Report Highlights

Louisiana School Employees' Retirement System

February 2005

Louisiana Legislative Auditor

The Louisiana School Employees' Retirement System (LSERS) is a retirement plan created by state law to provide retirement benefits for non-instructional personnel of Louisiana public school systems and their beneficiaries. The system's membership as of June 30, 2004, consisted of 25,769 members of which 10,355 are retired. LSERS's primary goal is to safeguard and manage the funds it holds in trust so that future benefits are guaranteed and protected.

As directed by Senate Concurrent Resolution Number 14 of the 2004 Regular Session, we examined various aspects of LSERS's investment activities, including the system's asset allocation policy, investment return data, investment contractor fees, selection and monitoring of investment advisors, and corrective actions for underperforming investment advisors.

Audit Results

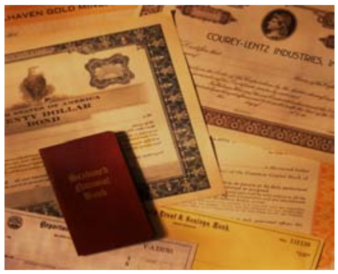
- LSERS's long-term investment returns have exceeded the system's actuarially assumed rate of return of 7.5% since December 31, 1989. Returns for two out of three of LSERS's broad asset classes and for LSERS's total portfolio were above their relevant benchmarks. However, these returns are not adjusted for investment management fees (i.e., they are presented gross of fees).
- In practice, LSERS's current asset allocation procedures appropriately balance investment risks with returns and ensure that investments are of sufficient quality to minimize the risk of loss. However, some of the risk management procedures that LSERS follows are not included in its written investment policies.
- LSERS effectively monitors compliance with the asset allocation set forth in the system's investment policy. LSERS's officials and the system's consultant review the system's asset allocation quarterly and, if necessary, adjust the amount invested in an asset class to rebalance asset amounts toward the established targeted guidelines.
- The fees LSERS is paying to its investment managers, consultant, and custodian are below or in line with the averages obtained from fee surveys of public pension plans.
- LSERS uses competitive, objective procedures with performance based criteria to select its money managers. However, the system's policies are not collected in a single document.
- LSERS has properly monitored its investment managers, although the performance data reported to the board of trustees are not adjusted for investment management fees. In addition, LSERS properly monitors trades by its custodian bank, but it does not formally evaluate its custodian or consultant regularly.
- LSERS takes corrective action for poorly performing investment managers. The system has taken no corrective action with its custodian bank or consultant because LSERS's management stated that it has not experienced any significant custodial or consultant problems.
- The policies and procedures of LSERS may not always ensure that primary decision makers avoid conflicts of interest as well as the appearance of conflicts of interest. We found two instances where gifts were accepted by LSERS's staff and trustees from an investment manager, a possible violation of the Louisiana Code of Governmental Ethics. In addition, LSERS's trustees and staff have accepted meals from its investment managers and the custodian.
- LSERS does, however, employ policies and procedures to help ensure that investment managers and consultants avoid potential conflicts of interest.

Steve J. Theriot, CPA

Legislative Auditor

How Do the Investment Returns for Different Asset Classes of LSERS Compare to Relevant Benchmarks?

- LSERS's investment returns have exceeded the system's actuarially assumed rate of return (7.5%) by 1.46 percentage points over 10 years and 1.40 percentage points since inception (December 31, 1989).



- The returns reported by LSERS's consultant are "gross of fees," which means that the investment managers' fees have not been subtracted when computing the rate of return. Therefore, we could not precisely determine the degree to which LSERS's overall long-term return, after subtracting investment fees, exceeded the actuarially assumed rate of return.
- Since December 31, 1989, LSERS's investment returns for two of three broad asset classes were above the relevant benchmark indices. LSERS's U.S. equity investment return was below the benchmark index. However, the returns on LSERS's international equity and fixed-income investments exceeded the relevant benchmark indices. This performance resulted in the return of the entire portfolio slightly exceeding the policy index.

RECOMMENDATIONS

- ✓ LSERS should ensure when investment returns are compared to the actuarially assumed rate they are presented net of investment management fees or with the information necessary to accurately adjust these rates to show returns net of fees.
- ✓ LSERS should determine why its long-term investment return for the U.S. equity asset class was below its benchmark index and take appropriate corrective action, if necessary.
- ✓ LSERS should develop a method to track and report long-term investment returns within the U.S. equity's asset class by subclasses.
- ✓ LSERS should add provisions to its consultant's contract to ensure that the data necessary to track and report investment returns for U.S. large cap and small cap equities are preserved in the event that LSERS replaces the consultant.

Has LSERS Developed and Implemented an Investment Policy That Allocates System Assets by Balancing Risks With Returns on Investments and Ensures That Investments Are of Sufficient Quality to Minimize the Risk of Loss of System Assets?

- In practice, LSERS's current asset allocation procedures appropriately balance investment risks with returns and ensure that investments are of sufficient quality to minimize the risk of loss. However, some of the risk management procedures that LSERS follows are not included in its written investment policies.

RECOMMENDATIONS

- ✓ LSERS should clarify its written investment policy so that it more clearly adheres to the maximum of 65% of assets invested in equities as provided in state law.
- ✓ LSERS should include provisions in its written investment policy to ensure that at least 10% of its equity investments are in index funds.
- ✓ LSERS should include provisions in its written investment policy to ensure that the use of index funds as an alternative to active management is formally and regularly evaluated.

Does LSERS Monitor Compliance With the Asset Allocation Component of the System's Established Investment Policy?

- LSERS effectively monitors compliance with the asset allocation set forth in the system's investment policy and adopted by the system's investment committee and board of trustees. LSERS's officials and the system's consultant review the system's asset allocation quarterly and, if necessary, adjust the amount invested in an asset class to rebalance asset amounts toward the established targeted guidelines. However, the policy contains little specific methodology concerning rebalancing.

How Do LSERS's Investment Managers, Consultant, and Custodial Fees and Charges Compare to Other Pension Plans?

- The fees LSERS is paying to its investment managers, consultant, and custodian are below or in line with the averages we obtained from fee surveys of public pension plans. Thus, LSERS is not overpaying for these types of services and keeps more of its assets invested.

Does LSERS Use Competitive, Objective Procedures With Performance Based Criteria to Select Investment Managers, Investment Consultants, and Custodians?

- LSERS uses competitive, objective procedures with performance based criteria to select investment managers. However, the system's policies are not collected into a single document.
- We did not evaluate the selection process for the system's custodian and consultant, because of the length of time (11 years and 9 years, respectively) that has elapsed since they were selected.

RECOMMENDATION

✓ LSERS should review the selection policies (for investment managers, consultants, and custodians) the board has adopted and place these policies in one document to help guide the selection process.

Does LSERS Use Objective Procedures With Performance Based Criteria to Monitor Investment Managers (Including Investment Performance and Churning), Investment Consultants, and Custodians?

- LSERS effectively monitors investment managers' performance and the trades by its custodian bank. However, LSERS does not formally and regularly evaluate its consultant and custodian.
- LSERS has put several controls in place to guard against churning by its investment managers. Managers are paid by LSERS based on the amount of assets they have under management and commissions are paid out of the account overseen by the investment managers. Since churning increases the commissions paid to a broker, this practice would reduce the value of the account and thus reduce the manager's fee. LSERS also prohibits investment managers from using affiliated brokers. Finally, LSERS reviews each manager's turnover ratio and rate of return.
- LSERS does not formally evaluate the performance of the system's consultant. LSERS does not have a policy regarding the monitoring and evaluating of its consultant.
- LSERS monitors its custodian by reconciling trades reported by its investment managers with information provided by the custodian on a monthly basis. Any discrepancies are investigated by LSERS's staff.

RECOMMENDATIONS

✓ LSERS should develop and implement written policies for formal consultant reviews (at least annually). These policies should state the frequency of evaluations and the areas to be evaluated.

✓ LSERS should develop and implement written policies for formal custodial reviews (at least annually). These policies should state the frequency of evaluations and the areas to be evaluated.

If Performance by Investment Managers, Investment Consultants, or Custodians Is Below Relevant Benchmarks, Does LSERS Take Corrective Action?

- LSERS does take corrective action against poorly performing investment managers. At the very least, the system places poor performers on probation and closely monitors the managers' performance.
- LSERS has not experienced any significant problems with its custodian or consultant; therefore, the system has not needed to take any corrective action.

RECOMENDATION

✓ LSERS should review its probation/termination policies and consider making the policies more specific to include reasons other than poor performance for placing investment managers on probation (e.g., changes in key personnel).

Does LSERS Employ Adequate Policies and Procedures to Ensure That Primary Decision Makers Avoid Conflicts of Interest as Well as the Appearance of Conflicts of Interest?

- LSERS does not employ adequate policies and procedures to ensure that key staff members and trustees avoid potential conflicts of interest. As a result, we found that members of LSERS's staff and trustees may have violated the Louisiana Code of Governmental Ethics by accepting gifts from an investment manager hired by LSERS. We found that the LSERS's office received Christmas poinsettias (valued at $55) and the trustees received king cakes (valued at $100) from an investment manager used by LSERS.
- From July 1, 2003, until September 15, 2004, LSERS's board of trustees, key staff, and consultant accepted meals paid for by investment managers and custodians valued at approximately $8,100. These meals do not violate the Code of Ethics; however, they represent a potential conflict of interest for trustees and key staff.
- LSERS does employ policies and procedures to help ensure that investment managers and consultants avoid potential conflicts of interest. LSERS requires disclosure relating to conflicts of interest from investment managers and consultants (in accordance with R.S. 11:269). It also requires certifications by investment managers and prohibits certain activities as additional controls to guard against conflicts of interest by investment managers and consultants. For example, LSERS requires consultants to disclose business affiliations and client referral fees received.

RECOMENDATIONS

- ✓ LSERS should obtain an opinion from the Louisiana Board of Ethics concerning whether acceptance of these gifts constitutes a violation of the Louisiana Code of Governmental Ethics. If the Louisiana Board of Ethics' opinion states that these are violations, LSERS should strengthen policies and procedures to ensure that all staff adhere to the Louisiana Code of Governmental Ethics. They should clearly communicate the applicability of the ethics code to LSERS's staff and the provisions of the code to all investment managers and custodians.
- ✓ LSERS should strengthen policies and procedures to ensure that all staff avoid conflicts of interest and the appearance of conflicts of interest with current and prospective investment managers and custodians.

