



*Investment Program*

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## RETIREMENT PLANS' TOTAL EXPENSE RATIO

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Office of Retirement Services

# Investment Policy Statement on Investment Fees

“The Plan will seek alignment of interests when negotiating fees while pursuing the best net of fees performance results. Investment costs shall be monitored, controlled, and whenever possible negotiated to ensure cost effectiveness. The Board shall give consideration to the impact of administrative expenses, external management fees and performance fees when establishing the asset mix policy of the Plan. The Board will be provided reports on investment costs of the Plan at least annually.”

# Understanding Total Expense Ratio

- Complex topic
- Declining return expectations → Increased focus
  - $\text{Net returns} = \text{Gross returns} - \text{Total expense ratio}$
- A function of asset allocation and asset class structuring
  - Higher complexity = higher fees
- ORS comprehensive annual fee reporting started 2015
  - Includes embedded or unobserved fees/expenses (e.g., fees not reported on statements)
  - Few public plans have comprehensive fee reporting (CalPERS, CalSTRS, LACERA, OCERS)
  - No public-sector standard methodology for comprehensive fee reporting
- Complies with California Government Code §7514.7

# Understanding Total Expense Ratio

Net returns = Gross returns – Total expense ratio

Fee type	Description	Examples
<b>Management fees</b>	Fees paid to investment management firms	
<b>Incentive fees</b>	Performance-based fees paid to investment management firms	
<b>Operating expenses</b>	Costs of administering individual investment vehicles	Audit, tax, legal, custodian
<b>Other expenses</b>	Costs incurred at the plan level	Staff salaries and benefits, consultants, third party vendors

# Calendar Year 2018 Fees

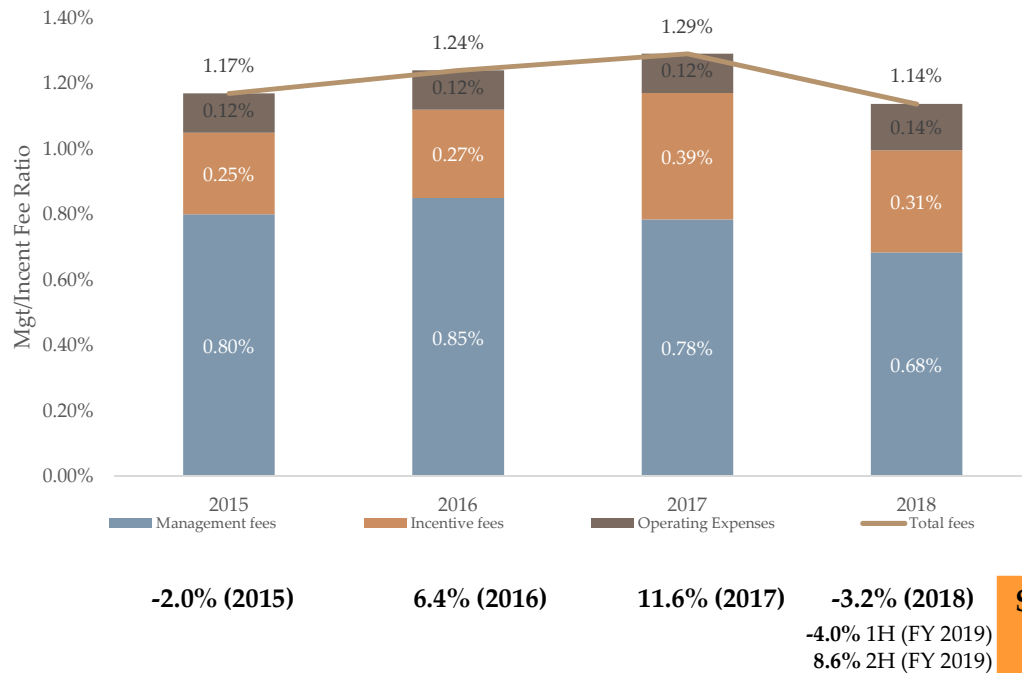
	Management Fees (\$)	Incentive Fees	Operating Expenses	Mgmt, Incent, and Op Exp	Average Balance	Fee Ratio
Federated Pension	\$15.9	\$6.3	\$3.2	\$25.4	\$2,171	1.17%
Police & Fire Pension	\$26.0	\$13.2	\$5.5	\$44.7	\$3,658	1.22%
Federated Health Care	\$0.8	\$0.1	\$0.1	\$1.0	\$295	0.32%
Police & Fire Health Care	\$0.2	-	\$0.0	\$0.2	\$140	0.15%
All 4 ORS Plans	\$42.8	\$19.6	\$8.9	\$71.2	\$6,263	1.14%

Source: ORS 2018 Fee Report  
Values show are in \$ millions

	Investment Staff Salary and Benefits	Consultants	Custodian	Travel and Other Third Party Vendors	Total Other Costs	Fee Ratio
All 4 ORS Plans	\$1.7	\$1.5	\$0.7	\$1.0	\$4.8	0.08%

Source: ORS 2018 Fee Report  
Values show are in \$ millions

## Total Expense Ratio (Comprehensive)



ORS Annual Fee Reports (Comprehensive)

