Report Highlights

Louisiana State Employees' Retirement System

April 2005

Louisiana Legislative Auditor

The Louisiana State Employees' Retirement System (LASERS) is a retirement plan created by state law to provide retirement benefits for Louisiana state officers and employees and their beneficiaries. The system had 137,719 members, of which 33,456 are retired, as of June 30, 2004. LASERS' mission is to improve the financial security and quality of life of its members and their families.

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

Audit Results

- LASERS' long-term investment return of 8.8% over the past 10 fiscal years has exceeded the actuarially assumed rate of return of 8.25%. Ten of LASERS' 17 asset classes have yielded investment returns for the last 10 years (as of June 30, 2004) above their relevant benchmarks.
- LASERS has developed and implemented an investment policy that allocates system assets by balancing risks with returns.
- The fees LASERS pays its money managers are lower than the medians of two fee surveys but higher than the average in a third survey. The fees LASERS pays its consultant and custodian are significantly lower than a survey's averages for similarly sized systems.
- LASERS uses competitive, objective procedures with performance based criteria to select investment managers and the custodian. We were unable to evaluate the selection process for the system's consultant because of the length of time (11 years) that has elapsed since it was selected.
- LASERS has properly monitored its investment managers, consultant, and custodian bank. However, LASERS has no policies in place for a formal annual review of the consultant's and custodian's performance.
- LASERS takes corrective action for poorly performing money managers and for the system's custodian bank. LASERS has not needed to take corrective action for its consultant.
- LASERS has invested almost $500 million (7.3% of its portfolio) in alternative investments, as of June 30, 2004. LASERS' approximate rates of return, net of fees, as of June 30, 2004, were 11.9% for private equity (over a five-year period) and 1.58% for absolute return strategies (over a three-year period).
- LASERS does employ some policies and procedures to avoid conflicts of interest. However, in a possible violation of the Louisiana Code of Governmental Ethics, we found instances where gifts were accepted by some of LASERS' key staff, trustees, and consultant from investment managers.
- LASERS' trustees, staff, and consultant have accepted meals from investment managers, the consultant, and the custodian. The trustees, staff, and consultant are responsible for selecting, monitoring, and evaluating these same investment managers, consultant, and custodian. Although such meals are allowed by the Code of Ethics, they may give the appearance of a conflict of interest.

Steve J. Theriot, CPA

Legislative Auditor

How do the Investment Returns for Different Asset Classes of LASERS Compare to Relevant Benchmarks?

- LASERS' investment returns (gross of fees) have exceeded the system's actuarially assumed rate of return of 8.25% by 0.55 percentage points over 10 years and by 0.75 percentage points since LASERS began computing returns with the presently used methodology (in 1990). These numbers are "gross of fees," which means that the money managers' fees have not been subtracted when computing the rate of return. Therefore, we could not exactly determine the degree to which LASERS' overall return, net of fees, exceeded the actuarially assumed rate of return.

- For the last 10 years (ending on June 30, 2004), LASERS' investment returns (gross of fees) for 10 of 17 asset classes were above relevant benchmark indices. The positive dollar impact of returns for a majority of asset classes being above their relevant benchmarks is approximately $203 million.

RECOMMENDATION

✓ LASERS should ensure that its investment managers' returns are presented net of management fees when it is reviewing investment managerial performance.

Has LASERS 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?

- LASERS has implemented an investment policy that allocates system assets by balancing risks with returns on investment and ensures that investments are of sufficient quality to minimize the risk of loss.

- LASERS' investment policy does not ensure that the use of index funds is formally and regularly evaluated as an alternative to active management of investments. However, LASERS does follow this criterion in practice.

- To meets its cash needs, LASERS has approximately $50 to $100 million in its short-term investment fund. LASERS' officials estimate that the system needs operating funds of $12 to $15 million each month.

RECOMMENDATION

✓ LASERS' written investment policy should ensure that the use of index funds as an alternative to active management is "formally and regularly" evaluated.

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

- LASERS' investment policy provides that at least quarterly, the system's chief investment officer (CIO) will examine the portfolio and rebalance any asset class that is over or under its specified range. LASERS complies with this policy. On a weekly basis, the CIO reviews and monitors LASERS' portfolio and whether the amounts of investment in asset classes are within their target range.

- All asset classes were within their target ranges, except for the alternative investment of absolute return strategies. Its percentage of the portfolio (2.84) was slightly under its minimum target range of 3%.

How Do LASERS' Investment Manager, Consultant, and Custodial Fees and Charges Compare to Other Pension Plans?

- The fees LASERS is paying to its investment professionals are mostly lower than the median fees obtained from two fee surveys. These two surveys were prepared by the Independent Consultants Cooperative and Cost Effectiveness Measurement Inc.

- However, the fees LASERS is paying to more than half of its external investment managers are higher than averages of similarly sized pension plans, according to a fee survey conducted by Greenwich Associates.

- LASERS pays 18% less in consultant fees and 75% less in custodial fees than the average paid by similar sized public retirement systems, according to the Greenwich survey.

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

- LASERS uses competitive, objective procedures for the selection of investment managers and its custodian that are in line with industry standard criteria recommended by the Government Finance Officers Association (GFOA). We were unable to evaluate the selection process for the system's consultant because of the length of time (11 years) that has elapsed since it was selected.

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

- LASERS has effectively monitored its investment managers, consultant, and custodial bank.
- LASERS has several controls in place to guard against churning 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.
- LASERS does not have policies regarding formal monitoring and evaluating of its consultant and custodian. In practice, LASERS does not formally evaluate its consultant's performance but formally monitors its custodian on a monthly basis.

RECOMMENDATIONS

- ✓ LASERS 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.
- ✓ LASERS 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 LASERS Take Corrective Action?

- LASERS takes corrective action when its investment managers underperform.
- LASERS takes corrective action when its custodian underperforms. The system has had the same consultant since 1993, and has not needed to take any corrective action.

What Role Do Alternative Investments Play in LASERS' Investment Portfolio?

- LASERS has alternative investments in private equity and absolute return strategies totaling almost $476 million, as of June 30, 2004, which constituted 7.3% of LASERS' portfolio. The approximate rates of return, net of fees, as of June 30, 2004, were 11.9% for private equity (over a five-year period) and 1.58% for absolute return strategies (over a three-year period).
- Alternative investments have historically produced above-average returns and they provide portfolio diversification. The disadvantages of alternative investments include their high management fees, the risks associated with these investments, and the concern that their reported rates of returns may not be accurate and reliable.
- The overall rate of return for private equity investments, gross of fees, is 14.2% for a five-year period ending June 30, 2004. The overall rate of return for absolute return funds, gross of fees, is 2.8% for the three-year period ending June 30, 2004.
- The percentage of LASERS' portfolio allocated to private equity and absolute return (hedge) funds is higher than an average of public retirement systems in the U.S. and also higher than six other state systems comparable in size to LASERS, according to a Wilshire Consulting (Wilshire Associates Inc.) survey.

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

- LASERS does not employ adequate policies and procedures to ensure that key staff and trustees avoid potential conflicts of interest. LASERS has a policy requiring training of board members regarding the ethics code; a policy to return gifts; notification letters are sent to investment managers regarding the ethics code; and ethics statements are signed by key staff and the trustees. However, we found that some of these policies and procedures may not have been properly communicated to all parties involved.
- Members of LASERS' staff and trustees may have violated the Louisiana Code of Governmental Ethics by accepting gifts from investment managers hired by LASERS. From July 1, 2003, through September 30, 2004, certain LASERS' staff and trustees received various gifts with a total value of $701.
- From July 1, 2003, through September 30, 2004, LASERS' board of trustees, key staff, and consultant accepted meals from investment managers, consultant, and custodian valued at approximately $56,541. These meals do not violate the Code of Ethics; however, they represent a potential conflict of interest for trustees and key staff.
- LASERS does employ policies and procedures to help ensure that investment managers avoid potential conflicts of interest.
- LASERS does not employ adequate policies or procedures to ensure disclosure and proper treatment of potential conflicts of interest with its consultants. We found that the consultant has received gifts with a value of $430 from LASERS' investment managers.

