, consistent with the exclusive fiduciary responsibilities vested in it, shall have the sole and exclusive power to provide for actuarial services in order to assure the competency of the assets of the public pension or retirement system.”

To this end, SDCERA has retained an actuary with the expertise to determine how much to put into the fund each year to fully fund a person’s pension by age 60, such that an annuity has been established to cover his/her payments and any surviving beneficiaries for the remainder of their lives. In accomplishing this task, the actuary completes an actuarial valuation each year, which updates the status of active members to reflect changes in age, salary, and other demographic factors affecting longevity and how much funding will be required as a retiree. After completing this process, the actuary is prepared to determine (1) “normal cost” for all employees of what it takes to stay even

each year, and (2) the payment needed for the unfunded liability which is currently under a 20 year amortization plan ending in 2024. The latter is the debt the fund incurred in 2002 when the stock market declined and the Board of Supervisors authorized enhanced retiree benefits as a part of its salary package that year. In determining how much the County's Annual Required Contribution (ARC) is for the next fiscal year, employee contributions are added to the "normal cost" and the payment due for the amortized debt (unfunded liability). Employee contributions include the percentage of overall salary designated by the plan even though some employee contributions are picked up by the County. The total of the three: normal cost, amortized debt, and employee contributions represent the County's ARC, and the funds are wired to SDCERA's bank in one lump sum payment in July of each year.

Assumed Rate of Return:

This is the percentage return expected from fund investments over a long period of time. Currently, the SDCERA Board has set the rate at 8.25%, which is higher than the 8% recommended by the actuary in June 2006. The actuary uses S&P 500 indexed returns to project the long term rate of return adjusted for inflation. Other '37 Act counties use an Assumed Rate of Return in the range of 7.75% to 8.25%. Investment earnings above 8.25% are considered "excess earnings" which are used to fund other programs to be discussed in other sections of this report. The Assumed Rate of Return is also used in calculating the interest due to SDCERA from the County on the unfunded liability (debt) which stood at \$1,232,275,000 on June 30, 2006.

There is some public perception that the SDCERA Board is not accepting the professional advice of its expert consultants. According to the minutes of the July 6, 2006 meeting, the Board reached its conclusion on the basis that the "Alpha Engine Portfolio" has consistently beat the market such that a 0.25% increase is justifiable on a long term basis. This is a risk tolerant board that believes that "Alpha" can be attained through its alternative investments, such as hedge funds. A decrease in the Assumed Rate of Return would cause, among other things, an increase in employer and employee contributions. This, however, is a policy decision of the board.

FACTS/FINDINGS/RECOMMENDATIONS

Fact: The actuary is the expert hired to recommend the steps necessary to keep fund assets on an actuarial sound basis.

Finding: 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.

Recommendations

The 2006-2007 San Diego County Grand Jury recommends that the San Diego County Employees Retirement Association (SDCERA):

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

RETIREE HEALTH CARE BENEFITS

Background:

SDCERA offers to County retirees a post-retirement health benefit plan wherein monthly medical insurance premiums are paid to pre-selected groups of healthcare providers. The current maximum medical allowance is \$400 per month for those with 20 years of service, and for retirees with 10-20 years of service, the monthly allowance is pro-rated. For Medicare recipients, the benefit is \$300 per month for the retiree and surviving spouse. The plan also reimburses Medicare retirees 100% of the Medicare Part B premium which is \$93.50 per month effective January 1, 2007. For fiscal year 2006, \$32,878,648 was expended on healthcare benefits. For various reasons, 34% of retirees do not participate in the program.

401 (h) Conundrum:

U.S. Treasury Regulation 1.401-1(b)(1)(i) states the general rule that the assets of a tax-qualified pension plan can be used only to provide traditional retirement benefits. This precludes the plan from, among other things, paying for healthcare benefits out of pension assets including earnings from investments. The Internal Revenue Code (IRC) does, however, permit the payment of health-related benefits, when the plan sponsor sets up a separate account subordinate to the retirement benefits provided by the plan, and the employers contributions to this separate account are **reasonable** and **ascertainable**. Such contributions to a 401(h) account must not exceed 25% of the plan sponsor's normal contribution to the pension plan. Once these requirements are met, the healthcare benefits become tax exempt.