Calendar year basis

All 4 ORS plans aggregated  
(Federated and Police & Fire Pension and health care trusts)

San Jose  
Plan  
Return

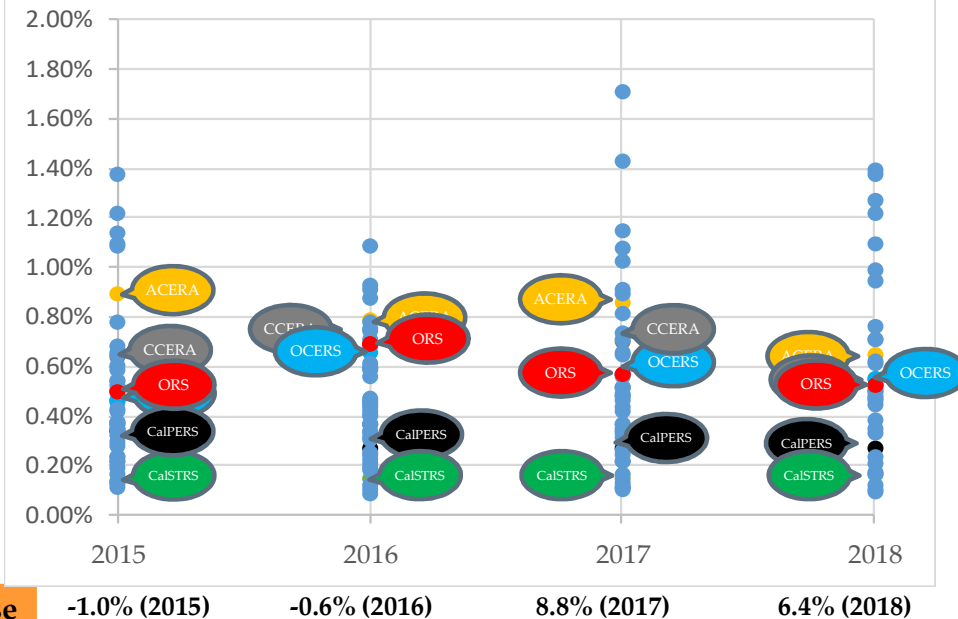
Source

Time  
Periods

Data  
Points

## Peer Comparison (CAFR's)

Reported Expense Ratio Over 4 Years



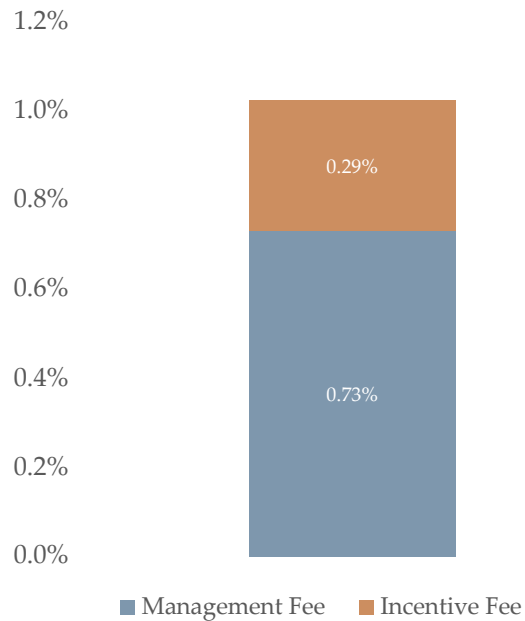
Public Plans Database (from CAFRs)

Fiscal year basis

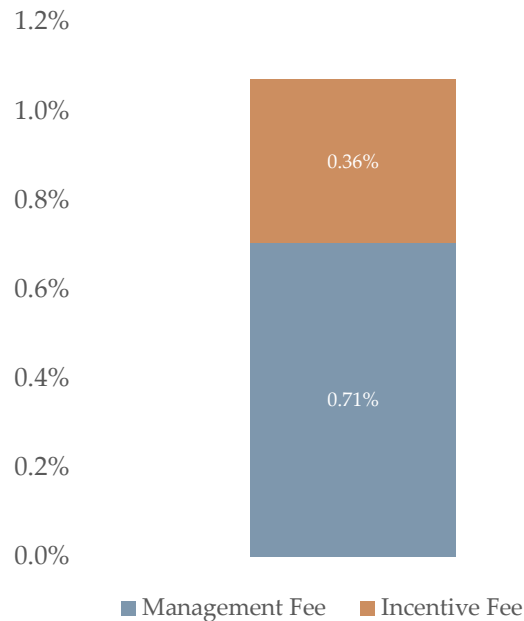
42 diversified U.S. Public Pension Plans \$2-13 B & CA Public Plans  
All 4 ORS plans aggregated

