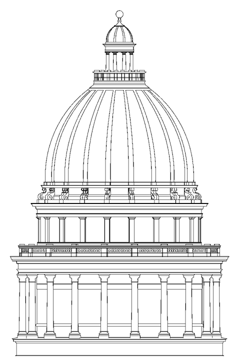
REPORT TO THE

UTAH LEGISLATURE

Number 2009-07



A Performance Audit of Utah Retirement Systems' Administrative Costs

April 2009

Office of the
LEGISLATIVE AUDITOR GENERAL
State of Utah

STATE OF UTAH
Office of the Legislative Auditor General

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Senator Patricia W. Jones • Representative David Litvack

JOHN M. SCHAFF, CIA
AUDITOR GENERAL

April 7, 2009

TO: THE UTAH LEGISLATURE

Transmitted herewith is our report, **A Performance Audit of Utah Retirement Systems' Administrative Costs** (Report #2009-07). A digest is found on the blue pages located at the front of the report. The objectives and scope of the audit are explained in the Introduction.

We will be happy to meet with appropriate legislative committees, individual legislators, and other state officials to discuss any item contained in the report in order to facilitate the implementation of the recommendations.

Sincerely,

John M. Schaff, CIA
Auditor General

JMS/lm

A Digest of
A Performance Audit of
Utah Retirement Systems' Administrative Costs

Chapter I: Introduction

The Utah Retirement System administers both defined benefit (DB) and defined contribution (DC) plans for employees of state agencies, universities, colleges, state courts, public school districts, and many other public entities. The DB plan has a set lifetime benefit according to a formula based on the member's salary and number of years of service. The DC plan allows participants to invest pre-tax dollars as a supplement to their retirement and includes 401(k), 457, and IRAs. As of December 2008, the DB plan included 181,994 members with assets totaling about $15.9 billion and DC investments totaling about $2.4 billion. Investment returns from 1999 to 2007 ranged from a loss of 7.7 percent in 2002 to a gain of 26 percent the following year and the funded ratio has been between 90 and 100 percent. In 2008, due to the economic downturn, the fund lost 22.3 percent and the funded status decreased to 84 percent.

Chapter II: URS Costs Need Closer Monitoring

For the same time period, URS' administrative and investment costs for the DB plan have risen 107 percent, primarily due to an increase in investment costs. For 2008, administrative costs totaled $17.9 million or $74 per active and retired member. Per member administrative costs have not increased. Investment costs were $50.8 in 2008 but had increased every year until the market downturn in 2008 reduced investment fees. The investment expense ratio increased from .15 percent in 1999 to .30 percent in 2008 which suggests closer monitoring is needed.

When compared with 26 other retirement systems, URS' administrative costs per member for the DB plan are lower but investment expense ratios are higher. URS' $73 administrative costs per member for 2007 is less than both the $84 average and $79 median costs for the systems in our sample. URS' .31 percent investment expense ratio is higher than both the .27 percent average and .22 percent median expense ratios for the systems we sampled.

Because we do not have the expertise to identify and evaluate the many factors impacting costs, we suggested to URS that either we hire a consultant or they contract with an independent company to evaluate the cost and performance of their pension system. An in-depth analysis is being completed by an independent benchmarking company that will evaluate both administrative and investment costs in greater detail and compare URS with its peers. These reports should be provided to the Legislature. Although URS is now obtaining an analysis of its costs, URS currently retains a consultant to evaluate investment performance. The consultant's evaluation shows that URS has met its benchmark return targets in 5 of the past 10 years. In addition, when compared to other retirement systems, URS' returns ranked from the 10th to the 87th percentile and in 2008, URS ranked in 16th percentile.

Chapter III: Analysis of Specific URS Costs Identifies Potential Concerns

Comparisons of specific cost categories over time and with other retirement systems revealed potential concerns. Investment advisor fees make up the majority of URS' costs and have increased substantially. Typically, as fund assets increase, the ratio of fees to assets declines because advisors generally charge proportionally less to manage larger portfolios. However, URS' expense ratio for investment advisor fees (excludes other investment costs) has increased from .18 percent in 2002 to .29 percent in 2007 which shows a larger proportion of assets are used to pay advisor fees. Although many factors impact costs, one factor increasing costs has been allocating a larger proportion of investments to higher cost alternative asset classes such as absolute return. Advisor fees are more costly but the shift resulted in fewer losses in 2008. The independent analysis currently being completed should help URS evaluate the reasons for its higher investment costs.

Comparisons of several specific cost categories revealed concerns. For example, salary and benefits have not increased but appear higher than other retirement systems with DC plans. We also reviewed several other cost categories that had grown or were questionable including office space rental, legal costs, consulting services, and postage costs.

Concerns with several of these categories involved DC cost allocations. The majority of DC plan costs are allocated costs based on estimates and appear relatively lower than DB costs. DC plan costs must be accurately assessed because only those members participating in the voluntary supplemental program should pay its operating costs. Periodic reviews of DC costs and comparisons with DC other plans are needed to ensure that costs are reasonable.

Recommendations

1. We recommend that the Utah Retirement System provide the results of its benchmarking reports to the Legislative Auditor's Office and to the Legislature.

2. We recommend that the Utah Retirement System evaluate how its investment strategy impacts the growth in investment advisor fees.

3. We recommend that the Utah Retirement System evaluate salary and wage costs per member and compare the costs to retirement systems of similar size and service levels.

4. We recommend that the Utah Retirement System periodically complete a more in-depth review of the costs allocated to the defined contribution plan, and ensure that costs are reasonable compared to DC plan of similar size, structure, and service level.

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April 7, 2009

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Chapter I
Introduction

The mission of the Utah Retirement System (URS) is "to provide financially sound retirement and 401(k)/457 investment benefits, as well as comprehensive health and dental, disability, and life insurance benefits to active and retired Utah public employees and their beneficiaries in a courteous, timely, and professional manner." URS administers both defined benefit and defined contribution plans. Defined benefit (DB) plans have a set lifetime benefit according to a formula based on the member's salary and number of years of service. Defined contribution (DC) plans provide a payout at retirement dependent upon the amount of money contributed and the performance of the investments. Participants are allowed to invest pre-tax dollars as a supplement to their retirement.

As an independent agency, URS administers defined benefit and defined contribution plans for 444 public employers.

As of December 2008, 444 public employers were within the Utah Retirement System. The retirement system covers employees of state agencies, state universities, colleges, state courts, and public school districts. Additionally, URS has entered into separate agreements with many public entities to provide their employees with a retirement benefit. These entities include counties, local governments, and judicial entities. The six DB systems include the Public Employees' Noncontributory Retirement System, the Public Employees' Contributory Retirement System, the Public Safety Retirement System, the Firefighters' Retirement System, the Judges' Retirement System, and the Governor's and Legislative Service Pension Plan. DC plans include 401(k), 457, Roth and Traditional IRA plans. URS also administers the Public Employees' Health Program (PEHP) and a health reimbursement arrangement.

URS "is an independent state agency . . . subject to legislative and executive department budgetary review and comment" (***Utah Code*** 49-11-201(2). URS is under the direction of a seven-member board who appoints an executive director to administer the office. In addition to examining and approving an annual operating budget for the office, the board is required to "take actions not in conflict with the board's trust and fiduciary responsibilities or other law, with respect to the governance of the office which are substantially similar to those governing other public agencies" (***Utah Code*** 49-11-203(1)(p)).

URS pools and commingles the funds from each system into a common trust fund for investment purposes. Except for the DC plan, general administrative costs of operating the office are assessed to the systems, plans, programs, and funds on a pro rata basis and are paid from earnings of the Utah State Retirement Investment Fund (***Utah Code*** 49-11-304). DC plan costs are paid for by participating members.

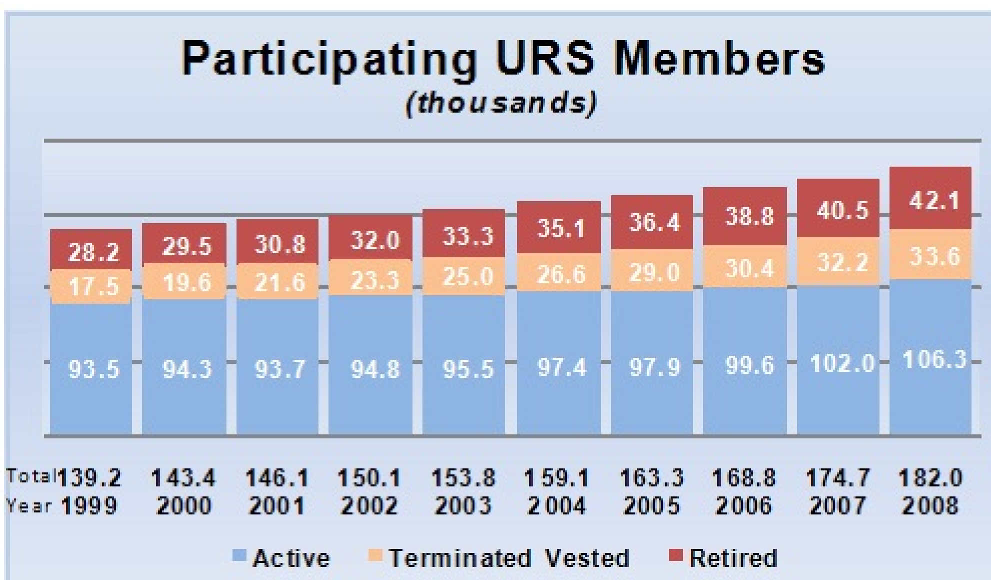
The following sections provide historical information for URS for the past 10 years.