When the Retirement Board originally authorized healthcare benefits in 1974, it did so under the provisions of Section 31592.2 of the '37 Act which allowed pension boards to pay additional benefits to members from "excess earnings" once a 1% contingency reserve fund is in place. SDCERA created the eligibility rules, determined the dollar allowances, and negotiated group rates with health insurance providers. This, however, was not a 401(h) plan until the '37 Act was amended in 1993 to allow the County of San Diego to act as the plan sponsor and still have SDCERA pay the healthcare benefits from "excess earnings." However, Section 31592.4 of the '37 Act could not be operative until both the boards of retirement and supervisors in each county enacted it by separate

resolutions. SDCERA's board did so on July 15, 1999, and the County Board of Supervisors enacted its own resolution on June 20, 2000, making the 401(h) plan operative for fiscal year 2001. In adopting Section 31592.4, both agreed to a convoluted accounting arrangement, wherein the County, in the annual transmittal letter of its required contribution (ARC) to the pension fund designates a portion, not to exceed 25%, to be placed in a 401(h) account already set up by SDCERA to pay monthly healthcare benefits to retirees. SDCERA would immediately transfer an equal dollar amount from its own healthcare reserve, funded by "excess earnings," back to the County's required annual contribution to make it whole. The conundrum is that this paper shift of funds allowed SDCERA to operate its health plan as a 401(h) tax-exempt account, while, at the same time, the County sponsored a health benefit for which all its payments were immediately reimbursed. Hence, there is no direct cost to the County, except that there are fewer dollars from "excess earnings" to reduce the overall unfunded liability. While the County is plan sponsor in "name only," should it decide to stop this annual distribution in its letter of transmittal, the 401(h) plan would cease to exist and SDCERA could not pay a tax-exempt health allowance to retirees.

County Resolution 06-229, December 5, 2006:

The County, in reaction to recent changes in accounting standards issued by the Government Accounting Standards Board (GASB), enacted this resolution to reduce the fiscal impact of GASB changes that require public employers to include unfunded liabilities in their financial statements. The SDCERA post-retirement health plan is an unvested/unfunded liability that the County would now have to show on its financial statements. The intent of the resolution is to reduce this liability. The County Resolution recommends that the SDCERA Board **remove the health care allowance from all current and future Tier A** (post 3/8/02) retirees. This means the only members covered by the 401(h) tax exempt plan will be Tier I and II, who retired prior to March 8, 2002. The logic behind this decision is that Tier A members receive a substantially higher level of retirement pay than the Tier I and II members with similar years of service. Failure on the part of the SDCERA's Board to adopt this policy would result in the County refusing to designate a contribution to the 401(h) plan in July 2007. If this should occur, health insurance payments would be eliminated for all retirees at such time as the 401(h) account is depleted. This was a unilateral action taken by the County without discussion or negotiation with SDCERA. According to one expert witness, the County feared the same kind of legal complications that took place in the City of San Diego in 2002, when city management negotiated alleged improper acts with its own independent pension board.

The Board of Retirement is currently trying to deal with the issue of Tier A (post 3/8/02) retirees losing their health benefits under the County resolution. Different proposals have been put forward to continue to offer it as a taxable benefit. However, the Board's own tax legal advisor has advised in a February 9, 2007, memorandum that a supplemental benefit can only be issued so long as it is not conditioned on the incurring of medical

costs or tied to health insurance premiums. The advisor believes that this is necessary to maintain compliance with the IRC tax qualification requirements for the plan as a whole. Here, the conundrum is that a supplement creates eligibility for all those Tier A retirees not currently receiving healthcare benefits under the existing plan. As previously mentioned, 1/3 of retirees do not participate in the healthcare program.

FACTS/FINDINGS/RECOMMENDATIONS

Fact: If the SDCERA Board fails to act by June 30, 2007, on the County's proposal to limit participation, all retirees will lose their benefits when the 401(h) account runs out of money. Based on current projections, this could occur in October 2007.

Finding: 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.

Recommendations

The 2006-2007 San Diego County Grand Jury recommends that the San Diego County Employees Retirement Association (SDCERA):

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

Fact: Current Tier A retirees will lose their health insurance coverage regardless of action taken by SDCERA. These are retirees who retired after March 8, 2002 with enhanced pension benefits.

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.

Recommendations

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

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.

