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City and County of San Francisco
Employees' Retirement System
Office of the Executive Director

October 15, 2012

RECEIVED
BOARD OF SUPERVISORS
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Honorable Judge Katherine Feinstein
Presiding Judge
Superior Court of California, County of San Francisco
400 McAllister Street, Room 008
San Francisco, CA 94102

Re: Response to 2011-2012 Civil Grand Jury Report - Investment Policies and Practices of the San Francisco Employees' Retirement System

Dear Judge Feinstein:

The following attachment is provided as the requested responses from the San Francisco Employees' Retirement System (SFERS) Board and the SFERS Executive Director to the 2011-2012 Civil Grand Jury report titled "Investment Policies and Practices of the San Francisco Employees' Retirement System". For ease of administration, they have been provided in the format used by the Controller's Office to track implementation of Civil Grand Jury recommendations.

The responses provided by the SFERS Board have been reviewed and approved by the SFERS Board. The responses provided by the SFERS Executive Director are mine.

Do not hesitate to contact me with any questions or comments at (415) 487-7015.

Respectfully submitted,

Jay Huish
Executive Director

Cc: The Honorable Edwin M. Lee
Ben Rosenfield, Controller
Angela Calvillo, Clerk of the Board of Supervisors
Members of the SFERS Board

Status of the Recommendations
by the 2011-12 Civil Grand Jury

California Penal Code Sections 933.05(a) and (b) requires the responding party to report for each recommendation of the Civil Grand Jury one of the following actions:

1. Recommendation Implemented - Date Implemented - Summary of Implemented Action	2. Will Be Implemented in the Future - Anticipated Timeframe for Implementation	3. Requires Further Analysis - Explanation - Timeframe (Not to exceed six months from date of publication of grand jury report)	4. Will Not Be Implemented: Not Warranted or Not Reasonable - Explanation

For each recommendation below, indicate one of the four actions you have taken or plan to take in the "Action Plan" column and provide the required explanation in the "2012 Response Text" column.

CGJ Year	Report Title	Recommendation or Finding Number	Recommendation or Finding Text	Response Required From	Action Plan	2012 Response Text
2011-12	Investment Policies and Practices of the San Francisco Employees' Retirement System	**F1**	The San Francisco Employees' Retirement System Pension Fund is currently underfunded by more than $2 billion.	**SFERS Board** **SFERS Executive Director**	This item is a finding - there will be no action plan in response.	**SFERS Board:** As of the most recent SFERS Actuarial Valuation (July 1, 2011), the SFERS Unfunded Actuarial Liability was $2.285 billion. **SFERS Executive Director:** As of the most recent SFERS Actuarial Valuation (July 1, 2011), the SFERS Unfunded Actuarial Liability was $2.285 billion.
2011-12	Investment Policies and Practices of the San Francisco Employees' Retirement System	**F2**	The San Francisco Employees' Retirement System Board did not complete a "failure analysis" subsequent to the funding loss suffered in 2008-2009.	**SFERS Board** **SFERS Executive Director**	This item is a finding - there will be no action plan in response.	**SFERS Board:** We disagree with this Finding. The unrealized loss in market value of the SFERS Trust in 2008-2009 was not a "failure" of the SFERS investment policy, but rather the result of unprecedented conditions in the financial markets. In compliance with our long-standing policy and practice, the Retirement Board reviews the fund's investment performance each quarter. To prepare for that review, SFERS investment staff and the Retirement Board consultants conduct a comprehensive review and analysis of the investments and present their conclusions to the Retirement Board at its regularly scheduled meetings. This process was followed quarterly, before, throughout, and after 2008-2009. In addition, at the September 8, 2009 meeting, we reviewed the annual investment performance and approved recommended changes in the sub-asset class structure of the SFERS portfolio. The changes were recommended by investment staff and the consultant as a result of their review and analysis of the financial markets at the time. Moreover, at the October 13, 2009 meeting, we approved recommended changes to the Investment Policy Statement that were recommended to us. **SFERS Executive Director:** I disagree with this Finding. As is the SFERS Board's long-standing policy and practice, Retirement investment staff and consultants conducted a comprehensive review and analysis of the SFERS Trust investment performance and presented the results of its analysis to the SFERS Board on a quarterly basis throughout and after 2008-2009. The investment performance report of SFERS Trust investment outcomes for Plan Year 2008-2009 was presented to the SFERS Board at its regular meeting on September 8, 2009. The SFERS Board approved recommended changes in the sub-asset class structure of the SFERS portfolio at its September 8, 2009 SFERS Board meeting which were a result of investment staff and consultants' review and analysis of the then-current financial markets. In addition,the SFERS Board approved changes to the Investment Policy Statement as recommended by investment staff and consultants after completion of their extensive review and analysis at its regular meeting on October 13, 2009. The unrealized loss in market value of the SFERS Trust in 2008-2009 was not a "failure" of the SFERS investment policy, but rather the result of extraordinarily difficult financial markets.