Membership Has Increased Moderately

As of December 2008, the number of members participating in the system totaled 181,994. Of these, 106,261 (58 percent) were active employees of participating governmental units, 42,138 (23 percent) were retired employees or their beneficiaries who were receiving monthly payments, and 33,595 (19 percent) were former employees vested in the system and eligible to receive annuities in the future. Figure 1.1 shows membership from 1999 to 2008.

The total number of participating members increased 31 percent over the past 10 years.

Figure 1.1 Participating Members, 1999 to 2008. Over the past 10 years, total membership increased 31 percent.



Total membership increased from 139,190 in 1999 to 181,994 in 2008. There was a 14 percent increase in active members, 49 percent increase in retired members, and a 92 percent increase in terminated vested members.

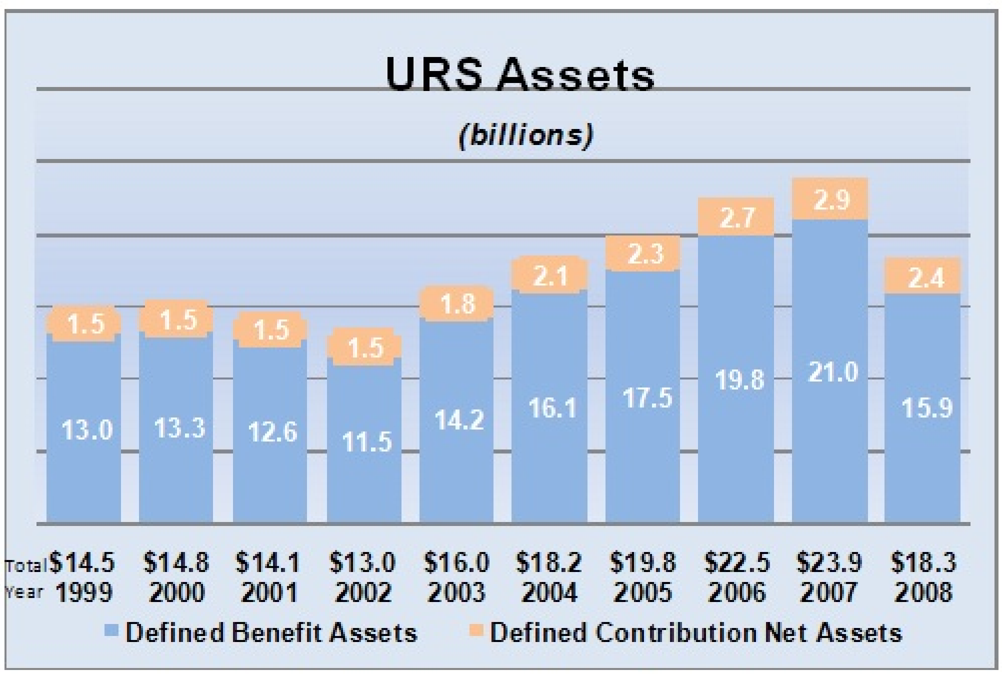
Economic Downturn Reduced Assets

Both Defined Benefit (DB) and Defined Contribution (DC) assets declined dramatically in 2008 due to the current economic climate. At year end 2008, URS net assets totaled $18.3 billion, which included $2.4 billion invested in DC plans. DC plans are voluntary, allowing participants to supplement their retirement with pre-tax contributions which are tax deferred until time of withdrawal. URS' DC plan includes 401(k), 457, and both traditional and Roth IRAs.

From 1999 to 2007, net assets for the DB plan increased 61 percent until the 2008 market downturn.

Although from 1999 to 2007, net assets increased 61 percent for the DB plan, Figure 1.2 shows in 2008 assets declined to about $15.9 billion. DC assets declined to about $2.4 billion.

Figure 1.2 Net Assets, 1999 to 2008. Defined Benefit assets increased 61 percent from 1999 to 2007 until the 2008 market downturn. DC assets increased 90 percent through 2007.



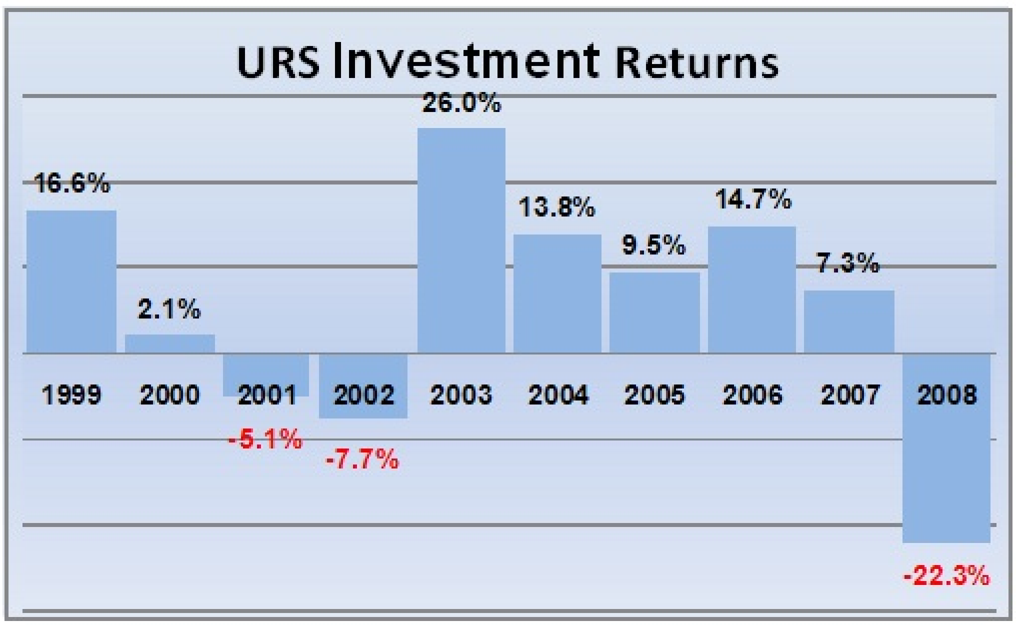
Note: Totals may include rounding adjustments.
Changes in asset levels include investment returns, contributions, and expenses.

Investment Returns Have Met Performance Objectives

Investment returns from 1999 to 2007 ranged from a loss of 7.7 percent in 2002 to a gain of 26 percent the following year. In 2008, returns showed a loss of 22.3 percent. Over a 10-year period (1998 to 2007), the annualized rate of return for URS investments averaged 8.22 percent, which was above the 8 percent performance return objective needed to meet future obligations. Because of the market downturn in 2008, the 10-year average dropped to 4.6 percent.

Over the past 10 years, investment returns have ranged from a gain of 26 percent to a loss of 22 percent in 2008.

Figure 1.3 Investment Returns, 1999 to 2008. The 10-year annualized rate of return has met or exceeded the 8 percent performance objective until 2008 when the average return dropped to 4.6 percent.



Source: Callan Associates, Inc., Investment Measurement Service, Quarterly Review.

Funded Status Indicates Benefits Are Relatively Secure

In 2007, the 100 percent funded status of the URS retirement fund provided assurance that funds will be available to pay future retirement benefits. The funded ratio is calculated by dividing the actuarial value of net assets by the actuarial accrued liability. Stronger systems generally have a higher funded ratio, providing a greater assurance that pension benefits are secure. An actuary estimates URS' liability for each system and the contribution needed to accumulate enough assets to pay benefits when they are due. Higher returns increase the funded ratio and decrease the necessary contribution rate. The funded ratio dropped to 84.2 percent in 2008, but the contribution rate has not yet been changed.

Figure 1.4 shows that over the past 10 years, the funded ratio for the noncontributory retirement system ranged from 84.2 to 106.2 percent and the contribution rate for employers ranged from 10.4 percent to 14.22 percent. The noncontributory system includes the majority (85 percent) of members. Other URS systems have various funding ratios and contribution rates.

The funded ratio for the noncontributory system has mostly been strong but decreased in 2008.

Figure 1.4 URS Funded Ratio & Contribution Rates, 1999 to 2008. The noncontributory retirement system's funded ratio has mostly been strong. Higher returns increase the funded ratio and decrease the contribution rate.

Year	Funded Ratio (Dec 31)	Contribution Rate for State and School Employers (percent of salary)
1999	101.8	14.16
2000	106.2	13.68
2001	103.3	10.40
2002	93.6	10.40
2003	92.5	11.70
2004	92.4	13.38
2005	92.2	13.38
2006	96.4	14.22
2007	100.8	14.22
2008	84.2	14.22

Source: Utah Retirement System Comprehensive Annual Financial Reports.

URS' 2007 funded ratio exceeded all but three of the sample retirement systems we reviewed (see appendix).

Audit Scope and Objectives

This audit was requested by the past chair of the House Retirement and Independent Entities Appropriation Committee. In his audit request letter, he noted concerns with the Legislature's lack of information concerning URS' administrative functions and controls. Specifically, we were asked to review their operation and overhead costs including, but not limited to, compensation, FTEs, facilities, and contracts and to compare URS costs with other similar-sized public retirement systems.

We gathered information from the Comprehensive Annual Financial Reports (CAFR) for URS and 26 other retirement systems. Similar information is provided in each fund's CAFR, but other systems may include different information which made comparisons difficult. For example, URS lists investment advisor fees in its schedule of administrative expenses, while other retirement systems do not.

In selecting retirement systems for comparison, we chose systems with a similar number of members or assets, systems from surrounding states, or other studies that used Utah in their comparisons. Based on 2007 information, the 26 different systems ranged in membership from approximately 54,000 to 544,000 thousand (retired and active members) and held from $5 billion to $105 billion in assets. In 2007, URS had approximately 143,000 members (excluding terminated vested), and $21 billion in assets (excluding DC assets). When comparing retirement systems, DC assets were excluded because all systems do not provide DC plans as a voluntary supplement to their retirement. DC plans include 401(k), 457, and IRAs.