# Calendar Year 2018 Management and Incentive Fee Ratios

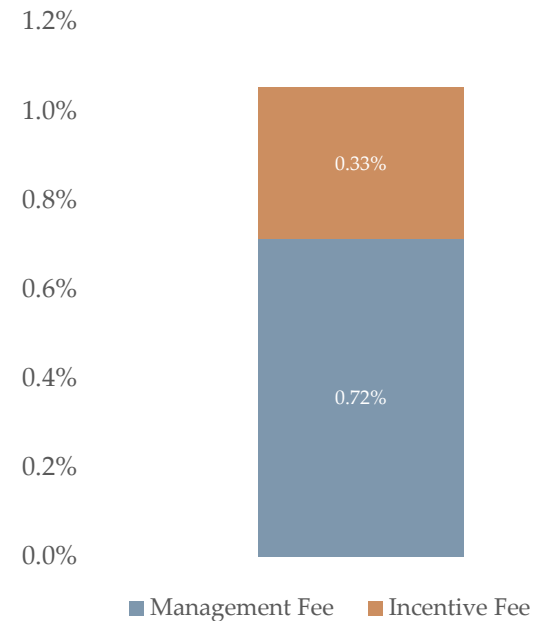
Fed Pension



P&F Pension



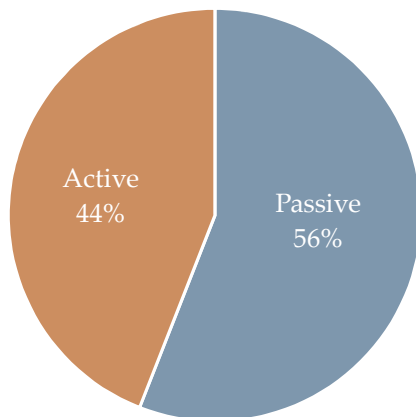
Combined Pensions



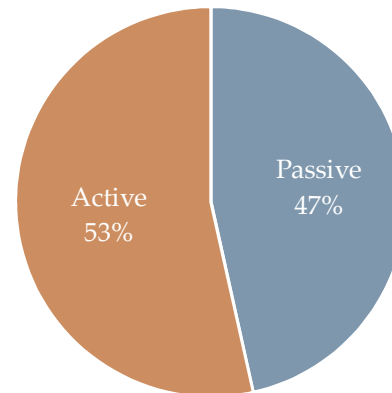
Source: ORS 2018 Fee Reports  
Indirect fund operating expenses not shown (Fed Pension: 0.15%, P&F Pension: 0.15%, Combined: 0.15%)

