CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: CITY COUNCIL

FROM: Mayor Sam Liccardo
Councilmember Johnny Khamis
Councilmember Lan Diep
Councilmember Chappie Jones
Councilmember Devora "Dev" Davis

SUBJECT: SEE BELOW

DATE: January 5, 2018

Lan Diep Sam Liccardo
Approved
Johnny Khamis J.F
Date 1-5-18
Devora Davis
RH

SUBJECT: RETIREMENT SERVICES AUDIT

RECOMMENDATION

1. Accept the Audit of Retirement Services, and the accompanying study from Stanford.
2. In response to Recommendation #11 and #12, direct that Staff join with our Council representatives to report to the full Council at least monthly with a status report on key Board decisions and relevant issues such as Fund performance, budgetary implications of that performance, and of any contemplated changes in demographic or economic assumptions.
3. Direct the City Attorney to clarify whether, under Measure G and other relevant authority, the City should consider investment fees within the Council-approved budget for Retirement Services' administrative costs. (While Retirement Services staff has expressed its own view to Recommendation 3, the City must have an independent assessment of the issue). If so, then direct staff to ensure greater disclosure of those anticipated costs, and the performance of those fund managers, as part of the Council's annual budget process.
4. Direct the City Manager to prioritize Recommendation #14 (p. 33 of audit), to designate a city staff person to liaise with Retirement Boards and facilitate communication with budget office and council offices on some of the audit recommendations.
5. Encourage the Chief Executive Officer of Retirement Services and the respective Boards to prioritize the following audit recommendations for completion in the next twelve months:
    a. Recommendations #2 and #3 (p. 13-19 of audit): Retirement Services should prepare a comprehensive annual budget document covering the entire aggregate expense of administering plans, including staffing and investment and manager fees (pursuant to our direction in Paragraph 3, above) for Council approval each year;

b. Recommendation #7 (p. 27 of audit): Joint annual meeting with Retirement Boards/City Council;
c. Recommendation #15 (p. 35 of audit): Boards should adopt a formal set of performance metrics for both the plan administration and investment program and provide to Council with an opportunity for input;
d. Recommendation #16 (p. 52 of audit): Establish more comprehensive policy on fees;
e. Recommendation #17 (p. 60 of audit): Establish policy on investment manager evaluation; and
f. Recommendation #18 (p. 64 of audit): Clarify lines of authority over investment decisions and implementation.

DISCUSSION

We thank the Auditor, audit staff, Retirement Services staff and Retirement Boards for their work and participation on this audit.

Voter approval of substantial restructuring of the retirement plans in 2010—such as by removing Councilmembers from the Plan boards, and by making the Director subject to the hire-and-fire authority of the boards—has made Retirement Services and their boards entirely independent administrative entities from the City.

The Plans continue to depend on large financial contributions from the City, however, which leaves the Council in a difficult position as the primary sponsor of a plan over which we have no control beyond appointment authority. This becomes a critical public issue to the extent that the tail of retirement costs continues to wag the dog of the City budget. The poor performance of the Plans' investment over the last three years—whether compared to peer public pension plans, to policy benchmarks, or most importantly, to the Board's own actuarial assumptions for rates of return - has substantially burdened both the Plans and the General Fund. Shortfalls in Plan returns have shifted tens of millions of dollars on to the City budget annually, severely constraining the restoration of services to our residents despite the strong economy and aggregate revenue growth.

In the past, Retirement Services and the Boards have formally sought input from the City administration concerning the City's risk tolerance. We should respond directly to this inquiry: the Boards should accept an appropriate risk-return tradeoff that enables them to meet—over the long run—the Boards' own assumed rate of return. For several years, however, the Plans have fallen woefully short, including two of the last three years. Even in the one year that we met—barely—the Board-approved rate of return, we've seen stratospheric returns in peer public funds which demonstrate that we continue to starkly underperform our peer group of public funds.

Here's the problem: these are the best of times. We're at a historic peak in the markets for equities, real estate, and other assets, after a record run in recent years. We expect the Plans to underperform during downturns of the economic cycles, but their poor performance in these very good times raises troubling questions. For example, what costs will the City, our residents, and our employees have to bear when those downturns come, particularly if we're unable to earn higher returns today that will be critical to buffer those anticipated shortfalls?

The audit's 25 recommendations and the accompanying Stanford report highlight the need for improvement. We'd like to focus the work over the next year to address several overarching priorities.

First, the Plans need to better execute on their own, board-approved strategies. Beyond the misalignment of investment strategies with the Board's assumed discount rate, there persists an excessive mismatch in the asset allocations in the funds and the Board-approved asset mix, for example, with a large cash (i.e., non-performing) component. We continue to hear anecdotal evidence that the investment committees' reluctance to delegate to staff to make investment decisions results in "analysis-paralysis," slowing the implementation of investment strategy.

Second, we have seen total investment expenses in both Plans balloon in recent years, making them "among the more expensively managed of the peer group." (p. 22-23 of the Stanford report). This reflects a change in asset allocation toward more heavily managed alternative investment products, with high fees. Perhaps we would not have concerns if we saw good performance, but in our current context, the active, high-fee strategy raises several concerns:

- Fund managers in those categories—particularly in alternative investments—earn large fees at the cost of the Plan's returns. The Stanford study concluded that the variance between actual and benchmark returns in specific asset classes—e.g., of 130 basis points for private equity in Federated Plan— "reflects, to some degree, the impact of active portfolio management." (p.19)
- With the growing ubiquity of low-cost passive investment strategies, questions historically persisted about whether active managers are really earning their higher fees. The preponderance of academic and financial literature does not give us much confidence, as findings in the mutual fund context routinely show that actively-managed funds being outperformed by their passive counterparts and by indices. See, for example, the 2015 S&P/Dow study (https://us.spindices.com/documents/spiva/spiva-us-yearend-2015.pdf); 2015 Morningstar study (http://news.morningstar.com/articlenet/article.aspx?id=701736) Even alpha-seeking investors increasingly look to algorithm-driven funds without the high fees of active managers.
- It appears unclear why the Plans need to be in so many different asset classes to achieve desired Plan diversification. For example, most other public funds don't invest in commodities, and the Stanford authors observed that "certain alternative asset classes, such as commodities and absolute return strategies have not generated consistent after-fee returns required to meet pension systems' target returns." (p. 7) By expanding into so many asset classes, our Funds are paying for additional expertise, and for staff to chase and monitor a diverse group of high-fee actively managers.
- Most importantly, it appears unclear the extent to which our Plans are holding high-fee fund managers accountable for performance. Little to no alignment exists in the managers' fee contracts between their fees and fund performance. It appears unclear whether Retirement Services Staff is adequately supervising poor performers, and whether the Boards nimbly divest from them. The Boards should provide more detailed policies and clear guidance on investment controls and performance evaluation.

Recommendations 15, 16, 17, and 18 provide direction on investment controls and performance evaluations, and should be reviewed by the City Council annually.

Finally, there appears to be a broadly acknowledged need for more formalized communication and input between the City and the Plans. City staff must be more engaged in monitoring and communicating with Retirement Services staff concerns about fund performance and management. Moreover, greater work needs to be undertaken to educate the Council about the relevant issues and decisions made by the boards. Recommendations 7, 11, 12 and 14 will facilitate the necessary education and communication needed between the Plans and their sponsor.