This report shows URS' administrative and investment costs over time and compared to other retirement systems. Chapter II compares total administrative and investment costs, and Chapter III identifies and compares specific cost categories.

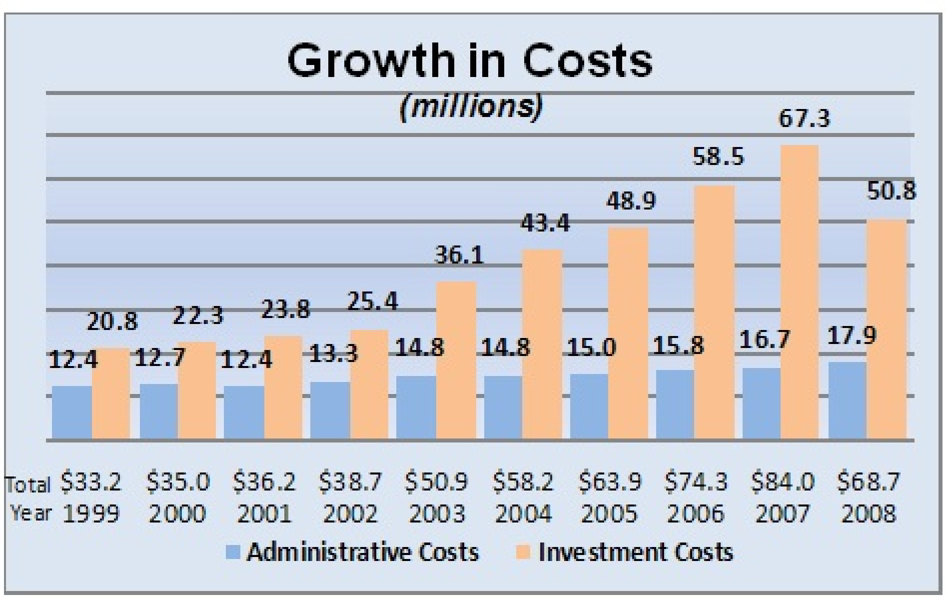
Chapter II
URS Costs Need Closer Monitoring

Over the past 10 years, the Utah Retirement System's (URS) administrative and investment costs have risen 107 percent, primarily due to an increase in investment costs. Administrative costs include both general administrative and investment costs. General administrative costs include the cost of managing the retirement systems such as salaries and benefits, office rental, data processing, postage, maintenance, and office supplies. Investment costs also include these types of costs for the investment department, but the majority of costs are for investment advisor fees. Rising investment advisor fees are a driving factor behind increased investment costs and are discussed in Chapter III.

As the following figure shows, administrative costs increased about 45 percent, from $12.4 million in 1999 to $17.9 million in 2008. Investment costs increased 144 percent, from $20.8 million to $50.8 million. Investment costs went down by 25 percent from 2007 to 2008 because the market downturn reduced investment advisor fees.

From 1999 to 2008, administrative costs increased 45 percent and investment costs increased 144 percent.

Figure 2.1 Administrative and Investment Costs for DB and DC Plans, 1999 to 2008. Cost increases are mostly due to an increase in investment costs; general administrative costs increased 45 percent and investment costs increased 144 percent.



The next section compares URS' administrative and investment costs over time and with other retirement systems.

Over Time, Administrative Costs per Member Were Steady While Investment Expense Ratios Increased

Over the past ten years, increases in URS' general administrative costs have been mostly steady, but investment costs have increased significantly. We used two measures to compare the growth of URS' administrative and investment costs over time and with other retirement systems. First, we calculated the administrative cost per member, which measures the resources used to support administration of the retirement systems. Second, we calculated investment costs as a percent of assets or an investment expense ratio, which measures if the fund is invested cost effectively. Although total costs should increase with an increase in the number of members and level of assets, these measures allow costs to be compared over time and with other retirement systems.

To compare URS costs with other states' retirement systems, we obtained information reported in each system's Comprehensive Annual Financial Report (CAFR). In this chapter, cost comparisons are *only* for the defined benefit (DB) plans. Costs associated with defined contribution (DC) (401(k), 457, IRAs) plans were excluded because not all retirement systems offer these plans.

Figure 2.2 shows the growth in administrative and investment costs for URS' DB plans from 1999 to 2008.

From 1999 to 2008, administrative costs per member for the DB plans declined from $76 to $74. Investment expense ratios increased from .15 percent to .30 percent.

Figure 2.2 Administrative Costs per Member and Investment Expense Ratios for the Defined Benefit Plans, 1999 to 2008. General administrative costs per member have remained about the same, while investment costs as a percent of net assets increased each year until 2008.

Year	Admin Costs *(thousands)*	Admin Costs Per Member*	Investment Costs *(thousands)*	Invest Costs to Net Assets
1999	$ 9,224	$ 76	$ 19,186	.15%
2000	8,747	71	20,647	.16
2001	8,568	69	22,125	.18
2002	9,011	71	23,768	.21
2003	10,234	80	34,213	.24
2004	9,766	74	41,299	.26
2005	9,516	71	46,420	.27
2006	9,876	71	55,763	.28
2007	10,449	73	64,320	.31
2008	11,031	74	47,607	.30

Source: URS CAFRs–Statements of Changes in Fiduciary Net Assets–Pension (and Other Employee Benefit) Trust Funds.
**When calculating per member costs, membership includes active and retired members but excludes terminated vested members.*

Administrative costs for URS' DB plans increased from about $9 million in 1999 to $11 million in 2008, or about 20 percent. The cost per member declined from $76 to $74. When adjusted for inflation, administrative costs per member were significantly reduced. Administrative costs that were $76 in 1999 would cost $94 in 2007. Thus, URS has effectively reduced its administrative costs by $20 per member ($94 minus $74).

Investment costs for the DB plan increased 148 percent.

Figure 2.2 also shows that for the same time period, investment costs for URS' DB plan increased from about $19 million to over $47 million, or 148 percent. When 1999 dollars are adjusted for inflation at 2007 dollars, the increase is 101 percent. A significant increase occurred between 2002 and 2003, when investment costs increased 44 percent. The increase corresponds to high returns which increased the level of assets and the investment costs. Additionally, investment costs declined by 26 percent in 2008 when assets went down. While it is expected that investment costs will increase as assets increase, the proportion of investment costs to net assets (expense ratio) generally declines as the level of assets increases. Instead, URS' ratio continued to increase each year, from .15 percent in 1999 to .30 percent in 2008. This is a concern that is discussed in Chapter III.

Comparisons Indicate URS Administrative Costs Are Low, But Investment Costs Are High

URS' administrative costs per member appear low when compared to other retirement systems, but investment costs as a percent of assets appear high. Other studies indicate that total URS' costs are in line. However, many factors affect costs, and specific expertise is needed to evaluate the complex variables. After notifying URS of our intent to retain a consultant, we learned they planned to hire an international benchmarking company to complete a comprehensive cost evaluation of their administrative costs. Because of high cost and growth, we suggested they also hire the company to evaluate their investment costs. Both evaluations are currently being completed. We recommend the reports be presented to the Legislature.

In the past, URS has not had an independent evaluation of costs, but they contract with an investment consultant who evaluates and compares URS' fund performance. The investment consultant's 2008 year end report shows that URS' higher cost investment strategy has resulted in fewer losses.

We compared URS costs with the costs of 26 other retirement systems.

Although we did not identify the different factors driving costs, we compared URS' 2007 administrative and investment costs with the costs of 26 other retirement systems. Because size impacts costs, systems were selected for comparison based on the number of members and assets. We also selected systems that were in close proximity to Utah, those that URS compared itself with, and those with state comparisons that included URS. Each system differs in its organization, the number and composition of members served, the number of employer units, plan complexity, level of assets, and investment strategy. An in-depth analysis is needed to evaluate how the different factors impact costs.

This section of the report compares URS' administrative costs per member, investment expense ratios, funding ratios, and historical returns over time. Our comparison of URS costs to the costs of other retirement systems is discussed in the next section and summarized in an appendix located at the back of the report.

Administrative Costs per Member Are Lower Than Costs of Many Other Retirement Systems

URS' administrative costs per member for the DB plans are lower than costs per member for many other retirement systems. As Figure 2.3 shows, URS' $73 administrative costs are less than both the $84 average and $79 median costs for the 26 systems in our sample.

URS' administrative costs per member are less than many other retirement systems.

Figure 2.3 Administrative Costs Per Member Compared to Other Retirement Systems for 2007. URS' administrative costs for the defined benefit plans are below the average and median costs of the 26 retirement systems in our sample.

Retirement System	Admin per Member	Retirement System	Admin per Member
Iowa	$ 36	Colorado	$ 79
Wyoming	39	Texas	80
Kansas	39	Minnesota Teachers	86
Mississippi	41	Ohio School Emp.	94
Minnesota Public Emp.	43	Hawaii	95
South Carolina	58	Arizona	97
Montana	60	Ohio Public Emp.	99
Illinois Teachers	61	New York Teachers	110
Nevada	62	New Mexico	112
Maryland	70	Pennsylvania	114
Idaho	70	Oregon	133
Utah	**73**	Louisiana	155
New Hampshire	78	Ohio Teachers	202
Illinois Municipal	78		
Average	**$ 84**	**Median**	**$ 79**

Note: *Membership includes active and retired participants but excludes terminated or inactive vested.*

URS' administrative costs per member are also lower than five of eight retirement systems with a similar number of members (Hawaii, Louisiana, Minnesota Teachers, Ohio School Employees, and Pennsylvania).

Investment Expense Ratio Is Higher Than Ratios of Many Other Retirement Systems

URS' investment expense ratio (costs as a percent of total assets) for the DB plan is higher than the expense ratio of many other retirement systems. As Figure 2.4 shows, URS' ratio of investment costs to total assets is .31 percent, which is higher than both the .27 percent average and .22 percent median of the 26 systems in our sample.