# Active vs. Passive Allocations as of 12/31/2018

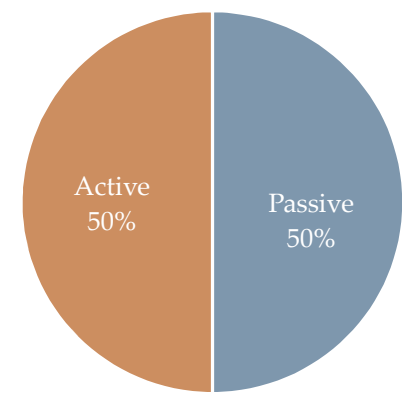
Fed Pension



P&F Pension



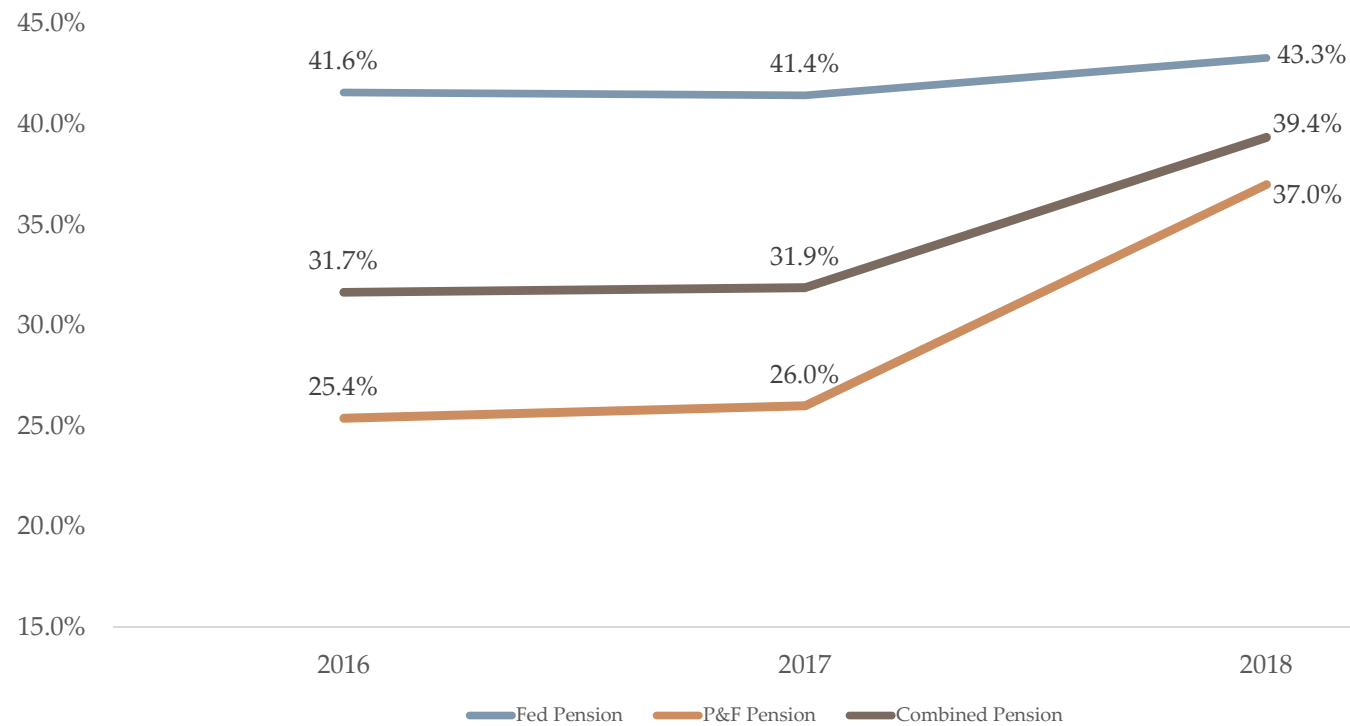
Combined



Source: ORS, State Street  
Active includes all non-passive investments (active, hedged, private)



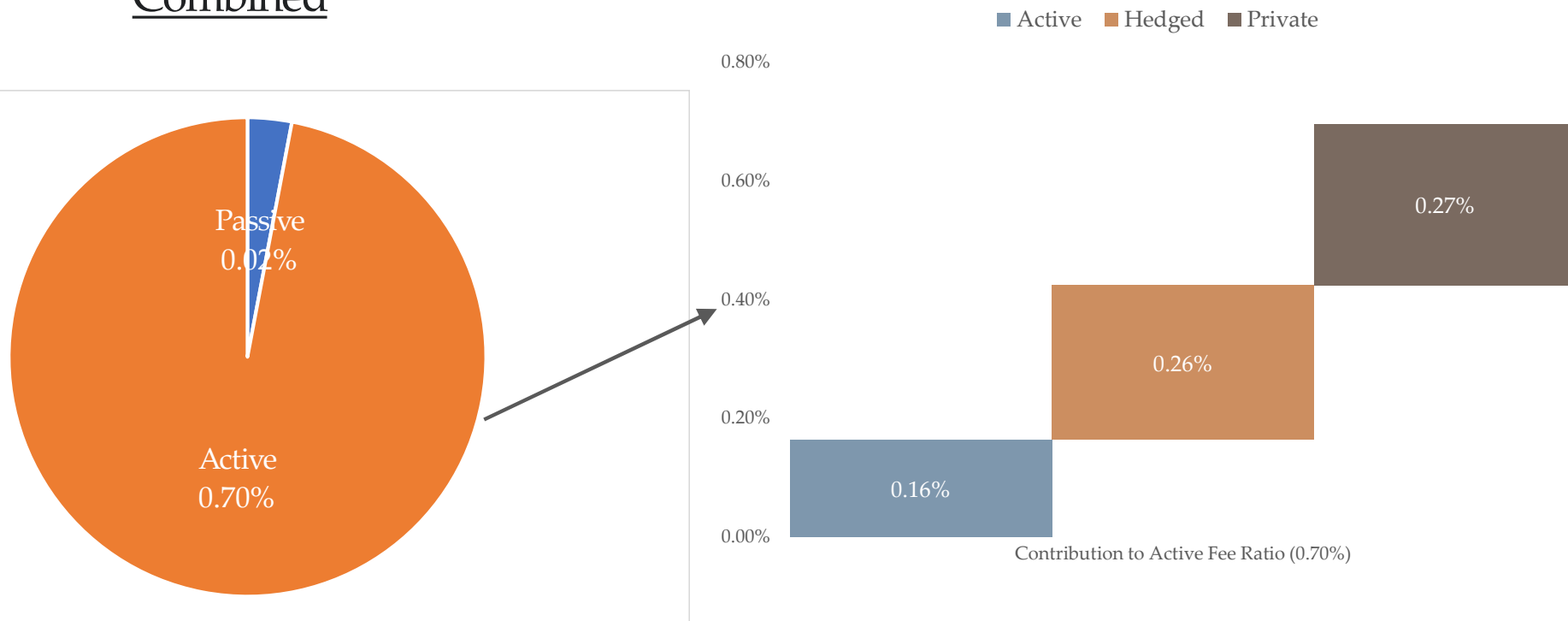
## Average Passive Allocations 2016 - 2018