RECOMMENDATIONS

- ✓ LASERS 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, LASERS should strengthen policies and procedures to ensure that all staff adhere to the Louisiana Code of Governmental Ethics. LASERS should clearly communicate the applicability of the ethics code to its staff and the provisions of the code to all investment managers.
- ✓ LASERS 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.
- ✓ LASERS should set policies regarding the frequency and dollar value of meals accepted by staff, trustees, and consultants from investment managers, custodians, and consultants.
- ✓ LASERS should develop and implement policies and procedures for the disclosure and treatment of conflicts of interest and the appearance of conflicts of interest with current and prospective investment managers, custodians, and consultants.

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Questions? Call Steve Theriot at 225-339-3800.

LOUISIANA STATE EMPLOYEES' RETIREMENT SYSTEM
STATE OF LOUISIANA

LOUISIANA
LEGISLATIVE
AUDITOR

PERFORMANCE AUDIT
ISSUED APRIL 13, 2005

LEGISLATIVE AUDITOR
1600 NORTH THIRD STREET
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April 13, 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 State 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 D 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

SJT/dl

LASERS05

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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 State Employees' Retirement System (LASERS)--investments and ethics. Our findings are summarized as follows:

Performance Audit Findings

Investments *(See pages 13 through 46 of the report.)*

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

LASERS' investment returns over a 10-year period of 8.8%, and since the inception of computing returns (1990) of 9.0%, have exceeded the actuarially assumed rate of return of 8.25%. Ten of LASERS' 17 asset classes have yielded investment returns for the last 10 years (as of June 30, 2004) above their relevant benchmarks. However, these rates of return are not adjusted for investment management fees (i.e., they are presented "gross of fees"). *See pages 13-15.*

Has LASERS 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 LASERS monitor compliance with the asset allocation component of the system's established investment policy?

LASERS has developed and implemented an investment policy that allocates system assets by balancing risks with returns. LASERS properly monitors compliance with the asset allocation component of its investment policy and makes adjustments to its portfolio when needed. *See pages 17-25.*

How do LASERS' money manager, consultant, and custodial fees and charges compare to other pension plans?

LASERS' money management fees are mostly lower than the medians in two fee surveys, and mostly higher than the averages in a third survey conducted by Greenwich Associates. *See pages 27-30.*

LASERS pays its consultant $225,000 annually, which is 18% lower than the average for similarly sized systems, according to the Greenwich Associates survey. *See page 31.*

LASERS paid its custodian $324,640 in fiscal year 2004, which is 75% lower than the average for similarly sized systems, according to the Greenwich Associates survey. *See page 31.*

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

LASERS uses competitive, objective procedures with performance based criteria to select investment managers and the custodian. We were unable to evaluate the selection process for the system's consultant because of the length of time (11 years) that has elapsed since it was selected. *See page 33.*

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

LASERS has properly monitored its investment managers and whether they are churning the assets held in their accounts. In addition, LASERS has properly monitored its consultant and custodian bank. However, no policies are in place for a formal annual review of the consultant's and custodian's performance. *See pages 35-38.*

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

LASERS takes corrective action for poorly performing money managers and for the system's custodian. LASERS has had the same consultant since 1993, and has not needed to take corrective action. *See pages 39-40.*

What role do alternative investments play in LASERS' investment portfolio?

LASERS has invested almost $500 million (7.3% of its portfolio) in alternative investments, as of June 30, 2004. The percentage of LASERS' portfolio allocated to these investments is higher than an average of state retirement systems in the U.S. *See page 41 and pages 45-46.*

Compared to traditional, public portfolios, alternative investments have higher risks but also have the potential to earn higher rates of return. LASERS' approximate rates of return, net of fees, as of June 30, 2004, were 11.9% for private equity (over a five-year period) and 1.58% for absolute return strategies (over a three-year period). *See pages 43-44.*

Ethics *(See pages 47 through 52 of the report.)*

Does LASERS 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?

LASERS does employ some policies and procedures to avoid conflicts of interest. However, in a possible violation of the Louisiana Code of Ethics, we found instances where gifts were accepted by some of LASERS' key staff, trustees, and consultant from investment managers. *See pages 47-49.*

LASERS' staff, trustees, and consultant have accepted meals from investment managers, the consultant and the custodian. The trustees, staff and consultant are responsible for selecting, monitoring, and evaluating these same investment managers, consultant and custodian. Although such meals are allowed by the Code of Ethics, they may give the appearance of a conflict of interest. *See pages 49-50.*

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:

- Louisiana State Employees' Retirement System (LASERS)
- Teachers' Retirement System of Louisiana
- Louisiana School Employees Retirement System
- State Police Pension and 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 LASERS compare to relevant benchmarks?
- Has LASERS 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 LASERS monitor compliance with the asset allocation component of the system's established investment policy?
- How do LASERS' money manager, consultant, and custodial fees and charges compare to other pension plans?
- Does LASERS use competitive, objective procedures with performance based criteria to select investment managers, investment consultants, and custodians?
- Does LASERS 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 LASERS take corrective action?
- What role do alternative investments play in LASERS' investment portfolio?
- Does LASERS employ adequate processes 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 LASERS

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:

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

The Louisiana Legislature established LASERS in 1946 by Act No. 126. LASERS is a defined benefit pension plan created to provide retirement benefits for Louisiana state officers and employees and their beneficiaries. LASERS' mission is to improve the financial security and quality of life of LASERS' members and their families by utilizing qualified personnel adhering to the highest level of professional standards, prudent management of system assets, and cost-effective administration.

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, LASERS' funded ratio was 66.2%, and it decreased to 59.6%, 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 assets. LASERS' UAL was $3.3 billion and $4.1 billion, as of June 30, 2003 and 2004, respectively. If a system achieves a long-term rate of return on its investments greater than the assumed actuarial rate (of 8.25%), the system's funding status will improve, assuming all other factors remain equal. Exhibits 1 and 2 on pages 9 and 10, respectively, provide background information concerning LASERS' finances, budget, and funding.

Exhibit 1 LASERS Statistics as of June 30, 2003 and 2004					
As of June 30	**Fiscal Year Net Investment Income**	**Net Assets**	**Unfunded Actuarial Accrued Liability**	**Percent Funded**	**Fiscal Year Administrative Expenses**
2003	$213 million	$5.7 billion	$3.3 billion	66.2%	$10,196,507
2004	$996 million	$6.6 billion	$4.1 billion	59.6%	$12,629,058
Source: Prepared by legislative auditor's staff using LASERS' audited financial statements for fiscal years 2003 and 2004.					

As shown in Exhibit 2 on the following page, LASERS' primary source of funding in fiscal year 2004 was investment income of approximately $1 billion. Funding sources in addition to investment income include:

- Employer contributions
- Member contributions
- Other income

Exhibit 2 details the system's budgeted uses of funds for fiscal year 2005 and actual sources and uses of funds in fiscal year 2004. LASERS does not budget for investment income and other sources of funds. Exhibit 2 also contains a variance calculation for these two years.

Exhibit 2

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

	Fiscal Year 2005 Budget	Fiscal Year 2004 Actual	Difference Between 2004 Actual and 2005 Budget	Percent Change From 2004 to 2005
Investment income	n/a[1]	$1,016,290,820	n/a[1]	
Employer contributions	n/a[1]	$335,991,617	n/a[1]	
Member contributions	n/a[1]	$163,277,178	n/a[1]	
Other income	n/a[1]	$9,325,389	n/a[1]	
Total Funding Sources	n/a[1]	$1,524,885,004	n/a[1]	
Retirement benefits and refunds of member contributions	n/a[1]	$601,912,811	n/a[1]	
Salaries	$6,680,218	$5,858,786	$821,432	14%
Board compensation	$16,200	$14,550	$1,650	11%
Related benefits	$1,867,354	$1,387,515	$479,839	35%
Travel	$266,876	$164,277	$102,599	62%
Rentals	$734,186	$543,593	$190,593	35%
Custodial fees	$375,000	$324,640	$50,360	16%
Other operating services	$1,929,565	$1,568,941	$360,624	23%
Supplies	$224,693	$224,337	$356	0%
Accounting and auditing services	$56,500	$60,985	($4,485)	-7%
Other professional services	$748,720	$608,591	$140,129	23%
Legal fees	$35,000	$26,921	$8,079	30%
Disability program	$100,000	$65,123	$34,877	54%
Actuarial fees	$98,000	$90,000	$8,000	9%
Professional travel	$24,000	$22,059	$1,941	9%
Acquisitions	$493,575	$392,276	$101,299	26%
Investment fee expense	$19,935,780	$20,266,725	($330,945)	-2%
Other	n/a[1]	$795,260	n/a[1]	
Administrative expenditures not included in budget	n/a[1]	$1,276,464	n/a[1]	
Total Fund Uses	$33,585,667	$635,603,854	n/a[1]	
Net Funding Sources	n/a[1]	$889,281,150	n/a[1]	

Note: [1]LASERS only budgets for select administrative and investment expenditures.

