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GOVERNANCE & INVESTMENT PRACTICES

PRESENTATION TO THE PENSION REFORM TASK FORCE
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Disclosure & Transparency

The first defense against problems that arise in public pensions is transparency[1]

Best practices for disclosure include:

- Annual actuarial valuations
  - ARCs calculated annually
- Alternative funding scenarios in addition to the base case that extend to future years and incorporate variability
- Consistency in actuarial methods
  - Asset smoothing/MVA
    - No changing to recognize sharp gains immediately and then lengthening recognition to delay reporting losses
    - MVA
  - Accrual method (EAN)
  - 5-year projections/employer contributions
  - Normal cost
    - Represents true present cost of pension benefits as they accrue
- Investment return reports
  - Quarterly
  - Relative to assumptions, benchmarks and comparable funds over same period
  - Net of fees
- Utilize technology to collect and distribute
  - Publish online for easy access

[1]The Stanford Institutional Investors' Forum Committee on Fund Governance Best Practice Principles ("The Clapman Report"), Peter Clapman, Chair, May 31, 2007, p.19.

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Pension Board

The size of the board and the skillsets of its members are important factors in the overall success of the plan and its thoughtful management

- Set strategy and oversee performance, management and risk
  - The Jacksonville Police and Fire Pension Plan ("PFPF") has 5 board members
    - Two are from labor, two are appointed by the City Council, one is elected by the four appointees
- GFOA optimal-size recommendation is 7 to 13 members[2]
  - Group dynamics studies suggest 6 or 7 is best for collective decision-making[3]
  - Larger numbers expand board expertise
  - Smaller numbers can bog down members with committee duties
    - There is no definitive right size
- More important than the precise number is overall efficacy
  - Pension plans' funded status and returns respond to measures of pension board composition, management practice, reporting practice, and investment practice[4]
    - Public pension boards often lack relevant skills/expertise

Best practice:

- Conduct inventories of board skills to establish a "fit for purpose" board

[2]Government Finance Officers Association, Governance of Public Employee Post-Retirement Benefits Systems, 2010

[3]Hackman, J. Richard, Leading Teams: Setting the Stage for Great Performances – The Five Keys to Successful Teams, 2003

[4]Yang, Tongxuan (Stella) and Olivia S. Mitchell, "Public Pension Governance, Funding, and Performance: A Longitudinal Appraisal," in John Evans and John Piggott, eds. Pension Fund Governance: A Global Perspective on Financial, 2008

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INVESTMENT PRACTICES

Investment Practices

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Investing public pension assets strategically and efficiently should follow policies that incorporate eight best practices in order to meet the fund's mission:[5]

I. Establish a rationale for investment goals

- This should be an exclusive purpose mission to invest solely in the interests of plan participants for providing retirement benefits

II. Identify the roles and responsibilities for key decision-makers

- Board
- External investment consultant
  - Provide independent perspective/analysis on fund
  - Review asset allocations and performance/make recommendations
  - Assist with external money manager selection
  - Provide quarterly reporting and commentary on total portfolio performance, by asset class and individual manager
  - Acknowledge fiduciary obligations to fund
- Money managers
  - Invest fund assets according to relevant laws, fund guidelines and specific mandate
  - Quarterly reporting
  - Restricted from gift giving/subsidized junkets
  - Acknowledge fiduciary obligations to fund in writing
- Plan staff/mgmt.
  - Organize and administer operations

[5] GFOA Best Practice, Pension Investment Policies, 2003

Investment Practices (cont'd)

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III. Define standard of care

- Prudent person or prudent expert

IV. Develop asset allocation statement

- Diversification mix should meet future liabilities with minimal fluctuations
- Passive vs. Active management
  - Emphasis on passive management in highly efficient markets
    - GFOA Recommended Practice: "…evaluate formally and regularly the role or potential role of passive or indexed investment strategies applicable to the portfolio, and appropriate strategies to minimize the costs of transactions, portfolio management, and consultants."[6]
- Market timing should be excluded as an acceptable investment strategy
- Economically targeted investments
  - GFOA recommends such investment meet certain criteria:[7]
    - Those with below-market rates of return or other concessionary terms are unacceptable
    - Yield a return commensurate with the recognized level of risk of the security
    - Meet the diversification and credit standards established by the investment policy
    - Anticipate the cash needs of the system