Fact: The San Diego County Employees Board's primary duty is to act as the fiduciary for the assets held for current and future retiree pensions. It was not constituted by the '37 Act to be the sponsor of an ancillary retiree health plan. Starting in 1974, the Board

started paying health benefits on a discretionary non-vested basis (in accordance with Section 31592.2) from excess earnings that exceeded a compulsory 1% contingency reserve. In developing a retiree healthcare plan, the retirement board created the rules of eligibility, negotiated with group healthcare providers, and paid the allowance to eligible retirees.

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.

Recommendations:

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

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 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.

Fact: The SDCERA Board has accumulated a five year health reserve of \$165,000,000 mainly due to “excess earnings” over the last few years.

Finding: 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.

Recommendations

The 2006-2007 San Diego County Grand Jury recommends that the San Diego County Employees Retirement Association (SDCERA):

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.

CONDUCT OF BOARD MEETINGS

The following recommendations concerning the conduct of SDCERA board meetings are derived from Grand Juror observations and testimony of witnesses.

Fact: Effective January 1, 2007, the Brown Act was amended to permit a local pension board to hold a “closed session” to consider the purchase or sale of specific pension fund investments.

Finding: 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.

Recommendations

The 2006-2007 San Diego County Grand Jury recommends that the San Diego County Employees Retirement Association (SDCERA):

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

Fact: SDCERA has purchased a new office building for its staff in Mission Valley that contains a large meeting room for the trustees to hold their administrative and investment meetings.

Finding: 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.

Recommendations

The 2006-2007 San Diego County Grand Jury recommends that the San Diego County Employees Retirement Association (SDCERA):

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.

Fact: The Investment Committee meetings also routinely include discussions of retiree health and STAR COLA issues.

Finding: 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.

Recommendations

The 2006-2007 San Diego County Grand Jury recommends that the San Diego County Employees Retirement Association (SDCERA):

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).

USE OF OUTSIDE CONSULTANTS AND AUDITORS

One of the primary functions of the San Diego County Grand Jury is to act as the public's watchdog, by investigating and reporting on the affairs of local governments. In conducting our studies, the Grand Jury records the sworn testimony of witnesses, and upon the completion of an interview, the witness is admonished not to discuss his/her testimony with anyone except legal counsel. During the course of our interviews, it became apparent that SDCERA was pre-screening our witnesses and suggesting what could or could not be said, and what information the expert witnesses could/should provide to the Grand Jury. While SDCERA may have had some concern about potential litigation with Amaranth, LLC., this did not justify attempts to influence responses in almost every area of our investigation. In one instance, we asked an expert witness to discuss matters within his professional expertise, and the response was "I cannot respond." Later, the same information that was declined to be discussed was located in public records! Interestingly, on April 13, 2007, we received a file copy of a letter from 2004 from SDCERA that contained most of the answers requested from the expert witness. An attached note indicated that the document had "inadvertently" been left out of the papers forwarded by SDCERA to the Grand Jury in January 2007. Overall, the Grand Jury believes that SDCERA acted in ways which thwarted our study.

Fact: The Grand Jury has discretionary authority to investigate local government and Boards such as SDCERA.

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

Recommendations

The 2006-2007 San Diego County Grand Jury recommends that the San Diego County Employees Association (SDCERA):

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

REQUIREMENTS AND INSTRUCTIONS

The California Penal Code §933(c) requires any public agency which the Grand Jury has reviewed, and about which it has issued a final report, to comment to the Presiding Judge of the Superior Court on the findings and recommendations pertaining to matters under the control of the agency. Such comment shall be made *no later than 90 days* after the Grand Jury publishes its report (filed with the Clerk of the Court); except that in the case of a report containing findings and recommendations pertaining to a department or agency headed by an elected County official (e.g. District Attorney, Sheriff, etc.), such comment shall be made *within 60 days* to the Presiding Judge with an information copy sent to the Board of Supervisors.

Furthermore, California Penal Code §933.05(a), (b), (c), details, as follows, the manner in which such comment(s) are to be made:

- (a) As to each grand jury finding, the responding person or entity shall indicate one of the following:
 - (1) The respondent agrees with the finding
 - (2) The respondent disagrees wholly or partially with the finding, in which case the response shall specify the portion of the finding that is disputed and shall include an explanation of the reasons therefor.
- (b) As to each grand jury recommendation, the responding person or entity shall report one of the following actions:
 - (1) The recommendation has been implemented, with a summary regarding the implemented action.
 - (2) The recommendation has not yet been implemented, but will be implemented in the future, with a time frame for implementation.
 - (3) The recommendation requires further analysis, with an explanation and the scope and parameters of an analysis or study, and a time frame for the matter to be prepared for discussion by the officer or head of the agency or department being investigated or reviewed, including the governing body of the public agency when applicable. This time frame shall not exceed six months from the date of publication of the grand jury report.