Source: Prepared by legislative auditor's staff using information furnished by LASERS and LASERS' audited statement for fiscal year 2004.

LASERS refers to the majority of its membership as "regular members." Regular 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. Regular members of LASERS with 30 years of service may retire and draw benefits at any age. Benefits are generally calculated by multiplying the applicable rate (2.5% rate for each year of service) times years of creditable service times the member's average earned compensation for the 36 highest successive months of employment. Retirement eligibility and the benefit formula may vary for groups of other members of LASERS. These other groups include the following:

- Correctional officers, security personnel, probation and parole officers employed by the Louisiana Department of Public Safety and Corrections
- Wildlife agents employed by the Enforcement Division of the Louisiana Wildlife and Fisheries Commission
- Governor, lieutenant governor, and state treasurer
- Legislators and certain officials of the House of Representatives and Senate
- Judges and court officers
- Bridge police employees of the Crescent City Connection Division

Exhibit 3 provides information concerning the membership of the LASERS system.

Exhibit 3

LASERS
Membership Components
Fiscal Years 2002, 2003, and 2004

Memebership Categories	As of June 30, 2002	2003	2004
Active members	64,692	65,441	64,149
Terminated vested members	1,245	1,317	1,324
Terminated nonvested members	29,579	30,940	35,955
Retired members	31,887	32,757	33,456
DROP participants	2,635	2,768	2,835
Total membership	**130,038**	**133,223**	**137,719**

Source: Prepared by legislative auditor's staff using LASERS' audited financial statements for fiscal years 2003 and 2004.

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How do the investment returns for different asset classes of LASERS compare to relevant benchmarks?

LASERS' long-term total investment returns as reported by its consultant have exceeded the system's actuarially assumed rate of return of 8.25%. The system achieved an 8.8% annualized return over the past 10 fiscal years. Ten of LASERS' 17 asset classes have performed above their respective comparable benchmark indices on a 10-year basis. However, these returns are not adjusted for investment management fees (i.e., they are presented "gross of fees").

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

According to LASERS' investment consultant, LASERS' investment returns (gross of fees) have exceeded the system's actuarially assumed rate of return by 0.55 percentage points over 10 years and by 0.75 percentage points since the inception of computing returns (1990). These numbers are "gross of fees," which means that the money managers' fees have not been subtracted when computing the rate of return. The actuarial rate is the rate of return that the system's actuary assumes the system will earn 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. A system with investment returns less than this rate worsens its funding ratio, all other factors (such as benefits and contributions) remaining equal.

Since LASERS' investment returns are being reported "gross of fees," we could not exactly determine the degree to which LASERS' overall return, net of fees, exceeded the actuarially assumed rate of return. However, we calculated the average fee paid by LASERS at the end of fiscal year 2004 for all of its managers. This average fee was almost 25 basis points (0.25 of 1 percent, as 1 percent = 100 basis points). We subtracted this fee amount from the investment return reported for LASERS to obtain the amounts shown in the middle column of Exhibit 4 on page 14. Therefore, we conclude that LASERS has exceeded its actuarially assumed rate over the long term, net of fees, although we cannot quantify by exactly how much. Exhibit 4 shows LASERS' investment returns over different time periods.

Exhibit 4 LASERS Total Investment Returns as of June 30, 2004 (Gross of Fees)				
Time Period	**LASERS' Investment Return**	**Estimated Investment Return (Net of Fees)***	**Actuarially Assumed Rate of Return**	**Excess Return (Gross of Fees)**
1 Year	18.0%	17.75%	8.25%	9.75%
5 Years	4.0%	3.75%	8.25%	(4.25%)
10 Years	8.8%	8.55%	8.25%	.55%
Since Inception	9.0%	8.75%	8.25%	.75%

Note: *We calculated the average fee paid by LASERS at the end of fiscal year 2004 for all managers to be 25 basis points. 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 New England Pension Consultants (LASERS' consultant) and LASERS' staff.

We discussed the issue of the consultant reporting returns gross of fees rather than net of fees with LASERS' chief investment officer. He 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 LASERS board of trustees and staff the information necessary to accurately adjust the reported rates.

Recommendation 1: LASERS should ensure that its investment managers' returns are presented net of management fees when it is reviewing investment managerial performance.

Management's Response: LASERS partially agrees with this recommendation. LASERS has always used gross-of-fee performance returns and believes this is the optimal way of reviewing performance. This belief is supported by the CFA Institute's Global Investment Performance Standards. LASERS is, however, transitioning to a new custodian bank and is working with this bank to develop a way to also report net-of-fee performance returns.

Ten of LASERS' Seventeen Asset Classes Have Yielded Long-Term Investment Returns Above Their Benchmark Indices

For the last 10 years (ending on June 30, 2004), LASERS' investment returns (gross of fees) for 10 of 17 asset classes were above relevant benchmark indices, as illustrated in Exhibit 5 on page 15. The positive dollar impact of returns for LASERS is approximately $203 million. LASERS' U.S. large cap equity and U.S. small cap equity were below their respective benchmark indices, as were the returns for two of the four index funds that LASERS manages internally. Also, rates of return for absolute return funds, real estate investments, and an index fund externally managed were below their benchmark indices. There are no widely accepted standard benchmark indices for the alternative investment classes of private equity and absolute return (hedge funds); however, LASERS uses benchmarks of 17% and 13%, respectively. Therefore, we used these numbers as benchmarks for these two asset classes in Exhibit 5.

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 LASERS' asset classes are listed and briefly defined in Appendix B.

Exhibit 5
LASERS
Annualized 10-Year Investment Returns as of June 30, 2004[1]
(Gross of Fees)

Asset Class	LASERS' 10-Year Annualized Return	Comparable Index 10-Year Annualized Return	LASERS Above or Below Index?	Dollar Impact ($000)
U.S. Large Cap Equity	10.2%	11.8%	Below	($85,513)
U.S. Small Cap Equity	13.4%	13.6%	Below	($7,727)
Internal S&P 500 Index[1]	2.3%	1.6%	Above	$37,623
Internal S&P 100 Index[1]	-6.7%	-6.6%	Below	($370)
Internal S&P 400 Index[1]	4.6%	4.4%	Above	$1,832
Internal S&P 600 Index[1]	32.2%	32.6%	Below	($2,144)
External Russell 2000 Index[1]	6.9%	7.5%	Below	($1,840)
Non-U.S. Large Cap Equity	6.2%	4.9%	Above	$58,444
Non-U.S. Small Cap Equity	7.4%	4.6%	Above	$46,127
Non-U.S. Emerging Markets Equity[1]	2.4%	1.7%	Above	$6,682
U.S. Fixed Income (investment grade)	7.9%	7.4%	Above	$34,817
U.S. High Yield	8.5%	7.8%	Above	$20,657
U.S. Mortgage Backed Securities	9.2%	7.3%	Above	$53,810
Global Fixed Income	8.0%	6.6%	Above	$55,304
Real Estate (Alternative Investment)	9.8%	10.4%	Below	($3,394)
Private Equity (Alternative Investment)	18.9%	17.0%	Above	$30,359
Absolute Return (Alternative Investment)[1]	1.8%	13.0%	Below	($41,640)
Total				**$203,027**

Note: [1]Internal S&P 500 Index contains 6 years of data, Internal S&P 100 contains 3.75 years, Internal S&P 400 contains 3.75 years, Internal S&P 600 contains 1.5 years, External Russell 2000 contains 5.1 years, Non-U.S. Emerging Markets Equity contains 8.5 years, and Absolute Return (Alternative Investment) contains 3.4 years of data.
Source: Prepared by legislative auditor's staff from information provided by New England Pension Consultants (LASERS' consultant) and LASERS' staff.

Has LASERS 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?

LASERS has implemented an investment policy that allocates system assets by balancing risks with returns on investment. LASERS' investment policy conforms with eight of nine criteria that we developed. While the investment policy does not conform to one of our criteria, we found that LASERS does follow this criterion in practice but has not yet incorporated it formally into the investment policy. LASERS' investment policy ensures that investments are of sufficient quality to minimize the risk of loss.

