



## Smoke & Mirrors: Debunking the City Manager's Retirement Board "Governance Models" Consultant Report

During difficult financial times, it's common for some to panic. Some freeze, some rush to action, and others attempt to capitalize on a crisis to consolidate power and push their own agenda. The latter seems to best describe the actions taken by City management in their attempt to dramatically reorganize the City's two retirement boards. Their tool is their high-priced consultant firm, Cortex Applied Research of Toronto, Canada.

Despite producing a lengthy document, **the Cortex report fails to provide any factual data to support changing the composition of the San Jose Police and Fire Retirement Board. They fail to make the case that changing the composition of these boards will lead to improved fund performance, tighter internal financial controls, or greater transparency of board actions.** In fact, many of the pension boards recognized for their "best practices" by Cortex have had horrific investment results over the last several years. Further, Cortex does not provide any information validating the funds it selected as "best practice" funds by any industry- recognized independent evaluation entity. Rather, Cortex has handed the City and taxpayers what appears to be a random collection of funds, with 3 of the selected 8 funds being Cortex clients.<sup>1</sup>

**The end result is a recommended governance scheme that takes accountability and oversight completely away from the elected City Council and gives it to a majority of appointed outside "financial experts" who have no obligation to the taxpayers, plan beneficiaries or the City Council.** Further, the experts are to be recruited from the ranks of the very industries whose reckless investment strategies hurled the global economy into chaos.

What is extremely disconcerting is Cortex's admission at the August 26, 2009 "Pension Reform" community meeting, and included in their PowerPoint presentation that they did zero investigation, analysis, assessment, review, and/or scrutiny of any "specific actions or decisions of the:"

- City
- Retirement Boards, or
- Any Board Members<sup>2</sup>

So what body of evidence did they base their recommendations upon? It appears that Cortex is rubber-stamping what City management wants utilizing the Ouija Board method of report writing.

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<sup>1</sup> Cortex Applied Research, Inc., *Clients & Testimonials*, <http://cortexconsulting.com/clientlist.htm>.

<sup>2</sup> Cortex Applied Research Inc., *A Review of the Governance Models of The Police and Fire Department Retirement Plan & The Federated City Employees' Retirement System*, August 26 & 27, 2009 PP Presentation, pg. 4.

### **Truth in Numbers**

It is important to note that the original impetus behind examining the governance structure of the Police & Fire Retirement Board was the investment returns for the previous 12-months. Today, the stated concern has shifted more towards an argument regarding “conflict of interest” and “relevant experience,” but all stakeholders involved clearly understand that the City Manager and Director of Retirement Services has repeatedly attacked fund performance. After reading this report, what has us scratching our heads is if the plans are so poorly managed then why would the Mayor and City Manager recommend pre-funding all of next year’s contribution early? <sup>3</sup> It’s because they want to take advantage of the steady long-term returns achieved by the fund and that pre-funding saves the taxpayers \$2 million dollars.

That being stated, many of the model funds included in the Cortex report had a rocky past 18 months. For example, the Yale Endowment, which according to Cortex, is “an example of a fiduciary body whose composition contains a very significant proportion of independent, expert members,” suffered a 25% loss between June 2008 and December 2008, reducing the fund’s value by \$6 billion. As a result, Yale put several capital projects on hold.<sup>4</sup>

Likewise, the Ontario Teachers’ Pension Plan (Cortex Client), which according to Cortex also is an example of a “fiduciary body whose composition contains a very significant proportion of independent expert members,” suffered an 18% loss in 2008 reducing the fund’s value by \$19 billion.<sup>5</sup> Similarly, the Canadian Pension Plan Investment Board, which carries the same Cortex description of independence and experts, suffered an 18.6% loss last year reducing the funds value by \$23.6 billion. San Diego (Cortex Client) posted a 4.66% loss.