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LEGISLATIVE AUDITOR

STATE OF LOUISIANA

LOUISIANA SCHOOL EMPLOYEES' RETIREMENT SYSTEM

PERFORMANCE AUDIT
ISSUED FEBRUARY 16, 2005

LEGISLATIVE AUDITOR
1600 NORTH THIRD STREET
POST OFFICE BOX 94397
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February 16, 2005

The Honorable Donald E. Hines,
President of the Senate
The Honorable Joe R. Salter,
Speaker of the House of Representatives

Dear Senator Hines and Representative Salter:

This report gives the results of our performance audit of the Louisiana School Employees' Retirement System. The audit was conducted under the provisions of Title 24 of the Louisiana Revised Statutes of 1950, as amended. Senate Concurrent Resolution Number 14 of the 2004 Regular Session directed our office to examine each of the four state retirement systems.

The report contains our findings, conclusions, and recommendations. Appendix C contains the agency's response. I hope this report will benefit you in your legislative decision-making process.

Sincerely,

Steve J. Theriot, CPA
Legislative Auditor

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EXECUTIVE SUMMARY

Article X, Section 29 of the Louisiana Constitution of 1974 provides that the legislature shall provide for retirement of teachers, other employees of the public educational system and state employees, and this is to be done by establishment of one or more retirement systems. This performance audit primarily examines two areas of the Louisiana School Employees' Retirement System--investments and ethics. Our findings are summarized below.

Performance Audit Findings

Investments *(See pages 11 through 34 of the report.)*

How do the investment returns for different asset classes of the Louisiana School Employees' Retirement System (LSERS) compare to relevant benchmarks?

LSERS's long-term investment returns have exceeded the system's actuarially assumed rate of return of 7.5%. Returns for two out of three of LSERS's broad asset classes and for LSERS's total portfolio were above their relevant benchmarks. However, these returns are not adjusted for investment management fees (i.e., they are presented gross of fees). *See pages 11-14.*

Has LSERS developed and implemented an investment policy that allocates system assets by balancing risks with returns on investments and ensures that investments are of sufficient quality to minimize the risk of loss of system assets? Does LSERS monitor compliance with the asset allocation component of the system's established investment policy?

In practice, LSERS's current asset allocation procedures appropriately balance investment risks with returns and ensure that investments are of sufficient quality to minimize the risk of loss. However, some of the risk management procedures that LSERS follows are not included in its written investment policies. *See pages 15-18.*

LSERS effectively monitors compliance with the asset allocation set forth in the system's investment policy. LSERS's officials and the system's consultant review the system's asset allocation quarterly and, if necessary, adjust the amount invested in an asset class to rebalance asset amounts toward the established targeted guidelines. *See pages 21-22.*

How do LSERS's investment managers, consultant, and custodial fees and charges compare to other pension plans?

The fees LSERS is paying to its investment managers, consultant, and custodian are below or in line with the averages obtained from fee surveys of public pension plans. *See pages 23-26.*

Does LSERS use competitive, objective procedures with performance based criteria to select investment managers, investment consultants, and custodians?

LSERS uses competitive, objective procedures with performance based criteria to select investment managers. Overall, LSERS's selection methodologies are in line with industry standard criteria recommended by the GFOA, but its policies are not collected into a single document. We did not evaluate the selection process for the system's custodian and consultant because of the length of time (11 years and 9 years, respectively) that has elapsed since they were selected. *See pages 27-28.*

Does LSERS use objective procedures with performance based criteria to monitor investment managers (including investment performance and churning), investment consultants, and custodians?

LSERS has properly monitored its investment managers, although the performance data reported to the board of trustees are not adjusted for investment management fees. In addition, LSERS properly monitors trades by its custodian bank, but it does not formally evaluate the custodian or its consultant regularly. *See pages 29-32.*

If performance by investment managers, investment consultants, or custodians is below relevant benchmarks, does LSERS take corrective action?

LSERS takes corrective action for poorly performing investment managers. The system has taken no corrective action with its custodian bank or consultant because LSERS's management stated that it has not experienced any significant custodial or consultant problems. *See pages 33-34.*

Ethics *(See pages 35 through 40 of the report.)*

Does LSERS employ adequate policies and procedures to ensure that primary decision makers (board members, key system staff, money managers, custodians, and consultants) avoid conflicts of interest as well as the appearance of conflicts of interest?

The policies and procedures of LSERS may not always ensure that primary decision makers avoid conflicts of interest as well as the appearance of conflicts of interest. We found two instances where gifts were accepted by LSERS's staff and trustees from an investment manager, a possible violation of the Louisiana Code of Governmental Ethics. In addition, LSERS's trustees and staff have accepted meals from its investment managers and the custodian. *See pages 35-39.*

LSERS does, however, employ policies and procedures to help ensure that investment managers and consultants avoid potential conflicts of interest. *See pages 39-40.*

AUDIT INITIATION AND BACKGROUND

Audit Initiation and Objectives

We conducted this performance audit under the provisions of Title 24 of the Louisiana Revised Statutes of 1950, as amended. Louisiana Revised Statute 24:522 requires, in part, that the legislative auditor establish a schedule of performance audits to ensure that at least one performance audit is completed and published for each executive department within a seven-year period beginning with fiscal year 1998. In accordance with this requirement, the Office of Legislative Auditor developed a plan scheduling a performance audit of the four state retirement systems:

- State Police Pension and Retirement System
- Teachers' Retirement System of Louisiana
- Louisiana School Employees' Retirement System (LSERS)
- Louisiana State Employees' Retirement System

The Legislative Audit Advisory Council approved this audit on March 5, 2004. In addition, Senate Concurrent Resolution Number 14 of the 2004 Regular Session directed our office to examine the four state retirement systems. The resolution specified that we focus on "the relationships between the state public retirement systems' boards and the investment advisors, consultants and managers." Appendix A contains our audit scope and methodology.

The objectives of this audit are:

- How do the investment returns for different asset classes of LSERS compare to relevant benchmarks?
- Has LSERS developed and implemented an investment policy that allocates system assets by balancing risks with returns on investments and ensures that investments are of sufficient quality to minimize the risk of loss of system assets?
- Does LSERS monitor compliance with the asset allocation component of the system's established investment policy?
- How do LSERS's investment managers, consultant, and custodial fees and charges compare to other pension plans?
- Does LSERS use competitive, objective procedures with performance based criteria to select investment managers, investment consultants, and custodians?

- Does LSERS use objective procedures with performance based criteria to monitor investment managers (including investment performance and churning), investment consultants, and custodians?

- If performance by investment managers, investment consultants, or custodians is below relevant benchmarks, does LSERS take corrective action?

- Does LSERS employ adequate policies and procedures to ensure that primary decision makers (board members, key system staff, money managers, custodians, and consultants) avoid conflicts of interest as well as the appearance of conflicts of interest?

Overview of LSERS

Purpose and Statutory Authority: Article X, Section 29 of the Louisiana Constitution of 1974 provides that the legislature shall provide for retirement of teachers, other employees of the public educational system, and state employees, and this is to be done by establishment of one or more retirement systems. There are four state systems:

- State Police Pension and Retirement System

- Teachers' Retirement System of Louisiana

- Louisiana School Employees' Retirement System (LSERS)

- Louisiana State Employees' Retirement System

LSERS was established in 1946 by the Louisiana Legislature. LSERS was created to provide retirement benefits for non-instructional personnel of Louisiana public school systems. LSERS's primary goal is to safeguard and manage the funds it holds in trust so that future benefits are guaranteed and protected.

Background Information: A retirement system's financial health is primarily measured by its funded ratio, which is the extent to which a system's assets are sufficient to pay for present and future liabilities. As of June 30, 2003, LSERS's funded ratio was 79.1% (or percentage funded). It decreased to 75.8%, as of June 30, 2004. Another measure of a system's financial health is the amount of its unfunded accrued liability (UAL). UAL is defined as that portion of the actuarially calculated liability not funded by the actuarial value of the system's assets. LSERS's UAL was $361 million and $440 million, as of June 30, 2003 and 2004, respectively. The decrease in the funded ratio and increase in the UAL that LSERS experienced from 2003 to 2004 are primarily driven by recent investment returns. The funded ratio and UAL calculations use a weighted-average of the returns over the last four years. These calculations assume a long-term rate of return on investments of 7.5%. On average, LSERS's returns have been below 7.5% over the last four years. Thus, its funded ratio has been reduced and UAL increased. The following two exhibits provide background information concerning LSERS's budget and funding.

Exhibit 1
LSERS
Statistics as of June 30, 2003 and 2004

As of June 30	Fiscal Year Net Investment Income*	Net Assets	Unfunded Actuarial Accrued Liability	Percentage Funded	Fiscal Year Administrative Expenses
2003	$50,126,072	$1,344,190,769	$361,195,000	79.1%	$2,404,706
2004	$157,897,575	$1,434,785,797	$439,804,000	75.8%	$2,632,840

Note: *Investment income is net of investment-related expenses.
Source: Prepared by legislative auditor's staff using LSER's fiscal years 2003 and 2004 audited financial statements.

As shown in Exhibit 2 on the following page, LSERS's primary source of funding in fiscal year 2004 was net investment income of approximately $158 million. Our state constitution guarantees an annual employer payment that is sufficient to pay for the system's normal cost as well as amortize the UAL. The UAL is amortized through 2029. Funding sources in addition to net investment income include:

- Member and employer contributions
- Transfers from other retirement systems

Exhibit 2 also details the system's budgeted sources and uses of funds for fiscal year 2005 and actual figures from fiscal year 2004. This exhibit also contains a variance calculation for these two years.

