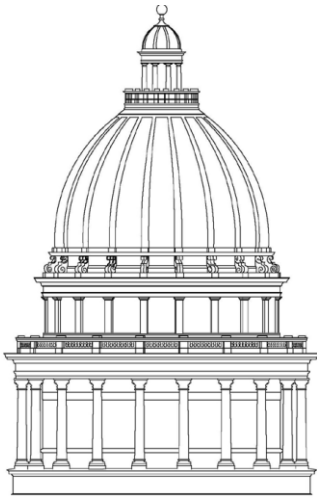
REPORT TO THE

UTAH LEGISLATURE

Number 2015-03



A Performance Audit of URS' Management and Investment Practices

May 2015

Office of the
LEGISLATIVE AUDITOR GENERAL
State of Utah

STATE OF UTAH

Office of the Legislative Auditor General

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AUDITOR GENERAL

May 5, 2015

TO: THE UTAH STATE LEGISLATURE

Transmitted herewith is our report, **A Performance Audit of URS' Management and Investment Practices** (Report #2015-03). 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

John M. Schaff, CIA
Auditor General

JMS/lm

Digest of a Performance Audit of URS' Management and Investment Practices

Utah Retirement Systems (URS) administers retirement benefits for Utah public employees. URS was created under ***Utah Code*** Title 49 with the purpose of establishing retirement requirements, benefits, plans and programs, and protections consistent with sound fiduciary and actuarial principles. Title 49, Chapter 11 also creates a common trust fund, known as the Utah State Retirement Investment Fund. This fund is managed by the Utah State Retirement Board. Our audit addresses concerns raised about transparency, the defined benefit asset allocation, qualifications of board members and advisory staff, and the selection and retention of external investment managers.

Chapter II
URS Can Take Steps to Be More Transparent

URS' Transparency Website Provides Detailed Information on Operating Costs. URS has made a considerable effort to become more transparent through its website and is compliant with Senate Bill 59, passed in the 2014 General Session. URS' website discloses administrative expense transactions, employee compensation information aggregated by department, information on operational costs, and financial and actuarial reports.

URS Could Be More Transparent Regarding Employee Compensation. URS should disclose individual employees' annual compensation on its website. Ten of the eleven peer retirement systems surveyed disclose employees' compensation. Furthermore, many governmental agencies, including Utah agencies are making information on employee compensation available to the public.

URS should disclose individual employee's annual compensation on its website.

Further Steps Can Be Taken to Improve URS' Information Practices. URS has transparency practices that are similar to Government Records Access and Management Act's (GRAMA's), but additional steps can be taken to improve transparency. URS should designate a records officer to manage information requests, establish time limits to respond to information requests, and better notify the public of administrative board meetings.

URS should designate a records officer to help ensure that information requests are handled and documented appropriately and consistently.

Chapter III
URS Should Consider Reviewing Its High Alternative Asset Allocation

URS' Defined Benefit Asset Allocation Has Shifted Substantially to Alternative Investments. URS' alternative investments increased from 16 to 40 percent from 2005 to 2013 as URS reduced its allocation in equities and debt securities. URS states that the objectives of the current asset allocation are to protect investment capital in negative equity markets, reduce volatility, and increase investment diversification. Callan Associates, URS' primary investment consultant, believes that URS' current portfolio composition is reasonable, though they do suggest that a more aggressive portfolio may be required to meet the assumed rate of return over the next 10-year time period.

URS states that its current asset allocation is intended to protect investment capital in negative equity markets, reduce volatility, and increase investment diversification.

Legislative Auditor's Consultant Recommends that URS Consider Reducing Alternative Assets. Our investment consultant pointed out that URS' performance, in terms of return on investment, is about average compared to peer retirement systems. However, URS' allocation of funds to alternatives (40 percent) is higher than that of peer systems. Furthermore, our consultant's model, which reflects a hindsight perspective, showed that if URS had maintained its 2004 allocation with fewer alternative assets and no hedge funds, URS would have theoretically gained $1.35 billion in additional assets by 2013. The consultant recommends that URS reduce its allocation of 40 percent alternatives over time, primarily by reducing the allocation to hedge funds.

A model of URS investments performed better than URS by maintaining the 2004 asset allocation.

Chapter IV
URS Board and Staff Are Qualified to Perform Fiduciary Responsibilities

URS Operating Costs Are Well Managed, But Investment Fees Are Driving Costs Higher. A change in URS' allocation of investment assets has resulted in higher investment fees, which make up the majority of URS operating costs. Though URS' investment costs are higher than similar public retirement systems a benchmarking report shows that URS controls those costs given its more expensive investments.

URS' investment costs are higher than similar public retirement systems because of its investment strategy.

URS' Board Has Sufficient Investment Experience. The composition of URS' board meets statutory requirements regarding member experience and background; and the board members who represent the investment community collectively hold over 150 years of investment experience. Furthermore, URS' board has more investment experience compared to other peer retirement systems' boards.

The board members who represent the investment community collectively hold over 150 years of investment experience.

URS Advisor Staff Are Qualified to Offer Investment Advice. Though the advisory program is still too new to be audited, advisory staff appear to be appropriately qualified in terms of education and training. Additionally, URS is exempt by federal and state law from licensing requirements. URS should establish in policy the outline and regulations of the advisory program and develop metrics that will measure the success and effectiveness of the URS advisory program.

Chapter V
DC Investment Manager Selection and Retention Processes Are Satisfactory

DC Investment Manager Selection Process Has Adequate Controls. URS' policy and procedures relating to defined contribution (DC) investment manager selection have adequate controls, including a clear process established in policy, multiple levels of complementary review and approval, and the clear acknowledgement of URS' fiduciary duty toward members. In a comparison of URS policy and procedures to other systems, we found that, though other programs differed slightly based on unique program structure or requirements, the core of the manager selection process is very similar.

URS' manager selection process is very similar to those of peer systems.

Ongoing Monitoring and Retention of DC Plan Investment Managers Are Acceptable. URS' process of monitoring DC plan investment managers is well-established, has adequate controls, is executed according to policy, and results in appropriate investment decisions. URS monitors managers on an ongoing basis by completing quarterly scorecards for each manager. If a scorecard reveals less than desireable results, the manager is put on a watch list and could face termination. Since 1998, seven investment managers have been terminated and replaced using current processes.

URS monitors external investment managers on an ongoing basis.

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May 2015

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Chapter I
Introduction

Utah Retirement Systems (URS) provides retirement benefits for Utah public employees. Utah has been providing retirement benefits to public employees since 1907, when the Utah Legislature authorized the organization of local teacher retirement associations. Over time, this and other public retirement plans developed independently until, in 1967, they were combined under what is now known as Utah Retirement Systems.

URS was created under ***Utah Code*** Title 49 with the purpose of establishing retirement requirements, benefits, plans and programs, and protections consistent with sound fiduciary and actuarial principles. Figure 1.1 shows ***Utah Code*** 49-11-201, which grants the Utah State Retirement Office the authority to administer the plans and programs.

URS was created in 1967 under *Utah Code* Title 49.

Figure 1.1 *Utah Code* 49-11-201. The statute establishes a retirement office as an independent state agency.

(1) (a) There is established the Utah State Retirement Office, which may also be known and function as the Utah State Retirement Systems or the Utah Retirement Systems.
(b) The office shall administer the systems, plans, and programs and perform all other functions assigned to it under this title.
(2) (a) The office is an independent state agency.
(b) It is subject to legislative and executive department budgetary review and comment.
(3) The office may establish branch offices upon approval of the board.
(4) The board and office are exempt from those acts which are applicable to state and other governmental entities under this code.

Source: ***Utah State Code***

Title 49, Chapter 11 also creates a common trust fund—known as the Utah State Retirement Investment Fund—to simplify investment functions. This fund is managed by the Utah State Retirement Board, the governing body of Utah Retirement Systems, as established in ***Utah Code*** 49-11-203.

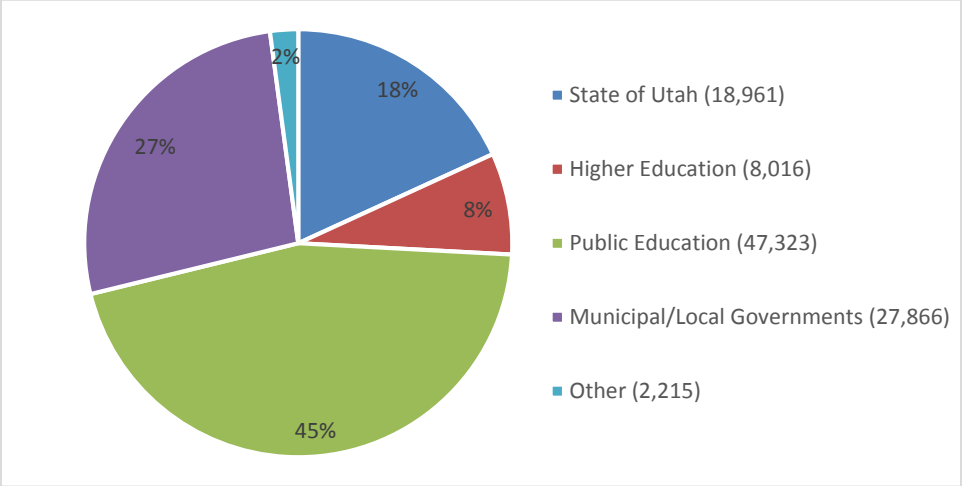
Title 49 also creates the Utah State Retirement Investment Fund, which is managed by the Utah State Retirement Board.

URS Administers a Number of Retirement Plans

URS currently administers retirement plans to 466 active public employers.

URS provides retirement benefits to employees of the state and other public entities through 12 retirement plans. As of December 2013, 466 active employers participated in Utah Retirement Systems and total membership—including active, retired, and terminated members—totaled 197,030. Figure 1.2 shows the composition of active URS membership by employer type for 2014.

Figure 1.2 Distribution of URS Membership in 2014. Terminated and retired employees are not included.



Other includes local and special service districts.
Source: URS

In 2014, URS active membership equaled 104,381.

As shown, the largest component of URS membership consists of public education employees, followed by employees of municipal and local governments. The State of Utah is URS' third largest employer—its employees make up 18 percent of URS' membership.

The State of Utah is URS' third largest employer—its employees make up 18 percent of URS' membership.

URS administers both ***defined benefit***[1] and ***defined contribution*** plans. Defined benefit (DB) plans are employer-sponsored retirement plans that provide retired employees with a lifetime specific amount based on a formula of salary history and years of service. In DB plans, the employer bears the investment risk. URS has eight defined benefit plans.

[1] Because of the technical nature of this subject matter, this report contains highlighted words that are defined in the report's glossary in Appendix E.

In addition to the DB plans, members can also elect to participate in the defined contribution (DC) plans. These plans allow employees to defer a portion of their salaries into investment plans in which the employees bear the risks. DC plans provide employees with retirement benefits that are determined by the amount of money contributed and the performance of the investments. URS offers four defined contribution options. Figure 1.3 shows all the DB and DC plans that URS provides.

In addition to employer-sponsored (DB) plans, members can also elect to participate in defined contribution plans (DC)

Figure 1.3 DB and DC Plans. URS administers eight DB plans and four DC plans.

Defined Benefit Systems/Plans	Defined Contribution Plans
• Public Employees' Noncontributory Retirement System • Public Employees' Contributory Retirement System • Public Safety Retirement System • Firefighters' Retirement System • Judges' Retirement System • Utah Governor's and Legislative Retirement Plan • Tier 2 Public Employees* • Tier 2 Public Safety and Firefighter*	• 401(k) • 457 • Roth IRA • Traditional IRA

**Tier 2 Plans combine a partial pension with a 401(k)*
Note: This figure does not include the Health Reimbursement Arrangement as a DC plan.
Source: URS

Detailed information for DB and DC plans can be found in URS' comprehensive annual financial reports (CAFRs). The CAFRs also provide a financial and statistical overview of Utah Retirement Systems, excerpts of which are described in the following section.

URS' CAFRs provide detailed information on DB and DC plans, as well as a financial and statistical overview of the organization.

URS Is Recovering from The Prior Economic Downturn

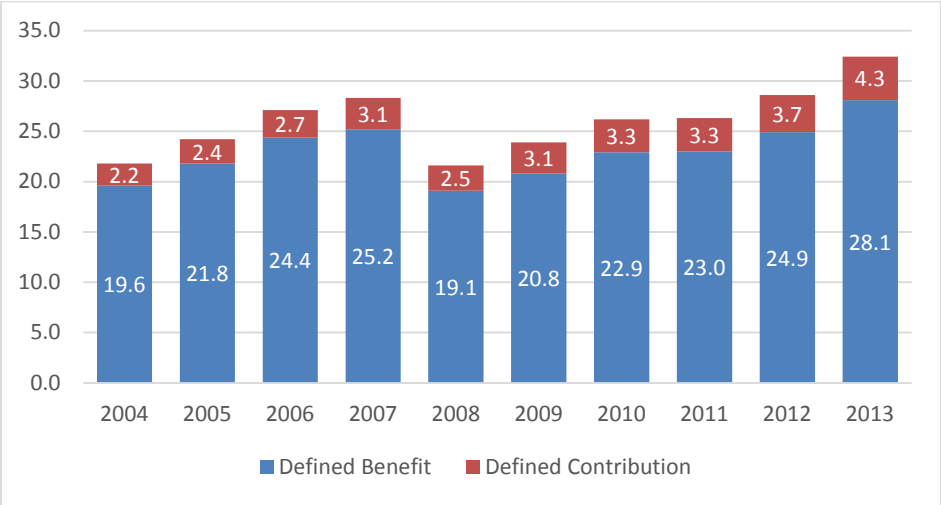
We reviewed URS' financial data for the past ten years, analyzing the periods before and after the economic downturn that occurred in 2008. In this section, we summarize a few of the key metrics that point to URS' stable financial position and recovery from the recent recession. We focused on the change in URS' assets, the funding of accrued liabilities (***funded ratio***), and the investment return assumption.

URS' Assets Have Recently Been Increasing

A decline of assets in 2008 has had a long-term impact on URS' net assets.

Both defined benefit (DB) and defined contribution (DC) assets were severely reduced in 2008 because of the economic recession at that time. Figure 1.4 shows that, although assets declined in 2008 to about $21.6 billion—thus having a long-term impact on net assets—net assets have increased every year since 2008.

Figure 1.4 Historic Total Assets. Since 2008, total assets have increased 50 percent and are currently the highest in the period analyzed.



Reported in billions.
Note: Changes in asset levels include investment returns, contributions, and expenses.
Source: URS Comprehensive Annual Financial Reports, 2004-2013

From 2004 to 2013, total assets reached their highest level in 2013 at $32.4 billion.

From 2004 to 2013, total assets reached their highest level in 2013 at $32.4 billion.

The Recent Economic Recession Had a Long-Term Impact on the Funded Ratio

The funded ratio, the ratio of ***actuarial assets*** to the actuarial accrued liabilities, shows the percent of funding needs being met at a given point in time. The funded ratio is calculated using the actuarial value of assets—which smooths the volatility of the investment returns over five-year periods—so that URS can plan for future funding needs and employers can budget for future contributions. As of December 2013, the funded ratio was 80.2 percent, increasing for the first time in six years.

Figure 1.5 below shows the actuarial values of the assets and liabilities, the difference between the two, and the funded ratio for all defined benefit plans.

Figure 1.5 URS Historic Funded Ratio for DB Plans. The funded ratio increased in 2013 for the first time in the last six years.

Calendar Year	Actuarial Value of Assets	Actuarial Accrued Liability	Difference	Funded Ratio
2004	15,393,467	16,667,893	1,274,426	92.4 %
2005	16,415,381	17,610,596	1,195,215	93.2
2006	18,093,491	18,886,114	792,623	95.8
2007	20,269,043	21,321,332	1,052,289	95.1
2008	**19,857,580**	**22,932,398**	**3,074,818**	**86.6**
2009	**20,818,430**	**24,274,639**	**3,456,209**	**85.8**
2010	**21,131,649**	**25,535,499**	**4,403,850**	**82.8**
2011	**21,117,218**	**26,564,932**	**5,447,714**	**79.5**
2012	**21,370,069**	**27,724,395**	**6,354,326**	**77.1**
2013	23,405,396	29,171,564	5,766,168	80.2

Reported in thousands.
Source: URS CAFRs 2004-2013, Auditor Analysis

As of December 2013, URS' funded ratio was 80.2 percent.

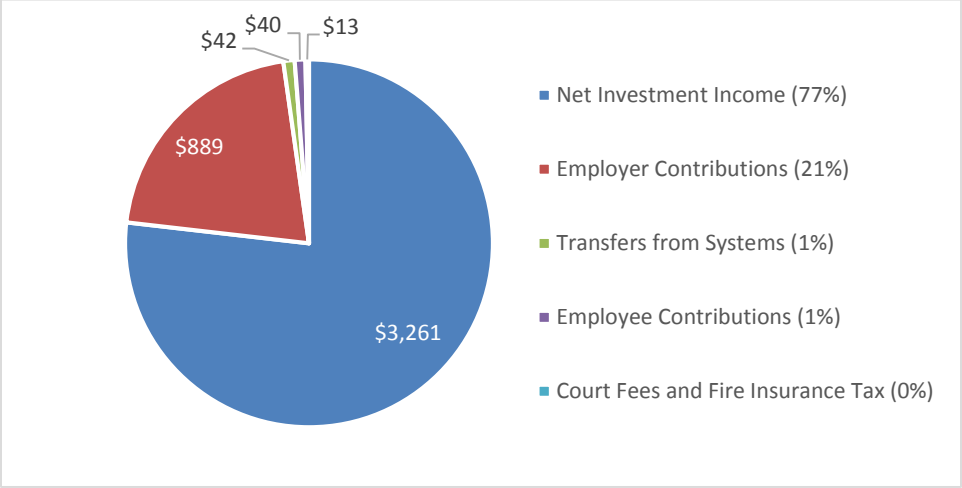
Because of the economic recession of 2008, the funded ratio declined in the four years following 2008 until it increased by 3.1 percent in 2013. Figure 1.5 shows the five-year decrease in the funded ratio beginning in 2008 in bold.

As of December 2013, the funded ratio was 80.2 percent. Industry professionals generally identify 80 percent as a fiscally sound funded ratio though others argue that a funded ratio below 80 percent should not necessarily be characterized as unhealthy, depending on market conditions. In 2012, Utah's funded ratio ranked 18th of all states with a funded ratio of 76.5 percent. The national average at that time was 72.4 percent.

In 2012, URS ranked above the national average of 72.4 percent with a funded ratio of 76.5 percent.

URS Is Primarily Funded by Income from Investments. Figure 1.6 shows the sources of revenue for URS in 2013 that offset accrued liability. These sources were comprised of 77 percent net investment income, 21 percent employer contributions, and 2 percent other sources, such as court fees, fire insurance tax, and transfers from other systems. The total financial increase in 2013 for the DB plans was $4.25 billion.

Figure 1.6 Defined Benefit Plans' Financial Increase in 2013 by Revenue Source. Additions in 2013 totaled $4,245,000,000.



Reported in millions.
Source: URS 2013 CAFR

In 2013, URS total financial gains were comprised of 77 percent net investment income, 21 percent employer contributions, and 2 percent other sources.

URS pools and commingles the funds from each DB system into a common trust fund for investment purposes. Except for the DC plans, 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 State of Utah provided 22 percent of employer contributions or 5 percent of total URS revenue.

Employer Contributions Have Increased. In 2013, employer contributions were $889 million, as shown in Figure 1.6 above. The State of Utah provided 22 percent of the employer contributions, or 5 percent of total revenue.[2] The state's and other employers' contribution rates have increased the last few years to recover the unfunded liability caused by 2008 investment losses. For example, the contribution rate for the state and public school employers in the noncontributory system increased from 13.38 to 20.46 percent in the last ten years. Increases occurred every year since 2010, but are not expected to increase for the State of Utah in FY 2016. Appendix B shows those contribution rates for the past 10 years.

[2] Based on the current year employer contributions.

Investment Return Assumption Has Been Lowered Due to Economic Expectations

URS' investment return assumption, or the rate of return that investments are expected to produce over a long period, is currently 7.5 percent. URS' investment return assumption has been adjusted twice since 2007, as shown in Figure 1.7.

URS' investment return assumption is currently 7.5 percent.

Figure 1.7 URS Historic Rates of Return. The 20-year average market return has exceeded the investment return assumption for the past ten years.

