

**REPORT OF FINDINGS AND
RECOMMENDATIONS
TO THE CITY OF SPRINGFIELD ON
THE RESULTS OF A PERFORMANCE AUDIT
FOR
THE POLICE OFFICERS' AND FIRE FIGHTERS'
RETIREMENT FUND**

JANUARY 2006

A MILLIMAN GLOBAL FIRM



Milliman

Consultants and Actuaries

TABLE OF CONTENTS

| | | |
|----|--|----|
| A. | Investment Performance | 2 |
| B. | Fees and Services..... | 4 |
| C. | Investment Policy | 7 |
| 1) | Goals | 8 |
| 2) | Asset Allocation..... | 8 |
| 3) | Investment Management Structure..... | 9 |
| 4) | Fund Oversight and Accountability..... | 12 |
| 5) | Communications | 12 |
| 6) | Fiduciary Issues | 13 |
| D. | Next Steps and Recommendations | 14 |

PERFORMANCE AUDIT FINDINGS AND RECOMMENDATIONS

This report is the result of work that was undertaken at the request of the City of Springfield's Police Officers' and Fire Fighters' Retirement Fund ("Fund"). The findings and recommendations herein will be in response to the SPECIFIC REQUIREMENTS Section 1.4 of the Request for Proposal No. 014-2005 for a "PERFORMANCE AUDIT" for the above-referenced Fund issued June 28, 2005. The work began in October of 2005 and concluded in January 2006. The following work was undertaken to evaluate the Fund: 1) the investment results of the Fund were independently produced with data obtained from the Fund's custodian, U.S. Bank, for the period October 1, 2002 through September 30, 2005; 2) a review of contracts with all vendors was made for fees and services; 3) a due diligence review of all current Investment Managers ("Managers") was performed; 4) a review of the current Investment Policy ("Policy") was completed; and 5) additional information that was obtained from the City's Finance Director, Attorney and Board of Trustees ("Trustees"). All information asked for was provided, if available. Our conclusions herein are based on the documents provided and Milliman's research and experience in the industry.

This report will focus on the following areas: Investment Performance, Fees and Services, Investment Policy, and Next Steps and Recommendations have also been made.

Investment Performance

The below returns plus additional information can be located in the Investment Performance Monitoring Reports or Manager Research Reports previously given to the City. It should be noted that returns were prepared using global AIMR-PPS standards and current managers were contacted to compare results with their internal calculations. Although specific market related benchmarks are not stated in the Policy, we used those benchmarks that are standard in the industry and in our opinion appropriate for the needs of your Fund. We also used appropriate style benchmarks and universes when evaluating specific Managers.

The total Fund's investment result for the period October 1, 2002 through September 30, 2005 was an annualized return of 10.23%. The total Fund is defined as those assets under management for the long term. It does not include the Money Market sub-account or any other short-term assets such as checking accounts that may not be held by the custodian. These returns have not had the Managers fees taken out of the results. Also, other expenses such as custodian, Investment Consultant ("Consultant"), legal, accounting and actuarial fees have not been taken out of the results. This return significantly exceeded the 8.5% (recently changed by ordinance to 7.5%) return stated in the Fund's Policy. We believe the return in the Policy is intended to be the actuarial interest assumption net of any fees. However, using other measurement goals, the Fund's performance was below average. Based on appropriate market related benchmarks, the Fund trailed by 2.2% annually. The primary reason the total Fund underperformed its market related benchmarks was an underweighting of equities in the Asset Allocation relative to what

was stated in the Policy of 50% Large Cap, 10% Small Cap, and 40% Fixed Income. Also in a broad universe of Balanced managers, the Fund was below average with a 63rd percentile ranking. However, a return of 10.23% was 7.05% annually better than the inflation rate of 3.18% over this time period.

Below is a discussion of the Fund's performance by Asset Class.