URS' investment cost ratio is higher than many other retirement systems.

Figure 2.4 Investment Expense Ratio Compared to Other Retirement Systems for 2007. URS' investment costs for the defined benefit plan are higher than the average and median costs of retirement systems sampled.

Retirement System	Invest to Net Assets	Retirement System	Invest to Net Assets
Texas	.11%	Wyoming	.23%
Nevada	.11	Montana	.24
Maryland	.12	Iowa	.25
South Carolina	.13	Illinois Municipal	.26
New York Teachers	.14	**Utah**	**.31**
Minnesota Public Emp.	.14	Colorado	.32
Minnesota Teachers	.14	Hawaii	.33
Mississippi	.17	Illinois Teachers	.36
Ohio Public Emp.	.18	New Hampshire	.40
Louisiana	.19	Idaho	.43
Ohio Teachers	.20	Oregon	.47
Arizona	.21	Ohio School Emp.	.48
Kansas	.21	Pennsylvania	.97
New Mexico	.22		
Average	**.27%**	**Median**	**.22%**

Note: Colorado, Illinois Municipal, Ohio Public Employees, Pennsylvania, Utah, and Wyoming are as of December 2007, Texas is as of August 2007, and all others are as of June 2007.

URS' investment expense ratio is also higher than seven retirement systems with a similar level of assets (Minnesota Public, Minnesota Teachers, Mississippi, Nevada, Iowa, Illinois Municipal, and Texas).

Many factors affect the investment expense ratio including level of assets, asset allocation, and investment strategy or implementation style.

- Retirement systems with more assets generally have lower operating expense ratios than those with less assets because they are able to negotiate lower fees.

- Asset allocation impacts costs because some asset classes have higher fees. For example, equities have higher fees than fixed-income securities.

- Implementation style (passive/active, internal/external) impacts costs. Passive management is a style of investing where a fund's portfolio mirrors a market index and is less costly than active management because they entail little or no research costs. Managing funds in-house or internally is generally less costly than external management. Therefore, funds with more internal and passive management generally have lower costs.

Many factors affect investment costs including the amount of assets invested and investment strategy.

We could not identify all of the factors affecting the ratios for each retirement system in our sample. To illustrate the different factors impacting costs, we compared a portion of URS' investment strategy with that of Nevada. Nevada is similar to Utah in its number of members and level of assets but has a much lower investment expense ratio (.11 percent). The lower ratio appears to relate to its mostly passive investment strategy. In 2007, about 70 percent of Nevada's investment portfolio was passively managed compared to 12 percent of URS' portfolio. In addition, Nevada does not invest as much in the alternative asset classes which has higher fees than other asset classes. In 2007, Nevada's asset allocation included 9 percent alternative investments compared to URSs' 31 percent.

This comparison illustrates only some of the factors driving costs and the importance of understanding the differences when comparing URS to other retirement systems.

Other Studies Indicate URS' Costs Are Reasonable

Although URS' investment costs appear higher than many of the retirement systems in our sample, other studies indicate that URS' costs are reasonable. For example, a study by Callan Associates, URS' investment advisor, reported investment related costs in averaged .33 percent for 9 funds with assets greater than $10 billion. URS investment related costs were .31 percent and the average for our sample of other retirement systems was .27 percent (see appendix).

Other studies indicate URS' total costs are reasonable.

Additionally, other studies indicate URS' administrative and investment costs are reasonable. An older study by the Investment Company Institute, a national association of mutual funds, shows the average expense ratio for public pension plans managing about $20.5 billion in assets was .36 percent. The study reports that for 1998, costs per participant for retirement systems from 94,000 to 182,000 members averaged from $412 to $467 per participant ($522 to $592 when 1998 costs are adjusted for inflation). URS' expense ratio for its total costs is also .36 percent and the cost per participant is $525. With $20.9 billion in assets in its DB plan and 142,500 members, URS is similar to other systems in this study. This indicates that even though URS costs are higher than many in our sample, *total costs* may be similar to those of other retirement systems.

The contradictory conclusions regarding what represents an appropriate cost should be resolved with an evaluation currently being completed as discussed in the next section.

Comprehensive Evaluation of URS Costs Is Necessary

URS has contracted with a company to evaluate their administrative and investment costs.

An in-depth analysis is being completed by an independent benchmarking company that will evaluate costs in greater detail and compare URS with its peers. This analysis is needed because it is difficult for our office to obtain the detailed information from other retirement systems necessary to make an accurate comparison.

Also, we do not have the expertise to identify and evaluate the many factors impacting costs. Consequently, we suggested to URS that either we hire a consultant or they contract with an independent company to evaluate and compare both the cost and performance of their pension system. URS has since contracted with CEM Benchmarking, Inc., an independent company that specializes in evaluating and comparing cost and performance for pension systems worldwide. The company obtains standardized cost and service information from over 170 different retirement systems. Our contact with company representatives indicated their process ensures the information is consistently collected and comparisons to peer retirement systems are valid. As shown in the appendix, most of the retirement systems used in this report participate in CEM's service.

CEM will complete two reports–one for administrative costs and one for investment costs. Preliminary reports are expected to be completed in May 2009. The reports will identify and compare URS to its peers, evaluate how various factors impact costs, and identify needed improvements. We expect that URS will present the results of these evaluations to our office and to the Legislature.

Consultant Currently Evaluates And Compares URS Returns

Although URS is now obtaining an in-depth analysis and comparison of its administrative and investment costs, URS also contracts with a consultant who evaluates investment performance. The consultant issues quarterly reports comparing and ranking URS' investment returns to other retirement systems with assets greater than $1 billion. Figure 2.5 shows the consultant's percentile ranking of URS to other systems from 1999 to 2008.

URS' returns met or exceeded targets in 5 of the past 10 years.

Figure 2.5 Comparison of URS Returns to Returns of Other Systems and to Target. URS percentile ranking of returns compared to returns of other systems varied each year. URS returns met its benchmark return targets in 5 of 10 years.

Year	Percentile Rank URS with Funds > $1B*	URS Return	URS Target Return	Met Target
1999	41	16.58%	16.03	Met
2000	31	2.05	(2.37)	Met
2001	54	(5.09)	(4.48)	
2002	37	(7.73)	(6.64)	
2003	19	26.03	24.75	Met
2004	10	13.75	12.75	Met
2005	18	9.47	8.18	Met
2006	48	14.74	15.18	
2007	87	7.29	8.59	
2008	16	(22.31)	(21.20)	

Source: Callan Associates, URS investment consultant.
** Lower number rankings show better investment performance compared to other systems.*

As shown, URS' percentile rankings ranged from the 10th to the 87th percentile. Because retirement systems are long-term investors that must balance risk and return, URS' goal is to rank around the 45th percentile. URS feels that consistent very high or low rankings indicate higher risk investments.

Figure 2.5 also shows URS' actual returns compared with its expected or targeted returns. Targeted returns are calculated based on benchmarks for each asset class. URS met or exceeded targeted returns in 5 of the past 10 years.

Through 2007, URS' 10-year investment returns averaged 8.2 percent, which exceeded its 8 percent actuarial goal.

Ultimately, the best gauge of investment returns is if the system is meeting the actuarially determined return goal needed to protect participants' future benefits. Until the market downturn, URS has met this goal. Through 2007, URS' 10-year investment returns averaged 8.2 percent, which exceeds its 8 percent actuarial goal. In 2008, the 10-year average declined to 4.6 percent.

An appendix at the back of the report compares historical returns for URS and the retirement systems in our sample. Although URS' 7 percent return for 2007 was lower than returns of other retirement systems, it is important to note that the date of each system's annual report differed. Most were as of June 2007, but a few, including URS, were as of December. Systems reporting earlier in the year generally reported higher returns. URS return as of June 2007 was 17.2 percent, which is in line with the other systems.

In conclusion, URS appears to have low administrative costs but high investment costs. Contrary to expectations, the investment expense ratio has not declined as assets increased. But because many other factors may impact costs, an international benchmarking company has been hired to evaluate and compare URS costs with costs of peer retirement systems. The next chapter discusses specific costs that appear high or that have increased significantly.

Recommendation

1. We recommend that the Utah Retirement System provide the results of its benchmarking reports to the Legislative Auditor's Office and to the Legislature.

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Chapter III
Analysis of Specific URS Costs Identifies Potential Concerns

This chapter identifies and compares the Utah Retirement System's (URS) administrative and investment costs by category over time and with other retirement systems. Some cost categories, such as investment advisor fees, have increased significantly while other costs, such as salaries, have not increased but appear high when compared with other retirement systems' costs. This chapter also addresses URS' method of allocating costs to the Defined Contribution (DC) plan. The DC plan is a voluntary, supplemental investment plan that allows members to contribute, before taxes, to 401(k), 457, and IRA accounts. Costs are paid by DC participants and must be accurately assessed because only those members participating in the program should pay the costs of operating the program. We are concerned the costs may not be accurately assessed.

Investment advisor and security handling fees make up (77 percent) of URS' costs.

Figure 3.1 identifies, by category, URS' investment and administrative costs for 2007. Higher cost and/or growth costs, identified with a checkmark (✓), were reviewed and are discussed in more detail in this chapter. The first section of the figure includes investment advisor and security handling fees, which make up the majority (77 percent) of URS' total costs. Investment advisor fees were over $63 million in 2007, an increase of 185 percent from 2002, when fees were about $22 million. This dramatic increase in advisor fees substantially raised total costs. The next section in Figure 3.1 lists administrative costs, which make up the remaining 23 percent of URS' costs. Salaries and benefits constitute 57 percent (39+18) of administrative costs. We also reviewed other administrative costs that experienced high growth or to answer questions about how the costs were determined.