Exhibit 2
Sources and Uses of Funds
Comparison of Fiscal Years 2004 and 2005

	FY 2005 Proposed Budget	FY 2004 Actual	Difference Between 2004 and 2005	Percentage Change From 2004 to 2005
Net Investment Income[1]	n/a[1]	$157,897,575	n/a	n/a
Member Contributions	n/a	$19,676,052	n/a	n/a
Employer Contributions	n/a	$28,005,156	n/a	n/a
Transfers From Other Systems	n/a	$204,178	n/a	n/a
Total Funding Sources	n/a	$205,782,961	n/a	n/a
Benefits Paid	n/a	$102,474,273	n/a	n/a
Refunds of Contributions	n/a	$3,866,339	n/a	n/a
Employer Contribution Refund	n/a	$6,064,685	n/a	n/a
Salary	$1,886,929	$1,617,387	$269,542	17%
Related Benefits	$406,081	$242,793	$163,288	67%
Travel	$102,800	$82,580	$20,220	24%
Supplies	$51,275	$47,659	$3,616	8%
Operating Services	$235,070	$249,344	($14,274)	-6%
Professional Services	$3,604,735	$3,194,198	$410,537	13%
Other Charges	$40,822	$64,432	($23,610)	-37%
Interagency Transfers	$6,900	$6,736	$164	2%
Acquisitions	$51,647	$29,550	$22,097	75%
Total Fund Uses	n/a	$117,939,976	n/a	n/a
Net Funding Sources	n/a	$87,842,985	n/a	n/a

Note: [1]LSERS does not budget for all fund sources and fund uses; therefore, a year-to-year comparison cannot be completed for all revenue and expenditure items.
Source: Prepared by legislative auditor's staff using information furnished by LSERS.

LSERS's members are vested after 10 years of service, meaning that after this time they are eligible for a retirement benefit once a certain age is reached. Members with 30 or more years of service may retire and draw benefits at any age; those with 25 years may retire at age 55; and those with 10 years may retire at age 60. Benefits are generally calculated by multiplying 3.33% times years of service times the member's average salary plus a supplementary allowance of $2 per month for each year of service. Average annual salary is computed using the three consecutive, active years of employment with the highest salary. Exhibit 3 on the following page provides information concerning the membership of LSERS.

Exhibit 3 LSERS Membership Components Fiscal Years 2002, 2003, and 2004			
Membership Categories	**As of June 30, 2002**	**As of June 30, 2003**	**As of June 30, 2004**
Active Members	14,638	14,486	14,212
Terminated Vested Members	63	61	418
Retired Members	9,702	10,068	10,355
DROP Participants	796	792	784
Total Membership	**25,199**	**25,407**	**25,769**
Source: Prepared by legislative auditor's staff using fiscal year 2003 and 2004 audited financial statements of LSERS.			

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HOW DO THE INVESTMENT RETURNS FOR DIFFERENT ASSET CLASSES OF LSERS COMPARE TO RELEVANT BENCHMARKS?

LSERS's long-term investment returns as reported by its investment consultant have exceeded its actuarially assumed rate of return of 7.5%. The system achieved an 8.96% annualized return over the last 10 fiscal years and 8.90% annualized return since December 31, 1989. Returns for two out of three of LSERS's broad asset classes and for LSERS's total portfolio were above their relevant benchmarks. However, these returns are not adjusted for investment management fees (i.e., they are presented gross of fees).

LSERS's Total Long-Term Investment Returns Have Exceeded the System's Actuarially Assumed Rate of Return

According to LSERS's investment consultant, LSERS's investment returns (gross of fees) have exceeded the system's actuarially assumed rate of return by 1.46% annualized over the last 10 years and 1.40% since December 31, 1989. The actuarial rate is the rate of return that the system's actuary assumes the system will earn to meet its benefit responsibilities when he computes its funding ratio. If a system's investment performance exceeds this actuarial assumed rate, the funding ratio and the system's overall financial health may be improved.

The returns reported by the consultant are gross of fees, which means that the investment managers' fees have not been subtracted when computing the rate of return. Therefore, we could not precisely determine the degree to which LSERS's overall long-term return, net of fees, exceeded the actuarially assumed rate of return. However, to estimate the investment return, net of fees, we calculated the average fee paid by LSERS at the end of fiscal year 2004 for all managers. This average fee was 21 basis points (0.21 of 1 percent, as 1 percent = 100 basis points). We subtracted this fee amount from the investment returns reported for LSERS to obtain the amount shown in the middle column of Exhibit 4 on the following page. Therefore, we conclude that LSERS has exceeded its actuarially assumed rate over the long-term, although we can only estimate by how much. Exhibit 4 also shows LSERS's investment returns over different time periods.

Exhibit 4 LSERS Total Investment Returns as of June 30, 2004				
Time Period	**LSERS's Investment Return (Gross of Fees)**	**Estimated Investment Return (Net of Fees)***	**Actuarially Assumed Rate of Return**	**Excess Return (Gross of Fees)**
1 Year	12.34 %	12.13%	7.5 %	4.84 %
5 Years	3.99 %	3.78%	7.5 %	-3.51 %
10 Years	8.96 %	8.75%	7.5 %	1.46 %
Since Inception (12/31/1989)	8.90 %	8.69%	7.5 %	1.40 %

Note: *We calculated the average fee paid by LSERS at the end of fiscal year 2004 for all managers. We subtracted this amount from the investment returns reported gross of fees in the second column of this exhibit.

Source: Prepared by legislative auditor's staff from information provided by Segal Advisors, Inc., the system's consultant.

We discussed the issue of the consultant reporting returns gross of fees rather than net of fees with LSERS's chief investment officer. She explained that reporting rates of return gross of fees is the industry standard. However, since the funding ratio calculations performed by the actuary assume rates of return are net of fees, it seems that the consultant should report rates of return net of fees or provide to the LSERS's board of trustees and staff the information necessary to accurately adjust the reported rates.

Recommendation 1: LSERS should ensure when investment returns are compared to the actuarially assumed rate they are presented net of investment management fees or with the information necessary to accurately adjust these rates to show returns net of fees.

Management's Response: LSERS partially agrees with this recommendation. The comparison will provide useful information, but it is not necessarily an industry standard to measure performance net of fees. Actuaries consider such expenses when they present the data in their annual reports. An indexed portfolio will also incur some costs. (See Appendix C for the system's full response.)

LSERS's Total Long-Term Investment Returns Have Outperformed the System's Composite Benchmark

According to data provided by LSERS's investment consultant, over the long-term (i.e., since December 31, 1989), LSERS's investment returns (gross of fees) were above a composite of relevant benchmark indices. LSERS's investment returns for two of three broad asset classes were above the relevant benchmark indices, as illustrated in Exhibit 5. LSERS's U.S. equity investment return was below the benchmark index. However, the returns on LSERS's international equity and fixed-income investments exceeded the relevant benchmark indices. This outperformance resulted in the return of the entire portfolio slightly exceeding the policy index.

Because of data limitations with LSERS's consultant, we were unable to calculate the dollar impact of LSERS's performance compared to each asset class since inception. However, we were able to provide the ten-year dollar impact for three broad asset classes. The ten-year dollar impact of returns being below the relevant benchmarks is approximately $57.4 million. In other words, had LSERS invested in the benchmark index for U.S. equities over the last 10 years, it would have almost $57.4 million more in assets, as of June 30, 2004.

Exhibit 5
LSERS
Annualized Investment Returns as of June 30, 2004 Since Inception
(Gross of Fees)

Asset Class [2]	LSERS Annualized Return Since Inception	Comparable Index [1] Annualized Return Since Inception	LSERS Above or Below Index?	Ten-Year Dollar Impact ($000)[3]
U.S. Equity	9.84%	10.84 %	1.00% Below	-$57,426
International Equity	7.86%	4.66%	3.20% Above	$23,037
Fixed-Income	8.00%	7.65%	0.35% Above	$198
Total Portfolio	8.90%	8.82%	0.08% Above	n/a[4]

Notes: [1] See Appendix B for index information.
[2] U.S. Equity returns include 14.5 years of data, International Equity 9 years, Fixed-Income 14.5 years, and Total Portfolio 14.5 years of investment return data.
[3] We were not able to obtain data since inception that would allow us to calculate dollar impact. Therefore, we used data from a 10-year period to calculate the dollar impact.
[4] For the total portfolio, LSERS uses its policy index as a benchmark. According to the consultant, this index is useful for comparative purposes, but the policy index is not appropriate for calculating dollar impacts. The policy index assumes that target allocations were precisely met and have held constant over the last 10 years while they have actually fluctuated. Calculating a dollar amount based on an ideal target allocation would be misleading.

Source: Prepared by legislative auditor's staff using information furnished by Segal Advisors, Inc., the system's consultant.

Benchmark indices are statistical indicators against which investment performance is measured. A typical index is composed of many securities of a similar class, such as securities of companies valued over a certain dollar amount (large capitalization companies) or securities of all international companies. Examples of indices are the S&P 500 and the Russell 2000. The relevant benchmark indices for LSERS's asset classes are listed in Appendix B. For the total portfolio, the comparable index is called a policy index. The policy index is composed of the returns of the benchmark indices of the three broad asset classes within the portfolio weighted by the asset class's target allocation within the portfolio.

As previously explained, the returns reported are gross of fees. Adjusting each broad asset class's annualized returns by the current average management fee within the asset class would require subtracting 0.24% from the U.S. equity returns, 0.49% from the international equity returns, and 0.13% from the fixed-income returns. It seems logical to conclude that after adjusting for fees, LSERS's international equity and fixed-income returns would still exceed the relevant index returns, although the size of their outperformance would be narrowed. Adjusting the total portfolio returns for the average management fee of 21 basis points per year, however, indicates that returns, net of fees, were probably slightly below the policy index.

The U.S. equities asset class is a very broad class. Often, for reporting purposes, retirement systems will further subdivide this class into U.S. large cap equities and U.S. small cap equities. Some systems further divide these classes into growth and value subclasses. However, neither LSERS nor its consultant could break out returns of LSERS's U.S. equity asset class into subclasses for long-term periods (e.g., 10 years and since inception). When the consultant was hired by LSERS in 1997, the data necessary to subdivide the U.S. equity asset class were not provided by the former consultant. We reviewed the current consultant's contract with LSERS and found that it does not contain provisions for LSERS to acquire this same type of information in the event of the consultant's termination. U.S. equity returns over the long-term broken out into small cap and large cap returns would be useful for the board of trustees in their decision making.

Recommendation 2: LSERS should determine why its long-term investment return for the U.S. equity asset class was below its benchmark index and take appropriate corrective action, if necessary.

Management's Response: LSERS agrees with this recommendation and has taken steps to implement it. LSERS's 5-year returns have exceeded the market benchmark (Russell 3000) by 70 basis points. (See Appendix C for the system's full response.)

Recommendation 3: LSERS should develop a method to track and report long-term investment returns within the U.S. equity asset class by subclasses.