The Fund's large capitalization investments collectively returned 16.70% over the three-year time period. These returns have not had any expenses deducted such as investment management fees. This return essentially equaled the return of the S&P 500 index of 16.72%, which is an industry standard benchmark. Both the S&P 500 index and your combined managers were below average in a broad universe of large cap managers with a 62nd percentile ranking. On a net of fee basis, an index fund would have outperformed because of a much lower fee and done so with less risk. In evaluating this large cap asset class performance, prior managers and related assets were included to eliminate any misleading survivorship biases.

There are three current Managers making up the large cap portion of the fund. Returns are not reduced by fees.

Wedge Capital Management. This is a new Manager to the Fund coming on board during 2005. In two quarters Wedge's return was 11.44% versus an appropriate benchmark for its investment style, the Russell 1000 Value, of 5.62%. The broader benchmark used for the total Fund and combined large cap asset class, the S&P 500, returned 5.02%. Obviously this Fund's performance was excellent in this short time period. It also significantly outperformed its large cap value peers with a 10th percentile ranking for the last quarter. The time period was too short for a meaningful risk analysis.

Legg Mason Capital Management. This is the only large cap Manager with a complete three-year track record with the Fund. Legg Mason's return over this time period was 23.76% versus the market and style related benchmark S&P 500 of 16.72%. Legg Mason was the top performing Manager in the large cap core universe. However, its portfolio is also one of the most risky in the core category as measured by volatility using standard deviation.

Marvin and Palmer Associates. Marvin and Palmer is the large cap growth Manager in the Fund. They have managed the Fund for 2½ years. During that time frame their return was 14.17% versus the Russell 1000 Growth style index of 10.31%. The S&P during that time frame was 12.83 %. The risk of this manager appears average for its category using standard deviation as a proxy for risk. By other measures this Manager carries significant risk. The peer group ranking was excellent at 14th percentile for the last year.

The Fund's small cap investments collectively (including prior managers and assets) returned 19.52% over the three-year period. Although this is a good nominal return, it significantly

lagged an appropriate broad based benchmark, the Russell 2000, which had a 24.12% return for this time period. There is only one current Manager for the small cap asset class. Returns are before fees.

Cortina Asset Management. Although the management of Cortina has managed money for the Fund previously, they did so with another organization. Since resources and other support is different, we have only measured their performance since May of 2004 when Cortina was formed. During this short time frame, they returned 12.93% versus the Russell 2000 Small Cap index of 11.51%. As the benchmark and universe were not stated in the Policy, we used what is standard in the industry for comparison purposes. This return was obtained with significantly higher risk when compared to an appropriate small cap core peer group. The peer group ranking was excellent at 17th percentile for the last year ending September 30, 2005.

The Fund's fixed income Managers collectively returned 3.6% over the three-year time period. This return showed an 88th percentile ranking against a universe of core fixed income managers. As the specific benchmark and universe were not stated in the Policy, we used what should be used as an appropriate benchmark and universe, in our opinion.

There are currently two Managers utilized for the fixed income asset class. Both have been managing fixed income for all three years included in this performance report. Again, returns do not have investment management fees taken out of the results.

ASB Capital Management. ASB's return over the three year period was 3.72% versus the Lehman Aggregate benchmark's 3.96%. This has been accomplished with less risk than its peer group of core fixed income managers. Their peer group ranking was 83rd percentile.

Fox Asset Management. Fox's returns were 3.51% with even less risk than ASB. Their peer group ranking was 92nd percentile in a core group of fixed income managers.

Fees and Services

All of the Investment Manager's fees are based on assets under management with each respective Manager.

1. Wedge's fee is 50 basis points ("bps") on the first \$25 million of assets under management with fee reductions above \$25 million. Wedge's investment style uses quantitative models rather than fundamental research so it should be lower than the other large cap managers. As of June 30, 2005, fees paid to Wedge were \$8,051.58 on approximately \$9 million in assets as of September 30, 2005, as they just started providing services.