Source: ORS, State Street

# Active vs. Passive Management Fees

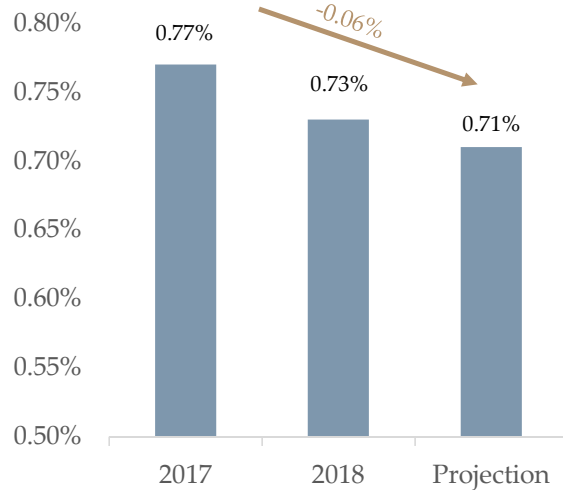
## Combined



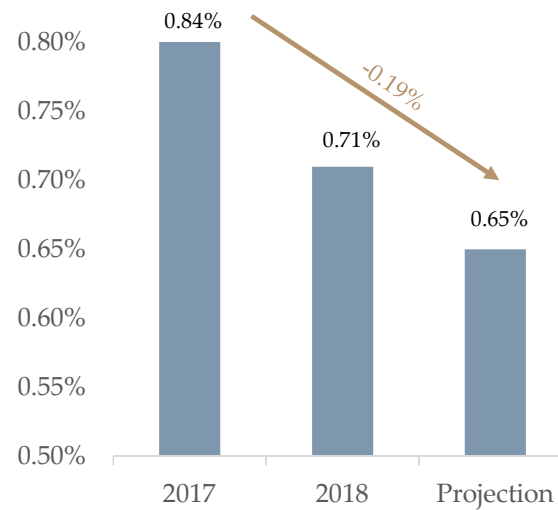
Source: State Street, ORS 2018 Fee Reports  
Active includes all non-passive investments (long only active, hedged, private)  
Charts only represent fund management fees, not incentive or fund operating expenses

# Projected Management Fees \*

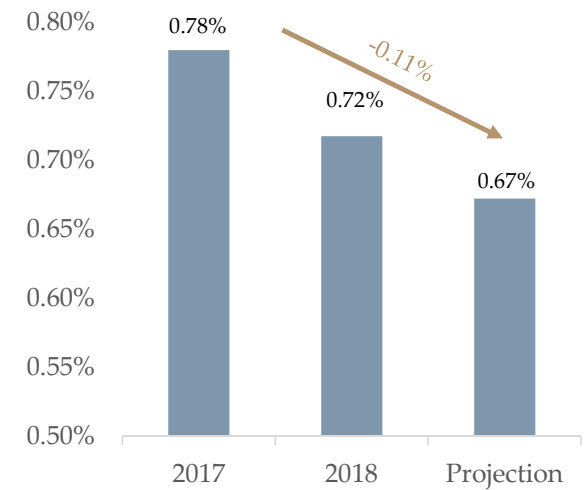
## Fed Pension



## P&F Pension



## Combined



Source: ORS, State Street

\* Projections are based on many assumptions with a wide margin of error. Actual fund management fees will vary as the composition of underlying funds and fund types changes over time  
 Projections calculated by multiplying the calendar year 2018 fee ratios for each fund type within an asset class by actual December 31, 2018 allocations  
 Charts only represent fund management fees, not incentive or fund operating expenses

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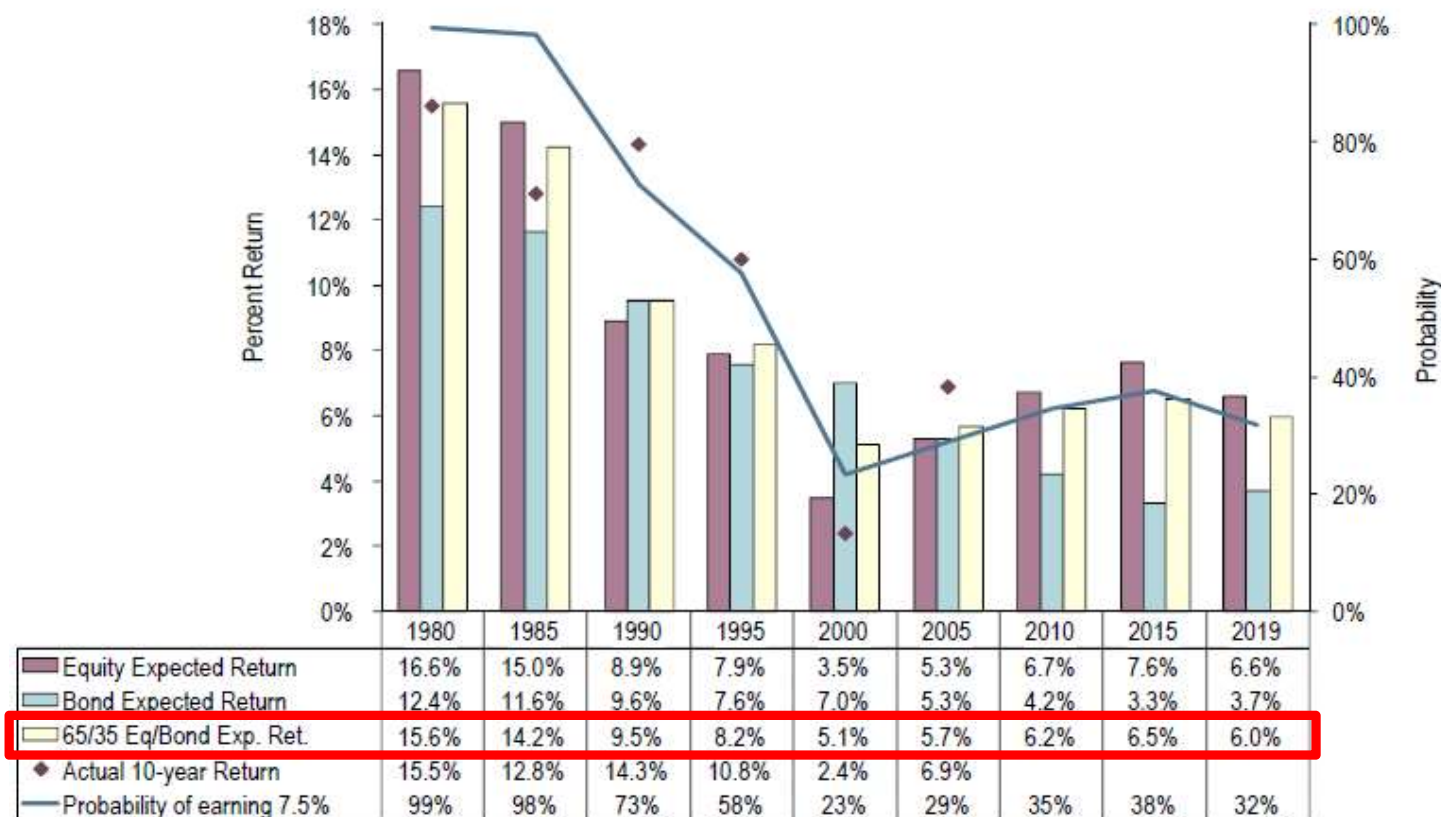
## Appendix