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Investment Return Assumption	8.00	8.00	8.00	8.00	7.75	7.75	7.75	7.50	7.50	7.50
20-Year Average Return	10.5	9.86	9.86	10.0	8.12	7.94	8.45	7.53	7.93	7.79
Difference	**2.50**	**1.86**	**1.86**	**2.01**	**0.37**	**0.19**	**0.70**	**0.03**	**0.43**	**0.29**

Shown as percentages.
Source: URS CAFRs 2004-2013, Auditor Analysis

While economic assumptions are based on the future, Figure 1.7 demonstrates the accuracy in predicting long-term outcomes. Since 2004, the 20-year average return has exceeded the current investment return assumption by an average of 0.56 percent.

Since 2004, the 20-year average return has exceeded the current assumed rate of return by an average of 0.56 percent.

The investment return assumption is recommended to URS by its actuarial firm, Gabriel Roeder Smith & Company (GRS). GRS recommends a rate of return assumption, along with other economic and demographic assumptions, in a triennial actuarial ***experience study***, which is available on URS' website.[3] The investment return assumption and other assumptions recommended in the experience report are adopted after board members individually review them and collectively approve them. Though opinions vary on what is an acceptable investment return assumption, our review of URS' 2013 experience study and other criteria show that URS' current investment return assumption is reasonable.

Our review of URS' 2013 experience study and other criteria show that URS' current investment return assumption is reasonable.

While appropriate measures are taken to predict a suitable investment return assumption, it is still merely a supposition of future returns. However, the adopted investment return assumption directly

[3] This information can be found at https://www.urs.org/. URS also has a dedicated transparency site at http://newsroom.urs.org/.

affects the employer contribution rate and other key indicators, as shown in Appendix C of this report.

Audit Scope and Objectives

The audit was divided into four areas: transparency concerns, asset allocation, fiduciary responsibilities, and investment manager selection and retention processes.

This audit was requested by a legislator who had several questions regarding URS management and investment practices. The scope of the audit was separated into four areas: transparency concerns, investment ***asset allocation***, fiduciary responsibilities, and investment manager selection and retention processes. Figure 1.8 shows the audit areas and lists each question. Figure 1.8 also shows the corresponding chapters in the report in which we responded to the questions.

Figure 1.8 Audit Scope. Audit work was performed in four areas.

Chapter II: Transparency Concerns	Chapter III: Investment Asset Allocation	Chapter IV: Fiduciary Responsibilities	Chapter V: Investment Manager Selection
• Does URS provide adequate information on operational costs to the public? • Is URS transparent in regard to meetings and requests for information?	• Is the current DB asset allocation, specifically alternative investments, reasonable?	• How do URS' operating costs compare to those of similar systems? • Does the URS board have sufficient investment experience? • Is URS advisory staff appropriately qualified and licensed?	• Do the URS DC Plan investment manager selection and retention processes have satisfactory documentation and controls?

The audit team took the following steps to answer the questions for each audit area. In the transparency audit area, we (1) compared URS' transparency website with the State of Utah's transparency website, (2) reviewed statutory requirements for both websites, as well as practices in other public retirement offices, and (3) compared URS' open and public meetings practices and request for information procedures with Utah's Open and Public Meetings Act and Government Records Access and Management Act.

For the investment asset allocation audit area, we (1) analyzed the change in URS' allocation of assets over time, and (2) used a consultant to determine the suitability of URS' asset allocation.

While auditing URS' management of fiduciary responsibilities, we (1) compared URS' operating costs to those of similar agencies, (2) analyzed the legal requirements and proposed structure of the advisory program and staff, and (3) compared the investment experience of URS' board with that of other public retirement boards.

Finally, to determine if the DC investment selection and retention process is adequate, we (1) reviewed the policy, process, and documentation from the recent selection of an investment manager within the DC plan and (2) compared URS' investment selection process to that of similar agencies.

For all areas, we gathered information from other comparable public retirement offices to compare operational costs, practices, and procedures. URS concurred that these are comparable systems. The following list shows the 14 retirement offices that were contacted during the audit:

For all audit areas, we gathered information from other comparable public retirement offices to compare operational costs, practices, and procedures.

- Public Safety Personnel Retirement System (Arizona)
- Arizona State Retirement System
- Fire and Police Pension Association of Colorado
- Colorado Public Employees' Retirement Association
- Public Employee Retirement System of Idaho
- Teachers' Retirement System of Illinois
- Teachers' Retirement System of Louisiana
- Teachers Retirement Association (Minnesota)
- Public Employees' Retirement System of Nevada
- State of New Mexico Educational Retirement Board
- Public Employees Retirement Association of New Mexico
- School Employees Retirement System of Ohio
- Oregon Public Employees Retirement System
- Washington State Department of Retirement Systems

As of 2013, these 14 different systems ranged in membership from 25,049 to 787,911 (retired and active members) and held from $5 billion to $78 billion in assets.

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Chapter II
URS Is Transparent, But Can Take Additional Steps

Our audit team was asked two transparency-related questions. We were asked specifically to determine if the Utah Retirement System (URS) provides adequate information on operational costs to the public, and whether URS is transparent in regard to information practices and meetings. Our review found the following:

- URS is compliant with Senate Bill 59 (2014 General Session), and discloses administrative expense transactions and aggregated employee compensation information on its transparency website. URS' transparency website also provides a wide range of information on operational costs and actuarial reports.
- URS should disclose individual employees' compensation annually on its transparency website. This would bring URS in line with practices in other states' peer retirement systems as well as in Utah state government.
- URS has transparent information-related practices, but additional steps can be taken. URS should designate an information or records officer to manage information requests, establish time limits to respond to information requests, and better notify the public of administrative board meetings.

When URS was created, the Legislature intentionally formed URS as a trust and an independent state agency to protect members and beneficiaries' private financial information and their investments. The Legislature, in Title 49, exempted URS from the Government Records Access and Management Act (GRAMA), the Open and Public Meetings Act, and exempted URS from participating in the state's transparency website (S.B. 59 passed in the 2014 General Session). ***Utah Code*** 49-11-618 states that "all [URS] data in the possession of the office is confidential, and may not be divulged by the office except as permitted by board action."

The Legislature intentionally formed URS as an independent state agency to protect beneficiaries' private financial information and investments.

URS board members "serve as investment trustees of the Utah state retirement fund" and statute gives the URS board the

URS board members "serve as investment trustees of the Utah state retirement fund."

responsibility to approve the sharing of URS data and information. This position has been supported by the courts[4] and the Office of the Attorney General.[5] However, URS strives to meet the public's expectation of transparency. This chapter compares current URS' transparency practices, as authorized by the URS board, with current practices of governmental entities in Utah and peer retirement systems in other states.

URS' Transparency Website Provides Detailed Information on Operating Costs

The audit team was asked to determine whether URS provides adequate information on operational costs to the public.

The audit team was asked to determine if URS provides adequate information on operational costs to the public. While URS has made a considerable effort to be more transparent by placing more detailed financial information on its website, The URS Newsroom (http://newsroom.urs.org), our review found the following:

URS is compliant with Senate Bill 59 (2014 General Session), disclosing administrative costs.

- URS' transparency website is compliant with Senate Bill 59, passed in the 2014 General Session; the bill requires URS to disclose administrative expense transactions and aggregated employee compensation information by department on its transparency website. The website also provides a wide range of information on operational costs, including actuarial reports.
- URS' Comprehensive Annual Financial Reports (CAFRs) also help to promote transparency and provide a complete set of financial statements.
- URS is exempt from the state's transparency website requirement. However, URS reports individual administrative expense transactions on its website in a format that is similar to

[4] Hansen v. Utah State Retirement Board (1982). "The various funds are administered as a common trust fund . . . solely for the benefit of the beneficiaries and not for the public at large."

Ellis v. Utah State Retirement Board (1988). "The Open and Public Meetings Act is not applicable to the Retirement Board . . . the Board is not vested with authority to make decisions regarding the public's business."

[5] Office of the Attorney General, Formal Opinion No.78-007. "The principal functions of the Retirement Board are to manage and invest these monies and to increase the Fund thereby, for the benefit of the beneficiaries."

the state's website. URS' employee compensation is summarized by department on its website. This is different from the state's website, which discloses employee compensation by department and by individual employee.

URS' Website Is Compliant with Senate Bill 59

In the 2014 General Session, S.B. 59 was passed into law, amending Utah state retirement laws and requiring URS to provide the following financial information for the public on its website:

- Administrative expense transactions from its general ledger accounting system
- Aggregated employee compensation information by department

URS is required by statute to report administrative expense transactions and aggregated employee compensation on its transparency website, The URS Newsroom.

As of September 2014, URS added all of its administrative expenses and aggregate compensation data under the Public Financial Information section of the transparency website, The URS Newsroom. Administrative expenses are updated quarterly and include year-to-date totals. The expenses are summarized by department and by expense category and are individually listed as well.

The URS' public financial information webpage is only required to report compensation, salaries, and employer-paid benefit totals by department. The compensation data is added quarterly and shows year-to-date totals for the current fiscal year. Later in the chapter, we recommend that URS take an additional step and voluntarily report compensation by individual employee, even though this is not required by S.B. 59.

The URS Newsroom website was developed to provide information about URS operations to policymakers, the media, and the public. The website has a section dedicated to providing the public with a wide range of information on operational costs about the retirement office beyond what is required in S.B. 59, including financial reports, actuarial reports, and contribution rates. URS is not required to report individual revenue transactions on its website, due to the confidential and proprietary revenue sources from investment income. However, financial reports show aggregated sources of revenue from investment income and employer contributions.

The URS Newsroom website was developed to provide information about URS operations to policymakers, the media, and the public.

URS' CAFRs Help to Promote Transparency

Both current and past URS Comprehensive Annual Financial Reports (CAFRs) are disclosed on URS' website.

Both current and past Comprehensive Annual Financial Reports (CAFRs) are disclosed on URS' website. The CAFRs contain a complete set of financial statements. In addition, the CAFRs provide information on the ***defined benefits'*** [6] investments, ***defined contribution*** plans' investments, and actuarial and statistical summaries.

The 2013 CAFR and all subsequent CAFRS will contain the new financial reporting requirements (GASB 67 and 68) that improve transparency.

The 2013 CAFR and all subsequent CAFRs will contain the new financial reporting requirements that improve transparency. The Governmental Accounting Standards Board (GASB) issued statements numbered 67 and 68 in June 2012 to improve financial reporting and transparency. Those statements have many requirements, such as requiring public pension plans to show net pension liabilities for all individual employers. URS presented the supplementary financial information that GASB 67 and 68 require in their 2013 CAFR, even though URS was not required to disclose GASB 67 information until the 2014 CAFR, and GASB 68 information until the 2015 CAFR. Additionally, URS provided information beyond what GASB required to assist employers in their pension reporting obligations, such as the employers' proportionate share of the plan pension expense.

URS Discloses Similar Data, Even Though Exempt from State's Transparency Website

Senate Bill 59 (2014 General Session) exempts URS from participating in the state's transparency website, because URS has developed its own website.

S.B. 59 exempts URS from the state's transparency website requirement, but URS reports individual administrative expense transactions in a way that is similar to the state's website. However, URS' employee compensation is only summarized by department and not reported in detail like the state's website.

The Utah Public Finance Website (UPFW), http://transparent.utah.gov, was created by ***Utah Code*** 63A-3-402 in the 2008 General Session. The Utah Transparency Advisory Board and the Division of Finance oversee the operations of the transparency website. The purpose of the website is to provide public access to state and local government financial information.

[6] Because of the technical nature of this subject matter, this report contains highlighted words that are defined in the report's glossary in Appendix E.

The participating entities are defined by statute (***Utah Code*** 63A-3-401) and include state and local entities. S.B. 59 also amended the transparency law requiring certain independent entities (as defined under Utah law) to provide data to the UPFW beginning with the first full quarter after July 1, 2014. S.B. 59 exempted the Utah State Retirement Office from reporting financial information to the UPFW because URS was developing its own transparency website.

The Transparency Advisory Board has directed that the UPFW be updated at least quarterly for expense and revenue data, and annually for employee compensation data. The State of Utah and some local entities update the data monthly. The information reflects raw data posted at a transaction level. The data is unaudited and presented in a rudimentary, unconsolidated format.

URS' Disclosure of Administrative Expense Data Generally Follows the UPFW's Format. URS updates administrative expense data quarterly on its website and shows year-to-date totals for the current fiscal year. The information is raw data posted at a transaction level similar to UPFW. Some of URS' expenditure data is considered private or protected under state and federal laws, contracts, and non-disclosure agreements. If a payee is private or protected, the vendor name is not displayed, similar to the UPFW.

Similar to the state's website, URS updates administrative expense data quarterly on its website.

URS' Disclosure of Compensation Data Differs from UPFW's Format. The state's transparency website shows detailed employee compensation transaction information, payroll, and total employer-paid benefits for each fiscal year for each employee. URS' public financial information webpage reports annual compensation aggregated by department. However, the next section of the chapter shows it is a common practice to report employee compensation individually and URS should consider adopting this practice.

The state's transparency website shows employee compensation in detail; URS reports employee compensation aggregated by department.

URS Should Be More Transparent Regarding Employee Compensation

URS should disclose individual employees' compensation annually on its transparency website. Most of the peer retirement systems surveyed in other states, 10 of 11 systems, disclose employees' compensation. Many governmental agencies throughout the nation,

URS should disclose individual employees' compensation on its transparency website.

including retirement systems, are making more financial information available to the public. In addition, the trend in Utah is for all state agencies and certain[7] independent state agencies to disclose individual employee compensation data.

In general, transparency helps to promote accountability, public confidence, and participation by stakeholders.

In general, transparency helps to promote accountability, public confidence, informed participation by stakeholders, and acts as a check against the possibility of mismanagement. However, there are also specific challenges in disclosing employee compensation to the public. For example, URS reports that public disclosure helps other entities recruit URS' experienced investment staff. This situation is not unique to URS, as other governmental agencies must deal with recruiting challenges.

Most Surveyed Peer Retirement Systems Provide Employee Compensation Data

As part of the audit, we contacted peer retirement systems in other states to determine if they disclose employee compensation data to the public. The survey found that 10 of the 11 retirement systems are required to report individual employee compensation each year. Figure 2.1 shows each of the 11 retirement systems surveyed.

[7] S.B. 59 requires all independent state agencies to report financial information to UPFW, with the exception of URS and Workers' Compensation Fund. Also, at the policy level, the Transparency Advisory Board exempts independent state agencies from reporting financial information to UPFW if both revenues and expenses are less than $1 million.

Figure 2.1 Survey of Disclosing Compensation in Other States. Six of the retirement systems surveyed are state agencies and five are independent agencies.

Retirement System	Type of Agency	Is Employee Compensation Public Information?
Arizona Public Safety	State	Yes
Arizona SRS	State	Yes
Louisiana Teacher's RS	State	Yes
New Mexico PERA	State	Yes
Idaho PERS	State	Yes
Oregon PERS	State	Yes*
Illinois Teacher's RA	Independent	Yes
Minnesota Teacher's RA	Independent	Yes
Nevada PERS	Independent	Yes
Colorado PERA	Independent	No
Ohio School Employee RS	Independent	Yes**

**Oregon PERS provides employee compensation information except for investment staff because investment services are contracted through a different entity.*
***Ohio School Employee Retirement System lists employee compensation by position.*

A survey found that 10 of the 11 peer retirement systems are required to report individual employee compensation.

Figure 2.1 shows that of the group surveyed only Colorado PERA does not disclose employee compensation information to the public. The Ohio School Employee Retirement System provides compensation information, but it is posted by position rather than the names of individual employees.

The retirement systems in other states also provide financial data available to the public, such as financial reports and actuarial reports. Governmental entities and related governmental entities throughout the nation continue to discuss transparency and many entities, including public retirement systems, are making more financial information available to the public.

Many entities, including public retirement systems, are making more financial information available to the public.

Competitive Compensation Should Help Ease Investment Staffing Challenges

URS reports that the recruitment and retention of investment staff is a challenging issue. As a public entity, URS is concerned about retaining experienced investment professionals in the competitive labor markets. URS provides aggregate employee compensation for all departments on its transparency website, primarily to avoid disclosing individual investment staff compensation. URS is concerned that, if individual investment employee compensation is made public, it will be more difficult to compete with private sector job offers. Last year,

URS reports that recruitment and retention of investment staff is a challenging issue.

URS lost two experienced investment employees to other private investment entities.

Investment staff need a diverse set of specialized skills to handle highly complex investments.

URS states that it needs experienced decision-making investment staff to be responsible for highly complex investments. The operations performed by the Investment Department require a diverse set of specialized skills, such as valuation and pricing and legal investment banking issues. The investment staff must analyze and make specific recommendations regarding sophisticated investments and markets. URS says it is difficult to find individuals with the diverse combination of skills required to perform all of the responsibilities. A recent compensation study showed that in general URS staff compensation (salary and benefits) is slightly above market, but investment staff are a little below market. Competitive compensation should help URS deal with this challenge.

Recent Study Shows that URS Staff Compensation Is Competitive Within the Market. In 2014, URS engaged CBIZ Human Capital Services (CBIZ) to conduct a comprehensive compensation study for all staff. CBIZ compared position to position within the public pension market and the private sector.

URS staff's total compensation is 14.5 percent above market; however, investment staff's total compensation is 7.1 percent below market.

When CBIZ compared URS' total compensation package (salary and benefits) for all staff to the market, the study showed that URS staff's total compensation is 14.5 percent above the market. When URS staff salaries (excluding benefits) were compared in the study; URS staff were 3.9 percent lower than the market average.

CBIZ Study Shows that Investment Staff Compensation Is Not as Competitive Within the Market. The CBIZ study compared URS investment staff total compensation (salary and benefits) to other public pension funds. It is important to note that many of those public pension funds give bonuses to investment staff. The URS investment staff does not receive bonuses. The CBIZ study shows that URS investment staff's total compensation is 7.1 percent below other public pension plans. When URS investment staff's salaries (excluding benefits) are compared in the study, they are 14.1 percent below other public pension plan salaries (which may include bonuses). URS should review investment staff compensation to ensure that URS is competitive. Being competitive can help URS with recruitment and retention challenges—specifically, needed investment professionals who have specialized skills to work in a highly complex field.

Competitive compensation could help URS better retain skilled investment staff.

Further Steps Can Be Taken to Improve URS' Information Practices

URS is striving to achieve a balance between transparency and protecting members' private information. We were asked to determine if URS is transparent regarding access to information and board meetings. The audit work found that:

We were asked to determine if URS is transparent regarding access to information and board meetings.

- URS' information request process has similarities to Government Records Access and Management Act's (GRAMA's) process. URS has defined, in detail, information access—who has access and what information can be obtained—through board resolutions. URS also has a comprehensive appeals process outlined in statute for URS and PEHP disputes.

- URS can improve its information request process by designating an information or records officer and establishing time limits in policy to respond to information requests.

- URS opened administrative board meetings to the public beginning October 2013 and began posting board meeting minutes on its website The URS Newsroom. However, URS can be more transparent by providing better notice to the public for the administrative board meetings.

URS has made efforts to implement transparency practices that are similar to the practices required by the GRAMA and the state's Open and Public Meeting Act, even though URS is exempt from those acts.

URS has made efforts to implement transparency practices that are similar to GRAMA and the Open and Public Meetings Act.

URS Information Process Is Similar to GRAMA

Utah Code 49-11-618 addresses URS' ability to provide information. The statute states that all data in the possession of URS is confidential and may not be divulged by URS except as permitted by board action. URS, through board resolutions, has a formalized framework for outside access to URS-related information and has an appeals process similar to GRAMA's. In comparison, GRAMA defines what a record is and establishes the criteria for accessing government records for Utah's governmental entities. GRAMA also provides for fees to cover the costs to governmental entities incurred by providing a record. The executive director has the authority, by board resolution, to approve the fee schedule for the cost of providing information.

URS has a formalized framework, adopted through board resolution, governing access to URS information.

Board Resolution Provides Specific Details of Who May Access Information and What Information Can Be Obtained from URS. The URS board has adopted resolutions, the most recent being the April 2013 board resolution (#2013-03) regarding the rules governing access to URS defined benefit and defined contribution information.

The resolution provides specific details of who has access and what information can be obtained. For example:

URS members, beneficiaries, and other people, including the general public, have access to specific URS information.

- Members can have access to their own defined benefit and defined contribution account information
- Participating employers shall have access to their own information and to information necessary to administer the systems, plans, and programs
- Beneficiaries have access to the amount of a benefit at the time the benefit is payable
- General public has access to annual reports, publications designated for general release, and general benefit information

In addition to these groups, the resolution specifies other people and entities (including the Legislature) that can obtain specific information as it pertains to their position and responsibilities. The resolution classifies the type of information different people or entities can access.