LASERS Has Developed and Implemented an Investment Policy That Balances Risks With Returns and Minimizes Risk of Loss

We evaluated LASERS' asset allocation based on a list of nine criteria that a system's investment and asset allocation policies should contain. LASERS' investment policy satisfied eight of nine criteria. In practice, LASERS' current asset allocation procedures appropriately balance investment risks with returns and ensure that investments are of sufficient quality to minimize the risk of loss. These criteria, if adhered to, should mitigate investment risks while maximizing returns. They are listed in Exhibit 6 on page 20. Asset allocation is the single largest determinant of investment returns according to the Government Finance Officers Association (GFOA). Allocation accounts for 94% of the variation in returns.

The criterion that LASERS did not meet requires its investment policy to ensure that the use of index funds is formally and regularly evaluated as an alternative to active management of investments. We observed instances of indexing being discussed in LASERS' investment committee meetings. However, the system's investment policy does not require it. LASERS has regularly evaluated the use of indexed funds over the past year, and the percentage of plan assets invested in such funds has increased from 39.2% (as of June 30, 2003) to 43.3% (as of June 30, 2004).

State law (R.S. 11:267) provides that 10% of LASERS' equity portfolio must be invested in indexed funds and up to 65% of its total portfolio can be invested in equities. In practice, LASERS complies with the indexing requirement because 43.3% of its portfolio is invested in indexed funds, as of June 30, 2004.

LASERS' policies and procedures with respect to each of the nine criteria are discussed in the following paragraphs.

Low correlation among asset classes: LASERS' portfolio is divided up among U.S. stocks, international stocks, U.S. and international fixed income investments, real estate, private equity, and absolute return investments. LASERS' investment policy allocates target percentages of its portfolio to these asset classes. Historically, many of these asset classes have had low correlations with each other. This correlation will help LASERS reduce the risk that its entire portfolio will decrease in value during a given time period.

Target allocations and ranges for each asset class: LASERS had an asset allocation study performed in the spring of 2004. Based on this study, LASERS revised some target percentages to allocate its portfolio into various asset classes. These target allocations are included in LASERS' investment policy. Since the value of the portfolio changes daily, the actual portfolio allocation will fluctuate around the target percentages. LASERS has established ranges around these target percentages. If the actual portfolio allocation moves outside of these ranges, LASERS' 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, LASERS is minimizing its risk for a given level of investment returns.

Asset allocation tailored with an asset-liability study: LASERS' actuary prepares experience studies in an attempt to predict the long-term liabilities of the retirement system. LASERS' most recent experience study is dated May 2002. In accordance with LASERS' investment policy, the information from this study was used in the system's most recent asset allocation study.

Up to 65% of assets invested in equities: State law [R.S. 11:267(C)] allows LASERS to invest up to 65% of its assets in equities. LASERS' investment policy targets 61% (45% in U.S. equities and 16% in international equities) of its assets to equities, which is within the maximum allowed under state law. Thus, LASERS is in compliance with this criterion.

At least 10% of equity assets invested in index funds: State law [R.S. 11:267(B)] requires LASERS to invest at least 10% of its equity allocation in index funds. As of June 30, 2004, LASERS had 39% of its portfolio invested in funds that track various indices (such as the S&P 500, S&P 100, and Russell 2000). Therefore, LASERS is controlling the risk of not tracking a stock market index by investing more than half of its equity investments in index funds. The 10% minimum index provision is included in LASERS' written investment policy.

Regular rebalancing: LASERS' chief investment officer (CIO) compares the system's actual asset allocation to its target allocation weekly. 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 LASERS' investment policy. Thus, LASERS is systematically reviewing its asset mix to ensure that it takes the least amount of risk to achieve a given level of return.

Indexing: LASERS' CIO informed us that he monitors LASERS' use of index funds to determine if more or less indexing would be beneficial. Thus, LASERS does consider the positive and negative aspects of using index funds compared to investment managers. However, this review is not formally required in LASERS' investment policy.

Prohibited investments: LASERS' investment policy prohibits investments in certain types of derivatives for managers of traditional (non-alternative investment) assets. The term "derivatives" refers to a contract whose value is based on the performance of an underlying financial asset, index, or other investment. LASERS' policy also contains limits on certain types of investments, which include the following:

- No more than 6% of the fair market value of a U.S. equity manager's portfolio can be invested in any one security.
- No single holding in LASERS' portfolio shall account for more than 5% of the outstanding common stock of any one corporation.
- No more than 6% of the market value of domestic fixed income assets may be invested in the debt securities of any one issuer.
- The overall average quality of each fixed income portfolio shall be rated AA by Standard and Poors or higher. However, this quality requirement shall not apply to managers of high yield fixed income portfolios.
- The global bond portfolio may not hold more than 30% of its assets, at market value, in the debt securities of any single government or non-U.S. governmental entity.

Exhibit 6

Evaluation of LASERS' Compliance With Criteria for Asset Allocation and Investment Policy

	Criteria	Met by LASERS' 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) in order 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 portfolio from being invested in equity securities.	✓
5.	To comply with state law, the investment policy should contain a provision that ensures that 10% of the system's portfolio will be invested in index funds.	✓
6.	Portfolios should be rebalanced in order 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.	The investment policy should ensure that the use of index funds as an alternative to active management is "formally and regularly" evaluated.	✗
8.	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.	✓
9.	Private equity and real estate investments should be constrained so that the system's portfolio does not become dominated by these non-liquid investments.	✓

Sources: Criteria develped by legislative auditor's staff based on the GFOA and the Louisiana Revised Statutes of 1950, as amended.

Limits on non-liquid investments: LASERS owns $17.2 million in real estate, which constitutes 0.26% of its total portfolio, as of June 30, 2004. LASERS' investment policy provides that the system cannot invest further in real estate or real estate-like investments. The system is holding real estate investments made years ago and is waiting for them to liquidate.

LASERS' investment policy provides that a maximum of 10% of its total assets may be invested in other types of alternative assets. This amount is broken down further into a maximum of 5% each for hedge funds (absolute return funds) and private equity investments. Some types of alternative investments are non-liquid and tie up invested funds for years. However, having up to 10% of the portfolio in these types of investments does not dominate the portfolio, and we therefore concluded that LASERS meets this criterion. Because LASERS has $493.1 million (7.6 % of its portfolio) invested in alternative investments (as of June 30, 2004) and has increased its target allocation for this asset class from 8% to 10%, we discuss and explain these types of investments in a subsequent section of our report, beginning on page 41.

Recommendation 2: LASERS' written investment policy should ensure that the use of index funds as an alternative to active management is "formally and regularly" evaluated.

Management's Response: LASERS agrees with this recommendation, and will add language to the appropriate area of its Statement of Investment Objectives to require "formal and regular" evaluation of the use of index funds.

LASERS Has Procedures to Provide for Its Cash Needs

To meet its cash needs, LASERS holds approximately $50 to $100 million in its short-term investment fund. LASERS' officials estimate that the system needs operating funds of $12 to $15 million each month. There are also capital calls from alternative investment managers, and the system typically has a one week notice to meet this funding need. A capital call is usually for not more than $3 million. The Investment Division receives a weekly forecast prepared by LASERS' Fiscal Division and then arranges with the custodian bank to ensure that adequate funds are available to meet cash requirements.

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Does LASERS monitor compliance with the asset allocation component of the system's established investment policy?

LASERS 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. We reviewed investments by each manager and found that LASERS is complying with its asset allocation targets.

LASERS Properly Monitors Compliance With Its Asset Allocation Policy

LASERS' investment policy provides that at least quarterly, the system's Chief Investment Officer (CIO) will examine the portfolio and rebalance any asset class that is over or under its specified range. Our review of LASERS' board of trustees and investment committee meeting minutes found that LASERS is complying with this policy. Also, on a weekly basis, the CIO reviews and monitors LASERS' portfolio and whether the amounts of investment in asset classes are within their targeted range, according to LASERS' officials. Exhibit 7 on the following page shows the targets and ranges for each asset class. There is a band ranging from 1% to 5% on either side of an asset class's target.