# Glossary of Terms

- Active strategies: Funds that attempt to outperform an index
- Asset allocation: Distribution of assets across a number of asset classes that each exhibit a unique combination of risk and expected return. Asset allocation is the most important determinant of long-term plan performance
- Hedged strategies: Investments that generally seek to achieve a return regardless of market direction
- Gross returns: Returns before the deduction of expenses
- Incentive fees: Performance-based fees paid to individual investment management firms. Incentive fees are a form of shared economics. Also known as “carried interest”
- Management fees: Asset-based fees paid to individual investment management firms
- Net returns: Returns after the deduction of management fees, incentive fees, and operating expenses
- Operating expenses: Costs of administering individual investment vehicles (not the retirement plans)
- Other expenses: Costs incurred at the plan level (staff, consultants, third party vendors, etc.)
- Passive strategies: Investments that intend to match the return of an index
- Private strategies: Investments in illiquid assets such as privately held companies or real estate
- Total expense ratio: Total expenses (sum of management fees, incentive fees, and operating expenses) divided by average plan assets

# Asset Allocation Considerations

**The Secular Decline in Investment Returns<sup>1</sup>**



Source: Meketa Investment Group

# Asset Allocation Considerations

	Federated (%)	P&F (%)	Global 60/40 (%)
<b>Expected Return<sup>1</sup></b>	<b>7.7</b>	<b>8.0</b>	<b>7.1</b>
<b>Standard Deviation<sup>1</sup></b>	<b>11.6</b>	<b>12.5</b>	<b>10.4</b>
<b>Probability of Achieving 6.75%</b>			
1 Year	53.2	53.9	51.4
3 Years	55.5	56.8	52.4
5 Years	57.1	58.7	53.1
10 Years	60.0	62.2	54.4
20 Years	63.9	67.0	56.2
<b>"Worst Case" Returns<sup>2</sup></b>			
1 Year	-16.0	-17.3	-14.4
3 Years	-6.7	-7.4	-5.9
5 Years	-3.6	-4.2	-3.1
10 Years	-0.5	-0.8	-0.2
20 years	1.9	1.7	1.9
<b>Expected Returns if Equities Decline 25%</b>	<b>-13.1</b>	<b>-14.8</b>	<b>-14.7</b>
<b>Expected Returns if Equities Decline 40%</b>	<b>-22.3</b>	<b>-25.3</b>	<b>-25.5</b>

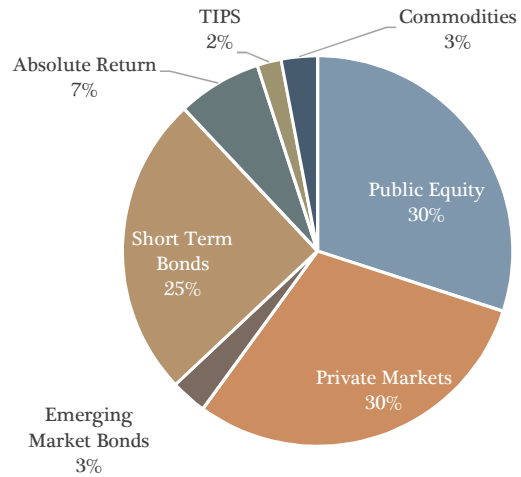
<sup>1</sup> Expected return and standard deviation are based on Meketa Investment Group's 2019 Annual Asset Study and reflect our 20-year expectations. Returns for periods longer than one year are annualized.