Management's Response: LSERS agrees with this recommendation; however, the increased cost to provide this information will have to be considered. (See Appendix C for the system's full response.)

Recommendation 4: LSERS should add provisions to its consultant's contract to ensure that the data necessary to track and report investment returns for U.S. large cap and U.S. small cap equities are preserved in the event that LSERS replaces the consultant.

Management's Response: LSERS agrees with this recommendation; however, the increased cost to provide this information will have to be considered. (See Appendix C for the system's full response.)

Has LSERS Developed and Implemented an Investment Policy That Allocates System Assets by Balancing Risks With Returns on Investments and Ensures That Investments Are of Sufficient Quality to Minimize the Risk of Loss of System Assets?

In practice, LSERS's current asset allocation procedures appropriately balance investment risks with returns and ensure that investments are of sufficient quality to minimize the risk of loss. However, some of the risk management procedures that LSERS follows are not included in its written investment policies.

LSERS Has Implemented an Appropriate Investment Policy That Balances Risks With Returns

We evaluated LSERS's investment policy and asset allocation based on nine criteria. These criteria, if adhered to, should mitigate investment risks while maximizing returns. They are listed in Exhibit 6 on page 17. In practice, LSERS's current asset allocation procedures meet all nine criteria. However, three of the criteria are not included in LSERS's written investment policies. LSERS's policies and procedures with respect to each of the criteria are discussed below.

Low correlation between asset classes: LSERS's portfolio is divided up among U.S. stocks, international stocks, and U.S. bonds. LSERS's investment policy allocates target percentages of its portfolio to these asset classes. Historically, these asset classes have had low correlations with each other. This correlation will help LSERS reduce the risk that its entire portfolio will decrease in value during a given time period.

Target allocations and ranges for each asset class: LSERS had an asset allocation study performed in 1996. Based on this study, LSERS set target percentages to allocate its portfolio into various asset classes. These target allocations are included in LSERS's investment policy. Since the value of the portfolio assets change daily, the actual portfolio allocation will fluctuate around the target percentages. LSERS has established ranges around these target percentages. If the actual portfolio allocation moves outside of these ranges, LSERS's policy is to buy and sell the assets necessary to get the portfolio back within the established ranges. Thus, through the use of these target allocations and ranges, LSERS is minimizing its risk for a given level of investment returns.

Asset allocation tailored with an asset-liability study: LSERS's actuary prepares experience studies in an attempt to predict the long-term liabilities of retirement systems. LSERS's most recent experience study is from March 2003. According to LSERS's investment policy, the information from this study was also used in its most recent asset allocation study. LSERS used the liability estimates from the experience study as it weighed the risk levels associated with the various possible asset allocation combinations. Although the most recent study has been completed, the results have not been formally incorporated into the current asset allocation plan.

Up to 65% of assets invested in equities: State law (R.S. 11:267.C) allows LSERS to invest up to 65% of its assets in equities. LSERS's investment policy targets 58% (51% in U.S. equities and 7% in international equities) of its assets to equities, which is within the maximum allowed under state law. Thus, LSERS is in compliance with this criterion and the risk it is assuming from equity investments is limited. However, the 65% maximum is not explicitly stated in its investment policy. In addition, the LSERS's investment policy also allows a band of plus or minus 5% around the allocation targets. Thus, if both of LSERS's U.S. and international equity investments were to exceed their targets by 5%, LSERS's total equity allocation could exceed the 65% maximum set in state law (51+5+7+5=67%). LSERS's chief investment officer stated that the intent is for the 5% band to apply to the whole equity allocation of 58%. She added that LSERS is aware of the 65% maximum and would not exceed it.

Exhibit 6 Criteria for the Evaluation of LSERS's Asset Allocation and Investment Policy	
Criteria	**Met by LSERS's Policies?**
1. The asset allocation set in the investment policy should contain two or more asset classes (domestic stocks, foreign stocks, domestic bonds, etc.) that have low correlation with one another (i.e., when one is up the other is down) to reduce volatility and therefore risk.	√
2. Asset allocation ranges should be set that include minimum, maximum, and target allocation percentages for asset classes.	√
3. The asset allocation of a system should be specifically tailored to the "unique circumstances of the individual system" through an asset-liability study.	√
4. Investment policies should contain a provision that prohibits and prevents more than 65% of the system's portfolios from being invested in equity securities.	**X**
5. Investment policies should contain a provision that ensures that at least 10% of the system's equity portfolio will be invested in index funds.	**X**
6. Portfolios should be rebalanced to stay in line with the established asset allocation ranges and to reduce volatility. The portfolio should be reviewed at least annually by the appropriate system official for rebalancing purposes.	√
7. Investment guidelines should identify permissible and non-permissible investments. They should also set maximum percentages of system assets allowed to be invested in a single issuer, asset class, economic sector, and nation.	√
8. Private equity and real estate investments should be constrained so that the system's portfolio does not become dominated by these non-liquid investments.	√
9. The investment policy should ensure that the use of index funds as an alternative to active management is "formally and regularly" evaluated.	**X**
Source: Criteria developed by legislative auditor's staff based on the Government Finance Officers' Association and the Louisiana Revised Statutes of 1950, as amended.	

At least 10% of equity assets invested in index funds: State law (R.S. 11:267.B) requires LSERS to invest at least 10% of its equity allocation in index funds. LSERS is aware of the state law regarding indexing and is in compliance with it. As of June 30, 2004, LSERS had 34% of its equity allocation invested in a fund that tracks the S&P 500 Index. Therefore, LSERS is controlling the risk of not tracking a stock market index by investing at least one-third of its equity investments in an index fund. However, the 10% minimum index provision is not included in LSERS's written investment policy.

Regular rebalancing: LSERS compares its actual asset allocation to its target allocation each quarter. If actual asset allocation percentages have moved beyond the ranges set by the board of trustees, assets within the classes are bought or sold to bring the allocations back within the ranges. This rebalancing process is included in the LSERS's investment policy. Thus, LSERS is systematically reviewing its asset mix to ensure that it takes the least amount of risk to achieve a given level of return.

Prohibited investments: LSERS lists prohibited investments and limits on certain types of investments in its investment policy. Examples of prohibited investments include the following:

- Purchase of securities on margin
- Direct purchases of single-family or commercial mortgages
- New purchases of non-U.S. dollar denominated bonds
- Short sales
- Investments in commodities or commodity contracts

Limits on certain types of investments include the following:

- No more than 10% of the cost basis of a U.S. equity manager's portfolio can be invested in any one security.
- No more than 5% of the market value of a fixed-income manager's portfolio can be invested in below investment grade securities.
- No more than 3% of the market value of a fixed-income manager's portfolio can be invested in securities with stated maturities in excess of 30 years.

Thus, LSERS reduces its risks by prohibiting or limiting its exposure to riskier investments and limiting the amounts invested in any one security.

Limits on non-liquid investments: LSERS owns $1.7 million in real estate. (It owns the building where its offices are located.) This amount is less than 1/2% of its total investment portfolio. LSERS does not have any private equity investments. LSERS's investment policy sets a real estate target of 0% and does not include private equity. Therefore, LSERS is thereby limiting its exposure to non-liquid investments.

Indexing: LSERS's chief investment officer stated that she monitors LSERS's use of index funds to determine if more or less indexing would be beneficial. Thus, LSERS does consider the positive and negative aspects of using index funds compared to investment managers. However, this review is not formally required in LSERS's investment policy.

Recommendation 5: LSERS should clarify its written investment policy so that it more clearly adheres to the maximum of 65% of assets invested in equities as provided in state law.

Management's Response: LSERS agrees with this recommendation. We are in compliance with the law. Compliance with the statutes has never been a problem, as we have allowed no more than a 2% variance from our asset allocation target. (See Appendix C for the system's full response.)

Recommendation 6: LSERS should include provisions in its written investment policy to ensure that at least 10% of its equity investments are in index funds.

Management's Response: LSERS agrees with this recommendation. We are in compliance with the law and we were indexing assets before there was a legal requirement to do so. (See Appendix C for the system's full response.)

Recommendation 7: LSERS should include provisions in its written investment policy to ensure that the use of index funds as an alternative to active management is formally and regularly evaluated.

Management's Response: LSERS agrees with this recommendation. This comparison is made with each performance review and we are in compliance with the law. (See Appendix C for the system's full response.)

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DOES LSERS MONITOR COMPLIANCE WITH THE ASSET ALLOCATION COMPONENT OF THE SYSTEM'S ESTABLISHED INVESTMENT POLICY?

LSERS effectively monitors compliance with the asset allocation set forth in the system's investment policy and adopted by the system's investment committee and board of trustees. LSERS's officials and the system's consultant review the system's asset allocation quarterly and, if necessary, adjust the amount invested in an asset class to rebalance asset amounts toward the established targeted guidelines. However, the policy contains little specific methodology concerning rebalancing.

LSERS Properly Monitors Compliance With Its Asset Allocation Policy

LSERS's investment policy provides that on a quarterly basis, actual allocations will be compared to targets. Ranges of +/- 5% are set around the targets and rebalancing takes place whenever allocations reach the outer limits of the target ranges. Exhibit 7 shows the targets and ranges for each asset class.

Our review of LSERS's board of trustees and investment committee meeting minutes found that LSERS is complying with this policy. Exhibit 8 on the following page shows the asset classes in LSERS's investment portfolio, the investment managers, and amount of funds invested by each manager. This exhibit also shows whether the asset class is in compliance with LSERS's asset allocation targets. As of June 30, 2004, none of LSERS's asset classes were over or under the ranges established in its asset allocation policy.

Exhibit 7
LSERS's Asset Allocation Policy
(Different Asset Classes as a Percentage of the Total Portfolio)
(June 30, 2004)

Asset Class	Minimum	Target	Maximum
U.S. Equity	46%	51%	56%
International Equity	2%	7%	12%
Real Estate	0%	0%	5%
U.S. Fixed-Income	37%	42%	47%
Cash	0%	0%	5%
Total		100%	

Source: Prepared by legislative auditor's staff using LSERS's investment policy and a report prepared by LSERS's consultant, Segal Advisors, Inc.

In addition, each quarter LSERS estimates its short-term cash needs for paying benefits and funding the system's operations and sells assets to help meet those needs. LSERS usually takes between $15 and $20 million each quarter from its investments for this purpose. LSERS reviews its actual asset allocation and sells assets from asset classes that are above their target allocations to generate the cash it needs. Thus, LSERS's rebalancing ensures that it has enough short-term cash and maintains its allocation within its target ranges.