[6] *GFOA Public Employee Retirement System Investments* (1993, 1995 and 1997)
[7] *GFOA Public Employee Retirement System Investments* (1993, 1995 and 1997)

Investment Practices (cont'd)

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- Alternative Investments
  - GFOA recommends the following for these investments:[8]
    - » An articulation of the investment's economic rationale
    - » The organizational resources in terms of staffing, culture and managerial discipline, and the ability to monitor performance, risks, and costs
    - » Expanded due diligence efforts by plan trustees, staff, and external providers
    - » Development of appropriate benchmarks for comparison of returns and risk
    - » A review of the plan's liquidity needs to determine if the investment cash flows are adequate
    - » Selection of an experienced manager or general partner
    - » Construction of alternative portfolios over time, with staggered start dates and/or investment periods to smooth the maturity, returns, and cash flows to further mitigate the risks

V. Rebalancing – periodic adjustments to match allocation targets

- Quarterly

VI. Guidelines for external investment professionals

- Permissible investments
  - Credit risk
- Prohibited investments
  - Shorts

[8] GFOA Recommended Practice, Alternative Investments Policy for Public Employee Retirement Systems (PERS), 2000

Investment Practices (cont'd)

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VII. Reporting and monitoring

- Money managers
  - Quarterly results
  - Current holdings
- External investment advisors
  - Quarterly fund performance to benchmarks, largest holdings, portfolio composition
- Annual reports
  - Performance to benchmarks net of fees by quarter, year, three years and five years
  - Performance versus assigned benchmarks for the total portfolio, for each asset class, and for each money manager net of fees
  - A summary of the portfolio's diversification and fundamental characteristics
  - Analysis of portfolio by sector
- Fee disclosure
  - Annual review of plan fees and expenses, including investment management, investment consulting, transactional, banking, and custodial

VIII. Guidelines to vote proxies

Investment Fees and Passive Strategies

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The PFPF is relying largely on active investment strategies, which increases plan costs

Active Equity Management[9]		
	Jacksonville PFPF (Recommended Targets)	
	Active	Passive
Equities	83.0%	17.0%

PFPF Total Plan Fees: FY2012 and FY2013[10]		
	FY13	**FY12**
Professional Services Fees	$5,937,000	$5,745,347
Administrative Expenses	$3,265,154	$2,547,264
Total Fees	$9,202,154	$8,292,611
Assets (BOY)	$1,173,771,828	$1,116,370,870
Professional Fees as % of Assets	50 bps	51 bps
Administrative Fees as % of Assets	28 bps	23 bps

[9]Summit Strategies Group Memo Dec 20, 2012

[10]PFPF 2012 Annual Report (p. 4) and Budget Review FYTD2013, Kevin Stork, 10/23/2013 -- Attachment supplied by the PFPF