Status of the Recommendations
by the 2011-12 Civil Grand Jury

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2011-12	Investment Policies and Practices of the San Francisco Employees' Retirement System	F3	The City must pay increasing contributions to the Fund due to underfunding.	**SFERS Board** **SFERS Executive Director**	This item is a finding - there will be no action plan in response.	**SFERS Board:** The SFERS consulting actuary prepares projections under several scenarios, using future long-term investment returns which estimate the City's required contribution rates into the future. The most recent projections, provided to us at the February 2012 meeting, demonstrate that the City's required contribution rate is anticipated to rise over the next two years as SFERS recognizes the deferred losses from Plan Year 2008-2009 under the plan's 5-year smoothing methodology for valuing Plan assets. These projections also indicate that under certain scenarios (e.g.the Plan achieves its assumed investment return on an annualized basis over the long term), the City's required contributions may decrease over time after fiscal 2014-2015 when SFERS recognizes its final installment of the deferred loss associated with Plan Year 2008-2009 under the 5-year smoothing methodology. We also note that increases in City contributions can be triggered by causes other than underfunding. **SFERS Executive Director:** The SFERS consulting actuary has prepared projections under several scenarios of future long-term investment returns which project the City's required contribution rates into the future. The most recent projections provided to the SFERS Board at its February 2012 regular meeting demonstrate that the City's required contribution rate is projected to rise over the next two years as SFERS recognizes the deferred losses from Plan Year 2008-2009 under the Plan's 5-year smoothing methodology for valuing Plan assets. These projections indicate that under certain scenarios (e.g.the Plan achieves its assumed investment return on an annualized basis over the long term), the City's required contributions may decrease over time after Plan Year 2014-2015 when SFERS recognizes its final installment of the deferred loss associated with Plan Year 2008-2009 under the 5-year smoothing methodology. Further, increases in City contributions can be triggered by causes other than underfunding of the SFERS Trust.
2011-12	Investment Policies and Practices of the San Francisco Employees' Retirement System	F4	The increases in pension contributions by the City are growing at a faster rate than expenditures on most other City services since 1999.	**SFERS Board** **SFERS Executive Director**	This item is a finding - there will be no action plan in response.	**SFERS Board:** The SFERS Board can neither confirm nor deny the validity of this Finding. **SFERS Executive Director:** The SFERS Executive Director can neither confirm nor deny the validity of this Finding.

Status of the Recommendations
by the 2011-12 Civil Grand Jury

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For each recommendation below, indicate one of the four actions you have taken or plan to take in the "Action Plan" column and provide the required explanation in the "2012 Response Text" column.

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2011-12	Investment Policies and Practices of the San Francisco Employees' Retirement System	F5	The Fund can artificially reduce the City's estimated liabilities by increasing its investment return assumptions for future years.	**SFERS Board** **SFERS Executive Director**	This item is a finding - there will be no action plan in response.	**SFERS Board :** The Board takes issue with the implications behind this Finding. We, and staff and the consultants, are fiduciaries to the trust beneficiaries. We take the obligations to our beneficiaries seriously. As fiduciaries, we are obligated to insure there are sufficient assets to pay the benefits granted by the voters. That promise could be jeopardized by engaging in the activity described in this Finding. For that reason, we carefully consider the investment return assumptions on an annual basis, relying on the independent, consulting actuary for analysis and recommendation. Further, the consulting actuary is bound by the Code of Professional Conduct and Actuarial Standards of Practice set out by the Actuarial Standards Board which strictly prohibit any such "artificial" rate setting recommendation to the SFERS Board. **SFERS Executive Director:** The SFERS Board, staff and consultants are bound as legal fiduciaries to the beneficiaries of the SFERS Trust by the California Constitution, the City Charter, and/or by contract. As fiduciaries to the SFERS Trust, the SFERS Board, staff or consultant's participation in the activity described in this Finding would be strictly prohibited. Further, the SFERS Board's consulting actuarial firm upon whose recommendation the SFERS Board approves the investment return assumption is bound by the Code of Professional Conduct and Actuarial Standards of Practice set out by the Actuarial Standards Board which would strictly prohibit any such "artificial" rate setting recommendation to the SFERS Board.