- (4) The recommendation will not be implemented because it is not warranted or is not reasonable, with an explanation therefor.
- (c) If a finding or recommendation of the grand jury addresses budgetary or personnel matters of a county agency or department headed by an elected officer, both the agency or department head and the Board of Supervisors shall respond if requested by the grand jury, but the response of the Board of Supervisors shall address only those budgetary or personnel matters over which it has some decision making authority. The response of the elected agency or department head shall address all aspects of the findings or recommendations affecting his or her agency or department.

Comments to the Presiding Judge of the Superior Court in compliance with the Penal Code §933.05 are required from the:

<u>Responding Agency</u>	<u>Recommendations</u>	<u>Date</u>
San Diego County Employee Retirement Association	07-24 through 07-31, 07-34 through 07-38	08/13/07
San Diego County Board of Supervisors	07-32, 07-33	08/13/07

Appendix A

Item	2006	2005	2004	2003	2002 **	2001	2000
1 Funded Ratio ***	83.6	80.3	81.1	75.5	75.4	106.8	109.8
2 Net Assets held On June 30	\$7,330,948	\$6,358,473	\$5,508,639	\$4,103,348	\$3,533,580	\$3,816,867	\$4,272,606
3 County Contributions	\$302,460	\$316,075	* \$700,583	* \$616,113	\$50,581	\$41,123	\$38,167
4 Plan Member Contributions	\$41,911	\$40,766	\$33,609	\$34,667	\$17,346	\$10,789	\$8,360
5 Net Investment Income	\$962,208	\$794,759	\$936,471	\$148,688	-\$165,653	-\$345,833	\$564,384
6 Net Investment Return	14.68%	13.91%	21.27%	3.72%	-4.57%	-8.10%	15.75%
7 Total Benefits Paid	\$290,197	\$292,089	\$286,429	\$222,514	\$177,906	\$154,828	\$125,405
8 Administrative Costs	\$8,034	\$7,491	\$7,408	\$7,007	\$7,633	\$6,383	\$5,318
9 Health Benefits	\$32,879	\$32,568	\$26,447	\$19,964	\$14,312	\$10,778	\$8,144
10 County 401(h) payments	\$17,000	\$35,808	\$38,100		\$11,475	\$18,975	N/A
11 STAR COLA	\$10,710	\$11,020	\$11,282	\$11,463	\$9,226	\$8,177	\$8,144

Notes:

\$ shown in thousands

Fiscal year ends on June 30

*** Funded ratio is percentage determined by actuary of the value of assets annually available to pay benefits vs. the assets required to be fully funded.

**Enhanced benefits 3/08/02

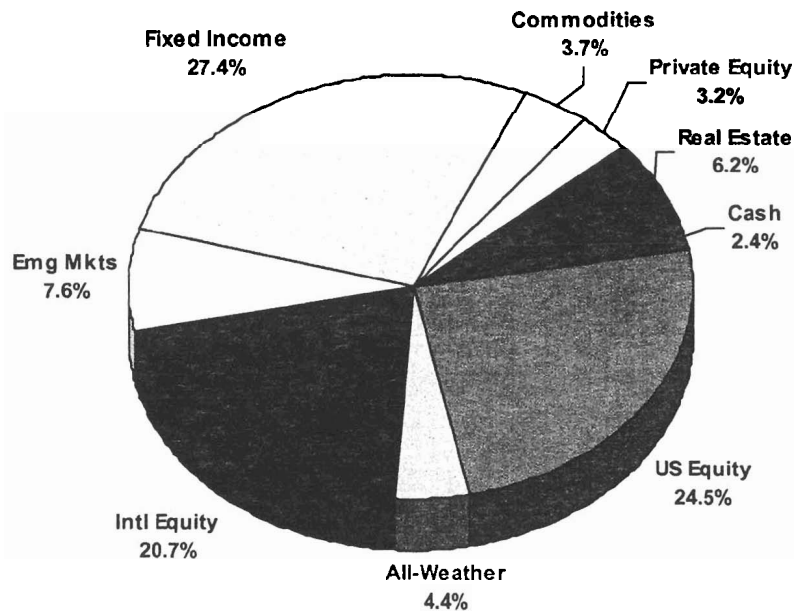
*Pension obligation bonds totaling \$1.2 billion were issued in years 2003-2004