The point is not to demonstrate that these plans are poorly managed (we have no opinion on this matter), but rather to show that having a governance structure stacked with “independent experts,” will not provide the City immunity from global economic crises like we are currently experiencing. Using Yale as an example, it is highly unlikely that you’d find a more impressive list of board members. Yet, marquee names didn’t prevent the university from huge investment losses in 2009.

We provide a more complete snapshot in the table below based on publicly available data. Information on some funds, such as the United Mine Workers of America was not publicly available. Cortex did not offer any financial performance figures for any of the funds in its report that they say implement “best practices.”

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<sup>3</sup> Mayor Chuck Reed, *March Budget Message for Fiscal Year 2008-2009*, March 18, 2008, pg. 15.

<sup>4</sup> Paul Needham, “Endowment Falls 25 Percent,” *Yale Daily News*, January 12, 2009.

<sup>5</sup> Ontario Teachers’ Pension Plan, *Consolidated Annual Financial Report*, 2008

Fund Performance of Cortex Funds & San Jose Retirement Funds						
Fund	2009	2008	2007	3 Year Avg. Return	5 Year Avg. Return	10 Year Return
San Diego City	Unknown	-4.66%	16.50%	7.78%	10.77%	
SJ Police & Fire	Unknown	-5.10%	19.3%	8.10%	10.70%	
SJ Federated	Unknown	-3.10%	16.22%	7.5%	9.50%	
Canadian Pension Plan	-18.63%	Unknown	Unknown	1.4%*	N/A	4.3%
Ontario Teachers	Unknown	-18%	4.5%	3.3%*	N/A	6.60%
National Railroad Retirement Investment	Unknown	-19.07%**	Unknown	Unknown	Unknown	Unknown
Delaware Retirement System***	Unknown	-1.3%	15.9%	Unknown	10.5%	7.1%
Mine Workers***	Unknown	Unknown	Unknown	Unknown	Unknown	Unknown
Yale Endowment	-25%*+	4.50%	28%	Unknown	Unknown	16.3%

\*Report is a 4-year return

\*\*Only 2008 Financial Report could be located. No data provided by Cortex.

\*\*\*No overall financials were available for their collection of 9 funds. No data provided by Cortex.

\*+ 2008 Consolidated Annual Report, pg. 3

## **False Perception of Accountability**

### *Conflict of Interest*

A key critique of San Jose's pension boards leveled by Cortex is that both of the current retirement board's governance models do not "ensure that the boards are free of significant conflicts of interest."<sup>6</sup> This is patently false. **First, every member appointed to either retirement board has a fiduciary responsibility, by law, to the fund and the fund's beneficiaries.** In fact, Cortex does not provide any examples of any votes taken in the past that have presented a "conflict of interest." The lack of a single example to support their accusation is consistent with their lack of any investigation or analysis of any decision made by either the Council or the Retirement Boards.

Cortex's example of a conflict of interest is when the City Councilmembers who sit on the retirement boards must set policies affecting City contributions, the "Council Members must potentially decide between the City's desire for lower contributions on the one hand and members' desire for benefit security on the other."<sup>7</sup>

<sup>6</sup> Cortex Applied Research Inc., *A Review of the Governance Models of The Police and Fire Department Retirement Plan & The Federated City Employees' Retirement System*, June 23, 2009, pg. 13.

<sup>7</sup> Cortex, *A Review of the Governance Models*, pg.17.

This “conflict” is then contradicted by Cortex in their recommendation that the City Council make the major decisions regarding the fund such as establishing the investment benchmarks and determining the plan’s asset allocation strategy and making the assumptions for the plan (Recommendation #6):

*The governance model should clearly acknowledge that the City is responsible for confirming and communicating to the retirement boards the investment and funding objectives to be achieved.*

In effect, the Council would be adopting fund objectives and directing the Board to achieve those objectives. **Thus, the City Council, without the benefit of having any of its members on the Board gaining expertise, would be in the same position of choosing between the City’s immediate bottom-line and members’ desire for benefit security.** The Cortex solution for resolving this perceived and undocumented conflict of interest for councilmembers fails to resolve this perceived conflict.