Figure 3.1 2007 Administrative & Investment Costs by Category. Most of URS costs are for investment advisor fees, which increased by 185 percent from 2002 to 2007. Costs include the DB and DC plans.

	2007 Costs (*thousands*)	Percent of Total	Percent Change 2002 to 2007	
Investment Advisor Fees	$ 63,145		185%	✓
Security Handling Fees	1,229		(29)	
Subtotal	**$ 64,374**	**77%**		
Salaries and Wages	7,637	39	12	✓
Benefits	3,510	18	32	✓
Office Space Rental	1,289	6	40	✓
Data Processing	1,182	6	49	
Legal	1,159	6	118	✓
Other Consulting Services	1,042	5	1,904	✓
Postage	997	5	77	✓
Insurance & Bonding Premiums	514	3	195	
Telephone	410	2	43	
Contractual Services	369	2	(23)	
Professional Development/Travel	369	2	5	
Actuarial Services	198	1	10	
Office Supplies	192	1	215	
Supplies & Maintenance	157	1	25	
Other (Subscriptions, Banking, DP Equip, Audit, Depreciation)	633	3	(32)	
Subtotal	**$ 19,658**	**23%**		
Total	**$ 84,032**	**100%**		

Source: Utah Retirement System 2002 and 2007 Comprehensive Annual Financial Reports.

Costs discussed in this chapter include both the defined benefit (DB) and defined contribution (DC) plans. In Chapter II, we excluded DC plan costs for comparisons with other retirement systems because, as shown in the appendix, only about half of the systems reviewed offer DC plans. The next section discusses specific cost categories that are either the highest administrative and investment costs or that have increased significantly.

Some URS Costs Have Increased And Some Costs Appear High

Our review of URS' administrative and investment costs revealed that some URS costs have increased significantly and some costs are higher than the costs of other retirement systems. Most of URS' costs are for investment advisor fees which have increased each year from 2002 to 2007 but declined in 2008. Investing in higher cost asset classes may have reduced losses in the recent market downturn. Salary and benefit costs have not increased significantly but appear higher than similar costs for other retirement systems in our sample. Some cost categories were misstated in URS' annual report because of adjustments or accounting misclassifications.

Ratio of Investment Advisor Fees Increased Each Year

As fund assets increase, expense ratios typically decline. However, URS' expense ratios increased each year from 2002 to 2007.

Investment advisor fees represent the majority of URS' costs and have increased substantially. Fees nearly tripled between 2002 and 2007, increasing from $22 million to $63 million (185 percent). URS' assets increased from $13 billion to $24 billion (84 percent) over the same period. Because fees are generally paid based on the level of assets invested, an increase is expected. But the expense ratio of advisor fees to assets typically declines due to economies of scale. A 2002 survey by URS' investment consultant, Callan Associates, Inc., stated "There is a negative 0.3 correlation between the size of the fund and the cost of operating and managing the fund; as fund assets increase, expense ratios decline." This is because advisors generally charge proportionally less to manage larger portfolios. Our concern is that URS' expense ratio for investment advisor fees has increased from .18 percent in 2002, to .29 percent in 2007 which shows a larger proportion of assets are used to pay advisor fees.

Figure 3.2 shows fees, assets, and the expense ratio for URS' DB and DC plans. Expense ratios are calculated by dividing advisor fees by assets. For example, the DB plan in 2002 had $20.5 million in fees divided by $11.5 billion in assets, which equals an expense ratio of .18 percent.

Investment advisor fees for the DB plan increased from $20 million in 2002 to $60 million in 2007.

Figure 3.2 Investment Advisor Fees 2002 to 2007. The investment expense ratio for the DB plan has increased each year, while the ratio for the DC plan has remained constant.

	2002	2003	2004	2005	2006	2007	Percent Change
Fees			*(million $)*				
DB	20.4	31.2	37.5	42.4	52.5	60.1	194%
DC*	1.7	1.8	2.1	2.5	2.7	3.0	82%
Total**	**22.1**	**33.0**	**39.6**	**44.9**	**55.2**	**63.1**	**185%**
Assets			*(million $)*				
DB	11,460	14,249	16,084	17,458	19,830	20,951	83%
DC	1,484	1,850	2,104	2,342	2,663	2,906	96%
Total	**12,944**	**16,099**	**18,188**	**19,800**	**22,493**	**23,857**	**84%**
Ratio							
DB	0.18%	0.22%	0.23%	0.24%	0.26%	0.29%	
DC	0.11%	0.10%	0.10%	0.11%	0.10%	0.10%	

** DC - Defined Contribution includes 401(k), 457, and IRAs*
*** Totals may include rounding adjustments and differ from the amounts listed in Figure 2.1 because the administrative costs for the investment department are excluded.*

The increasing expense ratios show a larger proportion of assets are used to pay advisor fees.

The above figure also shows that the expense ratio for the DB plan increased each year, while the ratio for the DC plan was relatively constant—between .10 and .11 percent. According to a study of national pension funds (Public Fund Survey), URS' ratio is comparable to the median of other funds. The report states that for 2006 the median investment management expense ratio was .25 percent, while URS' ratio was .26 percent for that year. URS' investment consultant also completed a survey showing that fees have increased (from a median of .32 percent in 2004 to .42 percent in 2008) which reflects a trend of investments in more costly asset classes. However, higher fees for more costly asset classes can counter potential savings derived from larger investments.

Some asset classes have higher fees.

Changes to Asset Allocation Increased Costs. In addition to fund size, another factor that affects the cost of investment advisor fees is the asset allocation. Asset allocation is dividing investments among different asset classes to balance risk and return. Investment advisor fees vary for each asset class. For example, equity managers typically have higher fees

URS shifted its asset allocation to include more costly alternative investments.

than fixed income managers and fees are higher for international equities than for domestic equities. URS' chief investment officer (CIO) believes changes in URS' asset allocation may partially explain the increased ratio. Figure 3.3 shows URS has increased its investments in higher-cost asset classes. From 2002 to 2007, the weighting of equity securities declined and alternative investments increased. Alternative investments include private equity, real estate, and absolute return investments. Average fees are significantly higher for private equity (1.11 percent) than for debt securities (.08 percent).

Figure 3.3 Changes to Asset Allocation, 2002 and 2007. The percent of the portfolio invested in asset classes with higher fees increased.

	Percent of Assets	
Asset Class	**2002**	**2007**
Equity Securities	54%	39%
Debt Securities & Short Term	30	30
Alternative Investments (Private Equity, Real Estate, Absolute Return)	16	31
Total Portfolio	100%	100%

Source: URS Comprehensive Annual Financial Reports.

The figure shows alternative investments almost doubled over five years while equity securities were reduced by 15 percent.

URS 2008 losses were lowered by investing in the higher cost Absolute Return asset class.

URS Realized Lower Losses By Investing in Higher Cost Asset Classes. Although absolute return investments are more costly, the CIO pointed out that shifting investments from equities has resulted in fewer losses. Absolute return investments are less volatile than most alternative investments, with lower returns when the market is up, but fewer losses when the market is down. Although the absolute return investments have yet to meet benchmark goals, the success of this strategy was confirmed when 2008 losses were 40 percent for domestic equity and only 13 percent for absolute return. Portfolio losses for 2008 would have been significantly greater than 22 percent if URS investments had remained in equities.

A recently completed survey confirms that factors other than the level of assets impact fees. A recent report by Callan Associates revealed the correlation between fund size and costs is less than in the past (from -0.4 in 2004 to -0.24 in 2008). They report that "while larger funds/trusts can benefit from economies of scale, they are more likely to have larger allocations to more expensive asset classes (e.g., alternatives), offsetting savings gained through size." Further, Callan points out that "as funds/trusts explore new and growing allocation to alternatives, the need for external support to advise, educate, manage and monitor these more complex investments is growing."

Hiring additional absolute return fund managers with set fees increased costs.

Hiring Additional Absolute Return Fund Managers Increased Costs. In addition to changes to the asset allocation, the CIO believes hiring additional absolute return fund managers increased costs. The total number of managers increased from 27 to 78, due mostly to the addition of 45 absolute return fund managers. Equity securities investments were shifted to absolute return investments and more managers were hired. The CIO explained they hire fewer equity managers because their fees are based largely on the size of the portfolio managed. Absolute return fund managers have set fees regardless of portfolio size. Thus, there is no fee break for giving more funds to one absolute return fund manager. In addition, absolute return fund managers' investments are not correlated to one another as are other asset classes, whose value tend to rise when another falls. URS' intent for hiring many absolute return fund managers was to minimize the risk that a manager would underperform or fail.

URS needs to determine why its investment costs are higher than costs of other retirement systems.

URS ratios are not consistent with professionals' claims that the ratio typically falls as the size of the fund increases. Although the increase in URS' ratio may partially be explained by changes in their investment strategy, we could not evaluate all of the factors influencing fees. With investment advisor fees over $63 million, URS needs to identify how changes in its investment strategy affect fees and determine why URS investment costs are higher than costs of other retirement systems. (Figure 2.4 in Chapter II shows that total investment costs are higher than many of the retirement systems in our sample.) An analysis currently being completed by CEM Benchmarking should help URS evaluate costs and compare URS to its peers.

Salary and Benefits Costs Have Remained Steady But Are Higher than Costs of Many Retirement Systems

URS' salary and benefit costs have remained relatively steady, and cost increases are consistent with local government and businesses. However, URS' costs per member are higher than many of the retirement systems in our sample.

Figure 3.4 lists URS' salary and benefits from 2002 to 2007. Total costs increased 17.8 percent, but after adjusting for inflation, there was no increase in the salary and benefit cost per member. The total salary and benefit cost per member was $75 in 2002 and $78 in 2007. When 2002 dollars are adjusted for inflation at 2007 dollars, the cost per member decreased by 8.6 percent.