Total Fund – Asset Allocation

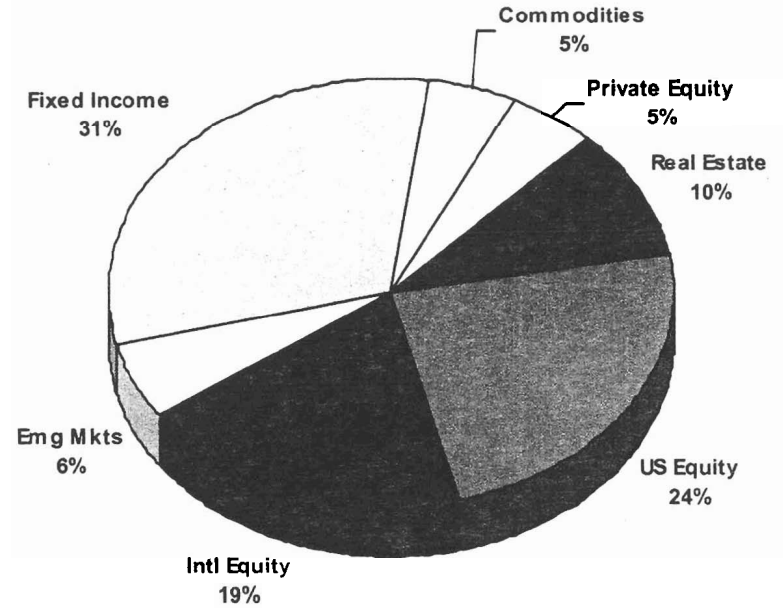


Total Investment Portfolio
\$7,997,753,892

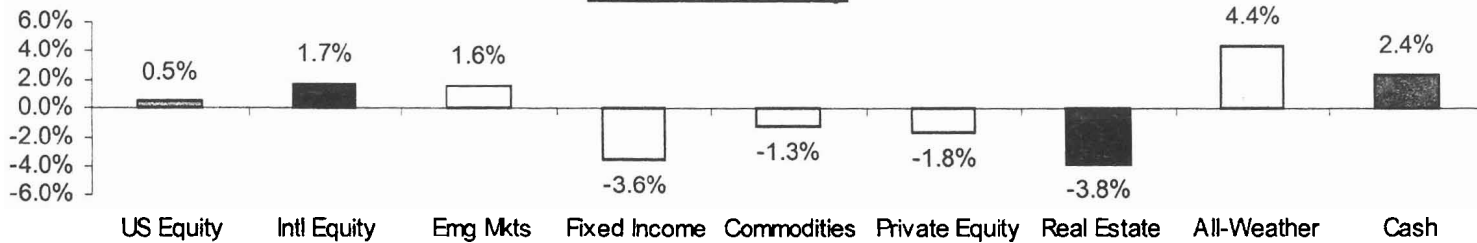
Actual Allocation



Policy Allocation



Actual vs Policy



Appendix B
(as of 12/31/06)



Review of SDCERA Alpha Engine
December 18, 2006

The Alpha Engine Concept

SDCERA uses an innovative approach to earning returns above market indexes, which it calls “Alpha Engine.” A small but growing number of other endowments and retirement plans have implemented basically the same strategy but “portable alpha” has become the industry’s more commonly used label. We use “Alpha Engine” in this report to refer to SDCERA’s specific program and “portable alpha” when making generic references to the strategy. Other public funds that currently use portable alpha include the retirement systems of Massachusetts, Missouri, and Pennsylvania, and, to our knowledge, most institutional investors that use the strategy have been pleased with the results. This probably explains why recent industry surveys report that portable alpha is expected to be a rapidly growing approach to institutional investing.¹

S&P 500 allocations have been by far the most common market fund segment to apply the portable alpha concept because large capitalization stock indexes have been the most difficult to outperform through traditional stock managers. SDCERA has chosen the same application for its Alpha Engine. As of the last asset allocation study, SDCERA’s target allocation to S&P 500 stocks is 19.2% of total fund assets, and SDCERA has chosen to use the Alpha Engine for the entire allocation. At total fund assets of \$7.6 billion at September 30, the target dollar allocation to the Alpha Engine is \$1.48 billion.