Exhibit 7

LASERS' Asset Allocation Policy (Different Asset Classes as a Percentage of the Total Portfolio) (June 30, 2004)

Asset Class	Minimum	Target	Maximum
Domestic Large Cap	24%	27%	30%
Domestic Small Cap	11%	13%	15%
Domestic Mid Cap	3%	5%	7%
Established International (Large Cap)	7%	9%	11%
Established International (Small Cap)	3%	4%	5%
Emerging International Equity	2%	3%	4%
Total Equities	**55%**	**61%**	**65%**
Core Fixed Income	4%	7%	10%
Mortgages	3%	5%	7%
Domestic High Yield	6%	8%	10%
Global Bonds	4%	6%	8%
Cash	0%	3%	7%
Total Fixed Income	**24%**	**29%**	**34%**
Private Equity	0%	5%	9%
Absolute Return	3%	5%	7%
Total Alternative Assets	**3%***	**10%**	**15%**
Total		**100%**	

Note: * It appears that 3% is the minimum amount of assets that must be invested in the total alternative asset class; however, LASERS' investment policy provides that zero is the minimum percentage.

Source: Prepared by legislative auditor's staff using LASERS' investment policy.

All asset classes were within their target ranges, except for the alternative investment of absolute return strategies, as shown in Exhibit 8 on the following page. Its percentage of the portfolio was 2.84 compared to its minimum target range of 3% (see Exhibit 7). Exhibit 8 on the following page shows the asset classes in LASERS' investment portfolio, the investment managers, and amount of funds invested by each manager. This Exhibit also shows whether the asset class was in compliance with LASERS' asset allocation targets. The information contained in Exhibit 8 is as of June 30, 2004.

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, LASERS is minimizing its investment risk.

Exhibit 8

LASERS' Investment Managers and Amounts Invested (As of June 30, 2004)

Asset Class	Investment Manager	Amount Invested	Percentage of LASERS' Portfolio	Complies With Target?
Large Cap Growth	Goldman Sachs Chicago Equity Partners	$113,900,000 $113,800,000	1.75% 1.75%	Yes
Large Cap Value	Aronson & Partners	$211,400,000	3.25%	Yes
Small Cap Growth	TCW Westfield	$97,700,000 $109,300,000	1.50% 1.68%	Yes
Small Cap Value	Brandywine THB LSV	$69,700,000 $69,100,000 $73,800,000	1.07% 1.06% 1.13%	Yes
U.S. Equity Index Funds (Passive)	SSGA Russell 2000 LASERS S&P 100 LASERS S&P 400 LASERS S&P 500 LASERS S&P 600	$29,400,000 $176,200,000 $337,800,000 $1,305,400,000 $375,000,000	.45% 2.71% 5.19% 20.05% 5.76%	Yes
International Large Cap Value	Delaware International Templeton International	$90,500,000 $96,500,000	1.39% 1.48%	Yes
International Large Cap Growth	Nicholas-Applegate	$144,600,000	2.22%	Yes
International Index Fund	SSGA Salomon PMI Fund	$334,800,000	5.14%	Yes
International Small Cap	Schroders (Growth)	$203,600,000	3.13%	Yes
Emerging Markets	Schroders	$169,700,000	2.61%	Yes
U.S. Investment Grade Fixed Income	Loomis Sayles & Company Orleans Capital Management	$297,000,000 $140,700,000	4.56% 2.16%	Yes
U.S. High Yield Fixed Income	W.R. Huff Asset Management	$277,100,000	4.26%	Yes
Fixed Income Index Fund	SSGA High Yield Bond Index	$262,100,000	4.03%	Yes
Mortgage	TCW	$272,600,000	4.19%	Yes
Global Fixed Income	Delaware Investment Advisors	$349,900,000	5.37%	Yes
Private Equity (Alternative Assets)	14 Different Managers*	$291,000,000	4.47%	Yes
Absolute Return Strategies	5 Different Managers*	$184,900,000	2.84%	No
Real Estate	4 Different Managers	$17,200,000	0.26 %	Yes
Cash Equivalents		$297,000,000	4.56%	Yes
Totals		**$6,511,700,000**	**100.0%**	

Note: *For more information on these managers, refer to Exhibits 13 and 14 on pages 44-45.

Source: Prepared by legislative auditor's staff using LASERS' investment report dated August 2004, and LASERS' investment policy.

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How do LASERS' money manager, consultant, and custodial fees and charges compare to other pension plans?

The fees LASERS is paying to all its investment professionals are mostly lower than the median fees obtained from two fee surveys. These two surveys were prepared by the Independent Consultants Cooperative (ICC) and Cost Effectiveness Measurement Inc. (CEM). However, the fees LASERS is paying to 72% of its external investment managers are higher than averages of similarly sized pension plans, according to a fee survey conducted by Greenwich Associates of Greenwich, Connecticut (Greenwich). In all three surveys, the fees LASERS pays to international investment managers are lower than average.

The annual fees LASERS pays to its consultant and custodian are lower than averages we obtained from the Greenwich survey. LASERS' custodian fees (approximately $325,000 in fiscal year 2004) were 75%, or $975,000, lower than the Greenwich annual average of $1.3 million, for similarly sized pension plans. LASERS' consultant fees ($225,000 in fiscal year 2004) were 18%, or $50,000, lower than the Greenwich average.

LASERS' Money Management Fees Are Mostly Lower Than the Medians in Two Fee Surveys

To determine whether the fees paid to LASERS' money managers were in line with averages paid by other retirement systems, we compared them to three fee surveys:

- An ICC study dated December 2003: 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.
- Analysis conducted by CEM dated October 2004: CEM is a global information company that provides performance benchmarking to retirement plans and health care plans and for motor vehicle administration. The CEM analysis compared LASERS to 16 other retirement systems (public and private) having total assets similar to the asset size of LASERS.
- Greenwich study dated July 2004: The Greenwich survey included 191 institutional investors and was prepared on behalf of a leading investment consulting firm during January and February 2004.

Using the ICC survey, LASERS' fees in all survey asset classes are lower than survey medians, as illustrated in Exhibit 9 on the following page. The ICC survey does not take into account the size of the plan. In fact, LASERS paid higher than median fees to only one of its money managers.

Exhibit 9 Comparison of LASERS' Fees to ICC Survey of Money Managers' Fees (Public Defined Benefit Plans)					
Asset Class	Median Fees per Survey (in basis points*)	LASERS' Money Managers Fees (in basis points)	Percentage That LASERS Is Above or Below Fee Study	Difference (in basis points)	Estimate Value of Difference in Fees**
Large Cap	46	30 (Aronson) 30 (Chicago) 44 (Goldman)	Below 34.8 % Below 34.8 % Below 4.4 %	-16 -16 -2	-$338,240 -182,080 -182,240
Small Cap	87	48 (Brandywine) 66 (LSV) 50 (Thomson) 35 (TCW) 77 (Westfield)	Below 44.9 % Below 24.2 % Below 42.6 % Below 59.8 % Below 11.5 %	-39 -21 -37 -52 -10	-$271,830 -154,980 -255,670 -508,040 -109,300
International	48	30 (Delaware) 30 (Templeton) 25 (Schroder) 30 (Nicholas)	Below 37.5 % Below 37.5 % Below 48.0 % Below 37.5 %	-18 -18 -23 -18	-$162,900 -173,700 -468,280 -260,280
Fixed Income	31	17 (Loomis) 12 (Orleans) 50 (Huff) 17 (Delaware) 23 (TCW)	Below 45.2 % Below 61.3 % Above 61.3 % Below 45.2 % Below 25.9 %	-14 -19 19 -14 -8	-$415,800 -267,330 581,910 -489,860 -218,080

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 survey. For the full names of LASERS' money managers, refer to Exhibit 8 on page 25.

Source: Prepared by legislative auditor's staff using an Independent Consultants Cooperative Fee Survey (dated December 2003), LASERS' contracts with money managers, and manager invoices to LASERS for the 4th quarter of fiscal year 2004.

Using the CEM study and comparing to a group of 16 other similarly sized pension plans, LASERS' fees were mostly below the median fees of its comparison group. LASERS' fees were higher than the median in four of 11 asset classes. Those four classes are comprised of two passively managed funds, domestic equity-large cap, and a high yield bond fund. In three of these four instances, LASERS' fee was less than 10% above the median fee of the particular asset class in the CEM study. One domestic equity large cap manager's fees were 37.5% higher than the median whereas the other two managers in that asset class had fees two basis points below the median. The results of the CEM study are shown in Exhibit 10 on the following page.