2. Legg Mason's fee is 1% (100 bps) on the first \$5 million, 75 bps on the next \$5 million and 65 bps on the next \$20 million of assets with further reductions thereafter. The weighted average fee the Fund paid in year ended June 30, 2005, was 73 bps. This amounted to \$215,612.20 at the end of the last fiscal year with assets as of September 20, 2005 of just under \$30 million.
3. Marvin and Palmer's fee is a fixed 75bps with no break points for additional assets. It amounted to \$82,395.12 on approximately \$11 ½ million.
4. Cortina's fee is a fixed 1% also with no break points. The fee is a little higher here because more work is required to manage smaller capitalization stocks due to the lack of information and additional research required. The annual fee was \$140,147.05 through June 30, 2005, with approximately \$15 million in assets as of September 30, 2005.
5. ASB's fee is 50 bps on the first \$10 million, 25 bps on the next \$10 million and 15 bps thereafter. The fee was \$97,621.92 based on just over \$36 million in assets as of September 30, 2005.
6. Fox's fees are 40 bps on the first \$25 million, 30 bps on the next 25 million and 25 bps above \$50 million in assets under management. The fee was \$61,462.19 on \$25 ½ million in assets.

U.S. Bank's fee as custodian amounted to \$41,602.25. It is calculated at 4 bps on the first \$50 million and 3 bps thereafter. This appears to be an all-inclusive fee which includes all reporting, benefit payments and trading.

In general, the above fees are not unreasonable but range on the high side. However, specific services need to be clarified to classify the appropriateness of the fees. Managers should include at least an annual summary of transaction costs by brokerage firm used and a description of research or other services provided to the Manager by those brokerage firms. These are expenses of the Plan and need to be monitored. The Manager reports should also include basic summary quantitative information such as alpha, beta, median market cap, duration, yield, etc. These statistics would allow the Trustees and Consultant to monitor the investment process of each Manager more closely. The exact information needed by the Trustees and the Consultant should be discussed with each Manager. Proxy voting should be part of the services with an annual report to the Trustees if possible. Managers should meet at least once a year with the Trustees to explain the performance of their portfolio during the year and more often if there is a perceived problem. Their presentation should also include an opinion of the capital markets for the next year and how the portfolio might be restructured accordingly. The Managers should be in constant contact with the Consultant so that someone representing the Fund is aware of all major events that could be relevant to the Fund's performance.

Rothschild, the Fund's investment Consultant, appears to have two contracts. The first is for approximately \$44,000 a year, which seems to include performance reporting, Manager searches and general consulting. The second is 5 bps on assets for Tactical Asset Allocation Rebalancing.

The total fee paid to Rothschild for investment consulting for the year ended June 30, 2005, was \$106,887.10. The contract is unclear as to specific services to be provided and the nature of the authority and responsibility of the Consultant. However, our concern is with the lack of documentation to the investment process from both a management and fiduciary process. For example, it does seem that the responsibility for manager searches falls to the consultant based on language in the contract and the fact that they did the manager searches in the past. To our knowledge the Trustees have no written documentation of the goals of the search. Also the search process is not documented. For example, how many managers were reviewed who fit the goals of the search, what criteria was important in selecting the finalists, why were other managers not included? There should have been written scatter plots showing risk and returns, schedules of fees and other statistics in writing comparing the finalists. Minutes should reflect a summary of the major reasons a particular manager was selected. In our opinion this is just one example of where the investment process is not documented adequately from a fiduciary standpoint. Normally the consultant would take the lead in this process for the Trustees. We do not know if this lack of documentation is their standard practice with institutional clients like Springfield or not. Therefore, we do not know if this lack of documentation is due to a lack of knowledge or resources in dealing with institutional clients.