By adopting the Cortex definition of a conflict of interest you will create an internal inconsistency for other City Council policies and activities. **For example, the City Council also acts as the Redevelopment Board of Directors, with its own fiduciary responsibilities to the RDA, taxpayers and its bond holders.** Yet, the Council makes decisions that impact both (such as diverting RDA funds for City services). Sometimes the Council sits *simultaneously* as the Redevelopment Board and the City Council. **Additionally, five members of the City Council sit on the VTA Board of Directors.** As such, they have their own fiduciary responsibility to the communities served by the VTA which may conflict with the best interests of the City or its residents. The same could be said regarding ABAG and MTC representation. We don’t think Cortex should smear the integrity of our City Council with their unsubstantiated accusations of a conflict of interest.

Further, in the area of conflict of interest, Cortex makes a particularly insulting assumption that the active or retired members of the board would choose short-term gain over the long-term benefit of the plan. Specifically, Cortex suggests that the active and retired members of the board would purposefully choose riskier investment strategies to increase benefit payments from the Supplemental Retiree Benefit Reserve (SRBR).

First, the only Board member that may benefit from the SRBR is the retired member, who is one vote among seven. Second, this assumes that this one individual would secure a majority of the board to disregard their fiduciary responsibility for a one-time bonus versus the long-term stability of the fund—which both the members and City representatives have an interest in. It is ridiculous. It is also extremely offensive to the men and women who dedicated their lives to protecting and serving the residents of San Jose. Again, Cortex provided no examples, of such behavior or activity ever occurring. Additionally, it is important to remember that the biggest winner when the fund does well is the City’s General Fund which is then able to *decrease* its contribution rate to the fund—to the tune of tens of millions a year.

One has to ask, who will most likely have a real or perceived conflict of interest, a City Councilmember serving on the retirement board or a senior executive working in the insurance, banking, or investment industry?

### *Experience*

The cornerstone of the Cortex report is its predetermined recommendation to change the composition of the retirement boards. Specifically, Cortex recommends a board structure where boardmembers have “sufficient and relevant expertise to effectively guide and oversee the retirement systems”, a laudable goal. However, as demonstrated above, the experience of a board doesn’t necessarily translate into

improved investment results. As referenced in the chart above, the current San Jose pension plans either outperform or track well with the plans selected by Cortex.

The specific Cortex recommendation is for the Council to change its structure from appointing two Councilmembers, a member of the Civil Service Commission, and a City Administration representative to appointing four members without any ties to the City. The examples of desired experience include senior executives of insurance, mortgage, and banking companies. This could include senior executives from companies such as AIG, Countrywide, Lehman Brothers, and the defunct Bear Stearns.<sup>8</sup> Absent from the list of desired experience is anyone with experience serving on any governing board whatsoever, or experience serving on the board of a pension fund. Further, Cortex recommends loosening residency requirements beyond the City of San Jose or Santa Clara County but to potentially include the “western region of the United States” and potentially exorbitant financial compensation for some board members.<sup>9</sup>

If Cortex’s recommendations are implemented, the Council will have ceded a majority of the votes on each retirement board to individuals not accountable to the taxpayers or plan members, and most likely the board members won’t even be local taxpayers themselves. Given the large financial implications for the city and its taxpayers, this seems counterintuitive. It also ignores the fact that the retirement boards receive extensive analysis and feedback from its professional staff, consultants, attorneys and fund and asset managers, and that the boards have a proven track record of managing the funds very well.

#### *A Single Administrative Body*

An area of the Cortex report we agree with is their recommendation for a single administrative body—the retirement board itself. The board should have the ability to establish its own operating budget, appoint and direct retirement staff, and appoint all necessary advisors and service providers. Our Association has suggested this for years.

