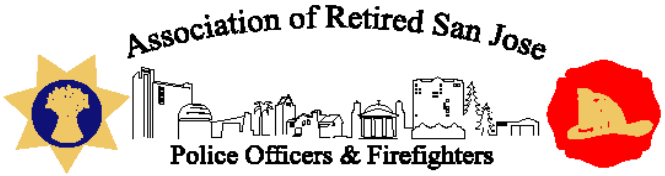

November 1, 2013

San Jose Police & Fire/Federated Ad
Hoc Cortex Response Committee
SJPF/Federated Ad Hoc Cortex Response Committee

Dear Committee:

We write to convey our concerns with regards to the Cortex Phase II Report & Recommendations titled "a review of the Governance Models of Police & Fire Department Retirement Plan and Federated City Employees' Retirement System written by Cortex Applied Research, Inc.

Similar to our concerns with Cortex's original report produced for the City Manager in 2009, **Cortex once again fails to provide *any* factual data to support its recommendation in changing the composition of either retirement board, the selection process of board members or the consolidation of both boards. Similar to our position in 2009, we agree with the Cortex recommendation to provide the respective boards full autonomy in hiring, managing its Executive Director, legal counsel and all consultants. We believe this is both a requirement under California law and in the best interests of the plan.**

Prior to detailing our concerns with the Cortex recommendations, it is important to understand that the Association of Retired San Jose Police Officer & Firefighters led the effort to help change the current board structure of the retirement board. Our organization supported adding "public" members to the board and advocated for the current set of qualifications for boardmembers.

Our objections listed below bare no reflection on the current boardmembers, board structure or qualifications of board members. Rather, we are concerned with the selective use of research to fix problems that do not exist. As plan members, we do not want to see our retirement system used to create a board model that will be showcased around the country as a "model" to further the agenda of others.

Further, we are once again disappointed that as part of its analysis, Cortex did not reach out to stakeholders, mainly us, the retired plan members for any input as part of their analysis. Buy in from plan members, according to most of the academic papers cited by Cortex on governance in its report, is key to a successful pension system. We are at a loss as to why we didn't warrant any input.

Operational Autonomy
An area of the Cortex report we agree is with their recommendation that the retirement boards have their own autonomy. The board should have the ability to establish its own operating budget, appoint and direct retirement staff, and appoint all necessary advisors and service

providers. Our Association has suggested this for years. We believe this is consistent with California law as well.

We believe that the City's unwillingness to implement this previous recommendation has been detrimental to the plan. The Boards should have the authority to set the salaries and criteria for key administrative positions, choose those employees and be able to hold them accountable. The inability of the City Manager to fill key vacancies has cost the taxpayers, employees and retirees money.

One only needs to look to last month's Board meeting where the Board hired NEPC Consultants at a cost of $63,500 a month to perform outsourced CIO services[1]. While this was a prudent move given the harsh ramifications of the Plan continuing to function without a CIO, this agreement would likely be completely unnecessary if the Board were able to implement its own salary schedule and make the final decision on hiring for the CIO position.

This recommendation should be implemented as soon as possible.

Board Structure

Despite a dramatic restructuring of the membership of San Jose's two retirement boards, with each board now having a majority of "independent" boardmembers, Cortex once again recommends a further change in board composition to cut in half the representation of plan members on each board. **We strongly oppose this recommendation.**

What's most troubling about Cortex's recommendation is that the research cited by Cortex does not support its position. In fact, in many cases, the research goes against the Cortex findings.

For example, on page 25 of the Cortex report, in reference to recommendation #3, Cortex states that, "Academic research suggest that having plan members on a public board can help performance, provided plan members make up a ***small portion*** of the board" (emphasis added). Cortex cites a report written by David Hess published in the UC Davis Law Review as its source for that conclusion.

The Hess report, however, states that:

> **Board members who are also plan members may improve the performance of the fund due to their direct financial interest in the plan's performance. Due to the fact that their personal retirement is at stake, these trustees are analogous to corporate directors with significant equity ownership in the firm. In both cases, the financial interests of the agent are aligned with the performance of the firm (or the pension fund).[2] (**Emphasis added)

[1] Police & Fire Retirement Board, October 3, 2013, Agenda Item 2a.