The other area besides manager search where their services are documented in their contract is Tactical Asset Allocation Rebalancing. In our opinion it should not be discretionary, as it can cloud their objectivity when reporting on their performance. This makes them an investment manager not an investment consultant. Their advice should be in the form of a recommendation stating their reasoning to be approved by Trustees. The results should be accounted for in the performance reporting. We question the Tactical Asset Allocation fees for a consultant being asset based, as it puts too much emphasis on growing assets at the expense of possibly increasing risk to the fund. We see no documentation as to who is making those decisions and their qualifications in doing so. Are these decisions being made by your consultants individually, or is there a team supporting them? If there is a research team, who are they, and what is their background and experience in making these decisions? What is their investment process in making these decisions? Specifically, what criteria are they using, such as fundamental valuations, technical market criteria or other factors?

The Consultant's services that are not specifically stated in the contract, but in our opinion should be included as part of "general consulting" need to be improved to include enhanced performance reporting that covers the goals specifically set out in an upgraded Policy as discussed below with written summaries of portfolio performances of each Manager, risk criteria and portfolio analysis. Also, educational sessions for Trustees and City staff should be provided. Documented research regarding issues for discussion that arise in the ongoing investment process should be provided. Formal written Asset Allocation studies should be undertaken every three to five years (and perhaps formal Asset Liability studies every five to ten years). All of these documents need to be kept on file to satisfy the fiduciary requirements of the Fund. All issues presented to the Trustees for decisions should be supported with adequate research, kept on file and reflected in the minutes.

In general, we think there is room for renegotiation with all of your vendors' fees to perhaps reduce fees in certain cases, and especially to clarify what services are provided. We think it is important to get breakpoints in those contracts with investment Managers where there are none such as Cortina and Marvin and Palmer. In our opinion, all Managers should be held to a higher fiduciary standard such as in Section 3(38) of ERISA. Wedge, for example, acknowledges that they will be a fiduciary under ERISA if it's an ERISA account. We think they should be held to the ERISA standard anyway. We also recommend that all Managers acknowledge in writing that they will work within the guidelines of the Policy. Wedge, Cortina, and Martin and Palmer say or imply they will, but it's not clear that the current Policy is part of their contracts. Cortina actually says it may not use best execution even if they receive no research from the broker. This needs to be clarified and, in our opinion, is unacceptable. Fox declines to vote proxies unless the right is specifically given to them in the Plan document or client guidelines. We cannot see that the action has been taken. The Consultant should be familiar with issues specifically related to Manager contracts and should assist the Trustees and City Attorney in negotiating those contract details.

Investment Policy

This document is very important because it sets out in writing the goals for the overall management of the Fund's investments. The Policy is not only important for a clear understanding of the roles by those involved with the management of the investment Funds, but it also provides a documented process for management which provides fiduciary protection to all those involved, particularly the Trustees who have the most responsibility and personal liability. Another purpose of the Policy is to provide a means for accountability by all of the vendors involved. The primary areas of discussion in this section will be setting Goals, Asset Allocation, Investment Manager Structure, Fund Oversight and Accountability, Communications and Fiduciary Issues.

The Trustees are the primary individuals responsible for issues relating to investments by the Fund. Therefore, it is critical that they be actively involved in formulating all policies related to management of those investments. They should seek assistance when necessary from their staff, consultant, auditor, actuary and attorney, as necessary. They may be held to the standards of a prudent expert so they must be active in fulfilling their role as Trustee.

Ultimately, the City is responsible for the Retirement Fund. However, the authority to make all management decisions of the Fund should be delegated to the Trustees. This also means that the responsibility and authority to make decisions and corresponding accountability and fiduciary liability should fall primarily on the Trustees. This is an onerous responsibility, as Trustees are not compensated for their time and have significant responsibility and personal liability. Only Trustees who have the time and are dedicated to fulfilling these serious obligations should be appointed to serve. It is doubtful that the City Council members have both the time and expertise that is required to deal with the issues involved in management of the Fund on a timely basis. However, the City, through its Finance Director and Attorney, should have input in designing the Policy and related Investment Performance Monitoring Report so that information is adequately

communicated to the City. Once the Policy is implemented it must be followed, or it is clear evidence of a breach of fiduciary liability. In our opinion, the City will be able to adequately fulfill its supervisory role by the following methods: 1) the Consultants' quarterly Investment Performance Monitoring Report be made available for review by the City; 2) the Finance Director and City Attorney should attend Trustee meetings to monitor all activities and report to the City any important issues that are being discussed; 3) as representatives of the City, they should communicate the City's desires to the Trustees; and 4) the Trustees should report formally to the City at least annually the progress of the Fund, including any material relevant issues relating to management of the Fund.