<sup>2</sup> "Worst Case" return projections encompass 99% of all possible outcomes

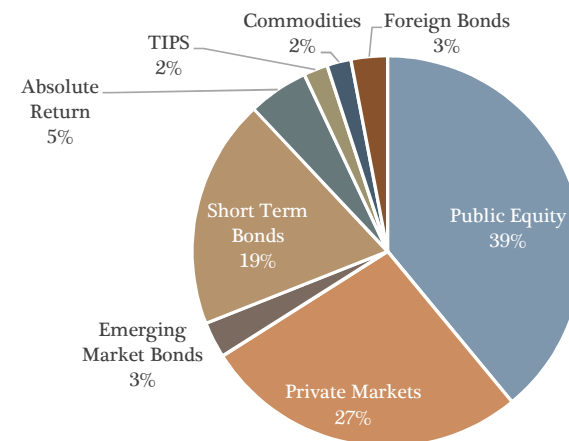
# Asset Allocation Targets

As of August 31, 2019

## Federated Pension



## Police & Fire Pension



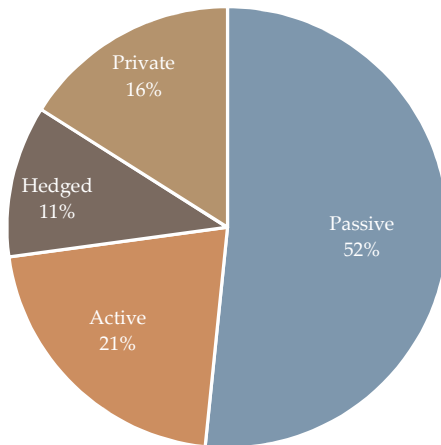
Source: ORS



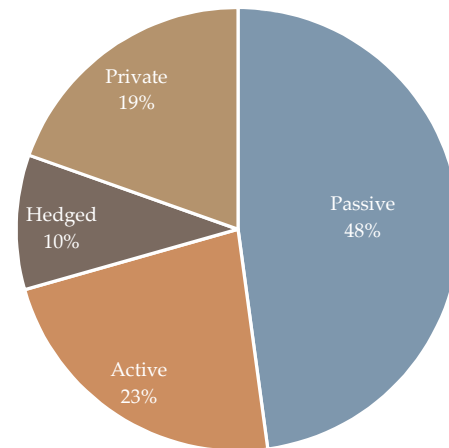
# Allocation to investment fund types

As of July 31, 2019

## Federated Pension



## Police & Fire Pension



Source: ORS, State Street

# Plan Return History

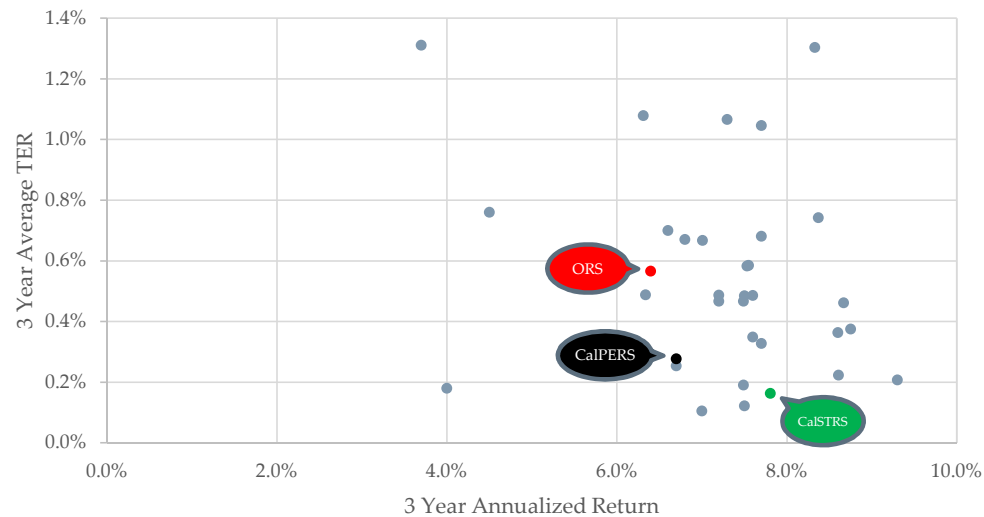
For period ending June 30, 2019

	10 years ending 6/30/19	10 years ending 12/31/18	10 years ending 6/30/18	10 years ending 12/31/17	20 years ending 6/30/19	1/31/94 - 6/30/19
San Jose Federated City Employees' Retirement System	6.5%	6.0%	4.1%	8.3%	5.0%	6.6%
<i>Federated Policy Benchmark</i>	7.2%	6.7%	5.0%	7.7%	5.1%	6.9%
<i>Federated Investable Benchmark Portfolio</i>	6.3%	6.0%	4.1%	--	--	--
San Jose Police & Fire Department Retirement Plan	7.2%	6.8%	4.6%	9.0%	5.4%	8.3%
<i>Police and Fire Policy Benchmark</i>	7.7%	7.2%	4.9%	9.0%	5.3%	--
<i>Police and Fire Policy Investable Benchmark Portfolio</i>	7.3%	6.9%	4.8%	9.0%	--	--
DB Plans >\$1 Billion Net Peer Universe	9.0%	8.2%	6.1%	7.4%	5.4%	7.2%
<i>Number of Plans</i>	65	151	120	64	44	34