Exhibit 10

Comparison of LASERS to CEM Survey of Money Managers' Fees (Pension Plans With an Average Size of $6.28 billion)

Asset Class	Median Fees per Survey (in basis points*)	LASERS' Money Managers Fees (in basis points)	Percentage That LASERS Is Above or Below Study	Difference (in basis points)	Estimated Difference in Dollars***
Domestic Equity - Large Cap - Active	32	30 (Aronson) 30 (Chicago) 44 Goldman Sachs)	Below 6.3 % Below 6.3 % Above 37.5 %	-2 -2 12	-42,280 -22,760 136,680
Domestic Equity - Small Cap - Active	66.4	48 (Brandywine) 65.69 (LSV) 50 (THB) 35 (TCW) 76.86 (Westfield)	Below 27.8 % Below 1.1 % Below 24.7 % Below 47.3 % Above 15.8 %	-18.4 -0.71 -16.4 -31.4 10.46	-128,248 -5,240 -113,324 -306,778 114,328
Domestic Equity - Small Cap - Passive	6.2	6.4 (SSGA)**	Above 3.3 %	0.2	588
Foreign Equity - Active	40	30 (Delaware Int'l) 25 (Schroder) 30 (Templeton) 30 (Nicholas)	Below 25 % Below 37.5 % Below 25 % Below 25 %	-10 -15 -10 -10	-90,500 -305,400 -96,500 -144,600
Foreign Equity - Passive	6.5	6.8 (SSGA)**	Above 4.7 %	.3	10,044
Emerging Equity	70	67.5 (Schroder)	Below 3.6 %	-2.5	-42,425
Domestic Fixed Income	20.4	16.63 (Loomis) 12 (Orleans)	Below 18.5 % Below 41.2 %	-3.77 -8.4	-111,969 -118,188
Foreign Fixed Income	34.9	16.9 (Delaware Int'l)	Below 51.6 %	-18	-629,820
High Yield Bonds - Active	46	50 (Huff)	Above 8.7 %	4.0	110,840
High Yield Bond Index - External	12.1	12 (SSGA)**	Below 0.9 %	-.1	-2,621
Fixed Income - Other	36.4	23.25 (TCW)	Below 36.2 %	-13.15	-358,469

Notes: * Basis points: 100 basis points = 1 percent.
** SSGA is an abbreviation for State Street Global Advisors, manager of three of LASERS' index funds. For the full names of LASERS' money managers, please refer to Exhibit 8 on page 25.
*** 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 median fee in the study.

Source: Prepared by legislative auditor's staff using the CEM confidential survey dated October 2004 obtained from LASERS, LASERS' contracts with money managers, and other information obtained from LASERS.

Using the Greenwich survey and comparing to similar sized public pension plans, the fees LASERS pays for most of its money managers are higher than survey averages, as illustrated in Exhibit 11. The fees for the four managers in the asset class of active international equity and for one fixed income manager are the only manager fees lower than Greenwich survey averages.

Exhibit 11

Comparison of LASERS Fees to Greenwich Survey of Investment Managers' Fees (Public Pension Plans With Assets Over $5 billion)

Asset Class	Average Fees per Survey (in basis points*)	Fiscal Year 2004 LASERS Investment Managers' Fees (in basis points)	Percentage That LASERS Is Above or Below Fee Study	Difference (in basis points)	Estimated Annual Value of Difference in Fees ***
Active Domestic Equity	29.4	30 (Aronson)	Above 2.1 %	.6	$12,684
		30 (Chicago)	Above 2.1 %	.6	6,828
		44 (Goldman)	Above 49.7 %	14.6	166,294
		48 (Brandywine)	Above 63.3 %	18.6	129,642
		66 (LSV)	Above 124.5 %	36.6	270,108
		50 (Thomson)	Above 70.1 %	20.6	142,346
		35 (TCW)	Above 19.1 %	5.6	54,712
		77 (Westfield)	Above 162 %	47.6	520,268
Passive Domestic Equity	3.1	6.4 (SSGA**-Russell 2000)	Above 106.4 %	3.3	$9,702
Active International Equity	39.7	30 (Delaware)	Below 24.5 %	-9.7	-$87,785
		30 (Templeton)	Below 24.5 %	-9.7	-93,605
		25 (Schroder)	Below 37.1 %	-14.7	-299,292
		30 (Nicholas)	Below 24.5 %	-9.7	-140,262
Emerging Markets Equity	57.3	68 (Schroder)	Above 18.7 %	10.7	$181,579
Active Fixed Income	14.9	17 (Loomis)	Above 14.1 %	2.1	$62,370
		12 (Orleans)	Below 19.5 %	-2.9	-40,803
		50 (Huff)	Above 235.6 %	35.1	972,621
		17 (Delaware)	Above 14.1 %	2.1	73,479

Notes: * Basis points: 100 basis points = 1 percent.

** SSGA is an abbreviation for State Street Global Advisors, manager of three of LASERS' index funds. For the full names of LASERS' investment managers, please refer to Exhibit 8 on page 25.

*** Calculated the difference in fees by multiplying the difference in basis points by the market value as of June 30, 2004, obtained from LASERS' investment report.

Sources: Prepared by legislative auditor's staff using information obtained from Greenwich Associates, LASERS' contracts with money managers, and other information obtained from LASERS.

According to LASERS' CIO, comparing LASERS' fees with the Greenwich survey is somewhat misleading because there are some problems with the Greenwich survey methodology. First, LASERS falls into the asset class size of more than $5 billion. In this asset class of the survey, Greenwich includes some systems that are much larger than LASERS. Larger systems with more to invest with a manager can obtain reduced fee arrangements. Thus, these large retirement systems are reducing the average fees in the survey, and thereby making LASERS' fees appear higher than if LASERS were compared to more similar sized systems. Second, Greenwich does not separate small and large cap in some of the asset classes it uses. Small cap management fees are higher than large cap fees, so it is important to differentiate between these two classes when comparing fees. Third, the Greenwich survey fixed income class is not broken into more than one category. The fixed income class includes high yield and global bond fund managers, which typically have higher fees than domestic fixed income managers.

LASERS' Consultant Fees Are Lower Than Average

LASERS paid its consultant $225,000 in fiscal year 2004. Similarly sized public pension plans (more than $5 billion in size) pay their consultant an average of $275,000, according to the Greenwich survey. Thus, LASERS pays 18% less in consultant fees than the average paid by similar sized public retirement systems.

LASERS' Custodian Fees Are Lower Than Average

LASERS paid its custodian $324,640 in fiscal year 2004. Similarly sized public pension plans (more than $5 billion in size) pay their custodian an average of $1,300,000, according to the Greenwich survey. Thus, LASERS pays 75% less in custodian fees than the average paid by similar sized public retirement systems.

Exhibit 12 shows the fees that LASERS paid its investment managers, consultant, and custodian during fiscal year 2004.

Exhibit 12

Fees Paid by LASERS to Its Investment Professionals
Fiscal Year 2004

Type of Professional	Amount of Fees	As Percentage of Total Assets (in Basis Points)
Investment Managers	$20,266,725	30.4
Investment Consultant	$225,000	.3
Custodian Bank	$324,640	.5

Notes: Total assets were $6,659,152,969, as of June 30, 2004.
Basis points: 100 basis points = 1 percent.

Source: Prepared by legislative auditor's staff using LASERS' audited financial statement for fiscal year 2004 and information furnished by LASERS' staff.

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

LASERS uses competitive, objective procedures with performance based criteria to select investment managers and its custodian. However, we were unable to evaluate the selection process for the system's consultant because of the length of time (11 years) that has elapsed since it was selected. Overall, LASERS' selection policies and procedures are in line with industry standard criteria recommended by the Government Finance Officers Association (GFOA).

LASERS Has Formal Policies and Procedures for Selecting Investment Managers, Consultants, and Custodians

We found that LASERS uses appropriate criteria for the selection of money managers and custodian, including:

- Key personnel--experience and education
- History of investment performance versus appropriate benchmarks
- Number of years a firm has been in business and other information about the firm
- Fee structure

In a typical search using Request for Proposals (RFPs), LASERS will obtain information concerning the above criteria. After LASERS receives responses to the RFP, staff analyze the information to narrow down the list of potential managers. LASERS' consultant performs the same process. When staff and the consultant have narrowed down the list of candidates to three or four finalists, LASERS' staff and consultant perform due diligence site visits. The GFOA recommends that retirement systems include in their investment policy the criteria used to select money managers and other professionals. These policies increase the likelihood that the same process will be consistently used in each search for an investment professional. LASERS' vendor selection policies contain such criteria.