1. Goals

We recommend that the dominant goal for the investment return of the Fund over time is to at least meet the actuarial interest assumption for the Fund net of all investment and other appropriate fees. If this return is not met, the Fund's status as a viable retirement vehicle will not be met. Other important goals would be to exceed inflation by a realistic amount to make sure the Fund's purchasing power is maintained over time. Realistic market related goals and peer group goals are also important for a perspective on performance of the Fund, especially over short time frames. We think your current peer group goal of requiring Managers to be in the top quartile of its peer group is too onerous and has led to high Manager turnover causing excessive expenses to the fund. These goals should be determined after the completion of an Asset Allocation or Asset Liability study indicated below. The market related and peer universe goals should be determined with adequate research provided by the Consultant for evaluation by the Trustees when considering Manager structure and implementation as discussed below. The goals should be understandable and clearly communicated to everyone, including the Managers. The quarterly Investment Performance Monitoring Report prepared by the Consultant should clearly measure what is stated relating to goals in the Policy so as the Trustees and the City have a clear understanding and perspective of the Fund's performance. The Consultant should always initiate suggestions for improvement as the markets change and the Fund matures.

2. Asset Allocation

The most important decision that the Trustees make is the Asset Allocation decision, as it is the prime determinate of returns and the corresponding risk associated with getting those returns. Asset Allocation refers to which asset classes will be permissible for the Fund to use and in what percentages should they be used. An Asset Allocation study would determine the probability of success of reaching the return goal above and the corresponding risk associated with achieving those returns for various combinations of asset classes. This study should be well documented and is usually prepared by the Fund's Consultant. The study will be based on the returns, risk and correlation of various permissible asset classes. In our opinion, the Trustees should include the following permissible asset classes for consideration in this study: domestic equities, domestic bonds, international equities and domestic real estate. As the Fund grows, other asset classes could be considered in the future. This would be the Fund's strategic or target allocation based on a time frame of perhaps ten years. This is a time frame less than the actuaries consider but longer than the Managers use to make their decisions.

A more thorough way of determining the appropriate allocation would be to include in the study the specific liabilities of the Fund for an Asset Liability study. The Fund's actuary would need to be included with this approach and would probably take the lead in its preparation. This gives the Fund a more specific result relative to your Fund.

3. Investment Management Structure

The specifics of implementation should be decided by the Trustees, as there are many choices in reaching the goals desired in the Policy. It requires a commitment of time by the Trustees after adequate research by the Consultant for informed decision making. Obviously, the final structure would not be completed until the Asset Allocation or Asset Liability study is complete. However, several issues can be resolved concurrently with the study.

The Asset Allocation or Asset Liability study should give the Trustees the probability of various combinations of asset classes that could be used in achieving the Fund's overall goals. We believe it will include some combination of domestic equities, domestic bonds, international equities, and probably real estate. We will assume for this discussion that the asset mix stated in your Policy of 50% large cap, 10% small cap and 40% fixed income with the addition of an international and possibly real estate asset class will be used in any discussion.