Source: Meketa Investment Group

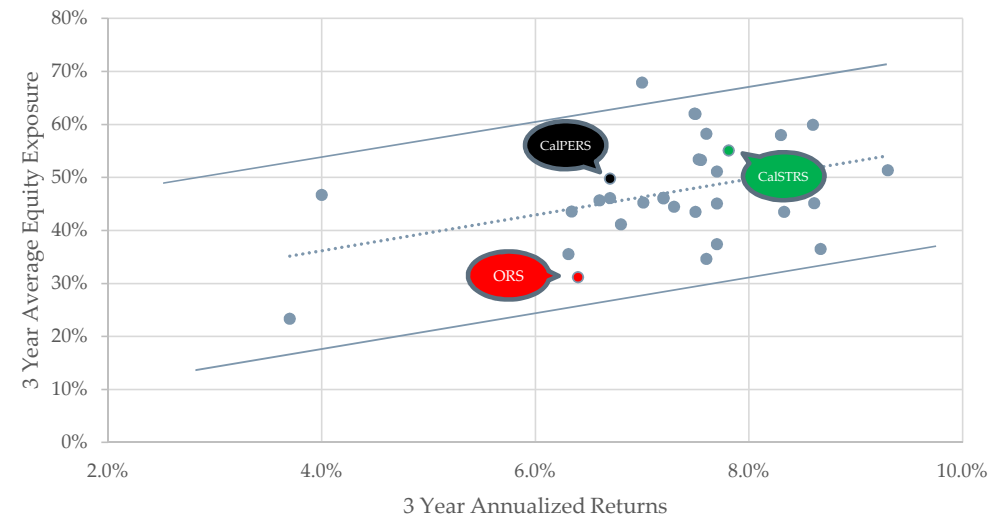
## Returns/Expense Ratios

Higher returns not correlated to higher expenses



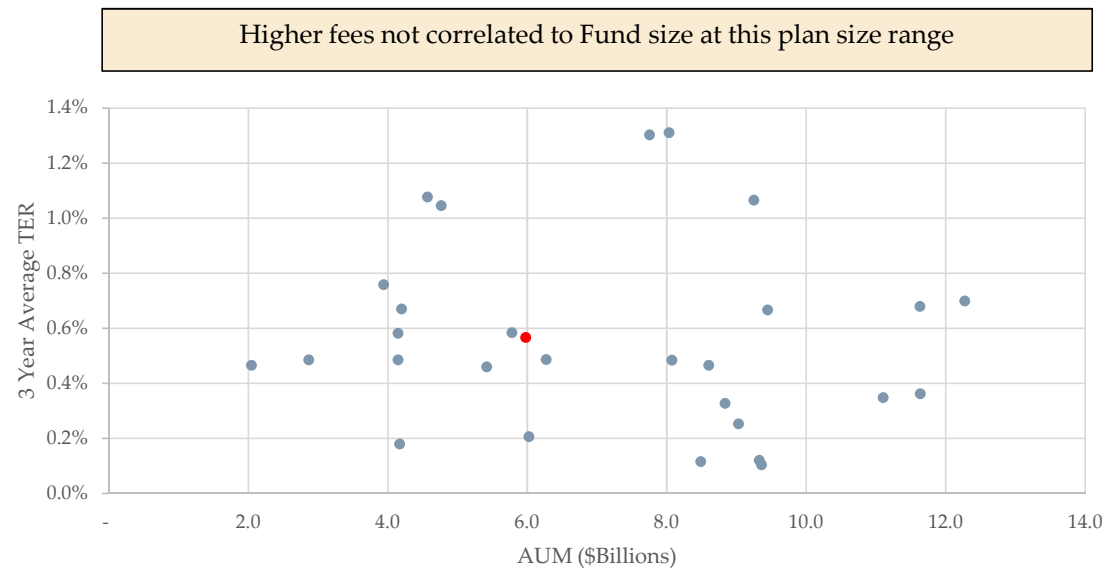
## Returns/Public Equity Exposure

Higher returns correlated to higher public equity exposure



<b>Source</b>	Public Plans Database (from CAFRs)
<b>Time Periods</b>	Fiscal year basis, ending June 30, 2018
<b>Data points</b>	31 diversified U.S. Public Plans \$2-13 billion, CA Public Plans All 4 ORS plans aggregated

## Plan Size/Expense Ratios



<b>Source</b>	Public Plans Database (from CAFRs)
<b>Time Periods</b>	Fiscal year basis, ending June 30, 2018
<b>Data points</b>	31 diversified U.S. Public Plans \$3-15 billion, CA Public Plans All 4 ORS plans aggregated (CALPers/CALStrs/SFERS excluded)