URS Has a Formalized Appeals Process. Like GRAMA, URS has a formalized appeals process, outlined in ***Utah Code*** 49-11-613. If a request for information is denied or an individual disputes a benefit, right, or obligation, that person can proceed with the appeals process. A person has the right to request a ruling in the following order:

URS has a formalized appeals process outlined in statute.

1. The executive director of URS
2. A hearing officer
3. The URS board
4. Judicial review

At each level in the appeals process, an individual dissatisfied with a ruling can appeal to the next level. While URS has a framework to process information requests by defining access and an appeals process, URS can improve the process.

URS Should Improve Its Information Request Process

We believe that URS can implement two practices that would better align its information request process with GRAMA requirements. URS should designate an information or records officer, and should establish in policy time limits to respond to an information request.

URS should designate an information or records officer to handle information requests.

URS Should Designate an Employee to Handle Information and Records Officer Responsibilities. During our audit work, we learned that URS does not have a specific employee who handles information requests. URS should consider designating an information or records officer to provide a clear initial point of contact for information requests. Having a designated officer will help ensure that information requests are handled and documented appropriately and consistently. In addition, URS should consider developing an information request form for the requestor to complete (similar to that used by other state governmental entities) to help the officer manage information requests.

Having an information or records officer will help ensure that URS' information requests are documented appropriately and consistently.

Employing a records officer is a common practice. In Utah, according to GRAMA, all governmental entities should have a records officer. The records officer should have the responsibility to handle the requests within appropriate timeframes.

We contacted 11 peer retirement systems in other states and found that all have either an information officer or records officer to manage information requests. Our survey of other states found:

All 11 peer retirement systems we contacted have an information officer or records officer.

- Six peer systems have a part-time officer
- Four peer systems have a full-time officer
- One peer system has an external officer

All contacted peer systems have a formalized process for information requests, set by statute or internal policy.

URS Should Establish Time Limits to Respond to a Request. According to GRAMA, a governmental entity receiving a request for a record has 10 business days to respond to the request. If the requester demonstrates that expedited response benefits the public, the entity has five business days to respond. URS does not currently have a

URS does not have a policy stating time frames to respond to information requests.

policy with a time limit to respond to a request of information, and should establish such a policy to align with GRAMA.

URS Can Provide More Notice For Administrative Meetings

URS opened its administrative board meetings to the public as of October 2013.

URS opened its administrative board meetings to the public as of October 2013. At that time, URS also began posting board meeting minutes on its website, The URS Newsroom. Administrative board meetings are usually held once a month. The URS board also holds a monthly investment board meeting, but those meetings are closed to the public because of the propriety investment information discussed in those meetings.

Although exempt from the Open and Public Meetings Act, URS should consider posting notices of public meetings following statutory guidelines.

While URS has made an effort to be more transparent regarding administrative board meetings, URS could consider taking a few additional steps to provide the public better notice of administrative board meetings. URS is exempt from ***Utah Code*** 52-4, the Open and Public Meetings Act, but should consider posting notices in the following ways:

- At its principal office, which is also the usual location where administrative board meetings are held
- On the *Utah Public Notice Website*
- In at least one newspaper of general circulation within the geographic jurisdiction of URS

Implementing these steps will provide more public notice of the administrative board meetings. It will also help align URS' practices with the state's Open and Public Meetings Act.

The URS Membership Council has statutory authority to make recommendations to the URS board, but it is not a decision-making body.

The Membership Council's Meetings Are Not Public. URS' membership council is composed of 13 council members representing all groups of members at URS, including school and public employees, municipal and county officers, retirees, judges, public safety officers, and firefighters. The URS membership council has the statutory authority to make recommendations to the board on policy and administration related to benefits and URS members, but it is not a decision-making body.

If URS were required to comply with the Open and Public Meetings Act, the membership council would still be an exempt body. The act defines a public body "as a body that is vested with the

authority to make decisions." The membership council does not have the authority to make decisions, only recommendations. Given the statutory language, there is not strong criteria to suggest that the membership council should hold public meetings.

Regarding the recommendations in this chapter, we recognize that the Legislature has the authority to require URS to comply with transparency laws, GRAMA, and the Open and Public Meetings Act. However, the following recommendations are written recognizing that URS is an independent state agency and a legal trust. Even though URS is exempt from certain laws, the following recommendations are intended for URS to proactively align transparency practices with the practices required by state agencies and peer retirement systems in other states.

Recommendations

1. We recommend that URS disclose all employees' compensation annually on its transparency website.

2. We recommend that URS designate an information or records officer to manage information requests.

3. We recommend that URS establish in policy time limits to respond to information requests.

4. We recommend that URS provide adequate public notice for administrative board meetings.

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Chapter III
URS Should Consider Reviewing Its High Alternative Asset Allocation

We were asked to determine whether the current URS Defined Benefit (DB) Plan's ***asset allocation***[8] is appropriate. URS' percentage allocation to ***alternative investments*** (***private equity***, ***hedge funds***, and ***real assets***) has grown in the last decade and is now significantly larger than the alternative investment allocation of most state pension systems. The current allocation to alternative assets was selected to mitigate loss during economic downturns. Our investment consultant recommends that URS consider gradually reducing investments in alternative assets over time because URS has lost some positive investment returns in recent years, and he believes that positive ***equity markets*** are more likely to occur. URS should consider its high alternative asset allocation compared to peer retirement systems, anticipated market conditions, and our consultant's concerns as it reviews its defined benefit asset allocation.

We were asked to determine whether URS Defined Benefit (DB) Plan's asset allocation is appropriate.

URS' Asset Allocation Has Shifted Substantially to Alternative Investments

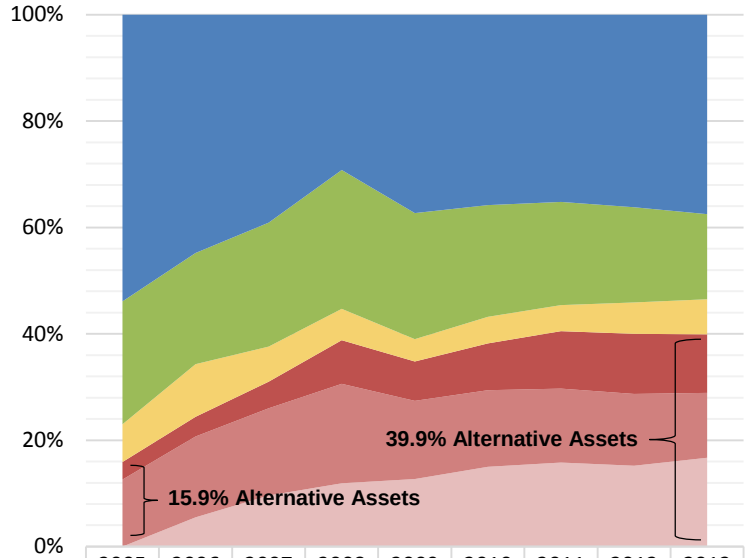
Beginning in 2005, the URS board began to make a significant change in the asset allocation of its ***defined benefit*** (DB) portfolio. Namely, the board approved both an increase in private equity investments and the introduction of hedge funds[9] to the asset mix. Figure 3.1 shows how URS' percentage allocation to alternative assets, which is the sum of private equity, hedge funds, and real assets (all three shown in shades of red) increased from 2005 to 2013.

Beginning in 2005, the URS board increased investments in alternative assets like private equity and hedge funds.

[8] Because of the technical nature of this subject matter, this report contains highlighted words that are defined in the report's glossary in Appendix E.

[9] These investments are classified as **absolute return** in the URS Comprehensive Annual Financial Reports (CAFRs). URS policy defines these as "Investment strategies whose objective is to earn a positive rate of return that does not depend on the return of standard market indexes. Typically these strategies are implemented by privately organized investment vehicles, commonly referred to as Hedge Funds."

Figure 3.1 Asset Allocation for the Defined Benefit Plan. The DB plan allocation to alternative investment has grown from 16 percent in 2005 to 40 percent in 2013.



	2005	2006	2007	2008	2009	2010	2011	2012	2013
Equities Securities	53.9%	44.8%	39.1%	29.2%	37.3%	35.8%	35.2%	36.2%	37.5%
Debt Securities	23.1%	20.9%	23.3%	26.1%	23.7%	21.0%	19.4%	17.9%	16.0%
Short-term Securities	7.1%	9.9%	6.6%	5.9%	4.2%	5.0%	4.9%	5.9%	6.6%
Private Equity	3.3%	3.7%	5.0%	8.2%	7.4%	8.8%	10.8%	11.3%	11.0%
Real Assets	12.6%	15.2%	16.4%	18.7%	14.7%	14.4%	13.9%	13.5%	12.2%
Hedge Funds	0.0%	5.5%	9.6%	11.9%	12.7%	15.0%	15.8%	15.2%	16.7%

Source: URS Comprehensive Annual Financial Reports (CAFRs)

From 2005 to 2013, alternative assets grew from 15.9 percent to 39.9 percent of total URS DB assets.

Figure 3.1 shows that URS' allocation to alternative assets more than doubled from 16 percent to 40 percent from 2005 to 2013. This shift to alternatives reduced equities and ***debt securities***. While the allocation to real assets remained relatively static over this period, hedge funds were introduced in 2006 and grew to 16.7 percent of assets by 2013. Private equity investments increased from 3.3 percent to 11 percent. By year-end 2013, alternative investments represented 39.9 percent of URS' DB assets.

Hedge funds represent the largest portion of the recent growth in alternative assets.

URS' Current Asset Allocation Was Established to Mitigate Losses During Economic Downturns

The purpose of alternative assets is to mitigate loss during negative equity markets.

URS' primary objectives for its current investment portfolio are to protect investment capital as much as possible in negative equity markets, reduce return volatility, and increase investment

diversification. As URS' chief investment officer stated in the 2013 URS CAFR,

> …[W]e expect markets going forward to be volatile. We will continue to be patient in this risky environment. We have built a portfolio to not give back in down markets all we have earned in up markets.…We believe that it is the best model to meet the long-term obligations of the Systems and protect the participants' benefits.

URS believes its current asset allocation best meets long-term program needs.

URS recognizes that its strategy may not generate the highest returns possible in positive equity markets and that it will likely not be the top-performing pension plan among its peers in terms of investment rate of return. URS feels that a high-performing plan may be taking too much risk and will likely be a low-performing plan in some market periods. URS' goal is to achieve consistently good returns and avoid large market losses.

URS Board Approves Asset Allocation Based on Recommendations

The URS board has the legal duty and authority to approve an investment strategy from many potential strategy options. Recommendations pertaining to asset allocation are made to the board by the URS Investment Committee which is comprised of URS management, senior investment staff, compliance officer and legal counsel. The board, acting as investment trustees of the Utah State Retirement Investment Fund, approves the asset allocation it believes will maintain the retirement plans and programs on a financially and actuarially sound basis.

The URS board makes the final decision regarding the asset allocation.

Once the board has approved an asset allocation, the duty to execute the strategy falls to the URS director and, by extension, URS staff. To this end, the URS investment portfolio is maintained and analyzed on an ongoing basis by URS management and staff, who seek and make investments, monitor portfolio risk and return, rebalance assets within the board's allocation parameters, and regularly report investment details and market analysis to the board. The investment committee mentioned above regularly reviews and approves actions affecting the URS investment portfolio.

URS' executive director has the duty and authority to execute the investment strategy approved by the URS board.

Given the ongoing relationship between the board and URS staff, conversations about URS' long-term strategy are frequent and

ongoing. URS' chief investment officer explained that URS' current investment strategy is based on current and anticipated market conditions. Because of the active monitoring and ongoing reporting to the URS board, the chief investment officer stated that, if any major market factors deviate from expectations over time, the board and URS staff have the ability to work together to adjust strategy accordingly.

URS' Investment Consultant Supports Current Asset Allocation

Analysis by URS' primary investment consultant (Callan) has resulted in the board reaffirming the current strategy.

Callan Associates (Callan) serves as the primary investment consultant for URS' DB portfolio. As part of its duties, Callan provides full asset allocation and liability studies every three to five years. The most recent study, in 2013, resulted in the board reaffirming the URS strategy as efficient and reasonable relative to URS risk tolerance and long-term liabilities. A memo from Callan to URS, dated March 2015, states that Callan is still of the opinion that the current asset allocation "represents a reasonable and well thought out investment program intended to meet the ***assumed rate of return***…."

In addition to its opinion on the overall investment return potential, Callan reports contain other indicators that support current allocation objectives. The URS portfolio is low risk compared to the Callan peer group, which is comprised of pension funds with assets over $10 billion. Specifically, the volatility of the URS portfolio, as measured by the standard deviation (dispersion) of its investment returns, ranks as one of the lowest among the peer group.

Callan investment return analysis shows that the URS portfolio compares favorably to peers in terms of volatility and risk-adjusted returns.

Callan reports show that the URS portfolio's risk-adjusted returns in recent years, as measured by the ***Sharpe Ratio***, are very good compared to Callan's peers. The Sharpe Ratio is commonly used in the investment industry to compare risk-adjusted returns among portfolios. Finally, the URS average investment returns over rolling 10-year periods are at or above the median of the Callan peer group for each of the 10-year periods over the last 10 years. Using rolling 10-year periods allows stakeholders to see investment performance over a market cycle, which contains a wide variety of market environments and risks.

The references and indicators listed above show URS' investment consultant's support of URS' strategy based on long-term market projects. It is also important to note that, in the 2013 study completed by Callan, the short-term investment return over a 10-year horizon was not expected to achieve the actuarially required 7.5 percent rate of return unless a more aggressive portfolio was selected. However, the same study indicated that, if the current asset allocation were to be applied to a 30-year horizon, the URS portfolio return would be projected to achieve the 7.5 percent return.

URS has a high funded ratio compared to peers but may need to consider a more aggressive investment strategy to increase short-term returns.

As of year-end 2013, URS' ***funded ratio*** was 80.2 percent (a high ratio compared to peers). According to URS' consulting actuaries, if URS' investment returns are consistently 7.5 percent each year, it will take about 20 years for URS to be 100 percent funded. URS may need to be more aggressive and consider reducing alternative assets to meet both the short-term and long-term horizons as it works toward being fully funded. In addition to URS' investment consultant's perspective, we hired an investment consultant to review URS' asset allocation. Our consultant provided a different perspective that is discussed in the next section of the report.

OLAG's Consultant Recommends that URS Consider Reducing Alternative Assets

We hired a consultant, Chris Tobe, to report on URS' investment performance. The consultant believes that URS should consider reducing investments in alternative assets gradually over time. The consultant reached this conclusion from his study (see consultant's report in Appendix A) showing the following:

Our consultant believes URS should consider reducing investments in alternative assets over time.

- URS' performance is about average compared to peers.
- URS holds more alternative assets and hedge funds than its peers.
- URS would have more assets today if the system had maintained its 2004 asset allocation.

The consultant's report is a compilation of publicly available data from URS and other public pension plans around the country. It includes a comparison of URS and other public pension plans, an expert opinion on underlying issues in URS' investment performance, and recommendations for future oversight by the Utah Legislature. To

URS' credit, the consultant ranks URS' funded ratio as "one of the best in the country."

URS' Performance Is About Average Compared to Peers

URS' investment performance is about average compared to peer groups.

The consultant used two types of comparison groups in his analysis. The first is a group of 10 peers selected from the peer retirement systems listed in Chapter I of this report. The second type of group is called a universe, or large group of public pension plans valued at over $1 billion. The consultant compared URS to three peer universes and the OLAG peer group across one-year, three-year, five-year, and ten-year time periods, as shown in Figure 3.2.

Figure 3.2 URS and Peer Group Market Performance. Groups are arranged in order of ten-year performance. The ending year for each period is fiscal year 2014.

	1-Year	3-Year	5-Year	10-Year
Peer Universe: BNY Mellon	17.13%	10.20%	13.12%	7.65%
Utah Retirement Systems	**15.55%**	**10.21%**	**12.10%**	**7.52%**
Peer Universe: TUCS	17.44%	10.01%	12.83%	7.43%
OLAG Peer Group	16.92%	9.81%	12.85%	7.42%
Peer Universe: InvestorForce	16.40%	9.60%	12.70%	7.20%

Source: Appendix A

Figure 3.2 shows that URS had the lowest return of any group in the one-year and five-year periods. However, URS had the highest return in the three-year period, and the second highest in the ten-year period.

URS Holds More Hedge Funds than Peers

Compared to 95 other state pension systems, URS has a significantly higher allocation to alternative assets.

According to our consultant, the driver of investment performance in the public plans studied in Figure 3.2 is the allocation to alternative assets versus the amount of US stock. In its 2014 Report on State Pension Asset Allocation and Performance, Cliffwater LLC showed that, since 2006, most state pension systems have been moving assets into alternative categories. The report stated that, among 95 state pension systems, the average percentage allocation to alternative assets grew from 10 percent in 2006 to 25 percent in 2013. Figure 3.3 shows how URS' 40 percent allocation to alternative assets compared to other pension systems in the Cliffwater report.

Figure 3.3 URS' Alternative Asset Allocation Compared to a Group of Peer Programs. URS' 40 percent allocation to alternative assets is significantly higher compared to the median of 22 percent.

URS	Cliffwater Report		
40%	*25th Percentile*	*Median*	*75th Percentile*
	31%	22%	15%

Sources: URS 2013 CAFR, Cliffwater LLC 2014 Report on State Pension Asset Allocation and Performance

In 2013, URS had one of the largest allocations to alternative assets at 40 percent, higher than the top quartile of systems (31 percent). In fact, URS is near the top 10 percent of the 95 pension systems included in the Cliffwater report.

The same study found that Utah has an especially high allocation to hedge funds. In 2013, URS had 42 percent of its alternative assets allocated to hedge funds, whereas other systems dedicated an average of 17 percent of their alternative assets to hedge funds. Furthermore, as shown in the figure titled *Current Asset Allocation Drivers, FY 2014* on page 64 of our Appendix A, URS has a higher percentage of funds directed to hedge funds than any other system in the OLAG peer group.

As a portion of total alternative assets, URS has an especially high allocation to hedge funds relative to peers.

In our consultant's report, he also highlighted varied philosophies of public retirement programs regarding hedge fund investments. In September 2014, the California Public Employees' Retirement System (CalPERS), one of the largest public pension systems in the United States, announced that it would eliminate its hedge fund portfolio worth over $4 billion. However, other public retirement plans, including Pennsylvania, New Jersey, and Texas Teachers, have publicly stated that they will maintain their hedge fund allocations.

URS Would Have More Assets Today if It Had Maintained Its 2004 Asset Allocation

Though URS currently has 40 percent of assets dedicated to alternative investments, that allocation was 13 percent in 2004. At that time, URS did not hold any hedge funds. Our consultant built a model showing what URS' present position would be if it had kept asset allocation constant since 2004. The analysis showed that the 2004 allocation, with no hedge funds and fewer alternative investments, performed better than the current URS allocation. URS

A model of URS investments performed better than URS by maintaining the 2004 asset allocation.

theoretically would have had $1.35 billion in additional assets, as shown in the figure titled *URS Allocation vs. 2004 Model Allocation, Model Savings* on page 67 of the Appendix A.

It should be noted that an analysis of this nature can produce varied results, depending on the time frame selected for examination. We acknowledge that the model described above reflects a hindsight perspective, which highlights and emphasizes an asset class that has performed well during the measurement period. Nonetheless, we feel that the analysis from a recognized expert is valuable in comparing the two asset allocations.

The Consultant Recommended that URS Consider Reducing Investment in Alternative Assets

Our consultant believes that risks start to gradually outweigh benefits when an allocation to alternative investments exceeds 20 percent.

According to the consultant, URS' current allocation outperforms peers in negative equity markets and underperforms in positive equity markets. When alternative investments exceed 20 percent of the total portfolio, he believes that risks gradually start to outweigh diversification benefits. Therefore, the consultant recommends that URS consider reducing its allocation of 40 percent in alternatives over time to be more in line with the allocation selected by peers described in the report, especially when considering investment in hedge funds.

Furthermore, it is the consultant's opinion that a significant amount of the alternative underperformance in the last five years has resulted from the high fees associated with these investments. Fees result in a significant drag on the overall performance of alternative investments. More information on the fees associated with alternative investments can be found in Chapter IV of this report.