In our opinion, the following issues for implementation of a management structure should be decided: 1) the asset classes and percentage of the total Fund that will be invested in each asset class as determined by the appropriate study discussed above; 2) after the study is concluded will additional value added need to come from active management and/or Tactical Asset Allocation (TAA)? It is possible that the risk and return from your current asset allocation using existing asset classes would give the Fund a high probability of success and no additional strategies with the inherent risk and fees is needed. We think that is highly unlikely in the low return environment going forward for the next few years. Therefore, we will proceed on the assumption that some amount of active management with tactical asset allocation to add value will be desired, particularly since the fund has implemented a strategy currently. We also assume, for purposes of this discussion, that active management and Tactical Asset Allocation is preferred over increasing equity exposure in the study to higher levels to achieve the probably needed higher returns, as the risk would be unacceptable to the Trustees.

Regardless of what asset classes and specific Managers are used, it is important to set criteria for their use such as expected return and clarification of risks they are allowed. The Policy should set out certain broad guidelines for each Manager to follow but not be so restrictive that the Manager cannot add any value. However, discussions about the following issues and others should be made so that it is clear what the Trustees expect: use of cash, turnover, brokerage, appropriate securities, appropriate transactions, etc. The most restrictive approach, but least costly and well-diversified strategy, would be using an index or similar approach. The criteria for the Manager would be easy to implement and monitor, but there would be no chance to add value at the asset class level. The amount of indexing verses the

value added with active management is an important decision for the Trustees to consider. If an index approach is used, we do not believe it is appropriate for use with the small cap or international equity asset classes, as these markets are relatively inefficient and active Managers have opportunities to add value. In our opinion, it is highly likely a combination of active management and indexing will be used.

Assuming active management is used, the guidelines need to be developed with research from your Consultant. For example, in the international arena how much should the Manager be exposed to Emerging Markets which could add return and diversification, but increase risk? Should your Manager hedge currencies? With real estate, do you want to use REITS which provide liquidity but reduce diversification or invest directly in real estate perhaps using a fund of funds approach? Another example of a discussion that should take place with research from your Consultant would be to determine the largest capitalization companies your small cap Manager should buy, \$1 billion, \$2 billion? This decision impacts diversification with your large cap Manager. How small can they buy, \$100 million, \$500 million? This determines how much risk the Trustees are willing to accept in volatile micro cap companies that may increase returns but significantly increase risk. These are just a few of the many questions that need to be decided with research assistance from your Consultant to satisfy the Trustees fiduciary liability, give guidance to your Managers, and provide for accountability.

The decision to use Tactical Asset Allocation is important to allow the weightings actually used around the Policy's strategic allocation targets in each asset class to be varied on a short-term basis, perhaps six months to three years because of market conditions. TAA can be used with either active or passive management. TAA refers to developing ranges of permissible weights around the targets set in the Policy as determined by the Asset Allocation study. Use of TAA requires some thought be given to its implementation. Should specific adherence to the targets be monitored by rebalancing fairly frequently with fixed time frames such as quarterly? This is a fairly rigid low cost process that works well for some plans and would eliminate a major expense, but may not add enough incremental value to the Fund. Other funds allow some movement around the targets usually within some range such as 5% or even up to 20% for some asset classes. These ranges allow for the possibility of value added, but also allow for the possibility of significant underperformance, as well, which needs to be seriously evaluated. As the Trustees should be responsible for the decision, the research of the Consultant is vital. The Trustees must also decide how the decision will be implemented and how the results will be accounted for. Also the costs associated with this service should be reasonable in proportion to the possible value added. Whoever assists the Trustees in this matter should be independent and objective in their research.

In our opinion, one large cap core strategy should be implemented with one or two supporting strategies for an attempt at additional value added. The core strategy could be an index, as the large cap markets are fairly efficient, fees are low, and the fund would be well diversified. However, an active Manager which does add some value or reduce risk in some fashion relative to the Fund benchmark, but whose performance is relatively consistent to the

benchmarks should be used, in our opinion. The first value added approach could be using a single Manager in addition to the core strategy with a flexible strategy like your existing Manager, Legg Mason. They have a demonstrated successful process that has added significant value but do not track the index very closely. Alternatively, it could be using two complimentary Managers like Wedge and Marvin and Palmer in combination with each having a unique process designed to add value above your benchmark. However, because they use unique strategies, there is a risk of significantly varying from the Fund's benchmark, particularly in the short term. This is why specific style benchmarks in the Performance Monitoring Report should be used for shorter time periods. The final determination of which strategy is appropriate can be made after the Asset Allocation study and the Consultant's research about returns, risk and fees is concluded.