We reviewed the RFPs used by LASERS for hiring all of its present investment managers. We found that a RFP process was used for all investment managers hired since July 2000, with seven exceptions. A RFP was not used in hiring five private equity managers; however, LASERS had previously invested with these managers and therefore did not need to repeat the RFP process. Also, a RFP was not used for a manager of two different index funds. A LASERS' official informed us that funds were held temporarily in the index funds until a manager could be selected to manage these funds.

We reviewed investment committee minutes and selection documents for three investment manager searches and the selection of a new custodial bank and found that LASERS' selection methodologies adhered to GFOA criteria. We did not review the selection process for LASERS' consultant because of the length of time (11 years) that has elapsed since this firm was selected.

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

LASERS uses objective procedures and has properly monitored its investment managers and whether they are churning the assets held in their accounts. In addition, LASERS has properly monitored its consultant and custodian bank. There are monitoring policies for the investment managers; however, no policies are in place for a formal annual review of the consultant's and custodian's performance.

LASERS Effectively Monitors Investment Manager Performance

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
- Determine if the firm's investment team is still in place
- Determine if the firm uses a consistent management approach (does not change style frequently)

LASERS has complied with GFOA's recommendations and has effectively monitored investment manager performance. For example, LASERS has a system in place to ensure that investment managers comply with LASERS' investment policy guidelines. LASERS communicates frequently with its consultant and the investment managers to keep abreast of any personnel changes. Statistical measures are also compiled by the consultant on the assets in the investment manager portfolios to help the LASERS board of trustees and staff monitor for any changes in a manager's investment style. LASERS's investment managers are required to report monthly on their actual performance and to reconcile their records to the custodian's records.

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. However, the rates of return reported are gross of fees. That is, the returns have not been adjusted downward to reflect the quarterly payments made by LASERS to investment managers for their services. Finally, LASERS' investment policy has requirements for monitoring investment managers.

LASERS 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. LASERS has several controls in place to guard against churning by its investment managers. First, managers are paid by LASERS based on the amount of assets they have under management. This provider provides managers with an incentive to increase the value of the account being managed for LASERS. The second control used by LASERS 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. LASERS uses a third control during the investment manager search process. LASERS' staff and its consultant evaluate whether a potential manager has affiliated brokers.

Finally, LASERS' custodian provides an annual report on the commissions paid for each investment manager. A manager's turnover ratio is another method to evaluate whether churning is occurring. A high turnover ratio could indicate churning by the manager. However, we found that LASERS does not review managers' turnover on a regular basis. We reviewed the trading activity of three managers for a quarter during fiscal year 2004 and found no evidence of churning. Thus, it appears that LASERS adequately safeguards the system's assets against churning by investment managers.

LASERS Informally Monitors Its Consultant

LASERS does not formally evaluate the performance of the system's consultant. LASERS' CIO stated that LASERS only formally reviews the consultant's performance if there are problems. However, the LASERS 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.

LASERS does not have a policy regarding the formal monitoring and evaluating of its consultant. Policies should specify the frequency of evaluations and the criteria to be used in an evaluation. For example, LASERS 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 continuity and consistency of consultant monitoring.

Recommendation 3: LASERS 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: LASERS agrees with this recommendation. LASERS currently evaluates its consultant's performance informally on a regular basis. LASERS will incorporate formal annual reviews into its Statement of Investment Objectives and make this review process a responsibility of the Board of Trustees. LASERS will develop a policy to regulate annual consultant review as well as the areas to be evaluated.

LASERS Monitors Its Custodian Bank, but Could Strengthen Its Written Monitoring Policies

LASERS monitors its custodian by requiring its investment managers and custodian to reconcile their records on a monthly basis. LASERS also has an Investment Accounting Division that reconciles the records of the custodian and managers to LASERS own records. These reconciliation processes help to ensure that any breakdown in the custodial system between annual financial audits will be identified on a timely basis. The investment-related data provided by the custodian is relied upon by LASERS' staff and its consultant to evaluate investment manager performance, make recommendations to trustees, and report to external parties. By properly monitoring its custodian, LASERS has ensured that the critical data are reliable and accurate. LASERS also monitors how well the custodian handles problems with transactions. LASERS has policies requiring reconciliation of records and system monitoring of how well the custodian handles transactional problems.

In addition to reconciliation and handling of transactions, GFOA criteria provide that a retirement system should also monitor its custodian based on the bank's focus on custodial business (as compared to other types of banking services) and the financial health of the custodial bank. However, LASERS investment policies do not contain these two criteria. To be consistent with GFOA recommendations, LASERS' investment policy should state how frequently LASERS will monitor its custodian's focus on custodial business and the bank's financial health.

LASERS' CIO 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 LASERS. It could also verify the financial condition of the custodian.

Recommendation 4: LASERS 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: LASERS agrees with this recommendation. LASERS currently evaluates its custodian's performance informally, and immediately contacts the custodian when there is a problem. LASERS will incorporate formal annual custodian reviews into its Statement of Investment Objectives, and make this review process a responsibility of LASERS' Investment Division, reporting to the Board of Trustees. LASERS will develop a policy to regulate annual custodian review as well as the areas to be evaluated.

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

LASERS does take corrective action for poorly performing money managers and for the system's custodian. The system has had the same consultant since 1993, and has not needed to take any corrective action.

LASERS Takes Corrective Action When Investment Managers Underperform

From fiscal years 2001 through 2004, five of LASERS' non-alternative investment managers underperformed their relevant benchmark index for at least one fiscal year. LASERS terminated two of these managers and replaced two other managers when their contracts expired. LASERS did not terminate the fifth manager because it expects this manager's performance to improve during fiscal year 2005. By creating and following policies for corrective action, LASERS has ensured that poorly performing money managers receive prompt corrective action and are held accountable for their performance.

GFOA recommends that systems develop a process for placing money managers on a watch list or terminating them for reasons such as the following: key personnel changes, portfolio characteristics, underperformance, and style deviations. LASERS' investment policy provides that underperforming money managers may be placed on a "watch list" in these circumstances:

- Failure to comply with any of LASERS' investment guidelines
- Significant changes in the manager's firm
- Anticipated changes in LASERS' structure
- Any other reasons which LASERS' investment committee deems appropriate
- If a manager's performance fails to meet certain benchmarks, over eight consecutive quarters or for any eight quarters during a 10-quarter period.

LASERS Takes Corrective Action When Its Custodian Underperforms

GFOA criteria state that the process of changing custodians should only occur over planned intervals and should not be initiated in reaction to financial hardship of a custodian. LASERS has complied with these criteria. LASERS was not satisfied with the performance of its previous custodian. The system terminated this custodian in late 2004 because of factors unrelated to the custodian's financial hardship.

LASERS' investment policies contain no corrective action guidelines for the system's consultant or custodian. We discussed this matter with a LASERS' official who pointed out that both of their contracts contain 30-day notice of termination clauses in them. Also, the consultant or custodian could be terminated for some of the same reasons that investment managers can be placed on a "watch list."

LASERS Has Not Needed Corrective Action for Its Consultant

LASERS' officials informed us that they have not experienced any significant problems with their consultant.

What role do alternative investments play in LASERS' investment portfolio?

LASERS has alternative investments in private equity and absolute return strategies totaling almost $476 million, as of June 30, 2004, which constituted 7.3% of LASERS' portfolio. Alternative investments have historically produced higher rates of return than more traditional investments. The approximate rates of return, net of fees, as of June 30, 2004, were 11.9% for private equity (over a five-year period) and 1.58% for absolute return strategies (over a three-year period). Alternative investments also provide diversification to a portfolio because they may not move in the same direction as other types of investments. However, these investments have disadvantages such as having higher management fees than traditional investments, and the fact that monies invested can be tied up for 10 years or longer.

The percentage of LASERS' portfolio allocated to alternative investments is higher than an average of public retirement systems in the U.S. LASERS' percentage of alternative investments is also higher than six other state systems comparable in asset size to LASERS.

Alternative Investments Are Different From Traditional Investments

LASERS had alternative investments in private equity and absolute return strategies totaling almost $476 million, as of June 30, 2004, which constituted 7.3% of LASERS' portfolio. This amount does not include real estate investments, which were approximately $17.2 million. LASERS has invested in four real estate funds but is phasing out its real estate investments. LASERS' investment policy provides that it will no longer invest in real estate once these four funds liquidate. A description of private equity and absolute return ("hedge") funds follows.