URS has the responsibility to meet its current and future obligations to members and beneficiaries. We recognize that URS' objective and fiduciary obligation is to meet the assumed rate of return, with the lowest amount of risk possible. URS has a conservative asset allocation designed not to be a top performer, but to reduce loss during negative equity markets. Market losses can have a significant negative impact on long-term compounded investment returns.

We also recognize that URS has been performing about average compared to peer systems and has experienced a 10-year return of 7.52 percent (meeting their assumed rate of return of 7.5 percent). However, URS should consider the concerns raised by our consultant, including URS' high alternative asset allocation compared to peer retirement systems, along with anticipated market conditions. Our consultant believes that over the long horizon URS will experience more strong equity markets than negative equity markets. URS should review the asset allocation to determine if it is too conservative and focuses too much on mitigating loss during periods of negative equity markets.

URS should consider risks and anticipated market conditions to determine whether its strategy focuses too much on mitigating loss in down markets.

Recommendation

1. We recommend that URS consider our investment consultant's concerns and anticipated market conditions as URS makes future asset allocation adjustments.

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Chapter IV
URS Board and Staff Are Qualified to Perform Fiduciary Responsibilities

Our audit team was asked to determine if URS sufficiently meets its fiduciary responsibilities to its members. Specifically, we were asked to review URS' operating costs and compare its costs to the costs of similar retirement systems. The analysis showed that URS' operating costs, though high, are well managed. Most of URS' operating costs consist of investment fees, which are driving the trend of increasing operating costs.

Secondly, we were asked to determine if the URS board has sufficient investment experience. We found that the board's members have more investment experience than other retirement boards within a peer group comparison, and believe that the URS board has sufficient investment expertise.

Finally, we were asked to determine if the URS advisory staff are appropriately qualified to provide advisory services. The advisory staff at URS have adequate education and training—including the completion of a qualifying exam—to fulfill their advisory responsibilities.

URS Operating Costs Are Well Managed But Investment Fees Are Driving Costs Higher

As part of a review of URS' fiduciary responsibilities, the audit team was asked to compare operating costs to other similarly sized public employee retirement systems. Operating costs are divided into two categories: investment and administrative. Most of URS' operating costs consist of investment fees, which are driving the trend of increasing operating costs. This increase has occurred because URS

Most of URS' operating costs consist of investment fees, which are driving the trend of increasing operating costs.

changed its DB ***asset allocation***[10], assigning a higher percentage of the assets in ***alternative investments***.[11]

URS has high investment costs compared to similar public retirement systems because of its investment strategy. However, URS is controlling its fees given its expensive investments. A recent study of public retirement systems by CEM Benchmarking estimated that URS' assertive management practices ensured proportionately lower investment fees than the fees charged for similar investments by peer systems. In accordance with Governmental Accounting Standards Board (GASB) rules, the ***withheld investment fees*** by contracted investment managers are not disclosed publicly. These withheld fees consist of a majority of the investment costs.

URS' administrative costs, which are a small component of its operating costs, have been fairly consistent. The year 2011 shows a noticeable decrease in administrative costs resulting from consolidations with PEHP and an upgraded IT system. When URS' total administrative costs for 2013, including both ***defined benefit*** and ***defined contribution*** costs, were compared with peer retirement systems, URS' administrative costs were $19 per member lower than the median of the peer systems.

Investment Costs Drive the Increase in Operating Costs

Operating costs, when adjusted for inflation, have increased 316 percent since 2001.

We reviewed the change in URS' operating costs from 2001 to 2013. As shown in Figure 4.1, operating costs (adjusted for inflation) have increased 316 percent since 2001. Operating costs include investment and administrative costs. The increase in operating costs resulted from rising investment costs. Administrative costs have been relatively consistent over time, with a noticeable decrease in 2011.

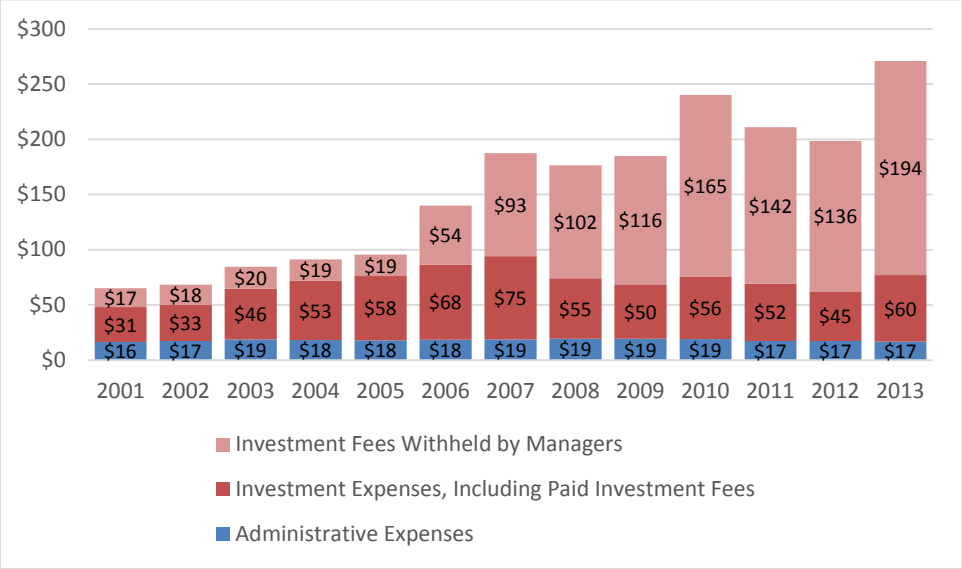
[10] Because of the technical nature of this subject matter, this report contains highlighted words that are defined in the report's glossary in Appendix E.

[11] ***Private equity***, absolute return (***hedge funds***), and ***real assets*** are considered alternative investments

URS distinguishes between investment fees paid by URS and fees withheld by contracted investment managers. URS pays some fees directly to managers that are then reported in the URS Comprehensive Annual Financial Report (CAFR) with other investment costs. In addition to these publicly reported fees, alternative investment managers have the ability per contract to withhold additional fees from investment proceeds before distributing those proceeds to URS, as is standard industry practice. At URS, the sum of these withheld fees is several times larger than the sum of publicly reported fees.

Industry practice allows for fund managers of alternative investment to withhold fees before distributing investment earnings.

Figure 4.1 Total Operating Costs Over Time, Shown in Millions. Administrative and investment costs are shown as reported in the CAFR. Investment fees withheld by managers are also shown.



Adjusted for Inflation to reflect 2013 dollar values.
Source: URS CAFRs, URS internal documents

Investment fees withheld by managers have increased significantly over time because URS has invested increasingly more assets in alternative investments.

Figure 4.1 shows that investment fees withheld by managers have increased significantly over time. This increase has occurred because URS has invested increasingly more assets in alternative investments, which are associated with higher fees. URS' primary objective of allocating a high percentage of assets into alternative investments is to protect investment principal as much as possible in negative ***equity markets***.

This point can be demonstrated using the investment consultant's model *Actual Allocation vs. 2004 Model Allocation, Market Returns CY 2004 to CY 2013* on page 66 of the Appendix A. The model shows

URS' actual market returns from 2004 to 2013, with a high percentage of assets invested in alternative investments. The model compares those returns with URS' 2004 asset allocation that has a small percentage of assets invested in alternative investments.

In 2008, during an economic downturn, the benefit of the investment return noticeably exceeded the high cost of alternative investments.

In 2008, when a significant market downturn occurred, URS lost about $436 million (2.18 percent) less with their current asset allocation, than would have been lost if the 2004 asset allocation had been used (that had significantly fewer alternative investments). The additional amount in investment fees for URS' 2008 allocation was about $68 million. URS' 2008 allocation reduced the loss noticeably more than the cost of the alternative investments. In 2008, the benefit of the investment return exceeded the high cost of the alternative investments.

However, since 2008, the industry has been experiencing stronger equity markets, and the model indicates that URS investment returns have not benefited from its higher cost alternative investments, except in 2011. In 2011, the current allocation outperformed the 2004 allocation by about $370 million. This return exceeded the additional amount in investment fees of $100 million for the 2011 allocation. The 2004 allocation (with lower alternative investments) yielded higher returns in most years compared to the current asset allocation. In 2010, the current allocation outperformed the 2004 allocation by 0.02 percent. However, the difference was so small that the investment portfolio did not realize a benefit from the costly alternative investments that year.

Our investment consultant believes that URS' high allocation of assets to alternative investment is increasing URS' operating costs and preventing URS from achieving the best returns.

As demonstrated by the consultant's model, alternative investments can help offset loss in negative equity markets and generate returns that exceed for the cost of investing. However, the consultant believes that the high percentage of expensive alternative investment in the URS allocation is increasing URS' operating costs and preventing URS from achieving the best returns.

Figure 4.1 also shows (in 2010 and 2013) what appear to be spikes in fees withheld by managers prior to the distribution of market returns. These spikes reflect a unique fee structure that URS has negotiated with alternative fund managers. URS capitalizes on the longevity of their investments with a fund manager by negotiating for payment of investment fees over longer periods of time rather than every year, and netting annual investment gains and losses to reduce

investment fees. Thus, more fees were paid in 2010 and 2013. This fee structure maximizes long-term performance. In 2009, URS was recognized by the Wall Street Journal for its efforts in improving pension systems' ability to negotiate investment terms with such strategies. The following paragraphs explains URS investment costs in more detail.

URS has been publicly recognized for its ability to effectively negotiate investment terms.

URS Investment Costs Are Higher than Those of Peer Systems. In 2014, URS hired CEM Benchmarking to examine the cost of URS investments relative to peers and benchmarks. Compared to a custom peer group of 19 similarly sized public pension plans, URS' 2013 investment costs were approximately 58 percent higher than the average. This is a direct result of URS selecting more costly alternative investments in its DB asset allocation.[12]

URS investment fees were 58 percent larger than a peer average, but URS controls its fee rates better than the peer group.

URS Is Better at Controlling High Investment Fee Rates than Peer Systems. Using sound methodology, CEM adjusted the 19 entities' asset allocation to reflect URS' fund size and large allocation to alternatives. Comparing the adjusted 19 entities' fee rates to URS' fee rates, URS' fees were approximately $25.1 million, or 11 percent, lower. This suggests that, though URS pays more fees than peers, due to its larger allocation to alternative investments, URS fee rates are less for certain asset types than its peers. Therefore, URS controls its fee rates better than the peer group. CEM attributes this 11 percent discount to URS' use of direct fund investment (rather than funds of funds or limited partnerships). In addition to this study, and as noted previously, URS has been publicly recognized for its efforts to improve pension systems' ability to negotiate investment terms.

A Majority of Investment Costs Are Not Disclosed Publicly

URS distinguishes between investment fees paid by URS and fees withheld by contracted investment managers. URS pays some fees directly to managers that are then reported publicly in the URS

[12] In 2005, the URS board approved moving a higher allocation of DB investments into alternative assets. URS currently holds 40 percent of its assets in alternative investments, including real assets, private equity, and hedge funds. URS' reported strategy behind this allocation change is to lower risk by offsetting potential losses during economic downturns—these concepts are discussed in more detail in Chapter III.

Comprehensive Annual Financial Report (CAFR) per requirements from the Governmental Accounting Standards Board (GASB).

Withheld fees are not reported in the CAFR in accordance with the Governmental Accounting Standards Board rules, yet are several times larger than the sum of publicly reported fees.

In addition to these publicly reported fees, alternative investment managers have the ability per contract to withhold additional fees from investment proceeds before distributing those proceeds to URS, as is standard industry practice (and similar to the mutual fund industry practice of withholding fees before distributing investment earnings to investors). When a higher percentage of assets are allocated to alternative investments, more investment fees are withheld. At URS, the sum of these withheld fees, which are not reported in the CAFR in accordance with the Governmental Accounting Standards Board rules, is several times larger than the sum of publicly reported fees. For example, 79 percent ($194 million) of the overall investment fees were withheld in 2013, whereas 21 percent ($52 million[13]) were paid. In accordance with Governmental Accounting Standards Board rules, other public employee retirement systems and government agencies do not disclose withheld investment fees.

Investors with alternative assets are required to accept terms of withholding fees.

Withheld Fees Lack Transparency. These fees lack transparency because they are not required to be reported publicly in URS' CAFR, although they are reported monthly to the URS Board. Even though withheld fees are not directly reported as an operating cost, those fees represent an operating cost for certain types of investments. These withheld fees are reflected as a cost through market returns, since market returns are calculated after withheld investment fees have been distributed. In other words, this large amount of withheld fees results in smaller returns. URS reports all investment rates of return net of fees which allows stakeholders to evaluate investment returns after all fees have been deducted, including fees withheld by investment advisors.

Withheld investment fees are reported only indirectly in the CAFR through market returns.

Withholding Fees Is an Industry Practice for Alternative Investments. The fee structure described above is not unique to URS. Almost any investor with alternative assets (or mutual funds) is required to accept terms of withholding fees in order to retain a manager's services. Though the fees can be high, they represent a premium for specialized strategies or knowledge that an investor like

[13] While Figure 4.1 shows total investment expenses to be $60 million for 2013, the amount reported here of $52 million refers only to paid investment fees.

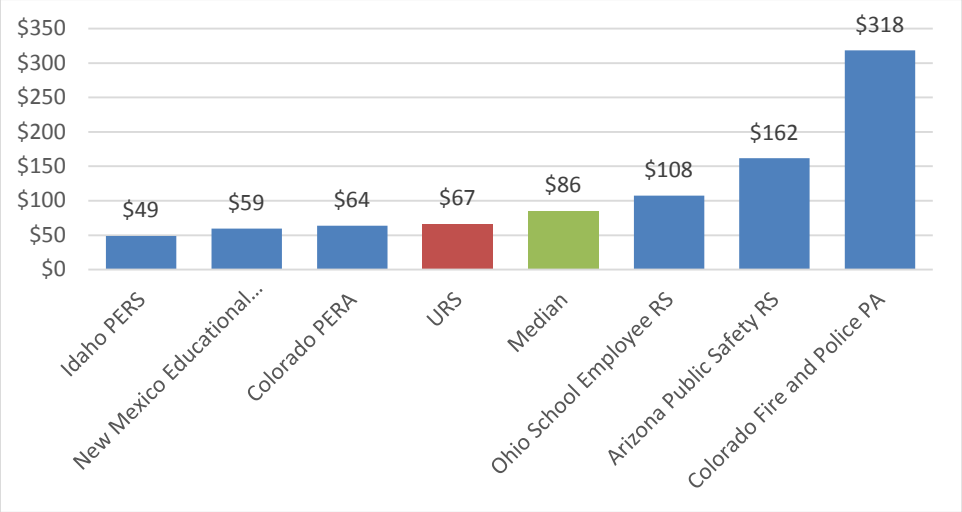
URS wants as part of its diversification efforts. The high fees for alternative investments and a lack of transparency are concerning, according to the consultant's report.

URS' Administrative Costs Are Lower Than Peer Retirement Systems

Figure 4.1 shows that administrative costs have been quite consistent when adjusted for inflation, with a noticeable decrease in 2011. URS' 2013 administrative costs per member were $19 lower than the median of a peer retirement system comparison.

In order to compare URS' 2013 administrative costs with other public employee retirement systems, total membership was used in the analysis in order to compare administrative costs per member among the peer group. Only systems that administer both defined contribution and defined benefit plans were used. Figure 4.2 shows the 2013 comparison of URS' administrative costs per member with 6 peer retirement systems.

Figure 4.2 2013 Comparison of Administrative Costs per Member. URS' administrative costs per member were $67 in 2013.



Only organizations with both defined benefit and defined contribution plans are included.
Source: System CAFRs, Auditor Analysis

Figure 4.2 shows that URS' total administrative costs per member were $19 lower than the median of six similar systems.

URS' 2013 administrative costs per member were $19 lower than the median of a peer retirement system comparison.

CEM Benchmarking showed that URS' total defined benefit administration cost was $18 lower than a peer benchmark that controlled for economies of scale, transaction volumes, and cost environment.

Though many factors influence administrative costs, the analysis above only considers total defined benefit and defined contribution administrative costs. However, in 2013, CEM Benchmarking conducted an analysis of costs related only to defined benefit administration that controlled for economies of scale, transaction volumes, and cost environment. In this study, CEM found that URS' total defined benefit administration costs were $18 lower than a calculated peer benchmark. URS should continue to closely monitor administrative costs.

URS Board Has Sufficient Investment Experience

The URS board has the fiduciary responsibility to "serve as investment trustees of the Utah State Retirement Investment Fund." The audit team was asked to determine if the composition of the URS board and individual board members have sufficient investment experience to fulfill their fiduciary responsibilities. We believe that URS' board has sufficient investment experience. In making this determination, we found that (1) the composition of URS' board meets statutory requirements, and (2) the investment experience of URS' board is greater than other public employee retirement systems' boards.

As trustees of the Utah State Retirement Investment Fund, the two most important functions of URS' board include approval of DB asset allocation and approval of investment policy statements.

The URS board provides oversight of the retirement systems. Board members serve four-year terms and are appointed on a nonpartisan basis, with the consent of the Senate. As trustees of the Utah State Retirement Investment Fund, the two most important functions of the board are the establishment of the DB asset allocation and the authorization of investment policies.

The Composition of URS' Board Meets Statutory Requirements

Currently, URS meets all statutory requirements relating to board composition.

Utah Code 49-11-202 defines URS' board composition requirements. Figure 4.3 demonstrates URS' compliance with board composition requirements as defined in Title 49. Currently, URS meets all statutory requirements relating to board composition.

Figure 4.3 URS Board Statutory Requirements. The URS board consists of seven members, five of whom come from the investment community.

Statutory Requirement	Requirement Met?
Four board members, with experience in investments or banking, shall be appointed by the governor from the general public.	Yes
One board member shall be a school employee appointed by the governor from at least three nominations submitted by the governing board of the school employees' association that is representative of a majority of the school employees who are members of a system administered by the board.	Yes
One board member shall be a public employee appointed by the governor from at least three nominations submitted by the governing board of the public employee association that is representative of a majority of the public employees who are members of a system administered by the board.	Yes
One board member shall be the state treasurer.	Yes

Source: Utah Code 49-11-202, URS Website

The composition of URS' board was specifically designed to recognize that investment oversight is the major responsibility of the board, and to match board member experience with that responsibility. The history of this is documented in "History of the Utah Retirement Systems," which describes the 1987 legislative decision to reduce the board from nine to seven members, with less employee representation and more members with investment experience.

The composition of URS' board was specifically designed to match board member experience with their responsibility to oversee investments.

Since that time, state statute regarding URS board composition has required suitable experience in the investment field, thereby qualifying the board to effectively make investment decisions. Currently, the four board members who represent the investment community, together with the state treasurer, collectively hold over 150 years of investment experience.

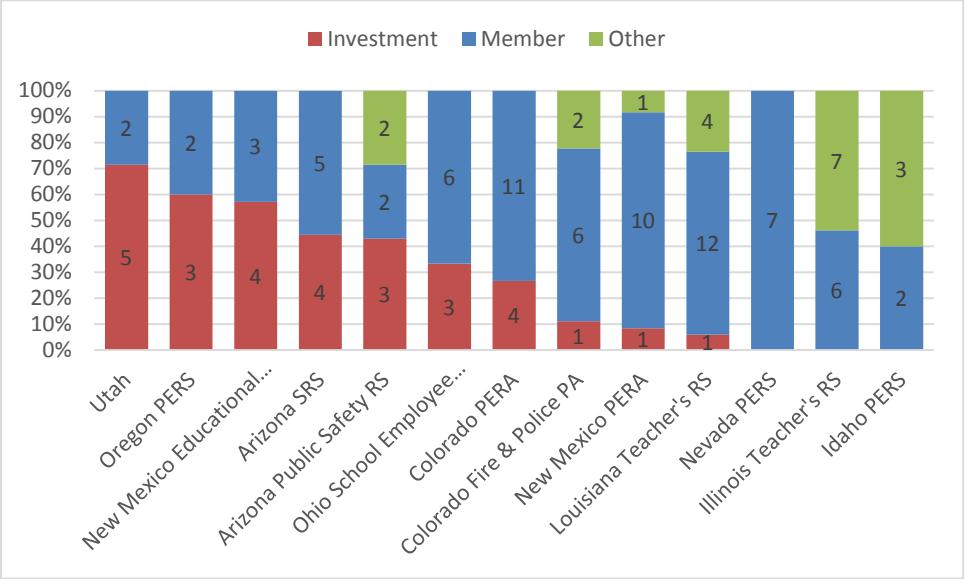
The board members who represent the investment community collectively hold over 150 years of investment experience.