SDCERA achieves its desired S&P 500 Index exposure using over-the-counter swaps that are managed by its internal staff. Similarly, most portable alpha programs use swaps to gain beta exposure though oftentimes the fund sponsor will use an external provider, such as a custodial bank or transition manager, to execute the index swaps at a few basis points cost.

Most portable alpha programs use hedge funds as their alpha source. There are two approaches fund sponsors use to gain access to hedge funds. Approximately half select hedge funds directly (referred to as a “direct hedge fund program”). SDCERA uses this direct approach for its Alpha Engine. Other fund sponsors prefer to pay an additional fee, generally 1% of assets, to invest in a “hedge fund-of-funds” because they believe fund-of-funds potentially reduce “headline risk” should investments go bad and because they provide a turnkey approach to investing in hedge funds.

The Alpha Engine, like any other portable alpha program, can be a low risk approach to investing despite the use of hedge fund strategies, which sometimes involve leverage and short selling.

- Key implementation issues are manager selection and diversification.

Cliffwater believes that SDCERA’s Alpha Engine, in concept, is a prudent approach to investing retirement assets that, while at the forefront of institutional investing, has been used successfully by other funds in similar circumstances.

Appendix C

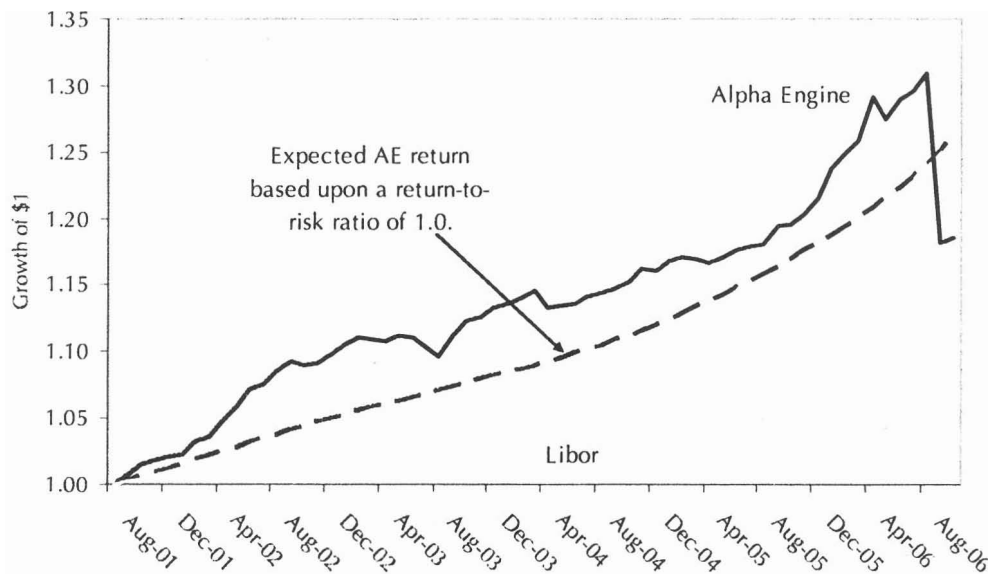
Alpha Engine Analysis and Recommendations

Alpha Engine Policies

Performance is shown in Exhibit 1, covering the period from August 31, 2001 through October 31, 2006.² The blue line plots cumulative Alpha Engine returns. The green dashed line plots the return objective for the Alpha Engine, equal to LIBOR plus an additional return equal to the realized risk level. LIBOR, a cash return, is plotted in the lower yellow line.

Alpha Engine performance, until September, had significantly exceeded its objective of earning an excess return (“alpha”) over LIBOR at least equal to the Alpha Engine risk level.³ But September losses reduced five year Alpha Engine annualized excess return over LIBOR from 3.4% to 0.8%.⁴ For the same pre and post September periods, SDCERA performance objective for excess return over LIBOR was 1.9% and 2.0%, respectively, levels corresponding to Alpha Engine risk. Despite September losses, the Alpha Engine has added a five year annualized 0.8% excess return over LIBOR but the level of excess return has now fallen below its performance objective.