Status of the Recommendations
by the 2011-12 Civil Grand Jury

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2011-12	Investment Policies and Practices of the San Francisco Employees' Retirement System	F6	The unrealistically high assumed investment return rate of 7.66% is driven by concern for the mandated member and City contributions, with little regard for prudent management.	**SFERS Board** **SFERS Executive Director**	This item is a finding - there will be no action plan in response.	**SFERS Board:** We vehemently disagree with this Finding. First, there is no basis in fact that the 7.66% assumed investment return rate is "unrealistically high". The annualized investment returns that SFERS has achieved over the past 20 years (8.17% net of manager fees) strongly support our decisions related to investment returns. Further, the annualized investment return for the the three years since 2008-2009 is 11.71% and demonstrates our prudence in setting the assumed rate of return at 7.66%. Second, the Civil Grand Jury's characterization of our motives and concerns in setting the assumed investment return rate is wholy unsubstantiated, and reckless in that light. As set forth above, we, staff and our consultants, are fiduciaries to the beneficiaries. It is our primary obligation to ensure that the SFERS trust assets are sufficient to pay the promised benefits. The Board takes its obligations seriously. **SFERS Executive Director:** The SFERS Executive Director vehemently disagrees with this Finding. First, there is no basis for the assertion that the 7.66% assumed investment return rate is "unrealistically high". The annualized investment returns that SFERS has achieved over the past 20 years (8.17% net of manager fees) strongly support the decisions made by the SFERS Board over the past 20 years related to long-term investment return assumptions for the SFERS Trust. Further, the annualized investment return for the SFERS Trust for the three years since 2008-2009 is 11.71%. Second, the Civil Grand Jury's characterization of the SFERS Board's motives and concerns in setting the assumed investment return rates is wholy unsubstantiated and reckless. The SFERS Board, Executive Director, staff and consultants are bound as legal fiduciaries to the beneficiaries of the SFERS Trust by the California Constitution, the City Charter and/or by contract. As fiduciaries to the SFERS Trust, the SFERS Board, Executive Director/staff or consultant's participation in the activity described in this Finding would be strictly prohibited.
2011-12	Investment Policies and Practices of the San Francisco Employees' Retirement System	F7	Studies show that public funds with low-risk investment policies perform as well as or better than those with high-risk policies.	**SFERS Board** **SFERS Executive Director**	This item is a finding - there will be no action plan in response.	**SFERS Board:** The SFERS Board can neither confirm nor deny the validity of this Finding. **SFERS Executive Director:** The SFERS Executive Director can neither confirm nor deny the validity of this Finding.

Status of the Recommendations
by the 2011-12 Civil Grand Jury

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2011-12	Investment Policies and Practices of the San Francisco Employees' Retirement System	**R1**	San Francisco Employees' Retirement System Board address the $2 billion dollar [sic] underfunding of the San Francisco Employees' Retirement System Pension Fund by forming a high-level task force with City officials, a panel of experts, community groups, and the public to develop courses of action.	**SFERS Board** **SFERS Executive Director**	**Will Not Be Implemented: Not Warranted**	**SFERS Board:** Throughout 2011, City officials, community groups, labor organizations and concerned members of the public engaged in discussions to address concerns over SFERS' funding. Their collaboration resulted in Proposition C, approved by the voters in November 2011. The reform measures approved by City voters will significantly address SFERS funding levels over the next 15 to 20 years. In addition, under the California Constitution and the Charter, the SFERS Board has plenary authority and fiduciary responsibility for the investment of the SFERS trust asets. We engage expert investment and actuarial consultants to support us in our role as fiduciaries. We cannot delegate our investment authority or fiduciary responsibility to the recommended task force. City officials, community groups and the public have other avenues (public comment at SFERS Board meetings or direct communication with the SFERS Board) to express "courses of action" on any subject that they would recommend to the SFERS Board. **SFERS Executive Director:** As pointed out in the report, by authority of the California Constitution and the City Charter, the SFERS Board has the plenary authority and fiduciary responsibility for the investment of the SFERS Trust. The SFERS Board also engages expert investment and actuarial consultants to support them in their role as fiduciaries. The SFERS Board cannot delegate their investment authority or fiduciary responsibility nor let another entity, such as the recommended task force, influence their investment decisions. City officials, community groups and the public have other avenues (public comment at SFERS Board meetings or direct communication with the SFERS Board) to express "courses of action" on any subject that they would recommend to the SFERS Board. The challenge of addressing the underfunding of the Plan is well known to the SFERS Board, staff and consultants and courses of action have been or are in the process of being implemented to address this challenge. Among them, independent from the SFERS Board, previous efforts similar to the task force recommended by the Civil Grand Jury by City officials, community groups, labor organizations and the public have resulted in pension reform measures approved by City voters which will significantly address SFERS funding levels over the next 15 to 20 years.