URS' Board Has More Members with Investment Experience than Other Comparable Systems

In order to determine if the URS board currently has sufficient investment experience to meet URS' needs, we compared URS board composition with that of other systems. We gathered board composition information for comparative systems in other states

(listed in Chapter I) from the National Association of State Retirement Administrators, state statutes, and system websites. After reviewing the other states' board requirements, each board member was classified as a representative of the investment community, a member group, or other group. For example, a board member is considered an investment representative if statute states that the member either must or may represent the investment community. Figure 4.4 shows the board compositions of various systems as a percentage of total by representative type.

Figure 4.4 URS Board Composition Compared to Peers. About three-quarters of URS' board members are required to have investment experience.



Of the systems listed in Chapter I, Board information for the Washington State Department of Retirement Systems and the Minnesota Teacher's Retirement Association is not included because the boards of these systems do not make investment decisions.
Source: OLAG Analysis

URS' board has more investment representatives than any other system to which we compared it.

As shown in Figure 4.4, URS has more investment member representatives than 12 peer retirement systems in other states. In fact, while 71 percent of URS' board members have investment experience, a median of only 19 percent of peer groups' board members had investment experience.

Notably, URS' large number of investment representatives is also balanced by a membership board. URS' membership council is composed of 13 council members representing all groups of members at URS, including school and public employees, municipal and county officers, retirees, judges, public safety officers, and firefighters. The URS membership council has the statutory authority to make recommendations to the board on policy and administration related to benefits and URS members. In the past, members of the membership counsel have primarily focused on conveying information to the groups they represent.

The membership council may make recommendations to the board on policy and administration of benefits.

As trustees of the Utah State Retirement Investment Fund, the two most important functions of the board are approving the DB asset allocation and authorizing investment policies. Chapter III of this report discusses the asset allocation and recommends that URS consider adjustments specifically regarding its allocation to alternative investments. URS' board has the fiduciary responsibility to approve a DB asset allocation. The board needs to carefully consider the information contained in this and the consultant's reports as they have the crucial responsibility to approve future allocations.

The board should carefully consider the information contained in this and the consultant's reports as they have the crucial responsibility to approve future allocations.

URS Advisory Staff Are Qualified To Offer Investment Advice

In January 2015, URS began offering new advisory services to better meet members' needs. We were asked to confirm that URS advisory staff are appropriately qualified to provide advisory services. Though the advisory program is still new and cannot be properly audited, advisory staff appear to be appropriately qualified in terms of education and training. As URS continues to build the advisory program, it should establish in policy essential elements of the advisory program and metrics to measure utilization and effectiveness. URS is exempt by federal and state law from licensing requirements and URS meets conditions relating to providing investment advice put forth in a ***no-action letter*** by the Utah Division of Securities.

Though the advisory program is still too new to be properly audited, advisory staff appear to be appropriately qualified in terms of education and training.

Prior to January 2015, URS employees did not provide recommendations or investment advice to members, though education about URS-administered benefits and general retirement planning was provided. For recommendations on retirement plans or the investment of defined contribution plans, members turned to financial advisers

not affiliated with URS or invested without professional guidance. Education about URS-administered benefits and general retirement planning is still provided through the current advisory program, but URS advisors are now allowed to also provide recommendations to members. Members still assume all risk related to their retirement plan choices and investments.

URS Investment Advisors Are Qualified to Offer Investment Advice

Advisory staff résumés indicate that they are qualified to provide investment advice to URS members.

Advisory staff résumés indicate that they are qualified to provide investment advice to the public. In the coming months, URS will hire one additional advisor, favoring applicants with recognized retirement or investment-industry certifications. Figure 4.5 shows the qualifications of URS' current advisors. One of these qualifications is the Series 65 exam, which is a nationally recognized professional designation. This exam is required for the licensing[14] of advisors not exempt from licensing requirements. By passing this exam, advisors show they are competent to give investment advice. An outline of the core competencies tested by the Series 65 exam is included in Appendix D.

[14] To register as an investment adviser representative candidates must have successfully completed required professional competency exams (the Series 65 *or* the Series 7 and 66) or currently hold one of five recognized professional designations: Certified Financial Planner®; Chartered Investment Counselor®; Chartered Financial Consultant®; Personal Financial Specialist®; or Chartered Financial Analyst®.

Figure 4.5 URS Advisor Qualifications. URS' advisors collectively hold five master's degrees, four advanced certifications, and 133 years of experience in retirement and financial services.

	Highest Degree	Years of Retirement/Finance Experience	Completion of Series 65 Exam	Additional Certifications
Advisor 1	MBA	6	Yes	
Advisor 2	MBA	30	Yes*	Certified Retirement Counselor® Retirement Income Certified Professional® Certified Financial Planner®
Advisor 3	MBA	16	Yes*	
Advisor 4	MBA	13	Yes*	Certified Financial Planner®
Advisor 5	Master of Integrated Marketing	25	Yes	
Advisor 6	BA Economics	7	Yes*	
Advisor 7	BS Finance	15	Yes*	
Advisor 8	BS Finance	21	Yes*	

**Advisor has passed additional exam(s) such as the Series 6, Series 7, or Series 63.*
Source: URS internal documents

URS' advisors collectively hold five master's degrees, four advanced certifications, and 133 years of experience in retirement and financial services.

Information on continued training and supervision of URS Advisors is included later in this chapter.

Both Federal and State Law Exempt URS from Required Licensing

Though URS advisors are qualified to provide investment advice, both federal and state law exempt them from the licensing required of other investment advisors. URS is in compliance with the conditions of a no-action letter, as later discussed.

Statutorily, URS investment advisors are not required to be licensed.

Two key federal acts regulate investment advisors: the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940. The former of these created the Securities and Exchange Commission (SEC), granting them broad authority over all aspects of the securities industry. The latter regulates investment advisers, requiring them to be licensed by the SEC and conform to regulations designed to protect investors. However, as an instrumentality of the State of Utah, URS is exempt from the registration and licensing provisions within these acts.

A no-action letter was authorized by the State of Utah Department of Commerce Division of Securities on June 25, 2014, ensuring that investment services are in compliance with state laws.

According to the Utah Uniform Securities Act, URS advisers are also exempt from licensing with the State of Utah Department of Commerce, Division of Securities. While formulating the advisory program, URS requested a no-action[15] letter in order to ensure that new investment services were in compliance with state laws. The letter was authorized by the State of Utah Department of Commerce Division of Securities on June 25, 2014. The authorization of the no-action letter states that URS is exempt from enforcement action against advisors who are not licensed with the Utah Division of Securities, based on the following conditions:

- URS is subject to statutory mandates and limitations as well as legislative and executive oversight.
- The scope of advice to be provided to plan members by URS and its employees is narrowly tailored to the limited investment products available in the URS defined contribution and defined benefit plans.
- Advice given will be in the best interest of plan members in consideration of members' individual situations and needs.
- The professionals giving advice will be properly (1) qualified, (2) trained, and (3) supervised.
- Services will be provided to plan members at no cost.
- The advice that will be provided to members is not related to compensation of URS advisors.

The advice that will be provided to members is not related to compensation of URS advisors.

Our review found that URS is currently meeting the conditions put forth in the no-action letter.

[15] An individual or entity who wishes to ensure that a particular product, service, or action does not constitute a violation of law may request a no-action letter from a regulatory agency. The no-action letter described here grants the request for no action and concludes that the Utah Division of Securities would not take enforcement action against URS based on the facts and representations described in URS' request.

Advisory Program Design Meets Conditions of Licensing Exemptions

Though the advisory program is still in its infancy—advisory sessions began in January and a full program launched in March—our team reviewed draft program documents and had extensive conversations with advisory program staff. We feel that URS is taking appropriate steps to fulfill the requirements listed in the no-action letter. However, though URS has created documents that outline the advisory process, the URS advisory program is not established or defined in URS policy. URS should establish the essential elements of the advisory program in policy to ensure that they meet the conditions of the no-action agreement with the Division of Securities.

We believe that URS is taking appropriate steps to fulfill the requirements listed in the no-action letter, but should establish the essential elements of the advisory program in policy.

Advisory sessions are available in various locations at no cost to members. URS employee compensation is not related to any investment advice provided to members—whether a member accepts or rejects investment advice has no impact on URS employee compensation. Before offering investment advice, advisors collect background information on members, determine member retirement goals, and conduct an assessment of members' risk tolerance.[16]

Before offering investment advice, advisors collect background information on members, determine member retirement goals, and conduct an assessment of members' risk tolerance.

URS employees serve members in an educational and advisory capacity with the goal of providing prudent, reasonable advice in the best interest of the member. URS investment advice may include a standard asset allocation, URS' DB and DC benefits, investment offerings, and elections. Investment advice is not to be offered regarding non-URS retirement account resources, though non-URS resources such as social security and spousal income will be considered when providing recommendations.

URS has chosen to require their advisory staff to pass the Series 65 exam prior to offering investment advice to members. Furthermore, URS employees will complete internal update training on all investment advice topics at least once a year. Finally, URS employees will be encouraged to work towards the advanced designations that qualify investment advisers for licensing and to maintain a designation's requisite continuing education requirements, including attendance at appropriate conferences and training events.

Advisory staff are required to pass the Series 65 exam prior to offering investment advice to members.

[16] The "Consequence-Based" Investor Risk Questionnaire was created in counsel with Boston Research Technologies.

URS also plans to implement appropriate supervisory controls. Management, legal counsel, and the URS compliance department will be involved in oversight of the investment advice process. URS managers will supervise all training activities to ensure compliance with the investment advice process and will conduct regular reviews of URS employees on at least an annual basis. Printed and electronic investment advice materials provided to members will be pre-approved by legal counsel and URS' compliance department.

URS should develop metrics to review utilization and effectiveness of the advisory program.

Furthermore, URS is developing a brief customer satisfaction survey that members can complete in order to help determine if URS advisors meet expectations. URS should also develop metrics to review utilization and effectiveness of the advisory program.

Recommendations

1. We recommend that URS establish in policy essential elements of the advisory program.

2. We recommend that URS develop metrics that will measure the utilization and effectiveness of the URS advisory program.

Chapter V
DC Investment Manager Selection and Retention Processes Are Satisfactory

We were asked to determine whether URS' Defined Contribution Plan investment manager selection and retention processes have satisfactory documentation and controls. We found that the process in the particular case we reviewed had appropriate documentation and adhered to URS policy, which has adequate controls. We also compared the URS process to that of three comparable retirement programs and found that URS appears to follow typical industry practice. Additionally, ongoing efforts by URS to monitor defined contribution investment manager activity are appropriate.

DC Investment Manager Selection Process Has Adequate Controls

We found that URS policy and procedure outline sufficient controls over the review and selection of investment managers within the URS ***Defined Contribution***[17] Plan (DC Plan). Examples of controls include: a clear process established in policy, multiple levels of complementary review and approval, and the clear acknowledgement of URS' fiduciary duty toward its members. To review the DC Plan manager selection process, we compared URS policy to documents and emails generated during a recently conducted investment manager search. Our work centered on first reviewing URS policy guiding the selection process, then confirming that each step of a recent investment manager selection was completed as policy directs.

URS policy and procedure outline sufficient controls over the review and selection of DC Plan investment managers.

Two URS Policy Documents Govern the DC Plan Manager Selection Process

The two primary policy and procedure documents used in our review were the URS DC Plan *Statement of Investment Policy* and a document titled the *Quality Assurance Checklist and Review* that was created and executed by URS compliance staff in cooperation with

Two URS policy documents govern the DC Plan manager selection process.

[17] Because of the technical nature of this subject matter, this report contains highlighted words that are defined in the report's glossary in Appendix E.

URS investment staff. The URS investment policy primarily outlines the overarching selection process while the checklist focuses almost exclusively on the details, analysis, and documentation of the investment due diligence process. Figure 5.1 combines and summarizes the steps of the investment manager selection and due diligence processes as outlined in both of these documents.

The DC Plan investment manager selection process includes review by multiple levels within URS.

Figure 5.1 Summary of URS DC Plan Investment Manager Selection Process. This figure shows involvement from multiple staff at different levels within URS and elements of the due diligence review.

1. URS board sets defined contribution investment options.
2. URS executive director and staff perform the actual manager search within the board-determined asset/option targets. URS board is informed by staff when a manager search is initiated.
3. Once a search is initiated, URS management, along with internal investment staff and an external investment consultant, develop manager search criteria.
4. Several potential investment managers are identified via internal knowledge, external consultant, or manager solicitation.
5. Search criteria are applied to candidates and two to three managers are selected for more robust due diligence review.
6. Internal due diligence is performed by in-house investment staff. Analysts examine performance against peers and benchmarks, risk, firm history/personnel, SEC registration/compliance, investment strategy, fee structure, reference calls, on-site visit, legal terms, other areas as indicated.
7. External due diligence is performed by the investment consultant. Similar to the considerations in Step 6, internal and external due diligence are compared for supporting or contrasting opinions.
8. URS Investment Committee, comprised of the URS executive director and other key URS management, reviews the due diligence results. The committee provides informal approval throughout the process and formal approval (via vote) of final manager selection.
9. Legal and compliance review is either completed in advance of investment committee approval or committee approval is given subject to completion of legal and compliance review.
10. Investment agreement is signed.
11. Manager selection is documented and reported to URS board.

Source: Although there is some overlap, the majority of the process comes from the URS DC Plan Statement of Investment policy. The URS Quality Assurance Checklist and Review primarily focuses on items 6 and 7. Additional detail was provided by URS staff.

We compared the URS investment manager selection process described in Figure 5.1 to that of three other comparable retirement programs and found that, though the other programs deviated slightly based on unique program structure or requirements, the core of the manager selection process was very similar. When it comes to procedural and due diligence steps, we found similarities between programs. For example, the order of process steps and general direction of the process shown in Figure 5.1 is nearly identical among the plans we compared. In general, the due diligence process within the industry is fairly standard for any institutional investor seeking an investment manager.

URS' manager selection process is very similar to that of other similar pension programs.

However, two unique practices we found demonstrate a different level of review for prospective managers. First, if Colorado Fire and Police Pension Association staff are considering an investment representing less than 2 percent of total assets, the search and manager selection can be performed without direct board oversight. Second, in the Public Employees Retirement System of Idaho (PERSI), a board member is typically assigned to participate in the selection process to gain deeper insight into the investment process and PERSI portfolio.

Despite similarities, some unique investment manager selection processes exist in other pension programs.

URS Adhered to Selection Policy, Which Has Adequate Controls

Our conclusion that controls are satisfactory is based primarily on the multiple levels of checks and approval within the manager selection process. As shown previously in Figure 5.1, the URS executive director, chief investment officer, investment staff, chief compliance officer, legal counsel, and external investment consultant all must review and approve relevant items before a manager is selected and a contract signed.

Our review found that URS adheres to its selection policy and the process has appropriate controls in place.

To attest to the selection process relative to URS policy, we reviewed relevant documentation generated during an investment manager selection process. We compared financial data, investment analysis, emails, investment committee minutes, and other documents to each required process step defined in policy. We also cross-referenced documentation to each component of the due diligence process to ensure that conclusions were supported.

We examined documentation to attest to URS' selection process relative to policy.

After our independent examination, we reviewed each process and due diligence step with URS compliance and investment staff to ensure that we had appropriately validated each item. Documentation

also showed that the process provides a thorough evaluation of multiple investment managers and that the decision to hire a manager is based on merit and considerations of URS member benefit.

An Internal URS Audit Corroborates Our Audit Findings. Prior to our audit work, URS internal auditors released a memo report in 2011 titled *Defined Contribution Investment Manager Review*. Like us, they sought to "determine if internal controls over the selection and hiring process of DC investment managers [were] adequate and [provided] appropriate documentation to support the decision." Using a methodology very similar to ours, URS internal auditors examined the selection of an investment manager for the DC Plan and concluded that control design and application was appropriate at that time.

A 2011 internal URS audit corroborates our audit findings.

Ongoing Monitoring and Retention of DC Plan Investment Managers Are Acceptable

In addition to the manager selection process, we examined the URS process for ongoing monitoring and retention of DC Plan investment managers. Based on our review, the ongoing monitoring of DC Plan investment managers is satisfactory and results in appropriate investment decisions. URS reported that, in the 17 years from 1998 to 2014,[18] the decision to terminate 7 investment managers was made based on considerations that are tracked in a scorecard process. During this time, several investment managers were also hired to replace those who were terminated and to fill new DC Plan needs.

Our review found that URS' monitoring of DC Plan investment managers is adequate.

The URS investment policy requires that the performance of DC Plan investment managers be monitored on an ongoing basis. Policy also states that if URS has concerns, it may place an investment manager on a "watch list" or terminate an investment manager at any time. The monitoring and watch list functions are completed using quarterly scorecards for each manager. At the time of our audit, one DC Plan manager was on watch list status.

URS monitors DC Plan investment managers by using quarterly scorecards.

Manager scorecards are created and maintained by URS investment staff and are based on quantitative information provided

[18] Beginning in January 1998, URS expanded its DC core fund lineup from four options to seven and added three asset allocation portfolios (Horizon Funds).

by URS' investment consultant, Callan Associates, and subjective considerations made by URS investment analysts. In the quantitative section, URS investment staff collaboratively establish ranges of both acceptable and unacceptable investment performance and risk, then chart how a particular manager performs against those expectations. Examples of the subjective considerations include non-quantifiable items like governance, fund structure, and attributes of firm management.

Investment managers' performance is tracked against ranges of acceptable performance and ranked according to level of concern.

For example, if an investment manager's performance measures are outside the predefined quantitative ranges, the scorecard automatically generates a score that indicates the level of concern for that manager. If a scorecard shows material concerns, the manager in question will be placed on watch list status until problems are resolved or the manager is terminated. URS analysts then have the option to provide a secondary, subjective opinion of the risk factors, in which the analysts may agree with or override the calculated score. If the calculated score is overridden (which does occur at times), a justification must be provided and documented before the scorecard can be submitted.

In reviewing scorecards, we found that investment managers' information had been updated and reviewed.

Our audit work included a review of the scorecard process and a limited verification that scorecards are being updated appropriately and accurately, according to information provided by Callan. In reviewing scorecards from the third quarter of 2014, we found that managers' information had been updated and reviewed appropriately.

In summary, our review found that the URS processes to select and monitor DC Plan investment managers are well established, have adequate controls, and are executed according to policy.

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Appendices

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Appendix A
Consultant's Report

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Utah Retirement Systems (URS) Review and Analysis of Investment Performance

For the Utah Office of the Legislative Auditor General

By Christopher B. Tobe, CFA, CAIA, Stable Value Consultants

Introduction

I have been asked by the Utah Office of the Legislative Auditor General to investigate and report on the investment performance of the Utah Retirement Systems (URS). The report is primarily a compilation and presentation of publicly available data from URS and other public pension plans around the country, including their own reported investment performance and peer universe data.

Public pensions vary in the amount of investment information they make public, and categorize them in ways hard to make precise comparisons, so report findings may be limited. URS provides asset class performance by calendar year, while many of their peers do it by fiscal years ending in June. URS and several other peers only provide investment performance in their Consolidated Annual Financial Reports (CAFR), while some other peers provide more detailed investment performance, some to the manager level in additional public reports.

At the end of the report is my analysis and expert opinion on underlying issues in the investment performance, how URS fits in with national trends with other public plans, and my recommendations for future oversight by the Utah Legislature. My analysis and expert opinion will be from my point of view as an investment consultant, former state auditor and former state pension trustee.

Why Investment Performance is Important

Public pensions have come under increased scrutiny as they have become larger and larger elements of state and local government budgets. The basic formula for pensions long term is that Contributions + Investment Performance (net expenses) = Benefits. Each of these three factors are very complex and many times, when reports try to cover all three, can become incomprehensible. According to the Center for Retirement Research at Boston College, the Utah Legislature has one of the best records in the country in making sound actuarial contributions which has led to one of the best funding ratios in the country.[i] To examine the investment part of the equation we need to look at benefits as a constant, as well as assuming Utah will continue its sound fiscal management by paying the full actuarially required contributions. This enables us to isolate the investment return after fees in this report.

Thus the higher the investment returns, the lower employer contributions will have to be over the long term. Over the history of public defined benefit pensions, because of their long term investment strategy, returns from these investments have been able to cover 60% to 70% of the

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total costs. This is significant to governments because the other 30% to 40% is made up of contributions from taxpayers. However, given their large size, the difference between even 30% and 40% can amount to hundreds of millions per year. Investment performance is not only important to the participants in the pension plans, but to all taxpayers.