Unfortunately, Cortex decides to use an unsubstantiated charge that the reason this does not exist is that the City believes there is a “lack of accountability safeguards”. This is the first time we’ve heard of this. We have done a search of legislative action by the City Council, who establishes City policy, to find such an accusation or concern or any policy action taken to substantiate this claim. We were unable to do so. We are hopeful that Cortex has uncovered this documentation and can share it with all stakeholders.

#### **“Reforms” Have nothing to do with Board Structure**

Most of the “reforms,” if we concede that the suggestions are truly reforms, recommended by Cortex can be implemented immediately. In fact, many of the recommendations are practices already adopted by the respective boards and are in place. Those which can be adopted or already exist in some fashion include (those in bold already exist and are not “reforms”):

- Create a single administrative body for the retirement plan (Recommendation #2)
- **Assets of the Trust Fund are to be held in trust for sole benefit of members and beneficiaries of the plan and board members are to be held to strict fiduciary standards** (Recommendation #3).
- **Process involved in changing plan benefits should reside solely with the plan stakeholders (Recommendation #4).**
- Governing statute should discourage economically targeted investing (Board doesn’t engage in this now) (Recommendation #5).
- **Governance model should require specific reporting to stakeholders (Recommendation #7).**

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<sup>8</sup> Cortex, *A Review of the Governance Models*, pg. 3.

<sup>9</sup> Cortex, *A Review of the Governance Models*, pg. 11.

- Stakeholders should have the ability to remove individuals that they have appointed or elected to the retirement boards for failure to act in accordance with their fiduciary duties or failure to carry out the requirements of governing legislation (Recommendation #8).

### **Hidden Cortex Cost: Duplicative Staff & General Fund Expense**

What's most interesting about the Cortex recommendation on governance board structure is the stated goal of bringing in board members with significant investment experience to better manage and oversee the funds, yet recommending that ***all*** of the major decisions that affect how the fund operates and dictates investment strategy will actually lie 100% with the City Council, including: investment benchmark (the % return the fund must aim for), asset allocation (proportions of how much money is invested in investment categories) and contribution rates. And as stated above, the Council is being asked to do this without any representation or oversight of the actual board.

To effectively oversee all of this, Cortex states that the City should:

Assign responsibility for developing the investment and funding objectives to a specific City department. That department should understand and assess all feasible strategies, including liability-driven investing, asset-liability mismatching, immunization, and contingent immunization. That department should also be able to retain outside, independent consultants or advisors for assistance.<sup>10</sup>

Based on our understating of the core competencies of existing City departments, these skill sets may exist in an isolated employee, but by no means does it exist within City staff. Further, the description seems duplicative of what the Retirement Board, its staff and the funds' consultants should be doing. Thus, the City Council will effectively need to create a new department utilizing precious General Fund dollars to fully implement the Cortex scheme. These functions could not be performed by the staff servicing the retirement funds—as that would be a conflict of interest and most likely a misuse of trust fund money. As a result, the City will need to appropriate hundreds of thousands of dollars to staff the department and hire consultants (such as Cortex), advisors, and most likely outside legal counsel on an on-going basis from the General Fund.

We were unable to find a cost estimate for the creation of a new city department in either the Cortex report or in the City staff memorandum. A safe assumption is at least \$120,000 per new employee, \$150-250,000 for upper management and the Director.

**Also in the area of cost, Cortex recommends paying a stipend to the “expert” board members as a financial incentive to attract candidates.** The benchmarks were the two Canadian plans which pay their board members an annual stipend of \$24,000-25,000, plus meeting “attendance fees” of approximately \$1,300-\$1,500 per board meeting and an additional stipend of \$1,250-\$1,300 per committee meeting. Under this model, the City would pay the eight experts (4 for each retirement board) a combined \$200,000 in retainers, \$124,800 in board meeting fees (12 meetings x 8 members), and \$120,000 in committee meeting fees (12 committee meetings x 8 members) for a total of \$444,800.