Exhibit 1: Alpha Engine Performance versus Expectation
August 31, 2001 to October 31, 2006



Alpha Engine return volatility, measured by the annualized standard deviation of returns over the last 36 months, has been consistently below the 3% maximum policy level (2% prior to July 2005) until the September losses. We expect future volatility to return to pre-September levels.

Portable alpha programs are commonly structured to have a risk level between 3% and 5%.⁵ The risk level for the Alpha Engine measured 2.23% for the five years ending August 31, low by portable alpha standards.

Appendix C

Alpha Engine Analysis and Recommendations

Alpha Engine Diversification

There are three allocation practices widely used by fund sponsors and fund-of-funds managers alike when creating a portfolio of hedge fund managers. They are:

1. **Number of Managers.** Most large portfolios of hedge funds have at least 15 managers and the majority will have between 20 and 30 managers. In Cliffwater's opinion, some fund sponsors have too many managers. Those that invest in multiple fund-of-funds have discovered that they may have invested in well over 100 underlying hedge funds. The Alpha Engine, with 11 managers, has fewer managers than most portfolios of hedge funds. At the same time, however, some of the managers selected for the Alpha Engine have a much lower level of risk than the typical hedge fund. As a result, Alpha Engine volatility has been below volatility levels for most hedge fund portfolios. Nevertheless, we would recommend adding five to ten managers to limit the downside that any one manager might cause. A simple but effective approach is to equal dollar weight managers and increase the number of managers (reduce the weight) until a significant loss scenario in one manager reaches an acceptable risk tolerance. Under this methodology, the maximum loss is 10% of the Alpha Engine (2% of total plan assets) with 10 managers and 5% of the Alpha Engine (1% of total plan assets) with 20 managers.

Exhibit 2 shows the current Alpha Engine managers with their assets and weighting (excluding Amaranth) at November 30, 2006.

Exhibit 2: SDCERA Alpha Engine Components

	Assets (\$000)	% of Assets	Risk	Risk
	at Nov 30	ex Amaranth		Weighting
Amaranth	89,740			
AQR	50,225	4%	9.0%	6%
Bridgewater	138,301	11%	18.0%	35%
DE Shaw	202,385	17%	6.0%	17%
Freeman	61,553	5%	5.0%	4%
Freeman FV	30,976	3%	12.0%	5%
Lotsoff	154,345	13%	2.0%	4%
Silver Point	145,915	12%	6.0%	12%
WAMCO	157,618	13%	3.0%	7%
WG	139,493	11%	0.2%	0%
Zazove	<u>143,659</u>	<u>12%</u>	<u>4.0%</u>	<u>8%</u>
	1,314,210	100%	5.8%*	100%

*Assumes a 1.0 correlation among managers.

2. **Risk Weighting.** Other investors in hedge funds go a step further and look at "risk weighting." This is the idea that if managers are known to have substantially different risk levels, then it makes some sense to allocate less to the more volatile managers and more to the less volatile managers. The final column shows the "risk weighting" of each manager, or the percent of overall Alpha Engine risk that is attributable to each manager. We recommend

that SDCERA shift manager weights to achieve a more equally distributed risk weighting among its Alpha Engine managers. The exception would be managers that are intended to provide only liquidity, which generally is set at 15% of portable alpha assets.

3. *Style Diversification.* Hedge funds are generally grouped into unique styles of investing and fund sponsors generally diversify across styles to further diversify a portfolio of hedge funds. SDCERA groups managers into three categories: security selection, arbitrage, and trading/macro. We recommend that SDCERA include additional categories in order to further diversify its Alpha Engine portfolio. For example, the event-driven category is one that we believe would help the Alpha Engine meet its objectives and further diversify the portfolio. We also recommend that the return contributions of existing managers be evaluated to determine whether each manager is making the expected return contribution for their style and risk level.

¹ Greenwich Associates

² While one manager account that is in the Alpha Engine dates back to 1996, the development of the Alpha Engine and its policies has been evolutionary. August 31, 2001 was selected as the starting date because it provides five years of performance measurement, not including the September Amaranth losses, and prior return history can be used to measure volatility which is used in the performance objective.

³ This is commonly referred to as achieving an “information ratio” that equals 1.0. Most traditional active management method, if successful, produce information ratios of about 0.25.

⁴ Time periods are August 31, 2001 to August 31, 2006, and August 31, 2001 to October 30, 2006.

⁵ Portable alpha risk levels are generally set to be equivalent to the desired level of tracking error risk that would generally be found with a traditional active equity program.