URS Performance Ranges from Below Average to Average when Compared to Peers

URS has had from below average to average (or a little above) performance compared to a peer group and publicly available universes. In the one year and five year periods, URS underperformed when compared to their peers. In the 3-year and 10-year periods the performance was slightly above their peers.

I created a peer group based primarily on peer retirement systems selected by the Utah Legislative Auditor. In addition to this peer group, I found three other sources for comparison: three publicly available universes of public pensions over $1 billion in size. The average of the 10 large state plan peer group we chose, and the average of the three public pension universes were extremely close in values. This gave me added comfort that our peer group selection was a good indicator of relative performance.

It is widely held in the investment industry that asset allocation drives 90% of returns, and I believe this holds for URS and its peers in these time periods. Also I believe that the specific allocation to US Stocks during these periods was the major driver over these time periods. While we have no individual manager performance data, nothing in the aggregate asset class data suggests that there are any material problems of manager selection with URS. Thus the asset allocation is the dominant factor in performance.

While 10 year returns are generally a good period to measure, this particular 10 year period (2004-2013), because of extreme volatility, has created some problems in comparing performance that I have seen in other plans. I have some trouble with the 10-year time period as a valid measure. The US Stock market starting 2007 through 2008 into 2009 saw the S&P 500 go from 1561.8 to 683.38, a 56% downturn. During this period of large swings, the timing of the rebalancing of assets, in my opinion, could skew results and make results less reliable. Also, over the 10-year period there are a number of changes in URS's asset allocation within all of the plans, which makes comparisons between plans more difficult.

The driver of investment performance in all the public plans studied in this period has been the allocation to alternatives versus the amount of US stock. Alternatives in most public plans historically started with real estate, but in recent years private equity and hedge funds have also been added. URS has a higher allocation to alternatives and a lower allocation to US stock, which was especially detrimental in the 1-year and 5-year periods.

Within the URS portfolio over calendar year 2013, the stock investment returns were at 26.1% while private equity was at 20.78%, hedge funds at 10.42%, and real assets 10.32%. Within the URS portfolio over the five years ending 2013, the investment returns of the stocks averaged at 17.95% per year while private equity was at 9.95%, hedge funds at 9.22%, and real assets 2.17%.

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URS, with around 40% in alternatives at the end of 2013, has one the largest allocations to alternatives of state public pension plans surveyed. Among a survey of large state plans by consultant Cliffwater, the median allocation to alternatives was 22%, and the top quartile mark was 31%.[ii] So, URS is clearly in the top quartile, and perhaps the top decile with nearly twice the allocation to alternatives than the average large state plan.

Within alternatives, Utah has had an especially high allocation to hedge funds. As of year end 2013, URS had a 16.7% allocation to absolute return, which is commonly known as hedge funds. This high allocation to hedge funds as a percentage of all alternatives was 42%. This compared to Cliffwaters average of only 17% hedge funds as a percentage of all alternatives. Many public plans have either no or very low hedge fund exposure, which lowers the averages within the alternatives class.

Peer Group Comparison on Fiscal Years

For our peer comparison, I used June 30th fiscal years ending June 2014, since most were on fiscal years. URS provided FY data as well. All peers had 1-year, 3-year, and 5-year data, but two peers did not have 10-year data. The table below, "*Peer Group Performance, FY 2014*" is arranged in order of 5-year performance.

Peer Group Performance, FY 2014

	1-Year	3-Year	5-Year	10-Year
Arizona	18.60%	10.80%	14.20%	7.50%
Oregon	16.58%	10.10%	13.81%	7.79%
Louisiana Teachers	19.49%	10.53%	13.80%	7.74%
New Mexico PERA	17.04%	9.61%	13.10%	N/A
Nevada PERS	17.60%	10.90%	12.90%	7.40%
Washington RS	17.06%	10.07%	12.83%	8.35%
New Mexico Educational	14.50%	9.00%	12.60%	7.30%
School Employees of Ohio	17.30%	9.90%	12.10%	7.30%
Utah RS	15.55%	10.21%	12.10%	7.52%
Idaho	17.20%	9.10%	12.00%	N/A
Arizona Public Safety	13.80%	8.10%	11.20%	6.00%

Over five years the highest performing plan—the Arizona Public Plan—outperformed URS on average by 210 basis points, or 2.1%, each year. On a $25 billion plan, that could theoretically add up to around $2.5 billion of underperformance by URS over five years. However, over ten years, which included the 2008 crash, URS did better than the AZ public plan but by only 2 basis points. This data is very sensitive to time periods, and comparisons are far from perfect. However, when you are dealing with such large asset size, differences can be have a large dollar impact.

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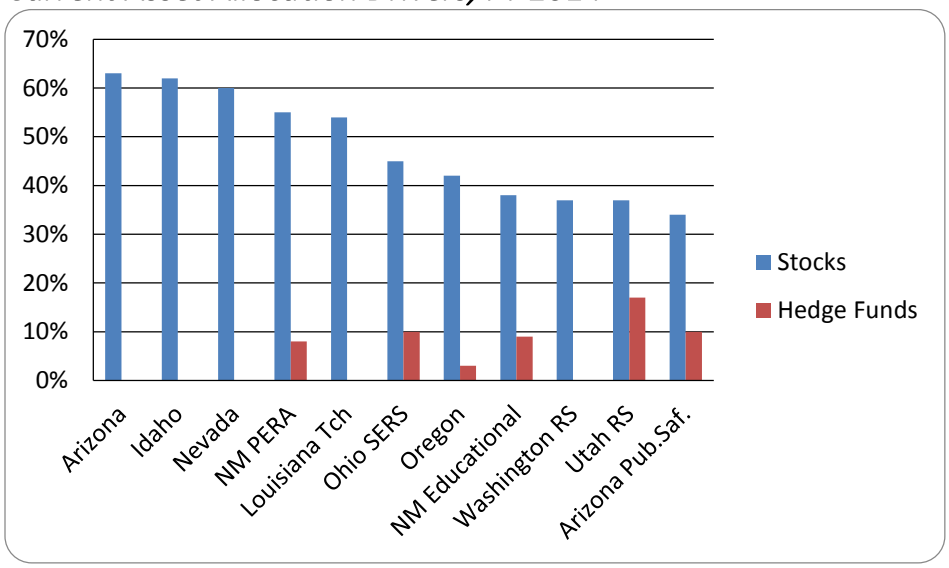
Asset allocation is difficult to compare exactly. Each plan has different ways of breaking up asset classes. For example, for a number of years URS had both a US Equity asset class and an International Equity asset class, but in 2013 combined them into one asset class. Not only the allocations themselves, but the allocation categories have changed for almost all plans over the last ten years. Many public plans, including URS, label hedge funds as absolute return. Some plans will put hedge funds in fixed income or equity if most of the underlying assets in hedge fund are in that category. For these reasons I looked primarily at the most current asset allocation, as shown in "*Current Asset Allocation Drivers, FY 2014,*" which I think provides useful information for the 2014 fiscal year.

Current Asset Allocation Drivers, FY 2014



The following observations explain how other peer systems are doing given their asset allocation drivers shown in the figure above.

URS, as of December 2013, had only 37% in stocks and 16.7% in hedge funds.

Louisiana Teachers, the top performer for the fiscal year ending June 2014 (see "*Peer Group Performance, FY 2014*" figure on the previous page), had no hedge funds, but did have 10% Private Equity and 8% real estate (not shown in the figure above) with 54% in stocks.

Arizona, another top performer, had no hedge funds, but did have 7% Private Equity and 8% real estate.

Nevada, above average, had high allocation to stocks 60% and no hedge funds.

Ohio Public Schools did a little about average with 45% in stocks and 10% in hedge funds.

New Mexico Education, one of the poor performers for FY 2014, had 9% in hedge funds and only 38% in stocks.

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New Mexico PERA, despite 8% hedge funds, performed in the middle of the pack but I think they were helped by a 54% stock allocation.

The worst for FY 2014, Arizona Public Safety, had sufficient risk parity and other alternative strategies in different, categories. In the end having only 34% allocated to stocks was probably the main performance driver.

To test the validity of this peer group, I looked at three public pension universes that are used by some of the peer plans, as shown in "*Peer Index vs. Larger Indices, FY 2014*." The universes are typically comprised of 50 to 100 different plans. The peer group of ten chosen falls closely in line with these universes and thereby validates them. It also confirms the peer group findings that URS underperforms significantly to an average of the three peer universes in the 1-year (144 basis points) and 5-year periods (78 basis points), and is slightly above average performer in the 3-year (+27 basis points) and 10-year (+9 basis points) periods compared to the broader universes. These universes have more plans and more plans that are smaller than the Cliffwater study cited earlier, so it is likely that they have fewer alternatives, especially hedge funds overall.

Peer Group Index vs. Larger Peer Universes, FY 2014

Other indices have asset sizes of greater than $1 billion.

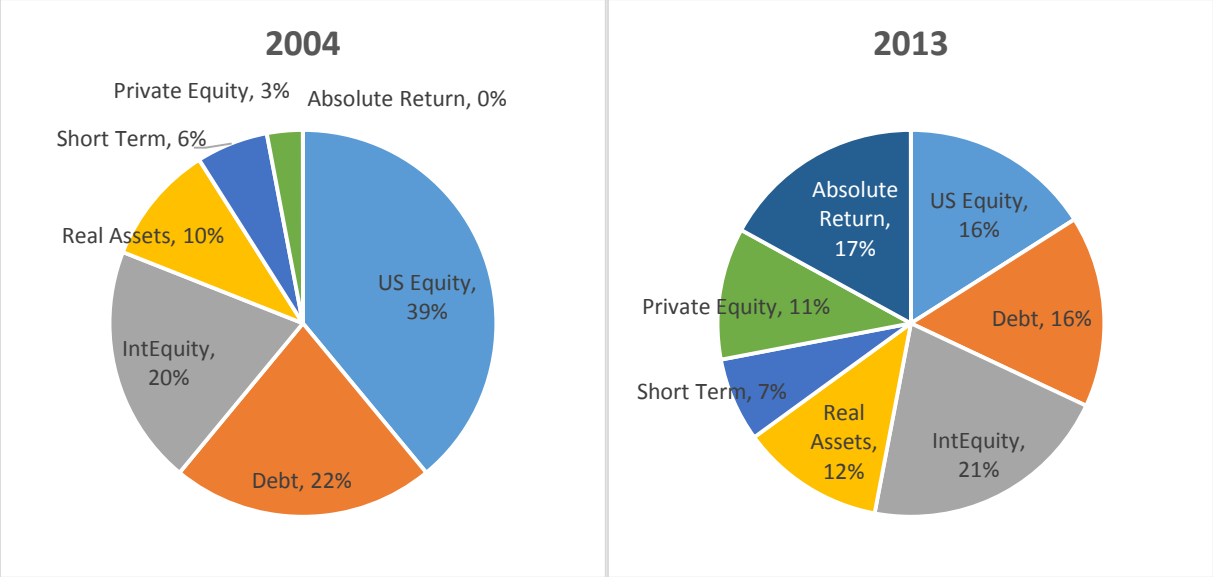
	1-Year	3-Year	5-Year	10-Year
Ten Peer Group Comparison	16.92%	9.81%	12.85%	7.42%
Three Public Pension Universes				
BNY Mellon	17.13%	10.20%	13.12%	7.65%
InvestorForce	16.40%	9.60%	12.70%	7.20%
TUCS	17.44%	10.01%	12.83%	7.43%
Average of three other Universes	16.99%	9.94%	12.88%	7.43%

"What If" Investment Analysis Shows Underperformance Over Ten Years

The Legislative Audit Staff asked to see some "what if" analysis on URS performance under different asset allocation scenarios. Most in the peer group had alternative assets of between 10% and 40% over the 10-year period. In 2004 URS had a 13% allocation to alternatives similar to their peers on the lower end of exposure, so a very relevant analysis would be: "what if URS had left their asset allocation constant at their 2004 level?" That is, using the exact same managers within asset classes with the same performance, just holding the asset allocation steady at the 2004 levels set by URS itself. For example, the 2004 allocation of 39% US Stocks was carried through the entire period and really boosted performance of the "what if" portfolio in 2009, when URS stocks soared 33.4%. The actual allocation to US stocks in 2009 for URS was only 23% which resulted in a loss of performance.[iii] Allocation for 2004 and 2013 are shown blow in "*URS Asset Mix, CY 2004 and CY 2013*."

URS Asset Mix, CY 2004 and CY 2013

Info found in URS 2004 and 2013 CAFR's, respectively



The URS 2004 allocation was superior to the current URS allocation in investment performance across most of the time periods measured, as shown in "*Actual Allocation vs. 2004 Allocation, Market Returns, CY 2004 to CY 2013*."

Actual Allocation vs. 2004 Model Allocation, Market Returns, CY 2004 to CY 2013

All calendar annualized returns Jan-Dec. 2004 allocation holds static December 31, 2004 asset allocation

	Actual Allocation Market Return	2004 Model Allocation Market Returns
2013	14.89%	16.95%
2012	13.10%	13.69%
2011	2.89%	1.05%
2010	13.73%	13.71%
2009	12.88%	20.13%
2008	-22.30%	-24.48%
2007	7.15%	7.43%
2006	14.77%	15.57%
2005	8.96%	9.26%
2004	13.24%	12.55%

Model Allocation stays constant as of January 2004 using a constant rebalancing assumption, keeping the proportions of each asset class at their original percentage, which explains why the actual market return in the up market of 2004, outperforms the model in 2004.

Using the same managers, but maintaining the 2004 asset allocation, URS theoretically would have had $1.34 billion in additional assets, as shown in "*URS Allocation vs. 2004 Allocation, Savings*." This is based on a model growth of 111.6% vs. 102.4% for the actual portfolio. The 7-

year number, which also includes the 2008 crash, is similar at $1.31 billion. The 5-year number catches big stock runs without the crash and comes in at $2.08 billion. The 3-year number is only $139 million better. For 2013 alone, the original allocation was better by $480 million.

URS Allocation vs. 2004 Model Allocation, Model Savings

Time Period		URS Allocation Market Return	2004 Allocation Model Market Return	2004 Allocation Unrealized Investment Income (millions)
1-Year	(2013)	14.9%	17.00%	$480
3-Year	(2011-2013)	33.7%	34.4%	$139
5-Year	(2009-2013)	71.6%	83.5%	$2,088
7-Year	(2007-2013)	42.9%	48.9%	$1,312
10-Year	(2004-2013)	102.4%	111.6%	$1,349

This takes the actual URS return minus the same asset class returns reallocated to 2004 levels times the assets to compute a model potential difference.

A closer look at the difference in the original 12% and the 40% in alternatives revealed that no hedge funds were in the original 2004 mix. Furthermore, only 3.3% of this was in private equity, leaving the rest of the alternatives in real assets, which was primarily real estate (as shown in the 2004 CAFR).

The asset allocation shifts out of US Equity helped approximately 200 basis points (bps) in 2008, hurt 700 bps in 2009, and then hurt another 200 bps in 2013. In my opinion, this was a main driver in the original allocation beating the actual allocation over many time periods. The big difference year was 2009, where domestic equities soared 33.4%. Instead of owning 38% domestic stocks (2004 allocation) URS was down to only 23% in US stocks.

During the 10-year period URS went from 38% US stocks to 19%, with the difference primarily invested in hedge funds and private equity. While this change in allocation was somewhat positive in 2008 during the downturn, it became costly during 2009 economic upturn. It also hurt quite a bit in 2013. For example, in 2009 while URS stocks were up over 33%, the URS private equity portfolio that replaced a lot of that allocation was down -11%. In 2013 URS stocks were up over 26% while their absolute return (hedge funds) were up 10%.

Analysis and Expert Opinion

Introduction

While URS has performed in line or slightly above its peers over ten years and longer periods, they have underperformed the last five years, after the 2008 crash. URS (along with around a quarter of the larger US public plans) significantly lowered allocations to US Stocks and

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primarily increased its allocations to alternatives. All of these plans, including URS, underperformed plans with more US Stocks in this period of very high stock market performance, especially compared to most alternative investments.

Fee Drag on Performance

My opinion and concern is that a significant amount of the alternative underperformance in the last five years for all public plans including URS is a result of high fees. Fees in alternatives, including performance fees, were calculated in a recent North Carolina report (completed by Benchmark Financial Services, Inc. for the State Employees Association of North Carolina) to be 300 basis points or more.[iv] Utah's 12% allocation to alternatives in 2004 has grown to nearly 40% allocation in 2014 which, by my estimate, means they could be paying over $300 million a year in fees just in alternatives.

While it is difficult to time markets and asset class, one thing plans can control, to some extent, is investment fees. It is important to note that URS was nationally lauded for its success in negotiating lower fees in 10 of its 40 hedge funds in 2009.[v] However, 300 bps a year, or even 200 bps, is a significant drag on performance. Given URS prior success and continued high allocation to alternatives, I think it is important for the Utah Legislature to encourage URS to continue and expand their effort to minimize fees.

Alternative Investment Performance & Risk Factors

Many plans and consultants nationwide claim that their plans are less risky because of the higher allocation to alternatives which have less correlation with the stock market. I believe that this claim of lower risks have led to higher allocations of alternative investments in public pensions nationwide. I contend that while alternatives lower some risks, they raise many other types of risks. Specifically, I believe that the proponents of higher alternatives over emphasize the use of one-dimensional risk models based on standard deviation and correlation with, primarily, the stock market. I think the proponents under emphasize other risks such as liquidity risk, leverage risk, legal risk, fiduciary risk, pricing risk, and fee risk. Alternative assets do look attractive in the one-dimensional risk models because they perform differently than the stock market. There are diversification benefits that smooth out the overall plans standard deviation of return. I contend that if you put what I consider proper emphasis on the multitude of risks with alternatives, they are less attractive from a risk return point of view and deserve a lower allocation in portfolios.

Public pension plans historically hired investment managers to manage the plans, stocks, and bonds that were owned and physically held in the name of the plan at a large custodial bank. This provided total transparency and instant liquidity, as well as reduced legal and fiduciary risk. Also, most custodians provided independent third party pricing for these stocks and bonds which provided an additional check on the investment valuation and performance provided by the managers.

However, in the last ten years many public pensions have moved significant assets into alternative assets. Most alternatives are not held by the custodian, but in a limited partnerships

that generally have much more limited liquidity and transparency of not only the underlying assets, but of the fees and expenses charged as well. Also, the pricing of the underlying illiquid assets—and thus the performance of these investments—are heavily influenced by the managers themselves with little or no independent third party pricing.[vi]

My opinion is that there is compelling evidence of very positive benefits for the first 10% in alternatives for the diversification benefits for most public pension plans under almost all market conditions. This is consistent with the 2004 URS allocation and some of the better performing peers, especially in the 5-year period. There are no hard and fast numbers, but as allocations get over 10%, and especially when they get over 20%, the other unmeasured risks I outlined before gradually, I believe, start to outweigh the diversification benefits from a normal stock market. A 40% allocation can be appropriate if the highest priority of the entity is to weather bad markets. But, for public pensions, in general, I think you are punished more for being wrong, than you are awarded for being right. **Therefore, I believe that over time URS should consider reducing its 40% exposure to alternatives more in line with the median state plan, especially the hedge fund allocation.**

Alternatives in Public Pension – Trends 2014

In April the SEC found that over half of the alternative managers (private equity & hedge funds) surveyed, charged additional fees on top of the already high fees.[vii] Toward the end of the year, under SEC pressure, major private equity firm Blackstone admitted to hiding fees.[viii] A few public plans in California, led by Orange County, are binding together to negotiate lower private equity fees collectively.[ix] Another report points out many plans have started to negotiate more regarding hedge fund fees in which URS already has a successful track record of aggressively negotiating fees.[x]

A look at the industry demonstrates that varied philosophies exist on asset mix. On September 16, 2014 CALPERS announced it would dump its entire hedge fund portfolio of over $4 billion because it finds them too costly and complicated.[xi] Days later, the State Auditor of Pennsylvania called for their major public plans to dump hedge funds.[xii] However many plans, including the Pennsylvania plan, and New Jersey and Texas Teachers have publicly declared they are sticking with their hedge fund allocations.

Conclusion

Investment performance is not only important to the participants in public pension plans, but to all taxpayers as it effects their contribution.

URS has nearly twice the allocation to alternative investments than the median large state plan. Within alternatives, they have around four times the amount of hedge funds of the median plan. While they have less exposure to stock market swings than the average plan, I think these alternatives at this level increase some other types of risks. In my opinion most hedge funds and other alternative investments increase liquidity risk, leverage risk, legal risk, fiduciary risk, pricing risk, and fee risk.