### **Governing Board Best Practices: Neither apples nor oranges**

When making comparisons, it is a best practice to compare “apples to apples” to the extent possible. The Cortex report doesn't come close. The funds chosen range from a private endowment that funds ongoing operations (Yale), to foreign pension plans. Of the eight selected, only San Diego can be considered close to comparable. Despite the recommendation of Cortex, many of these plans' governance models do not match Cortex recommendations:

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<sup>10</sup> Cortex, *A Review of the Governance Models*, pg. 2, Recommendation #6.

- **United Mine Workers of America Combined Benefit Fund:** seven member board (2 union representatives, 2 industry representatives, three other members selected by the 4 union/management trustees). No discernable criteria for qualifications to serve on board.
- **Ontario Teacher's Pension Plan:** Nine member board appointed equally by the union and Ontario government (4 union, 4 government, 1 chosen by both union/government).
- **National Railroad Retirement Investment Trust:** seven member board (3 union representatives, 3 railroad company representatives, 1 chosen by both union/management).
- **Maryland State Retirement and Pension System:** 11 voting members (6 appointed by the Governor, 5 elected by members/public employees).
- **Delaware Public Employees' Retirement System:** information for how this board is selected was unavailable in the Cortex report. However, based on DPER's 2007 CAFR, there are five voting members appointed by the Governor and confirmed by the Senate. There are two *ex-officio* members, the State Director of Finance and the Director of the State Office of Management and Budget. No information was found regarding a set of experience criteria for service on the board.
- **Canada Pension Plan Investment Board:** is a professional investment management organization with a nine member board appointed by the Federal Finance minister. It is a national plan with \$116 billion in assets and 17 million members (Police & Fire Retirement System has 3,800 members)
- **San Diego City Employees' Retirement System:** thirteen member board (7 appointed by Mayor, confirmed by Council; 4 elected by employees; 1 retired member; 1 City Management employee appointed by Mayor).

The method Cortex used to determine models for the sake of governance is a mystery. One can only guess that some were chosen just because *current* board members may have some financial experience, even though in many cases listed above that is not a *governance requirement*. It should also be noted that just because someone is a business executive, that doesn't necessarily qualify them as an investment expert for a pension board. Cortex's recommendation doesn't take this into account.

### **Conclusion**

**The Association of Retired San Jose Police Officers & Firefighters shares the City Council's goal of having a pension fund that is managed to maximize returns while minimizing risks. We all have a vested interest in that outcome.** To that end, for more than twelve years, this Association, and the San Jose Police Officers' Association and San Jose Firefighters, Local 230 have advocated and made attempts to add investment professionals to the staff of the Department of Retirement Services. In fact, previously as part of that recommendation, the Police & Fire Retirement Board commissioned a classification and wage comparability study by CPS consultants to assist the City in meeting that goal. These recommendations and efforts were continuously rebuffed by the City Manager's office.

Unfortunately, it is our firm belief that the set of recommendations sought by the City Manager, and delivered by Cortex provide the City Council with a false sense of security. We should always strive to improve the way the pension fund is managed. But to overhaul the board based on thinly supported recommendations being promulgated during an economic crisis will not get us there. It's not the answer.

Interestingly enough, the model that has served the Police & Fire Retirement Board is very similar to the model used by the City Council in its governance. A board of vested stakeholders oversees a professional staff, receives recommendations, debates, and makes decisions. To be Mayor or a councilmember, it does not require a degree in Public Administration, budgeting, finance, or social science. It's a system that places you in charge of over \$2 billion in public funds and asks you to certify complex Environmental Impact Reports which affect billion dollar economic development proposals.

The facts are the current model has served the City well. Having Councilmembers and representatives of the City Manager and the Civil Service Commission has been a benefit to the fund. Robbing the pension fund of that perspective, and then placing all the burden on the Council for the most critical pension fund decisions will be detrimental to both the fund and the Council.