When adjusted for inflation, URS salary and benefit costs have not increased.

Figure 3.4 Salary, Benefits, and FTEs, 2002 to 2007. When adjusted for inflation, salary and benefit costs did not increase.

	2002	2003	2004	2005	2006	2007	Percent Change
			(thousands)				2002-2007
Salaries	6,792	7,500	7,380	7,265	7,717	7,637	12.4%
Benefits	2,669	2,877	2,968	3,176	3,495	3,510	31.5
Total	9,461	10,377	10,348	10,441	11,212	11,147	17.8
Cost per Member/Participant							
DB	$ 50	$ 53	$ 50	$ 49	$ 48	$ 49	
DC*	$ 24	$ 27	$ 27	$ 27	$ 30	$ 27	
DB & DC*	$ 75	$ 81	$ 78	$ 78	$ 81	$ 78	
FTEs**	149	153	155	158	160	163	9.4%

Source: URS Comprehensive Annual Financial Reports.
** Cost per participant for the DC plan is based on the number of accounts which is greater than the number of members because each participant may have more than one type of account. Thus, the total cost is not the product of DB and DC.*
*** As of December 2007, 10 FTEs were allocated to the PEHP plan and 52 FTEs to the DC plan.*

Figure 3.4 also shows that for 2007, salary and benefit costs per member were $49 for the DB plan and $27or the DC plan. In addition, the number of employees increased by 14 FTEs from 2002 to 2007. The

FTE counts are not from the annual report but are from an analysis completed by URS. Generally, about one-third of URS employees are allocated to the DC plan.

URS Wage Increases Are Consistent with Local Market. Figure 3.5 compares COLA and merit pay increases from 2004 to 2009. URS' increases are generally consistent with the local market–URS totaled 25 percent, Salt Lake County totaled 26 percent, and the Wasatch Front area private sector totaled 28 percent. In addition, a survey of 40 participating retirement systems shows that URS wage increases were less than increases of other retirement systems which averaged almost 31 percent.

URS wage increases are comparable to local market.

Figure 3.5 Percent Merit/COLA Increases, Fiscal Years 2004 to 2009. URS salary and benefit increases were reasonable when compared with the local market.

	2004	2005	2006	2007	2008	2009	Total Increase
			(percent)				
Other Systems*	2.84	3.06	5.23	6.06	6.50	7.30	30.99
Wasatch Front**	4.20	4.60	4.80	4.60	5.40	4.81	28.41
Salt Lake County	3.75	3.75	3.75	4.75	4.75	5.75	26.50
Utah Retirement	**0.00**	**4.00**	**3.25**	**4.50**	**6.00**	**7.50**	**25.25**
Davis County	2.00	3.50	3.50	3.50	3.25	4.25	20.00
Weber County	2.00	2.00	4.00	3.50	4.00	4.00	19.50
Utah County	1.50	1.50	1.50	3.10	5.65	2.35	15.60
State of Utah***	0.00	1.00	2.50	3.50	3.50	5.00	15.50
CPI Increase	2.11	3.17	2.50	4.10	2.70	5.00	19.58

Source: Utah State Division of Human Resource Management, Utah Retirement System.
** Other systems information is from the Illinois Municipal Retirement Fund survey of 40 participating retirement systems.*
*** Wasatch Front pay/merit increases is from a survey of several industry types by AON Consulting. URS estimated COLAs were 1 percent each year.*
**** URS suggested that State of Utah 2005 increases should be 2 percent to include the 1 percent one-time COLA bonus and 2008 should be 5 percent which includes 1.5 percent discretionary funding to address hot-spot issues. Recognizing these increases would increase the state total to 18 percent.*

URS feels wage increases are needed to compete with the private sector. Their turnover analysis for the past seven years shows that most

URS used market surveys to evaluate and adjust wages.

employees who leave URS are to private, and not state employment. Only 2 of 41 employees who left went to state employment. Utah law requires the URS board to "establish the compensation of the executive director and adopt compensation plans and policies based on market surveys for positions in the office" (***Utah Code*** 49-11-203(1)(m)). Market surveys completed by URS were used to evaluate and adjust wages.

URS' Salary and Benefit Costs per Member Are Higher than Many Retirement Systems But Lower if DC Costs Are Excluded. We compared URS' salary and benefit costs per member with a sample of other retirement systems selected based mostly on a similar level of assets and/or number of members. The salary and benefit costs per member was determined by dividing the amount reported in each retirement system's CAFR by the total number of active and retired members. Figure 3.6 shows that salary and benefit costs per member for retirement systems with DC plans ranged from about $26 to $127. URS' $78 salary and benefit costs per member are higher than both the average ($62) and median ($59) of our sample.

URS' salary and benefit costs per member are higher than many other retirement systems with DC plans.

Figure 3.6 2007 Salary and Benefit Costs per Member Compared with Other Retirement Systems. URS costs per participating member are higher than many of the retirement systems in our sample that have a DC plan but lower when compared to systems that do not have DC plans.

Retirement System	Salary & Benefit Cost per Member*	Retirement System	Salary & Benefit Cost per Member*
Retirement Systems With DC Plan			
Wyoming	$ 26	**Utah with DC**	**$ 78**
Minnesota Public Emp	26	Colorado	81
Mississippi	28	Oregon	84
Montana	34	Texas	88
Idaho	37	Ohio Public Emp	90
Arizona	46	Ohio Teachers	127
New Mexico	59		
Average	$ 60	**Median**	$ 52
Retirement Systems Without DC Plan			
Kansas	$ 22	Hawaii	$ 54
Iowa	22	Illinois Municipal	55
Nevada	30	New Hampshire	58
South Carolina*	33	Pennsylvania	71
Maryland	43	Ohio School Emp.	72
Illinois Teachers	45	New York Teachers	77
Utah without DC	**49**	Louisiana	92
Minnesota Teachers	51		
Average	$ 52	**Median**	$ 52

** South Carolina has a DC plan but it is not considered part of their system for financial statement purposes.*

However, URS costs appear lower when compared to retirement systems that do not have DC plans. After excluding DC costs, URS costs per member ($49) are lower than both the average ($52) and median ($52) of the retirement systems in our sample.

URS should evaluate why their salary and benefit costs per member are higher than other retirement systems with DC plans.

One reason URS gave for their higher average cost per member for systems with DC plans is that URS financial services, information technology, and asset management functions are managed in-house, while other retirement systems may be structured differently. Other systems' salaries and benefits are less if some of their functions are outsourced or completed by other departments in state government. In addition, other systems provide different levels of service. We could not identify the organizational structure or service levels for each system but feel URS should evaluate why their costs are higher. An analysis being completed by CEM Benchmarking should help URS evaluate and compare salaries and benefits.

Other Administrative Costs Were Reviewed

In addition to reviewing the highest cost categories, we also reviewed other administrative costs with significant growth or if there were questions involving how the costs were determined. The costs reviewed include office space rental, legal costs, consulting services, and postage costs.

Office space rental costs for the DC plan reported in annual report are misleading.

Office Space Rental Costs Are Misleading. Reduced office rental costs for the DC plan as reported in the annual report excludes some costs that were charged to the program. Figure 3.7 shows that from 2002 to 2007, rental costs for the DC plan went down 16 percent. We questioned the steep reduction in 2006 (from $152,000 to $74,000) because the DC plan had been expanded and additional staff were hired. According to URS, the annual report does not identify all of the rent actually charged to the plan. Rent costs are sometimes classified in other cost categories. It appears the rent charged to the DC plan is correct but we are concerned that costs could be overlooked.

Figure 3.7 Office Space Rental Costs, 2002 to 2007. Rental charges increased 40 percent.

	2002	2003	2004	2005	2006	2007	Percent Change
			(thousands)				2002-2007
DB	$ 807	$ 846	$ 961	$ 1,130	$ 1,164	$ 1,196	48%
DC	111	126	143	152	74	93	(16)%
Total	**$ 918**	**$972**	**$1,104**	**$1,282**	**$ 1,238**	**$ 1,289**	**40%**

URS must take care in allocating costs to the DC plan because only those members who participate should pay the costs. Allocations to the DC plan are discussed at the end of this chapter.

Increase in Legal Costs Linked to Investment Decisions. Legal costs increased significantly in 2007. As Figure 3.8 shows, except for 2003, total legal costs increased moderately each year until 2007 when they jumped from $650,000 to $1.2 million. The increase was due to extraordinary legal costs for the investment department.

Legal costs increased sharply due to evaluating investments in a new asset class.

Figure 3.8 Legal Costs, 2002 to 2007. Legal costs increased 118 percent due primarily to the investment department evaluating a new asset class—Absolute Return.

Department	2002	2003	2004	2005	2006	2007	Percent Change 2002-2007
			(thousands)				
DB	$ 514	$ 738	$ 550	$ 582	$ 600	$ 679	32%
Investment	6	13	21	11	44	476	7,833%
DC	11	7	14	16	6	4	(64)%
Total	**$ 531**	**$ 758**	**$ 585**	**$ 609**	**$ 650**	**$1,159**	**118%**

Source: URS Comprehensive Annual Financial Reports.

Although URS' legal services are generally provided by a firm they have contracted with for many years, URS also hires other firms with specific expertise. In 2007, the investment department contracted with several firms to evaluate investments in a new asset class–absolute return. According to

URS, absolute return investments are complex hedge fund investments. As previously discussed, they are less volatile than most alternative investments with lower returns when the market is up, but fewer losses when the market is down. URS' legal costs regarding absolute return investments totaled over $835,000, part of which was reported in the 2007 annual report, while the other part will be reported in the next report. After 2008, the legal costs are expected to be much lower. Over the long run, it is important to evaluate if the increased costs, including investment and additional legal fees, were warranted.