[2] Protecting and Politicizing Public Pension Fund Assets: Empirical Evidence on the Effects of Governance, Structures and Practices, University of California Davis Law Review, 2005, pg. 199)

In Mr. Hess' report, he explains his mathematical analysis of the impact of "member-elected trustees" on fund performance. **Hess' model found that member-elected trustees have a positive impact on fund performance until they consisted of 47% or more of the board (Hess, pg. 215).** The elected members of the Police & Fire Retirement Board, as you know, make up 44% of the board, within the parameters identified by Hess. [3]

While it may be arguable as to whether 47% is a "small portion," when it suits Cortex's needs, the 44% of the member elected boardmembers is expressed as "active and retired plan members continue to make up approximately half the members of the each City Retirement Board" (Cortex, pg. 11). Which is it?

While Cortex uses the Hess report to make a case for limiting plan members serving on the Board, they all but ignore Hess' arguments and evidence demonstrating positive effects on fund performance for ensuring that they remain on the Board.

The selective use of research findings and color commentary does not stop with the Hess report. In providing justification for removing plan members from the respective retirement Boards, Cortex makes it appear that existing research and best practices dictate this step as they write "pension governance guidelines from around the world, as well as academic research, agree on this point." Removing plan members in place of "independent" board members is not the recommendation from the sources cited by Cortex when arriving at this conclusion by Cortex.

In making this conclusion, Cortex refers us to the Government Finance Officers Association's "Governance Guidelines." What do the GFOA guidelines suggest? GFOA guidelines essentially suggest a mix of board members similar to San Jose's systems:

> b) Board Composition – Any board that operates effectively includes members who have a mix of skills, competencies, and behaviors, including leadership, teamwork, communication, planning and organizational abilities, and knowledge of sound decision-making principles. A successful board actively pursues and makes use of these skills and behaviors. **Board composition should reflect the varied interests of those responsible for funding the plan and <u>should include plan participants and retirees</u>**, citizens of the governmental unit, and officers of the plan sponsor, as well as independent directors. This assures balanced deliberations and decision-making. (Emphasis added)

In referencing the same point, Cortex also refers us to the "Clapman Guidelines." The Clapman guidelines state:

> A governing body should promote policies that strengthen fiduciary principles in the selection and monitoring of trustees and that enable trustees to fulfill their fiduciary responsibilities. **Where trustees are elected to a board to represent a class of fund**

[3] In reference to the definition of member elected plan members, Hess states "Independent trustees are those elected by the plan members and are often members themselves," Pg. 198.

> **beneficiaries, the elected trustee should take reasonable steps to acquire the skills to serve appropriately as a fiduciary**. (Emphasis added) [4]

The research recommends continuing education, not removal from the Board.

Cortex also cites an article written by Thomas Fitzpatrick and Amy Monahan stating that most pension plan boards lack members with strong pension and investment expertise. **However, they fail to report that Fitzpatrick and Monahan found that "the strength of a plan's governance provisions does not appear correlated with a plan's financial health," (Fitzpatrick & Monahan, pg. 1). They also found that "With public funds, there is no real benefit to independent trustees in increasing the fund's performance" (Fitzpatrick & Monahan, pg. 10).**

When one looks at the balance of research cited by Cortex in its report, its clear that there is just as much evidence, if not more, including quantitative data, that suggests that plan members should remain on the board in their current numbers than research that suggests otherwise. Inferences made by Cortex regarding "best practices" are based on theory, not real world results.

In fact, the pension funds they highlight as being "noteworthy pension governance models" all consist of plan members serving on the pension boards. Every U.S. based plan they highlight has a significant number of plan members and other non-independent plan members. In fact, where San Jose's system differs from the "noteworthy" plan is largely around board authority and autonomy of the retirement system (a governance component we support), not board structure. San Jose's board structure and board qualifications meet or exceed the Cortex standards for independence of the U.S. "noteworthy" plans:

- **San Bernardino County Employees' Retirement System**: several "conflicted" members including plan members; no criteria for experience for ANY boardmembers),
- **Missouri State Employees Retirement System**: (board has "low level of independence", no requirement for board members to have any relative experience)
- **Texas Teachers' Retirement System:** 9-member board, 4 of who are active or retired plan members, 5 must have financial experience.

As can be seen through both the academic research and the model plans put forward by Cortex, San Jose's board structure has better or stricter standards than most plans for its members and qualifications for its members.

Furthermore, as in 2009, Cortex provides no actual identified problem it is attempting to solve. As such, we believe the current board structure and selection process should stay in place, especially since its still in its infancy.

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[4] Committee on Fund Governance Best Practice Principles, The Stanford Institutional Investors Forum, Peter Clapman, Chair, 2007, pg. 7.

Board Consolidation

Cortex recommends that the Federated and Police & Fire Retirement Systems be merged to be "more efficient". Again, we disagree with this recommendation. Once again Cortex is dismissive of any benefits derived from plan members, whom the funds are set up to serve, having confidence in the governance and responsiveness of the respective boards.