In our opinion, only one international, real estate and small cap manager should be used for a Fund of this size, assuming these are appropriate asset classes to be used as determined by the Asset Allocation study. The degree to which each of these managers are allowed to vary from core strategies needs to be evaluated in light of the need for value added and the probability of success. Specifically, we recommend Cortina Asset Management be replaced with a small cap manager with a core investment strategy, whose results are more consistent with the Russell 2000 benchmark. The Manager search should be researched by your Consultant for evaluation by the Trustees for their final decision. There should be clear criteria to begin the search and the search process should be documented by the Consultant to demonstrate that fiduciary obligations are met.

In our opinion, an international asset class and appropriate Manager should be added, after research by your Consultant, with documented criteria for the search demonstrated in writing. The real estate search can wait for valuations to come back to reasonable levels, as we think on a tactical basis it is not a good time to begin investing in this asset class. The strategic asset allocation study, including the possible use of real estate, should proceed. However, implementation can follow, if determined useful in the Asset Allocation study. This decision is a function of the strategic allocation in the Policy and is assuming the tactical ranges allow a zero allocation to real estate.

In our opinion, both fixed income managers should be replaced because either their organizations are in turmoil, such as Fox, or the management team and investment strategies are too new to have a meaningful track record to be evaluated, such as ASB. The replacement strategies could be either the use of one index manager to reduce costs and increase diversification, or one active manager to reduce costs (as they will have more assets to manage), but allow the active manager to use some percentage of non-investment grade assets to add value to the benchmark net of fees. The research on the appropriate approach for fixed income can begin now, but these final choices can be finalized after the Asset Allocation study is complete and research by your Consultant of the probability of value added with active management and an analysis of fees and risks involved is concluded.

A total of six or seven managers is appropriate for a fund of this size. Obviously the more managers used, the more fees will be required because each manager will have less assets to

manage which causes a high management fee and more time and expense in evaluating and monitoring will be required. However, more diversification is achieved.

4. Fund Oversight and Accountability

In order for the Trustees to obtain accountability, appropriate benchmarks need to be consistently applied. The total Fund should have benchmarks related to actuarial interest assumptions, appropriate peer groups, capital markets, and inflation. Long term should be defined as 10 years to provide a picture of performance over more than one market cycle. The purpose for having multiple benchmarks is to have multiple criteria to assess results. These results should be set out in detail in a quarterly Investment Performance Monitoring Report which should be satisfactory to the City as well as to fulfill its required oversight. The Finance Director should be responsible for reviewing it quarterly and reporting the results to the City. The Policy should have total Fund benchmarks that are fairly rigid, but the individual Managers and asset classes should have more flexible criteria, such as investment style related benchmarks, to measure shorter-term specific performance and perhaps allow for the flexibility of Tactical Asset Allocation.

If it is decided that Tactical Asset Allocation is an appropriate tool for adding value to the Fund, ranges around the targets established by the Asset Allocation/Liability study should be established. The size of the ranges (perhaps 5%-20% for each permissible asset class) is a function of the needs of the Fund to add value to meet its benchmarks, the comfort level the Trustees have in the entity making the Tactical Asset Allocation decisions, the probability of a successful strategy, and the risk assumed if decisions are wrong. As the Trustees are responsible for Fund management decisions and have the fiduciary liability, it should be their decision, after research by the Consultant, and decided on a timely basis. These implementation decisions should not be made at the City Council level, as they probably will not have the time to evaluate the decision adequately and may not be able to make the decisions on a timely basis to be effective.