Alternative Investments

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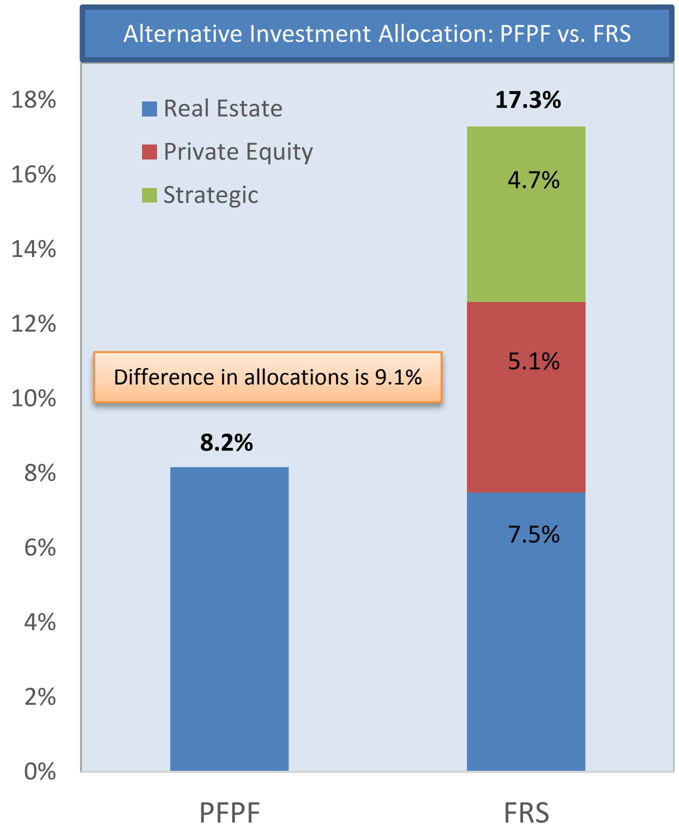
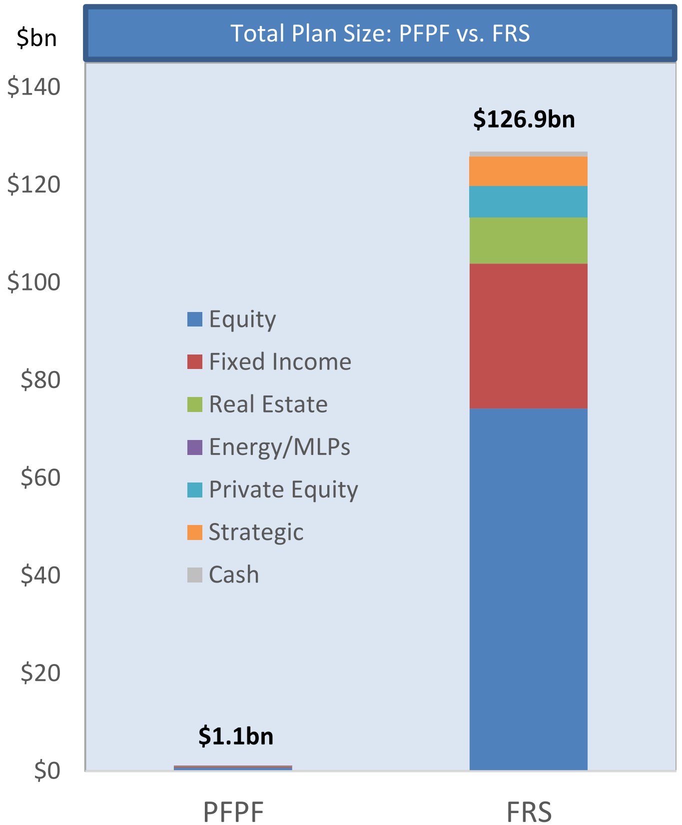
The PFPF has expressed its desire to invest in alternative assets

- The PFPF would need to shift 9.1% of its assets to alternative investments in order to mirror the asset mix in the Florida Retirement System ("FRS")
  - » That equates to about $90mm of PFPF assets





Sources:
Summit Strategies Group, City of Jacksonville Police and Fire Pension Fund Flash Report, September 30, 2012
State Board of Administration of Florida, Quarterly Report to the Trustees, September 30, 2012

Alternative Investments (cont'd)

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- FRS is over 100 times the size of the PFPF and gives out alternative investment mandates of ~$100mm each
  - That affords FRS access to invest in top-performing funds and the ability to diversify its alternative holdings

- For diversification, the PFPF would need to award ~$5 to $10mm mandates across 10 to 20 funds
  - The size of those mandates would not afford the PFPF access to large, top-performing private equity and hedge funds
    - PFPF investments would be limited to emerging funds, which is very risky
    - The alternative is to invest in fund of funds ("FoF"), which is expensive
      - Two sets of fees (FoF fees and the hedge fund/Private Equity fees)

FRS's scale allows it to access alternative investments at much more favorable terms than the PFPF. If PFPF tried to match the FRS approach, they would have a harder time investing in the top funds and would pay higher fees

      - The PFPF is already materially invested in real estate, which is an available alternative option
        - Local real estate is too correlated to Jacksonville's overall economic health and is antithetical to diversification

FRS STRUCTURE & INVESTMENT PRACTICES

How Does FRS Do It?