Periodically, rebalancing a retirement system's portfolio reduces risk and increases investment return and should be done at least annually according to the GFOA. By ensuring that its asset allocation policy is complied with and by reviewing it on a regular basis, LSERS is minimizing its investment risk. LSERS also uses the rebalancing to ensure that it has sufficient cash for the short-term.

Exhibit 8
LSERS's Investment Managers and Amounts Invested
(As of June 30, 2004)

Asset Class	Investment Manager	Amount Invested	Percentage of LSERS's Portfolio	Complies With Asset Allocation Targets?
S&P 500 Index (Passive)	Northern Trust	$272,106,227	19.1%	Yes
Large Cap Growth	Ark Asset Management	$123,426,844	8.7%	Yes
Large Cap Value	Trinity Asset Management	$150,747,232	10.6%	Yes
Small Cap Value	Brandywine	$79,975,389	5.6%	Yes
Small Cap Growth	J&W Seligman	$66,981,439	4.7%	Yes
International Equity	Walter Scott	$107,590,869	7.6%	Yes
Fixed-Income	Orleans Capital Management	$232,470,717	16.3%	Yes
Fixed-Income	Schroder	$282,266,016	19.8%	Yes
Fixed-Income	Tattersall/Evergreen	$100,347,117	7.0%	Yes
Cash		$9,041,869	0.6%	Yes
Total		**$1,424,953,719**	**100.0%**	

Source: Prepared by legislative auditor's staff using information furnished by Segal Advisors, Inc., the system's consultant and LSERS's investment policy.

HOW DO LSERS'S INVESTMENT MANAGERS, CONSULTANT, AND CUSTODIAL FEES AND CHARGES COMPARE TO OTHER PENSION PLANS?

The fees LSERS is paying to its investment managers, consultant, and custodian are below or in line with the averages obtained from fee surveys of public pension plans. Thus, LSERS is not overpaying for these types of services. This fee structure allows LSERS to keep more of its assets invested to pay future benefits.

LSERS's Investment Management Fees Are Below or in Line With Averages

LSERS paid a total of $2,906,037 in investment management fees in fiscal year 2004. To determine whether these fees were in line with averages paid by other retirement systems, we compared them to two fee surveys: a survey conducted by Greenwich Associates of Greenwich, Connecticut (Greenwich) dated July 2004, and an Independent Consultants Cooperative (ICC) study dated December 2003. The Greenwich survey included 191 institutional investors and was prepared on behalf of a leading investment consulting firm during January and February 2004. The ICC is a consortium of independent investment consulting firms and its study was based upon an extensive survey of management fees paid by clients of consulting firms that belong to the ICC.

Using the Greenwich survey and comparing to similar sized public pension plans, LSERS pays fees that are below average to seven of its nine investment managers, as illustrated in Exhibit 9 on the following page. The two exceptions, Brandywine and J&W Seligman, are both small cap domestic equity managers. On average, small cap equity managers have higher fees than large cap equity managers. Therefore, their fees being above the active domestic equity category average is not surprising. Based on the Greenwich survey, we estimate that LSERS saved about $1,470,000 last year by paying below average investment management fees.

Using the ICC survey, when compared to the average public plan (not taking into account the size of the plan), LSERS's fees for its large cap, small cap, and fixed-income investment managers are below or significantly below the survey averages. The fees paid for the international portfolio are slightly higher than average. This survey did not include averages for indexed funds. Based on the ICC survey, we estimate that LSERS saved about $1,985,000 in fees last year compared to other public defined benefit plans. This estimate, however, does not include a comparison of fees paid for indexed funds. Exhibit 10 on page 25 shows the results of the comparison of LSERS to the ICC study.

Exhibit 9
Comparison of LSERS's Fees to Greenwich Survey of Investment Managers' Fees
(Public Pension Plans Between $1 billion and $5 billion)

Asset Class	Average Fees Per Survey (in Basis Points*)	Fiscal Year 2004 LSERS Investment Managers' Fees (in Basis Points)	Percentage That LSERS Is Above or Below Fee Study	Difference (in Basis Points)	Estimated Annual Value of Difference in Fees**
Active Domestic Equity	43.0	27.0 (Trinity) 41.6 (Ark) 48.0 (Brandywine) 49.5 (Seligman)	Below - 37.2% Below - 3.3% Above - 11.6% Above - 15.1%	-16.0 -1.4 +5.0 +6.5	($241,196) ($17,033) $39,988 $43,492
Passive Domestic Equity	4.8	2.8 (Northern Trust)	Below - 41.7%	-2.0	($54,149)
Active International Equity	53.2	48.9 (W. Scott)	Below - 8.1%	-4.3	($45,815)
Active Fixed-Income	24.0	14.8 (Schroder) 10.2 (Orleans) 16.0 (Evergreen)	Below - 38.3% Below - 57.5% Below - 33.3%	-9.2 -13.8 -8.0	($795,028) ($321,698) ($80,278)
Total					($1,471,717)

Notes: *Basis points: 100 basis points = 1 percent.
For the full names of LSERS's investment managers, please refer to Exhibit 7 on page 21.
**Calculated by taking the amount of assets under management as of June 30, 2004, multiplied by the difference between the actual fee paid compared to the average fee in the Greenwich survey.

Source: Prepared by legislative auditor's staff using a survey conducted by Greenwich Associates dated July 2004, LSERS's contracts with investment managers, and other information obtained from LSERS.

Exhibit 10 Comparison of LSERS's Fees to ICC Survey of Investment Managers' Fees (Public Defined Benefit Plans)					
Asset Class	Average Fees per Survey (in Basis Points*)	Fiscal Year 2004 LSERS Investment Manager's Fees (in Basis Points)	Percentage That LSERS Is Above or Below Fee Study	Difference (in Basis Points)	Estimated Annual Value of Difference in Fees**
Large Cap	46	27 (Trinity) 41.6 (Ark)	Below - 41.3% Below - 10.0%	-19.0 -4.4	($286,420) ($54,061)
Small Cap	87	48 (Brandywine) 49.5 (Seligman)	Below - 45.0% Below - 43.1%	-39.0 -37.5	($311,904) ($251,227)
International	48	48.9 (W. Scott)	Above - 2.0%	+0.9	$10,132
Fixed-Income	31	14.8 (Schroder) 10.2 (Orleans) 16.0 (Evergreen)	Below - 52.0% Below - 67.1% Below - 48.4%	-16.2 -20.8 -15.0	($456,309) ($484,427) ($150,521)
Total					($1,984,737)

Notes: *Basis points: 100 basis points = 1 percent.
**Calculated by taking the amount of assets under management as of June 30, 2004, multiplied by the difference between the actual fee paid compared to the average fee in the Greenwich survey.
For the full names of LSERS's investment managers, please refer to Exhibit 7 on page 21.
Source: Prepared by legislative auditor's staff using an Independent Consultants Cooperative Fee Survey (dated December 2003), LSERS's contracts with investment managers, and other information obtained from LSERS.

Exhibit 11 shows the fees that LSERS paid its investment managers, consultant, and custodian during fiscal year 2004.

Exhibit 11 Fees Paid by LSERS to Investment Professionals Fiscal Year 2004		
Type of Professional	Amount of Fees	As Percentage of Total Assets (in Basis Points)
Investment Managers	$2,906,037	17.1
Investment Consultant	$133,542	.78
Custodian Bank	$230,425	1.2

Notes: Total assets were $1,701,511,647, as of June 30, 2004.
Basis points: 100 basis points = 1 percent.
Source: Prepared by legislative auditor's staff using LSERS's audited financial statement for fiscal year 2004.

LSERS's Consultant Fees Are Lower Than Average

LSERS pays its consultant $140,000 per year under its current contract, which began on May 1, 2004. Similarly sized public pension plans paid their consultants an average of $193,000, according to the Greenwich survey. Thus, LSERS pays $53,000 less in consultant fees than the average paid by similar sized public retirement systems.

LSERS's Custodian Fees Are Lower Than Average

LSERS's custodian fee is 1.2 basis points of the fair market value of assets held by its custodian bank. This fee is slightly lower than the average for similar sized public pension plans, which is 1.4 basis points, according to the Greenwich survey.

DOES LSERS USE COMPETITIVE, OBJECTIVE PROCEDURES WITH PERFORMANCE BASED CRITERIA TO SELECT INVESTMENT MANAGERS, INVESTMENT CONSULTANTS, AND CUSTODIANS?

LSERS uses competitive, objective procedures with performance based criteria to select investment managers. Overall, LSERS's selection methodologies are in line with industry standard criteria recommended by the GFOA, but its policies are not collected into a single document. We did not evaluate the selection process for the system's custodian and consultant because of the length of time (11 years and 9 years, respectively) that has elapsed since they were selected.

LSERS's Process Conforms With Criteria for Selecting Investment Managers

Following GFOA's recommendation, LSERS formally considers several criteria when selecting investment managers. These include:

- Years of experience
- Assets under management
- Tracking error compared to the relevant benchmark
- Past performance
- Manager's investment process
- Organization and staffing
- References

We reviewed investment committee minutes and other documents for two recent investment manager searches. We conducted a limited review of documents from earlier investment manager searches. We found that, as per GFOA's recommendations, LSERS consistently employed a competitive, merit-based selection process. This process helps to ensure that the best candidates are selected to serve as investment managers for LSERS.

LSERS advertises for potential candidates and has a request for proposal (RFP) packet that asks interested investment managers to supply a standard set of information for the staff and board of trustees. The staff and board then use this information to make comparisons among the candidates. The proposals are summarized on spreadsheets so that key comparisons can be made. Again conforming to GFOA recommendation, the board of trustees selects finalists and these finalists make presentations to the board. The board uses scoring sheets to rate each finalist based on pre-set criteria and the investment managers are ranked in order. Fee negotiations are conducted with the highest scoring candidate. Once fees are agreed upon, the new manager is hired.

In our review of board minutes, we found that the LSERS's board of trustees does formally adopt policies relating to the selection process. However, LSERS's staff does not collect the policies and place them in one formal document. Therefore, it is difficult to determine what selection policies the LSERS's board has formally adopted.

Recommendation 8: LSERS should review the selection policies (for investment managers, consultants, and custodians) the board has adopted and place these policies in one document to help guide the selection process.