The primary entity for preparing the quarterly Investment Performance Monitoring Report should fall to the independent Consultant hired by the Trustees with approval by the City. The form of the report should satisfy any needs the City Council may have regarding oversight of the management of the Fund's investments as well. The Finance Director and the City Attorney should have primary responsibility to make sure the City's needs are met as well.

5. Communications

In addition to the Consultant's quarterly Investment Performance Monitoring Report discussed above, the Custodian's and the Manager's reports should conform to the needs of the City, Trustees and Consultant. The Custodian's reports should be accurate and timely as to all transactions. Any special reports needed should be provided in a timely and effective format. Specifically, the Custodian should be able to verify all commission costs and turnover ratios given to the Trustees by the Managers. A summary of dividends and interest should be available plus any expenses paid and contributions received. There should also be a separate sub-account for each Manager to accurately reflect performance. There should be

a separate sub-account for cash reflecting contributions, benefit payments, expenses and other items relevant to management of the Fund. However, this account should not be part of the quarterly Investment Performance Monitoring Reports, as these funds are not long-term assets of the Fund.

The Managers should provide reports to at least the Consultant summarizing their investments quarterly. The specific information in the reports should be determined by the needs of the Consultant and Trustees and should include at least a summary of holdings, transactions, investment results, risks and basic modern portfolio statistics such as alpha, beta, sharp, ratio, etc. The Manager should provide an analysis of its current thinking of portfolio strategy reflecting its market outlook.

The Trustees, through their Consultant, should work to get the quarterly Investment Performance Monitoring Report in a satisfactory format. It can be in an executive summary format, as long as it covers the information required in the Policy. It can also include much detailed information if required by the Trustees. This document will be important to the City, as well, and should conform to their needs also. Communications to the Managers should be clear and in writing to include at a minimum the Policy. Every effort should be made to have all six current Managers make a formal in-person presentation to the Trustees at least once a year. The Managers should promptly notify the Consultant and either the Finance Director or Trustees of any material change in the Managers, people, investment philosophy or organizational changes. The Managers should be encouraged to make any recommendations they think appropriate to the Consultant, Trustees, or the City. Communications from the Managers generally should be made through the Finance Director as the representative of the City, but a representative of the Trustees could be authorized to receive communications as well.

6. Fiduciary Issues

As Trustees are fiduciaries to the Fund, they must invest substantial time in understanding their responsibilities. Because management of the Fund's investments is complex due to investment strategies, academic research, and the laws governing Funds are constantly changing, in our opinion various educational sessions should be undertaken to increase their knowledge of those issues. Education could consist of sessions conducted by the Consultant or possibly even the Managers. In our opinion, selected Trustees should go to educational sessions put on by various organizations such as the IFEBP or Guns and Hoses conferences. They should provide a summary of their findings to the other Trustees. The reasonable costs of attending should be reimbursed by the Fund. In order to document that there is an investment process that is being followed in accordance with a written Policy, consideration might be given to recording Trustee meetings in addition to the written minutes that are currently being prepared. This is the best protection from fiduciary liability issues.

Next Steps and Recommendations

We recommend the followings steps be undertaken as quickly as possible:

- Step 1) A review by the City Attorney of appropriate means for the City Council to obtain the oversight it needs from the Trustees. Documents should delegate responsibility and accountability to the Trustees for management of investment issues in the Fund. They should also state the role of the Finance Director and the City Attorney in representing the City's interests.
- Step 2) An Asset Allocation or Asset Liability Study should be prepared by the Fund's Consultant or Actuary, as appropriate.
- Step 3) An upgraded Investment Policy should be implemented per criteria outlined previously. This will not be able to be completed until step 2 is completed, but many issues which require time for discussion and research can be undertaken without step 2 being completed. Possibly a small sub-committee of the Trustees who have the time to devote to this project could be used to make recommendations to the full Board and City.
- Step 4) Renegotiation of appropriate vendor contracts for reduced fees if possible, clarification of services and a review of procedures relating to communication and fiduciary issues.