Status of the Recommendations
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2011-12	Investment Policies and Practices of the San Francisco Employees' Retirement System	**R2**	Adopt a realistic and consistent formula for estimating the assumed expected investment return rate.	**SFERS Board** **SFERS Executive Director**	**Recommendation Implemented**	**SFERS Board:** We have had a long-standing policy and practice in place to develop all economic and demographic actuarial assumptions, including the investment return assumption, in compliance with Actuarial Standards of Practice set out by the Actuarial Standards Board. As a result of this policy and practice, in December 2011, we voted to phase in a reduction of the long-term investment return assumption from 7.75% to 7.50%, over a 3-year period beginning July 1, 2011. This decison was based on the consulting actuary's recommendation and was consistent with our capital markets outlook as confirmed by our investment consultants, actual plan experience, and the directional trend in economic assumptions being recommended to public plans nationally by public plan actuaries. The annualized investment return that SFERS has achieved over the past 20 years [8.17% net of manager fees] supports our decision, as well as the fund's annualized investment returns of 11.71% since July 1, 2009. **SFERS Executive Director:** The SFERS Board has a long-standing policy and practice in place to develop all economic and demographic actuarial assumptions, including the investment return assumption, in compliance with Actuarial Standards of Practice set out by the Actuarial Standards Board. As a result of this policy and practice, in December 2011, the Retirement Board voted to phase in a reduction of the long-term investment return assumption from 7.75% to 7.50%, over 3-year period beginning July 1, 2011, as recommended by the Board's consulting actuarial firm and consistent with the Board and investment consultant's capital markets outlook, actual plan experience, and the directional trend in economic assumptions being recommended to public plans nationally by public plan actuaries. Historically, the annualized investment return that SFERS has achieved over the past 20 years [8.17% net of manager fees] supports the decisions that the SFERS Board has made over this same time period related to long-term investment return assumptions. Further, the SFERS Trust has annualized investment returns of 11.71% since July 1, 2009.

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2011-12	Investment Policies and Practices of the San Francisco Employees' Retirement System	**R3**	The San Francisco Employees' Retirement System Board undertake an in-depth investigation and "failure analysis" study of its investment policy and report its findings to its members and to the public.	**SFERS Board** **SFERS Executive Director**	**Recommendation Implemented**	**SFERS Board:** This recommendation embodies the fiduciary due diligence that we have embedded in our investment policies and procedures over the past decades. In accordance with our long-standing policies, there were thorough, in-depth analyses conducted by investment staff and consultants before, throughout and after 2008-2009, the results of which were reported to us on a quarterly basis at our public meetings. Specifically, at our September 8, 2009 meeting, they presented us with a comprehensive analysis of the investment outcomes for Plan Year 2008-2009, and recommended changes in the investment portfolio's sub asset class structure as a result of their review and analysis of the then-current financial markets. Thereafter, based on these findings, we approved changes to the Investment Policy Statement at our October 13, 2009. These reports are available to the public. **SFERS Executive Director:** This recommendation embodies the fiduciary due diligence that the Retirement Board has embedded in its investment policies and procedures over the years. In accordance with the Retirement Board's long-standing investment policies, there were thorough, in-depth analyses conducted by investment staff and consultants before, throughout and after 2008-2009, the results of which were reported to the nRetirement Board on a quarterly basis at its public meetings. SFERS investment staff and consultants completed a comprehensive analysis of the SFERS Trust investment outcomes for Plan Year 2008-2009, the results of which were presented to the SFERS Board at its regular meeting on September 8, 2009. SFERS investment staff and consultants also presented recommended changes in the sub-asset class structure of the SFERS portfolio at the September 8, 2009 SFERS Board meeting which were a result of their review and analysis of the then-current financial markets. In addition, SFERS investment staff and consultants completed an extensive review and analysis of the SFERS Investment Policy Statement and presented recommended changes to the Investment Policy Statement to the SFERS Board at its regular meeting on October 13, 2009. These reports are available to the public.