Management's Response: LSERS agrees with this recommendation. We had plans to do this and most of the procedures are already in place. (See Appendix C for the system's full response.)

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DOES LSERS USE OBJECTIVE PROCEDURES WITH PERFORMANCE BASED CRITERIA TO MONITOR INVESTMENT MANAGERS (INCLUDING INVESTMENT PERFORMANCE AND CHURNING), INVESTMENT CONSULTANTS, AND CUSTODIANS?

LSERS has properly monitored its investment managers, although the performance data reported to the board of trustees are not adjusted for investment management fees. In addition, LSERS properly monitors trades by its custodian bank, but it does not formally evaluate the custodian or its consultant regularly.

LSERS Adequately Monitors Investment Manager Performance, Although It Allows Returns to Be Reported Gross of Fees

GFOA states that retirement systems should continually monitor the work of investment managers and that systems do the following:

- Compare performance to relevant benchmarks and peer groups over multiple time periods
- Determine if there are any changes to key personnel on the manager's investment team
- Determine if the firm uses a consistent management approach (does not change style)
- Require regular reports from investment managers on investment strategies, approaches, and tactics

LSERS has complied with GFOA's recommendations and has effectively monitored investment manager performance. For example, each trade by an investment manager is reported to LSERS. Statistical measures are also compiled by the consultant and custodian on the assets in the investment manager portfolios to help the LSERS's board of trustees and staff monitor for any changes in investment style. At least annually, LSERS's investment managers make presentations to the board. These presentations include updates on key investment personnel, strategies, and performance. Requirements for monitoring investment managers are included in LSERS's investment policy.

In addition, the consultant prepares quarterly performance reports comparing each manager's rate of return over various time periods to those of the relevant benchmark index and the appropriate investment manager peer group. However, the rates of return reported are gross of fees. That is, the returns have not been adjusted down to reflect the quarterly payments made by LSERS to investment managers for their services.

Rates of returns that are net of fees are essential to making comparisons between LSERS's investment returns and relevant performance benchmarks, as well as the actuarially assumed rate of 7.5%. By reporting net of fees, the board of trustees and staff would be presented with data that are more reflective of actual returns.

LSERS Adequately Monitors the Churning of Assets by Its Investment Managers

Churning is the practice of excessive trading in an account, which increases the commissions earned by the broker handling the trades. LSERS has put several controls in place to guard against churning by its investment managers. First, investment managers are paid by LSERS based on the amount of assets they have under management. This condition provides managers with an incentive to increase the value of the account being managed for LSERS. The second control used by LSERS is that commissions are paid out of the account overseen by the investment manager. In practice, since churning increases the commissions that must be paid to a broker, this churning would reduce the value of the account and thus lower the fee earned by the manager.

With these controls in place, churning would probably only occur if the manager were getting some financial incentive from the broker to churn the account or if the manager and broker were affiliated in the same financial services company. A third control by LSERS prohibits investment managers from using affiliated brokers. This prohibition is in LSERS's investment policy, which is a part of the contract with each investment manager.

In addition, during the selection process, LSERS requires investment managers to provide copies of the ADV form they must file with the Securities and Exchange Commission. As part of this form, investment managers must disclose information about business activities other than investment advising, any affiliations they have, and what procedures they have for protecting the interests of their clients (e.g., LSERS) against conflicts of interest. LSERS's policy requires investment managers to send LSERS a copy of their current ADV form. Through these disclosures, LSERS can monitor the relationships between investment managers and the brokers they use. However, LSERS has not kept current files of these ADV forms. So, while LSERS is aware of any potential conflicts of interest before an investment manager is hired, if new relationships develop, LSERS may not be notified through this process.

Finally, LSERS reviews each manager's turnover ratio and rate of return. A high turnover ratio could indicate churning by the manager in LSERS's account and would also reduce the rate of return. We reviewed the turnover ratios of all current investment managers over the past fiscal year and found no evidence of churning. Thus, it appears that LSERS adequately safeguards the system's assets against churning by investment managers.

LSERS Informally Monitors Its Consultant

LSERS does not formally evaluate the performance of the system's consultant. LSERS's chief investment officer stated that LSERS only formally reviews the consultant's performance if there are problems. However, the LSERS's staff and board of trustees have frequent interactions with the consultant and through this less formal process monitor the consultant and convey their expectations to him. The GFOA recommends that consultants be evaluated based on how well they monitor investment managers' performance and whether the consultant's reports are accurate, timely, and relevant.

LSERS does not have a policy regarding the monitoring and evaluating of its consultant. Policies should specify the frequency of evaluations and the criteria to be used in evaluation. For example, LSERS could annually rate the consultant's performance in areas such as:

- Independence
- Investment Research and Education
- Asset Allocation Analysis
- Manager Search and Selection Process
- Asset Allocation Monitoring
- Monitoring of Manager Performance
- Overall Communications and Reporting

A formal monitoring process would help ensure that the consultant focuses on possible areas to improve service and/or broaden the services provided. Written policies will help ensure that there is continuity and consistency of consultant monitoring.

LSERS Monitors Trades by Its Custodian Bank But Does Not Have a Formalized Evaluation Process

LSERS monitors its custodian by reconciling trades reported by its investment managers with information provided by the custodian on a monthly basis. Any discrepancies are investigated by LSERS's staff. This reconciliation process helps to ensure that any breakdown in the custodial system between annual audits will be identified on a timely basis. The data provided by the custodian are relied upon by LSERS's staff and its consultant to evaluate investment manager performance, make recommendations to trustees, and report to external parties. By properly monitoring its custodian, LSERS has ensured that these critical data are reliable and accurate.

LSERS's chief investment officer stated that the custodian is not formally evaluated unless there is a problem. A formal evaluation of the custodian using predetermined criteria would help ensure the custodian focuses on areas to improve service and/or broaden the services provided to LSERS. It could also verify the financial condition of the custodian. GFOA recommends that custodians be evaluated based on the financial stability of the bank and whether the bank has a continuing focus on custody business, its handling of problems, and its fail-to-deliver rates.

Recommendation 9: LSERS should develop and implement written policies for formal consultant reviews (at least annually). These policies should state the frequency of evaluations and the areas to be evaluated.

Management's Response: LSERS agrees with this recommendation. We have the necessary forms to complete periodic evaluations, as we have utilized this method in the past. We will begin annual evaluations in 2005. We do want you to know that any issues have been promptly addressed. (See Appendix C for the system's full response.)

Recommendation 10: LSERS should develop and implement written policies for formal custodial reviews (at least annually). These policies should state the frequency of evaluations and the areas to be evaluated.

Management's Response: LSERS agrees with this recommendation. Problems are currently addressed as the need arises. We have no problem with implementing an annual evaluation in 2005. (See Appendix C for the system's full response.)

If Performance by Investment Managers, Investment Consultants, or Custodians Is Below Relevant Benchmarks, Does LSERS Take Corrective Action?

LSERS takes corrective action for poorly performing investment managers. The system has taken no corrective action with its custodian bank or consultant because LSERS's management stated that it has not experienced any significant custodial or consultant problems.

LSERS Takes Corrective Action When Investment Managers Underperform

According to LSERS's staff and system documents, LSERS does take corrective action against poor performing investment managers. At the very least, the system places poor performers on probation and closely monitors the managers' performance.

Because LSERS's policies regarding corrective action are very general, the board of trustees has a large amount of discretion when deciding how and when to take corrective action against managers. How and when the LSERS's board of trustees takes "corrective action" against managers differs. We reviewed investment manager performance since 2001 and found four managers who had underperformed their relevant benchmark for two years or more. Of these four investment managers, three were eventually terminated while the fourth is still on probation. LSERS kept one of the underperforming managers for about three years before the contract was terminated. The board has not yet terminated this other investment manager's contract, even after four years of being on probation. This manager's performance was significantly below average in its first year with LSERS but has had above average performance since then.

The GFOA recommends that systems develop a process for placing investment managers on a watch list or terminating them for reasons such as the following: key personnel changes, portfolio characteristics, underperformance, and style deviations. Generally, LSERS follows these recommendations by having a formal policy regarding corrective actions for managers. However, the policy does not include reasons, other than poor performance, to take corrective action.

LSERS Has Not Needed Corrective Action for Its Custodian or Consultant

LSERS's officials informed us that they have not experienced any significant problems with their custodian or consultant. Our review of LSERS's meeting minutes also revealed no mention of any issues or problems with the custodian or consultant.

Recommendation 11: LSERS should review its probation/termination policies and consider making the policies more specific to include reasons other than poor performance for placing investment managers on probation (e.g., changes in key personnel).

Management's Response: LSERS partially agrees with this recommendation. All investment manager contracts have 30 day cancellation clauses. We always pay close attention to any changes in our managers' companies. We have seen several instances where changes in key personnel have resulted in improved performance. We prefer to maintain the current flexibility and latitude so that we can review such changes at the time they occur and make the necessary judgmental decisions. (See Appendix C for the system's full response.)

DOES LSERS EMPLOY ADEQUATE POLICIES AND PROCEDURES TO ENSURE THAT PRIMARY DECISION MAKERS (BOARD MEMBERS, KEY SYSTEM STAFF, INVESTMENT MANAGERS, CUSTODIANS, AND CONSULTANTS) AVOID CONFLICTS OF INTEREST AS WELL AS THE APPEARANCE OF CONFLICTS OF INTEREST?

The policies and procedures of LSERS may not always ensure that primary decision makers avoid conflicts of interest as well as the appearance of conflicts of interest. We found two instances where gifts were accepted by LSERS's staff and trustees from an investment manager, a possible violation of the Louisiana Code of Governmental Ethics. In addition, LSERS's trustees and staff accepted meals from its investment managers and the custodian.

LSERS does, however, employ policies and procedures to help ensure that investment managers and consultants avoid potential conflicts of interest.

LSERS Could Strengthen Controls to Prevent Conflicts of Interest by Its Key Staff and Trustees

LSERS does not employ adequate policies and procedures to ensure that key staff members and trustees avoid potential conflicts of interest. As a result, we found that members of LSERS's staff and trustees may have violated the Louisiana Code of Governmental Ethics by accepting gifts from an investment manager hired by LSERS.