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- The State Board of Administration (“SBA”)
  - Manages FRS investments
  - Three-member board of trustees
    - Fiduciaries to plan members and beneficiaries
  - Dictates investment objectives to maximize returns within risk parameters
  - Establishes asset classes, allocations and reasonable ranges around them
  - Chooses benchmarks for each asset class

How Does FRS Do It? (cont'd)

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- Investment Advisory Committee
  - Investment professionals/experts appointed by the board to be "eyes and ears"
    - Each member makes 3 appointments (9 total)
  - Meets quarterly
  - Fiduciary responsibility
  - Reviews and studies portfolio objectives, policies, performance and strategies
    - By statute[12], the IAC opines on changes on investment policies and investment policy statement/asset allocations proposed by FRS management or considered by the board
    - The board "borrows" the wisdom of the IAC on key financial matters
      - IAC recommendations are presented at public meetings that are webcast and warehoused online – in accordance with Florida's Sunshine Law
      - Board trustees have final say
- The effect is a three-layered system, including the staff, the IAC and the board

[12] Florida Statute 215.444

How Does FRS Do It? (cont'd)

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- Internal controls
  - Investment consultants
    - Money manager recommendations come from staff and proceed to FRS investment consultants, who must provide a prudent man recommendation/letter
      - The staff does due diligence
      - Recommendation goes to the executive director for additional scrutiny
      - The ED "staffs the contract," at which point legal negotiates terms
      - A new money manager may remain in the FRS pipeline for 1 or 2 years
        - They must acknowledge they are fiduciaries to the FRS
      - Annual investment report lists every fund and returns by individual manager
      - Fees are grossed by asset class, but public requests for individual fees are easy enough

- Internal Audit Department
  - Trustees each appoint a member to the audit committee, to which the internal audit department is responsible
    - Audit committee assigns audits all year long (hundreds in the last few years)
  - Risk and Compliance Department
    - Monitors investment compliance in real time, including asset allocation
    - Outside annual commercial audit (published)

How Does FRS Do It? (cont'd)

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- Investment costs
  - Public market asset classes rely on low-cost passive strategies
    - » Passively managed funds managed internally
  - Lower alternative asset allocation than peers (the 17 largest public funds)
    - » SBA believes it beats benchmarks largely due to low costs and good manager selection

- Strategic Investments – The fund considers non-traditional investments opportunistically for the following purposes and based on the following criteria:
  - Long-term incremental returns that meet RORs commensurate with risk
  - Diversifying assets
  - Hedging against inflation
  - Increasing flexibility to access opportunistic investments

- Reporting
  - Monthly performance and actions
  - Quarterly performance reports online
  - Detailed annual report on investment
    - » Warehoused online

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How Could PFPF Do It?

Jacksonville could implement an Investment Advisory Committee to supplement the existing PFPF board, under a similar model to FRS

Best practices for helping professionalize financial oversight of existing pension boards:

- Investment Advisory Committee: volunteers/appointees who advise on financial matters and investment strategy
  - For general matters (e.g., asset allocation), the pension board reviews decisions with the Committee, solicits their feedback, which becomes public information, and retains final authority
  - For the selection of money managers, the Committee screens recommendations from the financial advisors or staff and has the ability to reject them before they reach plan administrator
    - Whenever a majority opposes the recommendation, the mandate would be denied
    - Whenever a majority supports the recommendation, the plan administrator/board retains final authority
      - Creates a double-veto system

- Investment Advisory Committees can supplement trustees in number and expertise without replacing them
  - Neutral referees with relevant skills and a fiduciary responsibility to the fund

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