Currently, the two boards are set up to serve two fairly distinct sets of employees: public safety officers and non-public safety. Each with very distinct set of employment characteristics in terms of vesting time, length of career and benefit level. Most critical to police and fire retirees is the reality that police officers and fire fighters suffer a much higher incidence rate of injuries on the job due to the very physical nature of our work. These injuries can come in catastrophic events and/or are compounded over the course of a career. Having a board that is focused on the very real and unique hazards of our jobs provides comfort and confidence to the employees in the field who are asked to risk their lives and physical safety every day to do their job that their medical cases will be taken seriously, fairly and with care. This is a huge factor that is completely missing from the Cortex analysis. Additionally, this problem will be exacerbated by the very real fear in new hires to the police and fire departments that they have zero protections relative to workplace injuries due to Measure B. Further salting this wound will hurt the City's ability to hire police officers and firefighters.

Setting aside that concern, Cortex fails to provide any risk analysis of challenges that may arise from combining the systems. Instead, they provide generic statements about "efficiencies" without much detail and gloss over the key factors in their own research which dictate how the real efficiencies are achieved.

According to the paper they source, the key factors to efficiency are not the relative small savings achieved through legal counsel or investment consultants, but rather due to growing the actual pension administration function (much larger staffs, specifically around managing their own investments), and getting involved in riskier (yet higher rewarding) investments. Here is what the academic research states:

- The largest plans outperform smaller ones by 43-50 basis points per year. Between a third and one half of these gains arise from cost savings related to internal management, where costs are at least three times lower than under external management (Dyck & Pomorski, pg. 1).
- Most of the superior returns come from large plans' increased allocation to alternative investments and realizing greater returns in this asset class (Dyck & Pomorski, pg. 1).
- More interesting is that large plans manage 13 times more of their active assets internally (2.7% in the 1st quintile versus 35.4% in the 5th quintile). This leads to substantial cost savings. While delivering similar gross returns, external active management is at least 3 times more expensive than internal active management, and in alternatives it is 5 times more expensive (Dyck & Pomorski, pg. 3 & 4).
- we find that larger plans shift towards asset classes where scale and negotiating power matter most and obtain superior performance in these asset classes. Larger plans devote

> significantly more assets to alternatives, where costs are high and where there is substantial variation in costs across plans (Dyck & Pomorski, pg. 4).

As you can see from the research cited by Cortex, just making your pension plan bigger does not magically make it better. It takes an incredible overhaul of the organization of the administrative structure, including massive hiring of highly skilled investment and financial professionals in house, and a change in investment strategy and asset classes. Also, as Cortex points out and the research demonstrates, these efficiencies are generally reached for plans exceeding $10 billion in assets. Our plans are significantly under that.

Along the lines of plan size, the examples cited by Cortex in its report, do not mirror their recommendation in San Jose. In Indiana, two large systems merged together to create a $26 billion fund (well above the $10 billion threshold for "large plans"); Massachusetts created the ability for failing small plans to be managed by a state board, the Canadian examples allow smaller funds to be managed by much larger funds, and in the Netherlands, it completely outsources the management of all public plans.

Cortex does cite theoretical savings from hiring similar consultants under one contract. We believe this can also be done through the existing system, however the savings cited as a result of this radical change, $700,000 represents 0.16% of the plan assets. We under stand that some may say that savings are savings. But this is a relatively small level of savings for the potential risk of complicating the mixing of plan assets and eroding stakeholder trust in the pension systems they have paid into. By contrast, it is our understanding that the fund lost several million dollars because the staff lacked the key personnel to address investment issues. Our priority should be on fixing this problem.

Conclusion

In summary, once again we find the Cortex report uses selective bits of research to promulgate a "best practices" model that in fact is not in practice anywhere. We believe that the respective boards and City Council should allow time for the relatively new changes to the systems to fully develop.

Continued radical changes to the system, during this time of flux given the vacancies of key positions such as the CIO is unwise, especially with no real conclusive evidence that those changes will improve the plan's performance or increase the stability of the plan for plan members. Further, given the City's catastrophic inability to recruit and retain employees in multiple departments, the City should be cautious not to continue to erode the confidence of plan members in the retirement systems they pay into and ultimately depend on.

Finally, the time has come to implement the reforms that active and retired members have urged for nearly twenty years—the autonomous operation of the retirement system by their respective

boards. Again, we believe the research, current conditions, and the law, dictate that this change should be implemented immediately.

We greatly appreciate the time and attention you give to our concerns, and as always, we are willing to discuss these issues further at any time.

Sincerely,

Jim Spence
President