We asked LSERS's investment managers, custodian, and consultant to identify any things provided to staff and trustees at LSERS during the period from July 1, 2003, through September 15, 2004 (14 ½ months). We also asked key staff members and trustees for a list of anything received from these investment professionals during the same time period. We found that the LSERS's office received Christmas poinsettias (valued at $55) and the trustees received king cakes (valued at $100) from Orleans Capital Management, one of the investment managers used by LSERS. While the dollar value of these gifts is not large, the Louisiana Code of Governmental Ethics (R.S. 42:1115) specifically provides that no public servant shall accept any thing of economic value as a gift from any person, if the public servant knows or should know that the person is seeking to obtain contractual or other business or financial relationships with the public servant's agency. A "thing of economic value" is defined as money or any other thing having economic value, except promotional items having no substantial resale value, according to R.S. 42:1102(22)(a).

In addition, we asked LSERS's investment managers, custodian, consultant, key staff, and trusteees to disclose any economic interests trustees, LSERS's staff, or their immediate family members have with any of the investment managers, custodian, or consultant. Based on the responses we received, we did not find any trustees, LSERS's staff, or their immediate family members with any economic interests in the investment professionals hired by LSERS.

LSERS's staff and trustees are involved in screening, selecting, monitoring, and evaluating the investment managers and custodians hired by LSERS. Therefore, any gifts received by LSERS's staff and trustees from the investment managers or custodians could be viewed as attempts to influence LSERS's oversight decisions. To avoid this potential conflict of interest, the Louisiana Code of Governmental Ethics prohibits public employees from accepting any thing of economic value as a gift from anyone with a contractual or other business relationship with the public employee's agency. This code also prohibits LSERS from contracting with any investment manager, consultant, or custodian at which a trustee or key staff member or a member of their immediate family have a substantial economic interest (R.S. 42:1113).

Recommendation 12: LSERS should obtain an opinion from the Louisiana Board of Ethics concerning whether acceptance of these gifts constitutes a violation of the Louisiana Code of Governmental Ethics. If the Louisiana Board of Ethics' opinion states that these are violations, LSERS should strengthen policies and procedures to ensure that all staff adhere to the Louisiana Code of Governmental Ethics. They should clearly communicate the applicability of the ethics code to LSERS's staff and the provisions of the code to all investment managers and custodians.

Management's Response: LSERS agrees with this recommendation. All vendors have been put on notice by letter, and on the website, that gifts of any sort, no matter how small, are forbidden. The Ethics Board was consulted and any future gifts will be donated to a nonprofit entity. (See Appendix C for the system's full response.)

Recommendation 13: LSERS should strengthen policies and procedures to ensure that all staff avoid conflicts of interest and the appearance of conflicts of interest with current and prospective investment managers and custodians.

Management's Response: LSERS agrees with this recommendation. A one hour ethics presentation was attended by the Board and selected staff members to review the applicable rules and regulations concerning interaction with vendors. An ongoing "ethics" education program is being instituted to be presented to both staff and the Board. (See Appendix C for the system's full response.)

LSERS's Staff and Trustees Have Accepted Meals From LSERS's Investment Managers and Custodian

Senate Concurrent Resolution (SCR) No. 14 of the 2004 Regular Legislative Session provides that the legislature is concerned about any impropriety that may occur among investment consultants, advisors, managers, and the board members of the state public retirement systems. SCR No. 14 therefore directed the legislative auditor to examine and audit all facets of the relationship among investment consultants, advisors, managers, and board members of the systems. Accordingly, we asked trustees, key LSERS's staff, and all of LSERS's investment advisors to inform us of meals paid for by investment advisors during the period from July 1, 2003, through September 15, 2004.

The prohibition against accepting any thing of economic value as a gift in the Louisiana Code of Governmental Ethics has exceptions. One such exception is for food, drink, or refreshments consumed by a public servant while the personal guest of some person [R.S. 42:1102(22)(a)]. According to the information reported by LSERS's investment managers, custodian, consultant, trustees, and key staff, during the 14 ½ month period from July 1, 2003, through September 15, 2004, trustees and staff accepted meals with investment managers and custodians valued at approximately $8,100. See Exhibit 12 on pages 38-39 for more information about the meals provided.

A few points should be noted regarding the meal information reported. First, most but not all persons contacted responded. Second, the dollar values of the meals reported in some cases include the cost of the investment manager or custodian's representative(s) who were present. Third, during the time period we reviewed, there was no requirement for trustees, staff, investment managers, custodians, or consultants to maintain records of meals provided or received. Therefore, the actual number and dollar values of meals received may be more or less than reported.

These meals do not violate the Code of Ethics; however, they represent a potential conflict of interest for trustees and key staff. LSERS's trustees and key staff are involved in screening, selecting, evaluating, and replacing the investment managers and custodians who work for LSERS. Therefore, meals provided by investment managers and the custodian could be viewed as attempts to influence LSERS's oversight decisions. By addressing such situations, we are complying with the intention of SCR No. 14. The providers, recipients, total costs, and dates of the meals are also shown in Exhibit 12.

Exhibit 12 Meals Accepted by LSERS's Trustees and Key Staff From Investment Managers and Custodians July 1, 2003 Through September 15, 2004			
Provider	**Recipient**	**Value**	**Date**
Northern Trust	Josie Meche (LSERS staff)	Unknown	7/21/2003
Harbor Capital	Pat Cosper, *Julia LeBlanc (LSERS staff)	Unknown	8/27/2003
J&W Seligman	Warren Ponder (trustee)	Unknown	9/6/2003
Brandywine	Not reported	$419.15	9/15/2003
Trinity	Pat Cosper, Julia LeBlanc, Josie Meche (LSERS staff); Betty Crain, Betty Jacobs, Warren Ponder (trustees)	$1,081.40	9/15/2003
J&W Seligman	Pat Cosper, Josie Meche (LSERS staff); Betty Crain (trustee)	Unknown	9/16/2003
Orleans Capital	Pat Cosper, Josie Meche (LSERS staff); Betty Crain (trustee)	Unknown	9/16/2003
Brandywine, Trinity, and Schroder (co-hosted)	Pat Cosper, Julia LeBlanc, Charlene Quinn (LSERS staff); Warren Ponder, Jeffrey Faulk, Joe Seymour, Betty Crain, Betty Jacobs, Sylvia Myers, Earl Richard, Larry Wilmer (trustees)	$617.44 (Brandywine) $729.62 (Trinity) $729.62 (Schroder)	11/24/2003
Brandywine	Pat Cosper, Julia LeBlanc, Josie Meche (LSERS staff)	$56.00	12/9/2003
AM South Asset Management	Betty Crain, Joe Seymour (trustees)	Unknown	12/9/2003
Ark Asset Management	Pat Cosper, Josie Meche (LSERS staff); Betty Jacobs (trustee)	$67.50	12/23/2003
Trinity	Warren Ponder (trustee)	$50.00	12/21/2003
Orleans Capital	Joe Seymour (trustee)	Unknown	2/1/2004
Hibernia National Bank	Pat Cosper, Debra Dudley, Julia LeBlanc, Charlene Quinn (LSERS staff)	Estimates of $15 & $20 from two recipients; others unknown	2/2/2004
Orleans Capital	Betty Crain, Jeffrey Faulk, Warren Ponder, Larry Wilmer (trustees)	Unknown	2/10/2004
J&W Seligman	Pat Cosper, Randy Roche (LSERS staff); Jeffrey Faulk, Joe Seymour, Betty Crain, Betty Jacobs, Earl Richard, Sylvia Myers, Warren Ponder (trustees)	$1,364.90	2/16/2004
Trinity	Julia LeBlanc, Josie Meche (LSERS staff)	$40.00	3/4/2004
Northern Trust	Julia LeBlanc, Pat Cosper, Randy Roche, Josie Meche, Tracey LaBry, Laurie Stark (LSERS staff)	$266.69	4/1/2004

Exhibit 12 Meals Accepted by LSERS's Trustees and Key Staff From Investment Managers and Custodians July 1, 2003 Through September 15, 2004 (Concluded)			
Provider	**Recipient**	**Value**	**Date**
Orleans Capital	Joe Seymour, Betty Crain, Jeffrey Faulk (trustees)	$485.94	5/1/2004
Wellington Management	Betty Crain, Jeffrey Faulk (trustees)	Unknown	5/2/2004
Northern Trust	Betty Crain, Jeffrey Faulk (trustees)	Unknown	5/3/2004
UBS Global Asset Management	Betty Crain, Jeffrey Faulk, Sylvia Myers (trustees)	Unknown	5/3/2004
Federated Investors	Jeffrey Faulk (trustee)	Unknown	5/4/2004
OFI International Asset Management	Joe Seymour (trustee)	Unknown	5/4/2004
Brandywine	Pat Cosper, Julia LeBlanc, Josie Meche (LSERS staff)	$165.76	5/25/2004
Northern Trust	Tracey LaBry, Julia LeBlanc, Josie Meche (LSERS staff)	Unknown	7/21/2004
Schroder	Julia LeBlanc (LSERS staff)	Unknown	8/25/2004
Orleans Capital	Pat Cosper (LSERS staff)	$59.65	9/1/2004
Brandywine	Pat Cosper (LSERS staff); Joe Seymour, Betty Jacobs, Earl Richard, Jeffrey Faulk (trustees)	$1,139.06	9/12/2004
J&W Seligman	Pat Cosper (LSERS staff); Jeffrey Faulk, Joe Seymour, Betty Crain, Earl Richard (trustees)	$827.23	9/13/2004
Orleans Capital	Earl Richard (trustee)	Unknown	9/13/2004
Total		**$8,134.96**	

*Julia LeBlanc is the chief investment officer for LSERS.

Source: Prepared by legislative auditor's staff using information provided by LSERS's key staff, investment managers, consultant, and custodian.

LSERS Does Have Controls to Ensure That Investment Managers Avoid Conflicts of Interest

LSERS does employ policies and procedures to help ensure that investment managers and consultants avoid potential conflicts of interest. LSERS requires disclosures relating to conflicts of interest from investment managers and consultants (in accordance with R.S. 11:269). It also requires certifications by investment managers and prohibits certain activities as additional controls to guard against conflicts of interest by investment managers and consultants.

LSERS requires disclosures by investment managers regarding business affiliations, relationships with the brokers it uses for trades, and client referral fees it may pay to consultants. LSERS requires disclosures by consultants regarding business affiliations, client referral fees it may receive from investment managers, sources of income other than from retirement systems, and payments it receives from investment managers, in hard or soft dollars, for any services they provide.