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URS overall performance has ranged from below average to average, since the 2008 crash, but is not unlike a number of other public plans who have lower US stock allocations and higher than average allocations to alternatives, specifically hedge funds. URS held up better than most in 2008, but lagged in the bull markets of mostly 2009 and 2013 accounting for most of the difference.

It is widely held in the investment industry that asset allocation drives over 90% of returns and this seems the case in Utah as well from the data. If URS had stuck with its 2004 asset allocation, using the exact same money managers, it would have been above average in performance, suggesting that selection of money managers has been mostly on target. URS current allocation of around 40% alternatives (Real Estate + Private Equity + Hedge Fund) is set up to outperform peers *if* the stock market underperforms the alternatives, and conversely should underperform if, like in 2013, the stock market outperforms the alternatives. **This is why I believe that over time URS should consider reducing its 40% exposure to alternatives, especially the hedge fund allocation.**

We do not know what future markets will be and how the investments will perform. It is a difficult for all plans to decide how much market risk they want to take. However we do know that pension contributions are not going away and that they will continue to be huge parts of state budgets. State governments will continue to grapple with the types and amount of oversight that they want to have over pension investments.

CHRIS TOBE, CFA, CAIA has 25 years of institutional investment experience with a focus on Public Pension plans. He currently is advising a city on public pension litigation. His recent critically acclaimed book "Kentucky Fried Pensions" has already become one of the all time bestselling books on public pensions and covers not only investments but actuarial and funding issues. In 2011 he consulted to major public plans in Texas and Maryland with his firm Stable Value Consultants. From 2008-2012 he served as a Trustee and on the Investment and Audit Committees for the $14 billion Kentucky Retirement Systems. From 2008-2009 he was a Sr. Consultant with NEPC and worked with a number of public pension plans including Oklahoma Investment Commission, Oklahoma Tobacco Fund, St.Louis Sewer District, St. Louis Public Schools, Amtrak & City of Dearborn. While at AEGON 2001-2008 he worked with Public Plans such as Montana, Pennsylvania, LA County, Cook County, Chicago, Ohio, Vermont, & Memphis. While at Fund Evaluation group 1999-2001 he worked with Public University Endowments at Purdue, U.of South Carolina, Indiana State and U. of Memphis. From 1997-1999 he worked with Kentucky State Auditor Ed Hatchett and published a 40 page report on the investments of both the Kentucky Retirement Systems and the Kentucky Teachers Retirements Systems. He has published articles on public pension investing in the Financial Analysts Journal, Journal of Investment Consulting, Journal of Performance Measurement, and Plan Sponsor Magazine. He has given over a dozen presentations on Public Pension investing to a number of national groups and conferences. In October 2013 he spoke on a Public Pension Panel at DePauw University, and in January 2013 spoke at a Public Pension forum at the Ohio State Law School and participated in the Federal Reserve Bank of Cleveland Public Pension conference in November 2013. In August 2014 he spoke to the National Council on State Legislatures on Public Pension fund investing. He holds an MBA in Finance and Accounting from Indiana University Bloomington and a BA in Economics from Tulane. He has the taught the MBA investment course at the University of Louisville, and is the former President of the CFA society of Louisville. As a public pension trustee in 2010 he completed the Program for Advanced Trustee Studies at Harvard Law School and in 2011 he completed Fiduciary College held at the Rock Center at Stanford University.

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[i] *"Boston College Center for Retirement Research http://crr.bc.edu/data/public-plans-database/*

[ii] *Cliffwater State Pension Investment Research https://www.virtus.com/vsitemanager/Upload/Docs/Cliffwater_Research_StatePensionStudyonAssetAllocationandPerformance_6724.pdf*

[iii] *On this "What If" analysis a number of assumptions were made. The same asset class returns and thus manager returns were used for both original and actual returns. Original allocation of 2004 was applied in each time period vs the real allocation which varied year to year. This*

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difference was applied to the actual year end value. I feel the actual year end value is more defensible than a year end based on hypothetical original allocation returns, but they are not large.

[iv] *North Carolina Forensic Investigation by Benchmark Financial Services, Inc. http://www.seanc.org/files/5113/9817/8618/North_Carolina_Pension_Fund_Forensic_Investigation_Report.pdf*

[v] *Hedge Fund Fee Negotiations http://www.nytimes.com/2009/04/15/business/15carlyle.html and http://www.wsj.com/articles/SB123629796624746265*

[vi] *George Washington U. Private Equity Fee Research http://pension360.org/private-equity-firms-may-inflate-returns-claims-research/*

[vii] *"SEC finds Bogus Private Equity Fees" Bloomberg April 7, 2014 http://www.bloomberg.com/news/2014-04-07/bogus-private-equity-fees-said-found-at-200-firms-by-sec.html*

[viii] *"Blackstone admits hidden PE fees" Bloomberg http://www.bloomberg.com/news/2014-12-31/blackstone-opens-up-about-hidden-fees-as-sec-pushes-transparency.html*

[iix] *Private Equity Investors Join Together for Lower Fees Pensions & Investments December 2014 http://www.pionline.com/article/20141221/PRINT/141229995/private-equity-investors-join-together-to-get-benefits-of-separate-account*

[ix] *Negotiating Hedge Fund Fees Ernst & Young http://pension360.org/chart-negotiating-hedge-fund-expenses/*

[x] *"CALPERS dumps Hedge Funds" Reuters September 16, 2014 http://www.reuters.com/article/2014/09/16/us-pensions-calpers-hedgefunds-idUSKBN0HA2D120140916*

[xi] *"Pennsylvania Plans should dump costly Hedge Funds" Philadelphia Enquirer http://www.philly.com/philly/blogs/inq-phillydeals/Auditor-Pa-should-dump-costly-hedge-funds.html*

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Appendix B
Contribution Rates, 2004-2013

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Contribution Rates, 2004-2013

Contribution Rates are for Noncontributory and Contributory Retirement systems, state and school employers only. Not included are the Firefighters, Judges, and Governors and Legislators Retirement Systems.

	Contribution Rate
2004	13.38%
2005	13.38%
2006	14.22%
2007	14.22%
2008	14.22%
2009	14.22%
2010	16.32%
2011	16.86%
2012	18.76%
2013	20.46%

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Appendix C
Assumed Rate of Return
Sensitivity Information

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Utah Retirement System

Valuation Interest Assumption Sensitivity Information

Fund 16 - Tier I Noncontributory Public Employees Retirement System for State and School

($ in Millions)

	Pro Forma Illustration based on the 2014 Actuarial Valuation				
Item	7.00% Return -0.50%	7.25% Return -0.25%	7.50% Return Valuation Assumption	7.75% Return +0.25%	8.00% Return +0.50%
(1)	(2)	(3)	(4)	(5)	(6)
1. Plan Assets					
a. Actuarial Value of Assets	$ 14,932	$ 14,932	$ 14,932	$ 14,932	$ 14,932
b. Market Value of Assets	15,994	15,994	15,994	15,994	15,994
2. Actuarial Accrued Liability					
a. Active Members	$ 8,875	$ 8,540	$ 8,220	$ 7,914	$ 7,623
b. Inactive Members	1,006	965	926	890	856
c. Retirees and Beneficiaries	9,535	9,334	9,141	8,955	8,775
d. Total Actuarial Accrued Liability	$ 19,416	$ 18,839	$ 18,287	$ 17,759	$ 17,254
3. Funding Ratio					
a. Actuarial Value Basis (1.a. / 2.d.)	76.9%	79.3%	81.7%	84.1%	86.5%
b. Market Value Basis (1.b. / 2.d.)	82.4%	84.9%	87.5%	90.1%	92.7%
4. Unfunded Actuarial Accrued Liability					
a. Actuarial Value Basis (2.d. - 1.a.)	$ 4,484	$ 3,907	$ 3,355	$ 2,827	$ 2,322
b. Market Value Basis (2.d. - 1.b.)	3,422	2,845	2,293	1,765	1,260
5. Development of the Employer Contribution Rate					
a. Normal Cost Rate	13.43%	12.56%	11.75%	11.00%	10.30%
b. Amortization of the UAAL	10.97%	9.81%	8.67%	7.53%	6.39%
c. Total Employer Contribution Rate	24.40%	22.37%	20.42%	18.53%	16.69%
6. Projected contribution requirement for FY 2016	$ 717	$ 656	$ 597	$ 540	$ 484

Notes and assumptions:

- The cost and liabilities are determined using asset and census information used to prepared the actuarial valuation as of January 1, 2014, which include the use of updated assumptions documented in the December 31, 2013 experience study report and adopted by the Board in August 2014.
- For purposes of calculating the pro forma information, only the real rate of return component of the investment return assumption was modified. All other economic and demographic assumptions remain unchanged.
- Per URS Statutes, the Board of Trustees adopts the actuarial assumptions used in the valuation and certify the contribution rates annually.
- The contribution rates include the amortization cost attributable to the 3% substantial substitute.
- The employer contribution rates are determined using the actuarial value of assets.
- The funding ratio and unfunded liability are reported on a market value of asset basis for accounting purposes under GASB Statements No. 67 and 68.

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Appendix D
Series 65 Exam
Specifications and Outline

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NASAA Investment Adviser Competency Exam
(Series 65)
Exam Specifications and Outline
(Effective 1/1/2010)

CONTENT AREA	**# of Items**
1. Economic Factors and Business Information	**19 (14%)**
A. Basic economic concepts	6
1. business cycles	
2. monetary and fiscal policy	
3. US dollar valuation	
4. inflation/deflation	
5. interest rates and yield curves	
6. economic indicators	
a. GDP	
b. employment indicators	
c. trade deficit	
d. balance of payments	
e. CPI	
B. Financial reporting	5
1. financial statements	
a. income statement	
b. balance sheet	
c. statement of cash flow	
2. financial ratios	
a. current ratio	
b. quick ratio	
c. debt-to-equity ratio	
3. corporate SEC filings	
4. annual reports and prospectuses	
C. Quantitative methods	3
1. time value of money concepts	
a. internal rate of return (IRR)	
b. net present value (NPV)	
2. descriptive statistics	
a. measures of central tendency (mean, median, mode)	
b. range	
c. standard deviation	
d. Beta and its derivatives	
3. valuation ratios	
a. price/earnings	
b. price-to-book	
D. Types of risk	5
1. systematic risk	
a. market	
b. interest rate	

c. inflation
2. unsystematic risk
a. business
b. regulatory
c. political
d. liquidity
3. opportunity cost
4. capital structure including liquidation priority

2. Investment Vehicle Characteristics **31 (24%)**

A. Types and characteristics of cash and cash equivalents 3
1. insured deposits
a. demand deposits
b. CD's
2. money market instruments
a. commercial paper
b. Treasury bills

B. Types and characteristics of fixed income securities 5
1. U.S. government and agency securities
a. Treasury securities
b. FNMA
c. TIPS
2. corporate bonds
a. coupon bonds
b. convertible bonds
c. tax implications
d. bond rating
3. municipal bonds
a. general obligation
b. revenue
c. tax implications
4. foreign bonds
a. risks and advantages
b. government debt
c. corporate debt
d. Brady bonds

C. Methods used to determine the value of fixed income securities 3
1. fixed income valuation factors
a. premium
b. discount
c. duration
d. maturity
e. yield to call
f. yield to maturity
g. coupon
h. conversion valuation
i. bond ratings
2. discounted cash flow

D. Types and characteristics of equity securities 5
   1. equity interests
      a. common stock
      b. preferred stock
      c. convertible preferred stocks
      d. warrants
      e. ADRs
   2. restricted stock
   3. foreign stocks
   4. employee stock options
      a. incentive
      b. non-qualified
   5. shareholder rights
      a. voting rights
      b. dividends
      c. liquidity preferences
      d. antidilution

E. Methods used to determine the value of equity securities 2
   1. fundamental analysis

F. Types and characteristics of pooled investments 4
   1. open-end investment companies (mutual funds)
   2. closed-end investment companies
   3. unit investment trusts
   4. exchange traded funds
   5. real estate investment trusts (REITs)

G. Methods used to determine the value of pooled investments 2
   1. net asset value
   2. discount/premium

H. Types and characteristics of derivative securities 1
   1. types
      a. options (definition only)
      b. futures (definition only)
      c. forward contracts (definition only)

I. Alternative Investments 2
   1. hedge funds (definition only)
   2. limited partnerships (definitions only)

J. Insurance-based products 4
   1. variable annuities
   2. fixed annuities
   3. equity indexed annuities
   4. life insurance (e.g., whole, term, universal, variable)

3. **Client Investment Recommendations and Strategies** **40 (31%)**

A. Type of client 4
   1. individual, sole proprietorship
   2. business entities
      a. general partnership

b. limited partnership
c. limited liability company
d. C-corporation
e. S-corporation

3. trusts & estates

B. Client profile 4

1. financial goals and strategies
    a. current income
    b. retirement
    c. death
    d. disability
    e. time horizon
2. current financial status
    a. cash flow
    b. balance sheet
    c. existing investments
    d. tax situation
3. risk tolerance
4. non-financial investment considerations
    a. values
    b. attitudes
    c. experience
    d. demographics

C. Capital Market Theory 3

1. Capital Asset Pricing Model (CAPM)
2. Modern Portfolio Theory
3. Efficient Market Hypothesis
    a. semi-strong
    b. strong
    c. weak

D. Portfolio management styles and strategies 5

1. strategic asset allocation
    a. style
    b. asset class
    c. rebalancing
    d. buy/hold
2. tactical asset allocation (e.g., market timing)
3. active vs. passive
4. growth vs. value
5. income vs. capital appreciation

E. Portfolio management techniques 3

1. diversification
2. sector rotating
3. averaging
    a. dollar-cost
    b. capital goal within specified time period

F. Tax Considerations 4

1. individual income tax fundamentals

        a. capital gains
        b. tax basis
    2. alternative minimum tax
    3. corporate, trust, and estate income tax fundamentals
    4. estate and gift tax fundamentals
G. Retirement plans 3
    1. Individual Retirement Accounts (traditional and Roth)
        a. traditional
        b. Roth
    2. qualified retirement plans
        a. pension and profit sharing
        b. 401(k)
        c. 403(b)
        d. 457
    3. nonqualified retirement plans
H. ERISA issues 3
    1. fiduciary issues
        a. investment choices
        b. 404(c)
    2. investment policy statement
    3. prohibited transactions
I. Special types of accounts 3
    1. education-related
        a. 529s
        b. Coverdell
    2. UTMA/UGMA
    3. account ownership options
        a. joint
        b. pay-on-death
        c. tenancy in common
J. Trading securities 5
    1. terminology
        a. bids
        b. offers
        c. quotes
        d. market, limit, or stop order
        e. short sale
        f. cash accounts, margin accounts
        g. principal or agency trades
    2. role of broker-dealers, specialists, market-makers
    3. exchanges and markets
        a. NYSE, AMEX, CBOE, regional, international
        b. OTC, Nasdaq
    4. costs of trading securities
        a. commissions
        b. markups
        c. spread

K. Performance measures 3
1. returns
A. risk-adjusted
B. time-weighted
C. dollar-weighted
D. annualized
E. total
F. holding period
G. internal rate of return
H. expected
I. inflation-adjusted
J. after tax
2. yield
A. yield-to-maturity
B. current yield
3. benchmark portfolios

4. Laws, Regulations, and Guidelines, including Prohibition on Unethical Business Practices 40 (31%)

A. State and Federal Securities Acts and related rules and regulations (19%)
1. Regulation of Investment Advisers, including state-registered and federal covered advisers 4
B. definitions
C. registration/notice-filing requirements
D. post-registration requirements
2. Regulation of Investment Adviser Representatives 4
a. definitions
b. registration
3. Regulation of Broker-dealers 4
a. definitions
b. registration
c. post-registration requirements
4. Regulation of Agents of Broker-dealers 4
a. definitions
b. registration
5. Regulations of Securities and Issuers 4
a. definitions
b. registration
c. post-registration requirements
d. exemptions
e. state authority over federal covered securities
6. Remedies and Administrative Provisions 4
a. authority of administrator
b. administrative actions
c. other penalties and liabilities

B. Ethical practices and fiduciary obligations (12%)
1. communications with clients and prospects 4
a. disclosure

b. unlawful representations concerning registrations
c. performance guarantees
d. client contracts

2. compensation 4
    a. fees
    b. commissions
    c. performance-based fees
    d. soft dollars
    e. disclosure of compensation
3. client funds and securities 4
    a. custody
    b. discretion
    a. trading authorization
    b. prudent investor standards
    c. suitability
4. conflicts of interest and other fiduciary issues 4
    a. excessive trading
    b. loans to and from clients
    c. sharing in profits and losses in a customer account
    d. client confidentiality
    e. insider trading
    f. selling away

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Appendix E
Glossary

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Glossary

1. Absolute Return—investment strategies whose objective is to earn a positive rate of return that does not depend on the return of standard market indexes. Typically these strategies are implemented by privately organized investment vehicles, commonly referred to as Hedge Funds.

2. Active Management—the use of a human element, such as a manager, to actively manage a fund's portfolio. Active managers rely on analytical research, forecasts, and their own judgment and experience in making investment decisions on what securities to buy, hold and sell. The opposite of active management is called passive management or "indexing".

3. Actuarial Accrued Liability—the present value of a pension fund's total future benefits (payable to the pension plan participants).

4. Actuarial Assets—calculated by partially recognizing investment gains and losses in the year they are incurred, with the remainder recognized in subsequent years. This method dampens large fluctuations in the employer contribution rate.

5. Alternative Investments—an investment that is not one of the three traditional asset types (stocks, bonds and cash). Most alternative investment assets are held by institutional investors or accredited, high-net-worth individuals because of their complex nature, limited regulations and relative lack of liquidity. At URS, private equity, absolute return (hedge funds), and real assets are considered alternative investments

6. Asset Allocation—apportioning a portfolio's assets according to an individual's goals, risk tolerance and investment horizon.

7. Basis Points (bps)—a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 0.01% (0.0001). The relationship between percentage changes and basis points can be summarized as follows: 1% change = 100 basis points, and 0.01% = 1 basis point.

8. Debt Securities—any debt instrument that can be bought or sold between two parties and has basic terms defined, such as notional amount (amount borrowed), interest rate and maturity/renewal date. Debt securities include government bonds, corporate bonds, CDs, municipal bonds, preferred stock, collateralized securities (such as CDOs, CMOs, GNMAs) and zero-coupon securities. Also known as "fixed-income securities."

The interest rate on a debt security is largely determined by the perceived repayment ability of the borrower; higher risks of payment default almost always lead to higher interest rates to borrow capital.

9. Defined Benefit Plan—an employer-sponsored retirement plan where employee benefits are distributed based on a formula using factors such as salary history and duration of employment. Investment risk and portfolio management are entirely under the control of the company. There are also restrictions on when and how you can withdraw these funds without penalties.

10. Defined Contribution Plan—a savings plan that allows participants to make pre-tax contributions that accumulate tax-free. Contributions, plus any earnings, are not subject to state or federal taxes until withdrawn, in most cases after retirement. The amount paid is determined by the amount of contributions made and the rate of return on the investments chosen.

11. Equity Security—an instrument that signifies an ownership position (called equity) in a corporation, and represents a claim on its proportional share in the corporation's assets and profits. Most stock also provides voting rights, which give shareholders a proportional vote in certain corporate decisions. Also known as equity or stock or corporate stock.

12. Equity Market—the market in which shares of publicly held companies are issued and traded either through exchanges or over-the-counter markets. The equity market provides companies with access to capital in exchange for giving investors a slice of ownership in the company. The terms positive and negative relate to whether the market is growing or shrinking in value. Also known as the stock market.

13. Experience Study—a report provided by an actuary that includes a recent analysis of plan experience, recommendations for actuarial assumptions and methods, and information about the actuarial impact of these recommendations on the liabilities and other key actuarial measures.

14. Funded Ratio—the ratio of actuarial value of assets to the actuarial accrued liabilities, which shows the percent of funding needs being met at a given point in time and enables planning for future funding needs.

15. Funded Status—the degree (as a percentage) to which a pension plan is able to pay future retirement benefits to members using accumulated assets that have been set aside. Unfunded plans do not have assets set aside and retirement benefits are usually paid directly from employer contributions.

16. Hedge Funds—alternative investments using pooled funds that may use a number of different strategies in order to earn return for their investors. Hedge funds may be aggressively managed or make use of derivatives and leverage in both domestic

and international markets with the goal of generating positive returns (either in an absolute sense or over a specified market benchmark). Because hedge funds may have low correlations with a traditional portfolio of stocks and bonds, allocating an exposure to hedge funds can be a good diversifier. Hedge funds are considered by URS to be an alternative investment.