Consulting Service Cost Increases Were Mostly Accounting Misclassifications. According to the annual report, consulting service costs increased over 1,900 percent from 2002 to 2007. However, our review disclosed that up until 2006, some consultant costs were put in the wrong account.

Figure 3.9 shows that if accounted for correctly, consulting service costs actually increased 176 percent.

Accounting misclassifications made it appear consulting service costs increased more significantly than they actually did.

Figure 3.9 Consulting Service Costs, 2002 to 2007. Adjustments to offset accounting misclassifications disclosed that consulting service costs increased 175 percent instead of 1,904 percent.

	2002	2003	2004	2005	2006	2007	Percent Change
			(thousands)				2002-2007
Consulting	$ 52	$ 85	$ 186	$ 431	$ 860	$ 1,042	1904%
Adjustments	326	172	397	507	42		
Adjusted Total	**$ 378**	**$ 257**	**$ 583**	**$938**	**$ 902**	**$ 1,042**	**176%**

Source: URS Comprehensive Annual Financial Reports.

This accounting misclassification also made it appear that security handling costs had declined 29 percent (Figure 3.1). After adjusting for the misclassification, security handling costs still showed a decline of 12 percent. Any reduction in costs seemed incorrect to us because the increased level of assets would require additional security handling. However, the CIO said that the reduction was valid because they had negotiated lower fees.

Another concern involving these fees is that, according to the annual report, the DC program was not charged security handling for two years.

Postage Costs Appear High for DC Plan. URS postage and mailing costs increased 77 percent from 2002 to 2007. Figure 3.10 shows that almost all of the increase was in the DC plan. We questioned the increase because DC plan participants only increased about 13 percent. In addition, postage costs fluctuated from one year to the next; in 2005, DC costs more than doubled.

Postage costs for the DC plan appear high compared to the DB plan.

Figure 3.10 Postage Costs, 2002 to 2007. Postage and mailing costs have increased more for the DC plan than for the DB plan. Membership increased about 13 percent for both plans.

	2002	2003	2004	2005	2006	2007	Percent Change
			(thousands)				2002-2007
DB	$ 353	$ 426	$ 455	$ 262	$ 546	$ 404	14%
DC	211	178	194	471	334	593	181%
Total	**$ 564**	**$ 604**	**$ 649**	**$ 733**	**$ 880**	**$ 997**	**77%**

Source: URS Comprehensive Annual Financial Reports.

According to URS, the fluctuations occurred because the full cost for postage was not allocated to the DC plan prior to 2005. Additionally, accounting misclassifications resulted in reporting some 2006 costs in 2007. If $79 thousand of DC postage costs are adjusted into the correct year, the increase would be 144 percent (from $211,000 to $514,000). The DC director said costs increased for a combination of reasons. There are more participants, postage rates are higher, and the mailings weigh more. It is not clear why DB postage cost increases were minimal and, in fact, the costs went down in 2005 and 2007. It appears to us that DC administrative costs have not always been appropriately charged to the DC program. The next section discusses concerns involving DC plan cost allocations.

Defined Contribution Plan Costs Must Be Accurately Assessed

Because the DC plan is a voluntary supplemental program and only those members participating should pay its operating costs, DC plan costs must be accurately assessed. DC is a voluntary plan established to allow participants to supplement their retirement with pre-tax contributions that are tax deferred until time of withdrawal. URS' DC plan includes 401(k), 457, and both traditional and Roth IRAs. Allocated costs should be periodically reviewed and compared with similar DC plans.

Allocated Costs Are Not Precise

DC plan costs must be accurately assessed because only those members participating should pay to operate the program.

It was difficult to evaluate and compare DC plan administrative costs over time because the majority (70 percent) of the costs are not directly charged to the program, but are allocated costs. Allocations are needed because URS shares employees, equipment, supplies, and other administrative costs with both the DC plan and the PEHP program in order to help minimize costs. Department managers within URS estimate how much of their time is used for the DC plan. That percentage of their costs is then charged to the DC plan. Costs allocated to the DC plan include information technology, mailing, telecommunications, professional services, member services, field services, printing and binding, and supplies and services. Other types of costs are also allocated to the DC plan but they are not identified as a separate cost category.

Costs for the DC plan listed by category in the annual report are not precise, which can be misleading. In the annual report, each allocation is divided between cost categories but without determining precisely all of the cost categories involved. For example, the IT manager estimated the percentage of time his staff dedicated to the DC plan, and that percentage of the department's costs were allocated to the DC plan. Instead of splitting the costs into each specific cost category, the costs were split only between salary and data processing regardless of whether other cost categories were involved. Thus, the amounts listed in the annual report for each cost category and shown in Figure 3.1 are not precise.

The imprecise allocations led us to question many of the costs. URS finance staff acknowledge allocations to specific cost categories are not precise but are confident the total costs charged to the DC plan are accurate. They feel it is not cost-efficient to try to precisely categorize each allocated costs. Our audit did not determine whether the full cost has been charged to the DC plan, and we feel periodic reviews are needed.

DC Plan Administrative Costs Appear Low

Estimated costs for the DC plan appear low when compared to DB costs. Based on a report by the National Association of State Retirement Administrators (NASRA), it appears either DC costs are low or DB costs are high. The report states, "In almost every instance, the administrative cost of a DC plan is higher–often much higher–than that of a DB plan." DB costs are expected to be lower because of economies of scale and lower investment management fees.

URS' DC plan costs appear to be proportionally lower than DB plan costs.

Figure 3.11 shows that in 2007, instead of being higher, the total expense ratio for the DC plan is less (.32 percent) than for the DB plan (.36 percent). This could indicate that DC plan costs may not be fully assessed. However, the higher ratio is a change from prior years and may be because the DB plan's increasing investment costs has raised the ratio. Excluding investment advisor fees, the DC administrative cost as a percent of assets is more (.21 percent) than the DB plan (.07 percent).

Figure 3.11 DC Costs Compared to DB Costs, 2002 to 2007. Despite what should be expected, DC administrative and investment costs appear low when compared to DB costs.

	2002	2003	2004	2005	2006	2007
	Percent					
Defined Contribution						
Invest Fees/ Assets	.11%	.10%	.10%	.11%	.10%	.10%
Admin Costs/Assets	.29	.25	.24	.23	.23	.22
Total Expense Ratio	.40	.35	.34	.34	.33	.32
Defined Benefit						
Invest Fees/ Assets	.18	.22	.23	.24	.26	.29
Admin Costs/Assets	.11	.09	.09	.08	.07	.07
Total Expense Ratio	.29%	.31%	.32%	.32%	.33%	.36%

DC plan costs should be carefully evaluated.

In our opinion, URS should periodically complete in-depth reviews of costs allocated to the DC plan as is required for PEHP allocations. An agreement with PEHP states charges to and from PEHP will be reviewed at least annually. Periodic, in-depth reviews are needed because URS may not be identifying all DC plan costs, and because the imprecision limits comparisons of costs over time. Comparisons with other DC plans are necessary to determine if costs are reasonable. The importance of reviewing DC plan costs is emphasized in a recommended practice of the Government Finance Officers Association (GFOA). They recommend that policies and practices are established and implemented "to assure that plan costs are reasonable and appropriate, compared to DC plans of similar size, structure and service levels," and that periodic audits of the actual charges be completed. We feel periodic reviews will help ensure that DC costs are accurately assessed and reasonable.

Recommendations

1. We recommend that the Utah Retirement System evaluate how its investment strategy impacts the growth in investment advisor fees.

2. We recommend that the Utah Retirement System evaluate salary and wage costs per member and compare the costs to retirement systems of similar size and service levels.

3. We recommend that the Utah Retirement System periodically complete a more in-depth review of the costs allocated to the defined contribution plan, and ensure that costs are reasonable compared to DC plans of similar size, structure, and service level.