In addition, as part of the process used to select investment managers, LSERS requires potential candidates to certify that no commissions or finders' fees will be paid to anyone for referring or recommending that LSERS hire the manager. There are also provisions in the LSERS's investment policy, which is part of the contract between investment managers and LSERS, prohibiting investment managers from using brokers with certain affiliations that would cause a conflict of interest. The policies and procedures used by LSERS help prevent conflicts of interest or the appearance of conflicts of interest for the investment managers and consultant hired by LSERS.

APPENDIX A: SCOPE AND METHODOLOGY

We conducted this performance audit under the provisions of Title 24 of the Louisiana Revised Statutes of 1950, as amended. We followed the applicable generally accepted government auditing standards as promulgated by the Comptroller General of the United States. Preliminary work on this audit began in April of 2004.

Scope

This audit focused on LSERS's investment activities from fiscal year 2002 thru August 2004. For certain parts of our investment work, we reviewed documents and information for years prior to fiscal year 2002. We obtained investment return data for different classes of assets and determined if the system had instituted an asset allocation plan in its investment policy. We evaluated whether LSERS's staff, its consultant, and the board monitored compliance with the allocation plan and made adjustment to asset levels when appropriate. We reviewed the fees the system is paying to its contractors and how the fees compare with averages obtained from two surveys. We examined how LSERS and its board of trustees selected and monitored their investment managers, consultant, and custodian. In addition, we examined how the system and its board took corrective action for any poorly performing contractor.

This audit also focused on certain ethics-related activities for the time period from July 1, 2003, through September 15, 2004. We examined relationships among the LSERS's board and key employees and the investment consultant, managers, and custodian of this system. We also reviewed the steps that the system takes to ensure compliance with the state's ethics laws.

Methodology

We performed several tasks, which include the following:

- Conducted background research, including reviewing laws and information concerning the four state retirement systems
- Held an entrance conference with LSERS on July 22, 2004
- Obtained investment return information from LSERS's investment consultant and interviewed the consultant concerning this information
- Reviewed LSERS's asset allocation study prepared by its consultant
- Obtained two surveys of pension plans that provided data on fees
- Determined the fees LSERS currently pays by reviewing the contracts and invoices for investment managers, the consultant, and the custodian

- Compared the survey data to the fees currently paid by LSERS
- Gathered criteria from the Government Finance Officers Association (GFOA), the Association for Investment Management and Research (AIMR), and state laws on selecting, monitoring, and taking corrective action for investment managers, consultants, and custodians
- Met with LSERS's management to discuss criteria; interviewed LSERS's management and reviewed LSERS's policies to determine how investment professionals are selected and monitored and how corrective action is taken for a poorly performing contractor
- Attended meetings of the system's investment committee and board of trustees and reviewed minutes of meetings of the committee and board
- Reviewed state ethics laws and all of LSERS's written policies for ethics work
- Drafted and sent representation letters to LSERS's staff, trustees, investment managers, consultant, and custodian asking them to list things of value given or received to one another and disclose relationships that could be a conflict of interest, such as those involving family members, business associates, ownership interests, financial interests, et cetera

APPENDIX B: COMPARABLE BENCHMARK INDICES

LSERS's Asset Classes and Comparable Benchmark Indices	
Asset Class	**Comparable Benchmark Index**
U.S. Equity	**Russell 3000 -** Composed of 3,000 of the largest U.S. companies, which represent about 98% of the U.S. equity market.
Total International	**MSCI Gross EAFE -** (Morgan Stanley Capital International, Europe, Australia, and the Far East) Composed of 21 MSCI Country Indices picked to represent the developed markets outside of North America.
Total Fixed-Income	**Lehman Aggregate Bond -** Composed of the Lehman Brothers Government/Corporate Bond Index, Mortgage-Backed Securities Index, and Asset-Backed Securities Index, including securities that are investment-grade quality or better, have at least one year to maturity, and have an outstanding par value of at least $100 million.
Total Portfolio	**Policy Index -** Composed of the returns of the benchmark indices of the three broad asset classes within the portfolio weighted by the asset class's target allocation within the portfolio.
Source: www.trading-glossary.com, www.investorwords.com, www.msci.com	

APPENDIX C: MANAGEMENT'S RESPONSE

State of Louisiana

SCHOOL EMPLOYEES' RETIREMENT SYSTEM

P.O. BOX 44516
BATON ROUGE, LOUISIANA 70804-4516
Telephone: (225) 925-6484
http://www.lsers.state.la.us

January 12, 2005

Steve Theriot, CPA
Legislative Auditor
State of Louisiana
Post Office Box 94397
Baton Rouge, LA 70804-9397

Dear Mr. Theriot:

Pursuant to your requests in the letter dated January 7, 2005, please find the following:

1. The checklist response to recommendations from the performance audit dated December 29, 2004 relative to the Louisiana School Employees' Retirement System.

2. Written responses to the 13 recommendations contained within the audit.

If you have any questions, please contact myself or Mrs. Debbie Dudley, Assistant Director, at (225) 925-6485.

Sincerely,

Patrick Cosper

Patrick Cosper
Director, LSERS

PC/jc

Enclosures: Checklist for Audit Recommendations
Responses to Performance Auditors Recommendations

Include social security number and current address on all correspondence

Fax: (225) 922-0350 • ADMINISTRATION/INVESTMENTS ~ Fax: (225) 922-1001 • RETIREMENT/ACCOUNTING

CONFIDENTIAL

Office of the Legislative Auditor – Performance Audit Division
Checklist for Audit Recommendations

Instructions to audited agency: Please check the appropriate box below for each recommendation. A summary of your response for each recommendation will be included in the body of the report. The entire text of your response will be included as an appendix to the audit report.

RECOMMENDATION(S) (corresponding report draft page no.)	AGREE	PARTIALLY AGREE	DISAGREE
Recommendation 1: (page 10) **:** LSERS should ensure when investment returns are compared to the actuarially assumed rate it is presented net of investment management fees or with the information necessary to accurately adjust these rates to show returns net of fees.		✓	
Recommendation 2: (page 12) LSERS should determine why its long term investment return for the U.S. Equity asset class was below its benchmark index and take appropriate corrective action, if necessary.	✓		
Recommendation 3: (page 12) LSERS should develop a method to track and report long-term investment returns within the U.S. equities asset class by subclasses.	✓		
Recommendation 4: (page 12) LSERS should add provisions to its consultant's contract to ensure that the data necessary to track and report investment returns for U.S. large cap and small cap equities are preserved in the event that the LSERS replaces the consultant.	✓		
Recommendation 5: (page 15). LSERS should clarify its written investment policy so that it more clearly adheres to the maximum of 65% of assets invested in equities as provided in state law.	✓		
Recommendation 6: (page 15) LSERS should include provisions in its written investment policy to ensure that at least 10% of its equity investments are in index funds.	✓		
Recommendation 7: (page 15) **:** LSERS should include provisions in its written investment policy to ensure that the use of index funds as an alternative to active management is formally and regularly evaluated.	✓		
Recommendation 8: (page 23) LSERS should review the selection policies (for investment managers, consultants and custodians) the Board has adopted and place these policies in one document in order to help guide the selection process.	✓		

RECOMMENDATION(S) (corresponding report draft page no.)	AGREE	PARTIALLY AGREE	DISAGREE
Recommendation 9: (page 27) LSERS should develop and implement written policies for formal consultant reviews (at least annually). These policies should state the frequency of evaluations and the areas to be evaluated.	✓		
Recommendation 10: (page 27) LSERS should develop and implement written policies for formal custodial reviews (at least annually). These policies should state the frequency of evaluations and the areas to be evaluated.	✓		
Recommendation 11: (page 29) LSERS should review their probation/termination policies and consider making the policy more specific to include reasons other than poor performance for placing investment managers on probation (e.g., changes in key personnel).		✓	
Recommendation 12: (page 32) LSERS should obtain an opinion from the Louisiana Board of Ethics concerning whether acceptance of these gifts constitutes a violation of the Louisiana Code of Governmental Ethics. If the Louisiana Board of Ethics' opinion states that these are violations, LSERS should strengthen policies and procedures to ensure that all staff adhere to the Louisiana Code of Governmental Ethics. This should include clearly communicating the applicability of the ethics code to LSERS staff and the provisions of the code to all investment managers and custodians.	✓		
Recommendation 13: (page 32) LSERS should strengthen policies and procedures to ensure that all staff avoid conflicts of interest and the appearance of conflicts of interest with current and prospective investment managers and custodians.	✓		

RESPONSES TO PERFORMANCE AUDITORS RECOMMENDATIONS

1. This comparison will provide useful information, but it is not necessarily an industry standard to measure performance net of fees. Actuaries consider such expenses when they present the data in their annual reports. An indexed portfolio will also incur some costs.

2. Action has been taken. LSERS' 5 year returns have exceeded the market benchmark (Russell 3000) by 70 basis points.

3. We agree with this recommendation; however, the increased cost to provide this information will have to be considered.

4. We agree with this recommendation; however, the increased cost to provide this information will have to be considered.

5. We are in compliance with the law. Compliance with the statutes has never been a problem, as we have allowed no more than a 2% variance from our asset allocation target.

6. We are in compliance with the law and we were indexing assets before there was a legal requirement to do so.

7. This comparison is made with each performance review and we are in compliance with the law.

8. We had plans to do this and most of the procedures are already in place.

9. We have the necessary forms to complete periodic evaluations, as we have utilized this method in the past. We will begin annual evaluations in 2005. We do want you to know that any issues have been promptly addressed.

10. Problems are currently addressed as the need arises. We have no problem with implementing an annual evaluation in 2005.

11. All investment manager contracts have 30 day cancellation clauses. We always pay close attention to any changes in our managers' companies. We have seen several instances where changes in key personnel have resulted in improved performance. We prefer to maintain the current flexibility and latitude so that we can review such changes at the time they occur and make the necessary judgmental decisions.

12. All vendors have been put on notice by letter, and on the website, that gifts of any sort, no matter how small, are forbidden. The Ethics Board was consulted and any future gifts will be donated to a nonprofit entity.

13. A one hour ethics presentation was attended by the Board and selected staff members to review the applicable rules and regulations concerning interaction with vendors. An ongoing "ethics' education program is being instituted to be presented to both staff and the Board.