17. Investment Return Assumption—the actuarially determined rate of return that investments are expected to produce. Also known as "assumed rate of return."

18. No-Action Letter—a document from a regulatory agency to an individual or entity providing assurance that a particular product, service, or action does not constitute a violation of law.

19. Paid Investment Fees—fees paid directly to investment managers that are then reported publicly per requirements from the Governmental Accounting Standards Board (GASB).

20. Passive Management (Implementation)—a style of management where a fund's portfolio mirrors a market index. Passive management is the opposite of active management. Also known as "passive strategy," "passive investing" or "index investing."

21. Private Equity—equity capital that is not quoted on a public exchange. Private equity consists of investors and funds that make investments directly into private companies or conduct buyouts of public companies that result in a delisting of public equity. The majority of private equity consists of institutional investors and accredited investors who can commit large sums of money for long periods of time. Private equity is considered by URS to be an alternative investment.

22. Real Assets—physical or tangible assets that have value, due to their substance and properties. Real assets include precious metals, commodities, real estate, agricultural land and oil. They are appropriate for inclusion in most diversified portfolios— with their proportion dependent on the investor's risk tolerance and preferences—because of their relatively low correlation with financial assets, such as stocks and bonds. They are particularly well suited for inflationary times, because of their tendency to outperform financial assets during such periods. Real assets are considered by URS to be an alternative investment.

23. Security—a financial instrument that represents (1) an ownership position in a publicly traded corporation (stock), (2) a creditor relationship with governmental body or a corporation (bond), or (3) rights to ownership as represented by an option.

24. Sharpe Ratio—the portfolio return, less the risk free return, divided by the standard deviation.

25. Withheld Investment Fees—fees that alternative investment managers have the ability per contract to withhold from investment proceeds before distributing those proceeds, as is standard industry practice. When a higher percentage of assets are allocated to alternative investments, more investment fees are withheld.

Agency Response

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Utah Retirement Systems

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R. CHET LOFTIS
Director

April 24, 2015

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

Dear Mr. Schaff:

Attached is the Utah Retirement Systems' (URS) response to *A Performance Audit of URS' Management and Investment Practices* (Report Number 2015-03) that provides additional information relating to the audit report.

This audit was very broad in its scope relating to many aspects of URS that required the review of several very complex issues. In light of this thorough review, I hope that legislators and other retirement stakeholders have confidence that URS administers systems and plans in compliance with the governing statutes provided in Utah Code Title 49, invests and protects the assets under management prudently, uses best practices, has sound management, and has adequate controls and processes.

Based upon many years of experience, it is my opinion that the members of the Utah State Retirement Board (Board) take their fiduciary responsibilities very seriously. The Board and its staff are committed to continually reviewing business activities and looking for ways to improve and innovate in light of the long term obligations of URS. I will present the audit report to the Board and explore ways to facilitate the implementation of recommendations, consistent with URS' purpose and fiduciary responsibilities.

Representatives of URS will be available to respond to questions relating to this audit report as it is presented to legislative committees.

Sincerely,

Daniel D. Andersen
Executive Director
Utah Retirement Systems

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Utah Retirement Systems' Agency Response to A Performance Audit of URS' Management and Investment Practices

Utah Retirement Systems (URS) recognizes the thorough analysis conducted by the Office of the Legislative Auditor General in performing this audit. For eight months, several auditors have conducted the in-depth review of URS required to address the many questions presented under the broad scope of this legislative audit request. These auditors took the time and effort to understand the complexity of the issues, reviewed numerous documents, and met repeatedly with URS staff to discuss issues. URS also made every effort to fully cooperate with the auditors and ensure they were provided all available information requested in a timely manner.

The scope of this audit covered four separate areas regarding URS management and investment practices and the report also provides an introduction with an agency overview. While the performance audit itself provides valuable information and discussion, URS believes that some additional information, background, and context will be useful for this report. Accordingly, this agency response will address:

- Introduction
- Transparency Concerns
- Investment Asset Allocation
- Fiduciary Responsibilities
- Defined Contribution Plan Investment Manager Selection and Retention Processes

Chapter I: Introduction

The status of the Utah Retirement Systems (URS) is unique. The Utah State Legislature, by statute, established URS as an independent agency free of management and control from the executive branch of state government. Unlike almost all other entities which may be deemed state agencies or quasi-state agencies, URS does not operate on state General Fund money or other state appropriations. URS' unique governance was also established in recognition that URS is not engaged in traditional governmental functions, but performs business and investment activities on behalf of a defined group of beneficiaries.

The URS systems, plans, and programs are maintained on an actuarially sound basis under the management of a board of directors, the Utah State Retirement Board (Board). The funds for the various systems and plans are administered as a common trust fund, known as the Utah State Retirement Investment Fund (Fund), exclusively to provide benefits to qualifying beneficiaries. Trust funds may not be diverted or appropriated for any other purpose. The Board members are the trustees of the Fund and exercise their duties pursuant to statutory and common law fiduciary responsibilities.

One key purpose of making the Board independent and separate from state management and control is to limit the liability of the State of Utah concerning the Fund and the Board's fiduciary activities. The state's obligation to URS, like other participating employers, is making the employer contributions for its own employees each pay period. This helps ensure that the state, except for its role as a participating employer, has limited legal responsibility for the obligations, contracts, activities, expenses, and debts of URS.

Eligible public employees are the beneficiaries of the Fund. Benefits, such as monthly retirement allowances and death benefits, are paid according to statutory provisions. The Legislature sets Utah retirement policy, plan design, and benefit specifications in statute. URS is the administrator of the systems, plans, and programs established under Utah Code Title 49, Utah State Retirement and Insurance Benefit Act.

Assets of the Fund generally come from three sources: employer contributions, member contributions, and investment earnings. However, investment earnings are the most significant source of the additions to the retirement systems. Income from the Fund accumulates for the advantage of the participating employers, which are the state and its political subdivisions. The greater the earnings from Fund investments, the smaller the amount the participating employers must pay as employer contributions—the Board certified rate expressed as a percent of the salary of active employee members—to URS to maintain the systems and plans on a financially and actuarially sound basis, as required by statute.

Employer contributions may be "public money" until the monies are contributed to URS, at which time the monies become fiduciary trust funds rather than public monies. Funds are accumulated to meet current and future benefit obligations to retirees and beneficiaries. Payments are made from the Fund for benefits for qualifying beneficiaries. Administrative expenses are paid exclusively out of investment earnings and no state or other public funds are appropriated to meet any administrative costs.

To meet its current and future obligations as a pension plan, URS must follow industry best practices for long-term investing, which include using sound investment processes, disciplined strategy, a sound asset allocation model, diversification, monitoring current market conditions, anticipating future markets, and adjusting the portfolio asset allocation based on various risks. URS' objective and fiduciary obligation is to meet the assumed investment rate of return, ideally with the lowest amount of risk and volatility possible.

Although URS is independent from the state management and control applicable to many other agencies, it has significant legislative oversight. URS regularly interacts with a legislative committee, the Retirement and Independent Entities Committee, which is principally focused on retirement policy and URS' administrative, financial, and investment issues. Working on an ongoing basis with legislators who develop and maintain legislative expertise in URS issues facilitates coordinated oversight of retirement policy and administration during General Sessions and throughout each interim.

Chapter II: Transparency Concerns

In this chapter, the legislative audit team reviewed a number of transparency-related questions relating to information practices and meetings. In short, the audit found that URS is in compliance with all statutory requirements.

The audit report affirmatively recognized that URS has made a considerable effort to become more transparent. One important development is the creation of the website, newsroom.urs.org, a forum URS uses to provide information for policymakers, media, and the public. This facilitates online access to more detailed financial information and reports. URS also opened its administrative Board meetings to the public beginning in October 2013. The minutes and agendas for these meetings are also posted online via the newsroom.

URS strives to be in front of transparency requirements and seeks ways to provide information that is important for stakeholders to see and understand. One example of this came from the changes arising from Governmental Accounting Standards Board (GASB) Statements 67 and 68. These Statements significantly change the accounting and financial reporting of pensions by pension plans and state and local governments. The audit report notes, "URS provided information beyond what GASB required to assist employers in their pension reporting obligations, such as the employers' proportionate share of the plan pension expense." URS implemented its part of the new GASB rules a year earlier than required in order to allow state and local governments in Utah an opportunity to review, by participating employer, Net Pension Liability and other information before they will be required to report that information in their own financial statements in the future. The GASB Director of Research and Technical Activities sent a letter to URS in February 2015 expressing appreciation of URS' early implementation of the new pension standards and noting that URS had been complemented by officials from many states. The letter stated, "when an entity like URS demonstrates leadership by implementing those standards, not only do the users of their financial statements benefit from this effort, but many other governments benefit. . . . Thank you for being a leader in the pension arena."

In general, transparency relating to governmental entities serves global public policy considerations, such as open government and the accountability of public finances. It is important to consider that URS has unique status as an independent agency and is not engaged in traditional governmental functions. Instead, URS performs business and investment activities on behalf of a defined group of beneficiaries. This means that transparency for URS will be different in some respects from other governmental entities.

Any changes relating to URS transparency should be consistent with and adequately protect the Board's fiduciary role and responsibilities, including its capacity as the trustee of the Fund. This helps ensure that the State of Utah is not liable for the obligations, expenses, debts, and liabilities of URS beyond the responsibility to pay the employer contributions for state employees. Also, appropriate transparency measures preserve URS' competitive business position regarding investments and the Public Employees Health Program (PEHP). Finally,

privacy protections for members and participants' personal information in retirement, defined contribution plan, and health insurance records must be maintained.

URS management will work with the Board and explore ways to facilitate the implementation of the auditor's transparency recommendations, consistent with URS' purpose and fiduciary responsibilities.

Chapter III: Investment Asset Allocation

In this chapter, the legislative audit team analyzed certain issues relating to the asset allocation of the Investment Fund. As noted in the audit report, "As trustees of the Utah State Retirement Investment Fund, the two most important functions of the board are the establishment of the DB asset allocation and the authorization of investment policies."

As a pension plan, URS is responsible to meet its current and future obligations to members and beneficiaries. This requires URS to follow industry best practices for long-term investing, which include using sound investment processes, monitoring current market conditions, anticipating future markets, and adjusting the portfolio asset allocation based on various risks.

The Board members are the trustees of the Fund and exercise their duties pursuant to statutory and common law fiduciary responsibilities. For example, Utah Code Section 75-7-804 requires, "A trustee shall administer the trust as a prudent person would, by considering the purposes, terms, distributional requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution."

URS' objective and fiduciary obligation is to meet the actuarially assumed investment rate of return of 7.5% with the least amount of risk in the portfolio. URS seeks to achieve consistent investment returns, which facilitates meeting the actuarially assumed investment rate of return over the long-term. To this end, the Board has worked with its investment staff and consultants to examine a wide array of potential asset allocations. There are many valid viewpoints among investment professionals around the world regarding appropriate asset allocations.

The URS Board has developed a conservative asset allocation designed to meet the assumed investment rate of return over the long-term in order to provide the associated long-term retirement benefits to URS members and their beneficiaries. Using sound investment processes, disciplined strategy, a sound asset allocation model, and diversification, URS' portfolio has been designed to emphasize downside protection.

While cognizant of the asset allocations of other plans, URS seeks first to construct an asset allocation that fits its needs and specific circumstances. URS does not seek to be a top performer in terms of investment returns; it does not chase the highest returns possible with disregard of risk to its portfolio. An asset allocation designed to produce high rates of return will often experience offsetting low returns. Those who try to hit home runs in their investment portfolio will often strike out; losses have a significant negative impact on long-term

compounded returns. The URS asset allocation is designed to minimize losses in down markets, allowing URS to take advantage of compounding returns on a larger asset base going forward.

The URS asset allocation is designed to have lower risk while meeting the assumed investment rate of return. Callan Associates, an independent professional investment consulting firm and the primary investment consultant for URS, indicates the URS investment portfolio has low risk compared to the Callan peer group. The volatility of the URS portfolio, as measured by the standard deviation of its investment returns, ranks as one of the lowest among the peer group. URS' risk-adjusted rates of return, as measured by the Sharpe Ratio, are in the top decile in recent years compared to its peers. The Sharpe Ratio is commonly used in the investment industry to compare risk-adjusted returns among investment portfolios.

The URS asset allocation has produced investment rates of return that meet the assumed rate of return of 7.5%. As noted in the audit report, the URS 10-year rate of return is 7.52%. URS also regularly monitors rolling 10-year returns. Rolling 10-year periods allow investment performance to be viewed over market cycles, which contain a wide variety of market environments and risks. URS' average investment returns over rolling 10-year periods are at or above the median of the Callan peer group for each of the 10-year periods reviewed in the audit. In addition, URS' 20-year average investment returns exceed the 7.5% assumed rate of return each year during the period analyzed in the audit.

Acting in its fiduciary capacity, the Board makes the final decision regarding the asset allocation of the Fund. The Board approves an asset allocation it believes will maintain the retirement plans and programs on a financially and actuarially sound basis. As noted in the audit report, the Board collectively has over 150 years of investment experience, and has more investment representatives than any other public employee retirement system surveyed. The Board also reviews and approves URS investment policies.

URS engages Callan Associates to conduct a detailed Asset Allocation and Liability Study every three to five years. An Asset Allocation and Liability Study helps determine an appropriate asset allocation that will support the retirement benefits payable to members and beneficiaries over both the short-term and long-term. The most recent Asset Allocation and Liability Study was conducted in 2013 and reaffirmed the current URS asset allocation. In addition, a Callan memo dated March 10, 2015, states, "we believe the asset allocation adopted by the Board and concurred with by Callan represents a reasonable and well thought out investment program intended to meet the assumed rate of return requirements of URS with relatively low corresponding levels of risk."

The Office of the Legislator Auditor General employed a consultant who expressed some concerns about the URS asset allocation. The auditor has recommended that URS consider the investment consultant's concerns and anticipated market conditions as URS makes future asset allocation adjustments. The URS management and investment staff consistently monitor investment performance and market conditions across asset classes. In its investment board meetings, which are usually held monthly, the Board, URS management, and investment staff

review the asset allocation and anticipated market conditions and will consider the consultant's analysis and opinion.

Chapter IV: Fiduciary Responsibilities

This chapter of the audit report examined if URS sufficiently meets its fiduciary responsibilities to its members in regards to three areas: 1) URS Operating Costs and Investment Fees; 2) Board Qualifications; and 3) Staff Qualifications to Offer Investment Advice to URS Members.

URS Operating Costs and Investment Fees

URS operating costs are divided into two categories: administrative costs and investment costs. The audit report noted that URS administrative costs are lower than peer retirement systems. Specifically, the audit determined that URS annual administrative costs were $19 lower per member than the median of peer retirement systems. CEM Benchmarking Inc., in its Defined Benefit Administration Benchmarking Analysis, found that URS annual defined benefit administrative costs were $18 lower per member than its peer benchmark. In addition, CEM noted that URS has a more complex system than its peers, in part due to administering eight different defined benefit pension plans and four different defined contribution plans with various rules and regulations.

Investment costs are primarily incurred to pay investment management fees which vary by asset class. Traditional equity and fixed income investment management fees are lower than alternative investment management fees. As noted previously, the diversified URS investment portfolio has been designed to emphasize downside protection and capital preservation while generating sufficient returns while meeting its actuarially assumed investment rate of return with the lowest amount of risk possible. As part of its initial and ongoing investment due diligence reviews, URS negotiates investment contracts, including investment fees, to obtain the best terms possible. The audit report indicates that URS controls its investment fee rates better than peer systems. CEM Benchmarking Inc., in its Investment Cost Effectiveness Analysis, shows that URS' assertive investment management practices attained proportionately lower investment fees than the fees charged for similar investments by peer systems. In fact, URS investment fees were 11% lower than the fees charged for similar investments by peer systems in the CEM analysis. As noted in the audit report, URS was recognized by the Wall Street Journal in 2009 for its effective negotiation of alternative investment fees with its investment managers. In conjunction with its judicious fee negotiations, URS is recognized in the industry for its Alignment of Interests initiative and seeks investment managers whose long-term investment philosophy, strategy, fiduciary responsibilities, and ownership interests align with those of URS.

The audit report noted that a portion of investment fees are withheld by the investment manager before distributing investment earnings. This is a standard industry practice which is also followed in the mutual funds industry. In accordance with GASB accounting rules, withheld investment fees are not reported with other investment fees paid by URS. Withheld investment fees are included in the calculation of the investment rate of return, and URS investment rates

of return are reported net of all fees. This allows an evaluation of investment returns after all fees have been deducted, including any fees withheld by managers. It is important to note that all investment fees, including withheld investment fees, are reported to the Board monthly.

As noted in the audit report, URS' operating costs are well-managed. URS will continue to closely negotiate and monitor its operating costs as part of its commitment to meet current and future obligations to members and beneficiaries.

Board Qualifications

The legislative auditors examined whether or not the Board has sufficient investment experience and found that the Board collectively has over 150 years of investment experience, and has more investment experience than other retirement boards within a peer group comparison. URS agrees with the audit report's conclusion that the Board has sufficient investment expertise and adds that the Board and its staff take their responsibilities regarding the investment portfolio very seriously; they fulfill their fiduciary obligation to exercise reasonable care, skill, and caution.

Staff Qualifications to Offer Investment Advice to URS Members

The legislative auditors were also asked to determine if the URS advisory staff are appropriately qualified to provide advisory services. URS appreciates the auditor's assessment that the advisory staff at URS have adequate education and training—including the completion of a qualifying exam—to fulfill their advisory responsibilities.

The new URS investment advice program was established in response to member requests for services beyond the distribution of publications and online information to members. Beginning with its March 2015 launch, URS members may get access to customized professional advice from qualified URS investment advisors at no charge. This program will provide individualized education about retirement savings and investments for URS members. Initial feedback indicates high demand for the available sessions.

The creation of this program had the approval of the Board and has taken much time and planning under the direction of URS management. Importantly, this process included obtaining a no-action letter from the Utah Division of Securities to clarify and address potential investment advice and licensing issues. A key fact is that the scope of advice provided to plan members by the URS advisors is narrowly tailored to the investment offerings in the URS defined contribution and defined benefit plans.

Advice given will be in the best interest of plan members in consideration of members' individual situations and needs. This requires using a process to assess a member's financial circumstances, risk tolerance, and retirement needs, and then making professional recommendations about URS investments and retirement planning in light of those considerations.

The following table, which can be accessed under the "Financial Advice" tab at www.urs.org, provides a summary of the types of and topics covered in the individual counseling sessions.

New URS Counseling Sessions

We're here to help you plan for a better future. URS offers two types of individual counseling sessions, customized to meet your needs:

SESSION A – Basic Questions and Recommendations

This session is for you if you want information or advice on any of these topics:

- **Pension benefits:** What are my payout options and which one is right for me?
- **Savings plans (401k, 457, IRAs):** Should I invest in a 401(k) or Roth?
- **Service purchases:** Should I purchase additional pension service credit?
- **Tier 2 decision:** Should I choose the Hybrid or Defined Contribution Plan?
- **Investment options:** Which one is right for me?
- **Other basic questions**

SESSION B – Comprehensive Retirement Plan

This session is for you if you want to develop a comprehensive plan for a better retirement. After reviewing all of your potential retirement income sources, we develop a snapshot of your overall retirement situation and assess what adjustments you should make to help reach your retirement goals. We will determine:

- Where you are now in terms of retirement readiness
- Where you want to be
- And how to get there

As this new program develops, URS understands that there will need to be ongoing monitoring, review, and adjustment to ensure that the program effectively meets its objectives to serve members. URS is committed that the program will be well-managed with adequate oversight through appropriate policies, processes, and controls.

Chapter V: Defined Contribution Plan Investment Manager Selection and Retention Processes

In the final chapter, the legislative auditors were asked to determine whether URS' Defined Contribution Plan investment manager selection and retention processes have satisfactory documentation and controls. URS concurs with the audit report finding, "In summary, our review found that the URS processes to select and monitor DC Plan investment managers are well established, have adequate controls, and are executed according to policy."

Conclusion

This audit report and its recommendations involve both administrative and policy matters relating to URS. URS will discuss the audit report with the Board and explore ways to facilitate the implementation of recommendations, consistent with URS' purpose and fiduciary responsibilities. Also, URS will work with legislative committees and individual legislators to address any questions or concerns.

URS is confident that these actions will help ensure the continued success of URS and its systems and plans into the future.