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Appendix

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Appendix

Administrative Costs Compared to Other States

2007 Defined Benefit Expenditures *(thousand dollars)*

	Adm Expense	Invest Expense	Total	Net Assets	Adm/Net Assets	Invest/Net Assets	Total/Net Assets	Members (Retired & Active)	Adm per Member	Invest per Member	Total per Member	Funding Ratio (%)	Number Employers	Returns (%) 1Yr	5Yr	10Yr	CEM*	DC Plan?
1 Arizona SRS	29,817	57,437	87,254	27,069,558	0.11%	0.21%	0.32%	308,369	$ 97	$ 186	$ 283	83.7	597	17.8	11.0	8.4	✓	Y
2 Colorado PERA	20,842	130,564	151,406	41,150,362	0.05%	0.32%	0.37%	265,086	$ 79	$ 493	$ 571	75.1	409	10.0	14.4	8.1	✓	Y
3 Hawaii ERS	9,602	37,349	46,951	11,462,417	0.08%	0.33%	0.41%	100,575	$ 95	$ 371	$ 467	67.5	5	17.7	11.7			N
4 Idaho-PERS of	6,681	48,403	55,084	11,257,959	0.06%	0.43%	0.49%	95,419	$ 70	$ 507	$ 577	105.5	701	20.0	12.8	9.0	✓	Y
5 Illinois Municipal RF	20,811	63,270	84,081	24,223,495	0.09%	0.26%	0.35%	265,470	$ 78	$ 238	$ 317	96.1	2,926	8.5	13.1	8.2	✓	N
6 Illinois-Teacher's RS of	15,246	150,926	166,172	41,909,318	0.04%	0.36%	0.40%	249,553	$ 61	$ 605	$ 666	63.8	1,031	19.2				N
7 Iowa PERS	9,060	58,315	67,375	23,217,167	0.04%	0.25%	0.29%	250,190	$ 36	$ 233	$ 269	90.2	2,293	16.3	11.6	9.0	✓	N
8 Kansas PERS	8,559	30,243	38,802	14,153,819	0.06%	0.21%	0.27%	217,214	$ 39	$ 139	$ 179	69	1,473	18.0	12.3	8.8	✓	N
9 Louisiana SERS	15,784	17,471	33,255	9,351,148	0.17%	0.19%	0.36%	101,790	$ 155	$ 172	$ 327	67.2	362	19.2			✓	N
10 Maryland -SRS of	21,271	45,791	67,062	39,444,781	0.05%	0.12%	0.17%	304,617	$ 70	$ 150	$ 220	76.8	113	17.6				N
11 Minnesota Teacher's RA	10,635	27,883	38,518	19,938,882	0.05%	0.14%	0.19%	124,232	$ 86	$ 224	$ 310	87.5	566	18.5			✓	N
12 Minnesota-PERA of	9,924	26,852	36,776	19,422,403	0.05%	0.14%	0.19%	229,255	$ 43	$ 117	$ 160	73.3	3,580	18.5	12.0	8.5		Y
13 Mississippi PERS	9,846	36,668	46,514	21,912,350	0.04%	0.17%	0.21%	237,339	$ 41	$ 154	$ 196	73.7	886	18.9				Y
14 Montana PER	3,271	12,124	15,395	5,019,936	0.07%	0.24%	0.31%	54,138	$ 60	$ 224	$ 284	91	1,064	18.0	11.0			Y
15 Nevada-PERS of	8,588	25,532	34,120	22,701,360	0.04%	0.11%	0.15%	139,380	$ 62	$ 183	$ 245	77.2	166	15.0	10.0	7.9	✓	N
16 New Hampshire RS	5,607	23,057	28,664	5,795,605	0.10%	0.40%	0.49%	72,050	$ 78	$ 320	$ 398	67	476	16.0	10.4		✓	N
17 New Mexico-PER of	9,145	29,635	38,781	13,290,538	0.07%	0.22%	0.29%	81,836	$ 112	$ 362	$ 474	93	714	18.1	11.7			Y
18 New York Teacher's RS	43,893	143,062	186,955	104,912,949	0.04%	0.14%	0.18%	398,713	$ 110	$ 359	$ 469	102.6	826				✓	N
19 Ohio PERS	53,944	128,618	182,562	70,116,506	0.08%	0.18%	0.26%	543,525	$ 99	$ 237	$ 336	93	3,714	8.5	13.9		✓	Y
20 Ohio-School Emp RS of	17,453	55,167	72,620	11,546,062	0.15%	0.48%	0.63%	186,542	$ 94	$ 296	$ 389	80.8	982	18.7	11.7	8.2	✓	N
21 Ohio-St Teacher's RS	60,002	142,539	202,541	72,935,433	0.08%	0.20%	0.28%	297,044	$ 202	$ 480	$ 682	82.2	1,094	20.7	13.2			Y
22 Oregon PERS	35,620	297,322	332,942	62,891,942	0.06%	0.47%	0.53%	267,916	$ 133	$ 1,110	$ 1,243	110.5	873	18.6	13.4		✓	Y
23 Pennsylvania SERS	24,748	344,707	369,455	35,516,198	0.07%	0.97%	1.04%	229,255	$ 108	$ 1,504	$ 1,612	97.1	108	17.2	17.5	10.1	✓	N
24 South Carolina RS	18,754	36,147	54,901	28,048,780	0.07%	0.13%	0.20%	322,625	$ 58	$ 112	$ 170	69.6	1,122	13.4			✓	Y
25 Texas-ERS of	19,588	26,995	46,583	24,460,276	0.08%	0.11%	0.19%	246,313	$ 80	$ 110	$ 189	95.6	208	13.9	11.2		✓	Y
26 Wyoming RS	2,289	15,431	17,720	6,600,812	0.03%	0.23%	0.27%	59,399	$ 39	$ 260	$ 298	96.5	579	7.4	12.1	7.5		Y
Average	18,884	77,366	96,250	29,551,925	0.07%	0.27%	0.34%	217,225	$ 84	$ 352	$ 436	84	1,033					
Median	15,515	41,570	54,993	22,959,263	0.06%	0.22%	0.29%	233,297	$ 79	$ 237	$ 322	83	770					
Utah Retirement System	**10,449**	**64,320**	**74,769**	**20,950,656**	**0.05%**	**0.31%**	**0.36%**	**142,519**	**$ 73**	**$ 451**	**$ 525**	**100.8**	**439**	**7.2**	**14.1**	**8.2**	**✓**	**Y**
													URS Returns thru Jun '07	**17.2**	**12.6**	**8.7**		

Note: Colorado, Illinois Municipal, Ohio Public Employees, Pennsylvania, Utah,Wyoming reports are as of December 2007, Texas is as of August 2007, all others are as of June 2007.

**CEM Benchmarking, Inc. is currently evaluating URS administrative and investment costs, service, and investment strategy in relation to other retirement systems. Those checked participate in CEM's service.*

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Agency Response

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JEFFREY L. JENSEN
Director

April 1, 2009

John A. Schaff, CIA
Auditor General
Office of the Legislative Auditor General
W315 Utah State Capitol Complex
Salt Lake City, UT 84114-5315

Dear Mr. Schaff:

Utah Retirement Systems' (URS) management and staff appreciate the professional conduct of your staff as they completed a performance audit of the administrative costs of URS. The auditors took the time and effort to understand the complexity of the issues, and met repeatedly with URS staff to discuss these issues. URS also made every effort to ensure that the auditors were provided with timely, accurate information.

Attached is the URS response to the audit. URS agrees with the recommendations and will implement the recommendations as provided in the report. Where appropriate, URS has provided additional commentary in response to the recommendations.

We look forward to responding to questions and suggestions as this audit report is presented to various legislative committees.

Sincerely,

Robert V. Newman

Robert V. Newman
Executive Director
UTAH RETIREMENT SYSTEMS

Response to the Legislative Audit
of
Utah Retirement Systems' Administrative Costs

Introduction

The Utah Retirement Systems (URS) is pleased to respond to *A Performance Audit of Utah Retirement Systems' Administrative Costs* (Report), Report Number 2009-07, issued by the Office of the Legislative Auditor General (OLAG). URS appreciated the opportunity to meet and discuss the Report with the staff of OLAG.

Chapter II

Recommendation: We recommend that the Utah Retirement System provide the results of its benchmarking reports to the Legislative Auditor's Office and to the Legislature.

URS Response: URS will comply with this recommendation and provide copies of the benchmarking reports to the Legislative Auditor's Office and to the Legislature. These reports will be provided by CEM Benchmarking Inc. (CEM), a vendor that engages in comparing public retirement systems.

Chapter III

Recommendation: We recommend that the Utah Retirement System evaluate how its investment strategy impacts the growth in investment advisor fees.

URS Response: URS will continue to monitor its investment strategy and associated investment advisor fees. As the Digest of the Report states, "...one factor increasing costs has been allocating a larger portion of investments to higher cost alternative asset classes..." The Report goes on to recognize that the various asset classes have different fees: "...equity managers typically have higher fees than fixed income managers and fees are higher for international equities than for domestic equities." The Report shows from 2002 to 2007, URS's allocation to Alternative Investments (Private Equity, Real Estate, and Absolute Return) has nearly doubled. Alternative Investment managers charge higher fees than fixed income or equity managers. URS has been rewarded for its allocation to Alternative Investments as Real Estate and Private Equity were the two top performing asset classes over the past 10 years. In 2008, URS was compensated for its allocation to Absolute Return as equities were down approximately 40% and Absolute Return was down only 13%. The URS portfolio continues to be structured to minimize losses in down markets. URS' past investment returns have demonstrated the payment of higher investment advisor fees has been rewarded through better investment performance. URS will continue to monitor its investment portfolio and investment advisor fees.

Recommendation: We recommend that the Utah Retirement System evaluate salary and wage costs per member and compare the costs to retirement systems of similar size and service levels.

URS Response: URS agrees with the recommendation. Prior to this audit, URS was in contract negotiations with CEM to participate in their surveys of public retirement systems. URS believes comparisons among public retirement systems can help management to identify certain functions or services that should be studied to ensure that budgets are being properly allocated and used.

As the Report states, being able to compare public retirement systems is a challenging endeavor as no public retirement system is structured the same. Figure 3.6 in the Report shows URS salary and benefit costs per member compared to other public retirement systems. This Figure shows URS' salary and benefit costs per member for public retirement systems providing DC plans are higher than both the average and the median. URS' salary and benefit costs are higher because those public retirement systems with lower costs are outsourcing the administration, record keeping, and other functions of the DC plan while URS is performing these functions internally. These costs are reported in other cost categories, other than in salaries and benefits as reported by URS. URS contacted the seven public retirement systems with lower costs referred to in the Report and confirmed all of them are using third party administrators for the recording keeping function. The seven are also outsourcing other services such as payroll, data processing, legal, etc., resulting in lower payroll and benefit costs. URS does not believe Figure 3.6 provides an accurate comparison among public retirement systems.

URS believes reviewing the similarities and differences in public retirement systems can provide useful information and will participate in CEM to facilitate this process.

Recommendation: We recommend that the Utah Retirement System periodically complete a more in-depth review of the costs allocated to the defined contribution plan, and ensure that costs are reasonable compared to DC plans of similar size, structure, and service level.

URS Response: URS agrees with the recommendation. Annually the URS Finance Director will meet with department managers to ensure cost allocation models are properly assessing the DC plan with those costs that appropriately belong to it. Additionally, the URS Internal Audit Department will annually review the allocation of costs to the DC plan to ensure the propriety of the allocation. URS will also continue to compare DC costs with plans of similar size, structure, and service level through CEM and other tools as they become available.