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2011-12	Investment Policies and Practices of the San Francisco Employees' Retirement System	**R4**	Investigate, quantify and address all the major risks in the portfolio and make this information public.	**SFERS Board** **SFERS Executive Director**	**Recommendation Implemented**	**SFERS Board:** We have a long-standing strategic business initiative related to analyzing, quantifying and reporting of investment risks in the SFERS portfolio. Most recently, the investment risk management intitiative was documented in the SFERS Strategic Plan, which we adopted at our October 12, 2011 meeting. SFERS has retained a risk consultant and licensed a risk measurement and reporting software program to facilitate staff's review, analysis and reporting of investment risk exposures in the SFERS portfolio. The results of the investment risk analysis have been reported to us on a monthly basis since February 2011. SFERS investment staff has fully intergrated the public (U.S. and international) equity portfolio into the risk analysis and is in the process of integrating the fixed income portfolio. All of the reports and presentation materials are available to the public. **SFERS Executive Director:** The SFERS Board has a long-standing business initiative related to the analyzing, quantifying and reporting of investment risks in the SFERS portfolio. Most recently, the investment risk management intitiative was documented in the SFERS Strategic Plan adopted by the SFERS Board at its October 12, 2011 regular meeting. SFERS has retained a risk consultant and licensed a risk measurement and reporting software program to facilitate investment staff's review, analysis and reporting of investment risk exposures in the SFERS portfolio. The results of the investment risk analysis has been reported to the SFERS Board on a monthly basis since February 2011. SFERS investment staff has fully intergrated the public (U.S. and international) equity portfolio into the risk analysis and has begun the integration of the fixed income portfolio. Further, the Investment Committee of the SFERS Board has received periodic briefings by SFERS investment staff and consultant over the past five years. All of the reports and presentation materials presented to the SFERS Board related to the investment risk management initiative are available to the public and the Civil Grand Jury.
2011-12	Investment Policies and Practices of the San Francisco Employees' Retirement System	**R5**	Investigate less volatile and risky investment policies that would attain sufficient returns for the San Francisco Employees' Retirement System Pension Fund.	**SFERS Board** **SFERS Executive Director**	**Recommendation Implemented**	**SFERS Board:** We routinely analyze a full range of investment policies and opportunities in relation to the goals of the SFERS Trust. **SFERS Executive Director:** The SFERS Board has a long-standing policy and practice in place to analyze the full range of investment policies and opportunities in relation to the goals of the SFERS Trust. As reported by the Retirement Board's general investment consultant, as of June 30, 2012, the risk level of the SFERS portfolio, measured by standard deviation of returns, was below the median peer (public funds with assets over $1 billion) over the trailing one, three and five-year periods.

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2011-12	Investment Policies and Practices of the San Francisco Employees' Retirement System	**R6**	Replicate the Stanford, Upjohn, and *The New York Times* evidence-based comparison studies using San Francisco data, to apply their findings to the San Francisco Employees' Retirement System Pension Fund.	**SFERS Board** **SFERS Executive Director**	**Will Not Be Implemented: Not Warranted and Not Reasonable**	**SFERS Board:** The findings of these types of comparison studies are routinely reviewed as part of the due diligence required as fiduciaries to the SFERS Trust. These comparison studies have tangential relevance to our decisions for SFERS, so the time and expense required to replicate these comparison studies are unwarranted and unreasonable. **SFERS Executive Director:** It is not reasonable for the SFERS Board to require investment staff and consultants to replicate these or similar studies. The SFERS Board, staff and consultants routinely review the findings of these types of comparison studies as part of the due diligence required as fiduciaries to the SFERS Trust.