Private Equity investments attempt to take advantage of opportunities in the private markets, by investing in business ventures. Private equity refers to investments other than direct investments in publicly traded equities and bonds, mutual funds, or certificates of deposit. Some categories of private equity investments are as follows:

- **Venture capital** refers to funds made available to start up firms and small businesses with exceptional growth potential. Such investing usually means buying early ownership in a company.

- **Mezzanine financing** is late-stage venture capital, usually the final round of financing prior to an initial public offering of a company's securities. Mezzanine financing can combine debt and equity.

- **Leveraged buyouts** take place with the acquisition of a company or a division of a large corporation, using borrowed funds.

Absolute return (hedge) fund is a fund that invests primarily in publicly traded securities. However, hedge funds are exempt from many of the rules and regulations governing mutual funds. This condition allows these funds to pursue aggressive investing goals unavailable to mutual funds. Hedge funds seek positive absolute returns, regardless of the performance of an index or sector benchmark. Strategies and positions can include selling of securities (referred to as "being short" on a company or a market in general), trading in commodities or options, and using leverage (borrowing). Typically, a hedge fund manager can be long (purchase of securities in anticipation of their rising in value) and also short (sale of securities in anticipation of their decreasing in value) on an industry or sector of a market. Some categories of hedge fund investing are as follows:

- **Event-driven strategies** take advantage of transaction announcements and other one-time events, such as mergers or distressed securities (securities of a company either reorganizing or very depressed in value for some other reason).

- **Directional or tactical strategies** can involve long/short positions, short sale strategies, or market neutral strategies. A market neutral manager, for example, might think that Lowe's will outperform Home Depot. Thus, he/she would purchase Lowe's stock and simultaneously short (sell) Home Depot stock. If the market and both stocks go down, as long as Lowe's outperforms Home Depot, the shorting of Home Depot's stock will produce a net profit for the position.

"Fund of Funds" Diversifies Investments. A typical alternative investment vehicle is a limited partnership. Such a partnership has a general partner who manages many investments owned by the partnership. The investing retirement systems are the limited partners of a partnership. If the partnership is formed for direct private equity investing, it may invest in 20 to 30 business ventures.

Most of LASERS' alternative investments are in a "fund of funds," which refers to an investment fund that invests in a number of other investment funds. Such a fund is designed to achieve greater diversification of investments than is available with a fund having only direct investments. For example, if LASERS invests in a private equity fund of funds, the fund of funds may own an interest in 20 other private equity funds. If each of these 20 funds has invested in 30 ventures, then the fund of funds has investments in 600 (20 X 30) different private ventures. A LASERS' official estimated that with its alternative investments alone, the system has investments in more than 4,000 ventures.

Advantages and Disadvantages of Alternative Investments

Alternative investments provide portfolio diversification because many of them are not highly correlated with the typical investment held by LASERS (i.e., they do not always move in the same direction). This condition means that if the stock or bond markets go down, the alternative investments may not go down as much or may move in the opposite direction and increase in value. A second advantage is the above-average returns these investments have historically produced.

One disadvantage of alternative investments is that their management fees exceed the fees charged for non-alternative investments. The reason alternative investment managers can command a higher fee is the historically higher rates-of-returns they have provided. Hedge funds can also charge a performance or incentive fee in addition to the normal fee (percentage of assets under management). These performance fees usually take the form of a percentage of the profits that reduces the profits shared by other investors.

Other risks of alternative investments include:

- A lack of liquidity for investments made by the manager because the investments are made for a long-term (particularly true for private equity)

- A lack of liquidity of an investor's interest. An investor is usually unable to withdraw from the investment or sell its interest; thus, an investor's funds may be tied up until (if) the investment manager makes distributions

- No assurance that the investments will be profitable because the investments are speculative and have a high degree of business and financial risk. An investor could lose all of the funds invested

- No investor input into management or the conduct of day-to-day business. The manager of a fund typically makes all the decisions concerning investments, and investors have no vote or other means of control over the manager's decisions

- Reliance on key personnel of the manager. If one or more of these personnel leave, the fund's performance could be adversely affected

- No assurance that investments will be diversified

Another concern related to alternative investments is that their reported rates of return may not be accurate and reliable. The fair market values of an alternative investment's assets are used to calculate the investment's rate of return. Many of these assets are privately held and not traded like securities on a public exchange where a fair market value is readily determinable. Different techniques can be used to value these assets, which can result in two different investment managers valuing the same asset at differing values. Since the accuracy of these assets' fair market values can be questioned, the rates of return reported for some alternative investments may not be accurate and reliable.

Rate of Return for Private Equity is High (14%), but Low (2.8%) for Absolute Return Strategies

The overall rate of return for private equity investments, gross of fees, is 14.2 % for a five-year period ending June 30, 2004. The rates of return for LASERS' private equity funds for the past one, three and five years are shown in Exhibit 13 on the following page. Private equity funds can take as long as 10 to 12 years to mature and liquidate, according to LASERS' officials. Therefore, using a five-year (and shorter) horizon to measure performance may be misleading.

Another consideration to note with the performance data in Exhibit 13 is that they are "gross of fees," that is, the managers' fees have not been subtracted from the rates of return. As of June 30, 2004, LASERS reported the average management fee was 2.34% (234 basis points) for private equity investments. So, net of fees, the rate of return for private equity has been approximately 11.9% (14.2 - 2.3) for a five-year period.

The approximate overall rate of return for absolute return funds, gross of fees, is 2.8%, for three years ending June 30, 2004. Obviously, this rate of return falls well short of LASERS' actuarially assumed rate of return of 8.25%. The rates of return for LASERS' absolute return funds for the past one and three years are shown in Exhibit 14 on the following page. LASERS has not invested for a five-year period with any absolute return investment manager. The performance data in Exhibit 14 are presented "gross of fees," that is, the managers' fees have not been subtracted from the rates of return. As of June 30, 2004, LASERS reported the average management fee was 1.22% (122 basis points) for absolute return investments. So, net of fees, the rate of return for absolute return strategies has been approximately 1.58% (2.8 - 1.22) for the three-year period ending June 30, 2004.

Exhibit 13

LASERS Alternative Investments' Performance
Rates of Return for Private Equity Investments
(As of June 30, 2004)

Investment Manager	1 Year Percentage	3 Years Percentage	5 Years Percentage
Adams Street Secondary	-3.4	-5.6	N/A
Adams Street Primary*	12.7	-9.0	9.9
Adams Street V - LP Direct	N/A	N/A	N/A
John Hancock*	17.9	-9.3	36.0
HIPEP Direct III	25.0	-1.4	-3.6
HIPEP Partnership III	19.2	4.4	-2.5
Harbourvest VI - Buyout	25.6	1.1	N/A
Harbourvest VI- Direct	34.1	-8.1	N/A
Harbourvest VI- PTNR	3.9	-16.8	N/A
HIPEP Direct IV	0.0	N/A	N/A
HIPEP Partnership IV	13.3	N/A	N/A
Pathway Capital Management*	45.0	7.9	10.7
Huff Alternative Fund	81.9	13.0	N/A
ERASMUS	N/A	N/A	N/A
Williams Capital	N/A	N/A	N/A
Total Private Equity	**16.9**	**-7.6**	**14.2**
Nominal Benchmark	17.0	17.0	17.0

Note: * The rates of return for a six-year period for Adams Street Primary is 9.6%; for John Hancock, 37.9%; and for Pathway Capital Management, 13.5%.

Source: Prepared by legislative auditor's staff using LASERS' investment report for periods ending June 30, 2004.

Exhibit 14 LASERS Alternative Investments' Performance Rates of Return for Absolute Return Strategies* (As of June 30, 2004)			
Investment Manager	**1 Year Percentage**	**3 Years Percentage**	**5 Years Percentage**
Arnhold & S. Bleichroeder	1.9	1.1	N/A
Kellner, Dileo & Co.	4.3	2.2	N/A
Kellner, Dileo & Co. Convertible Arbitrage	-4.3	N/A	N/A
Total Absolute Return	**5.3**	**2.8**	**N/A**
Nominal Benchmark	13.0	13.0	N/A

Note: * LASERS had absolute return investments with two other managers, PAMCO and K2 Advisors LLC, for less than a year as of June 30, 2004. Therefore, these two managers were not included in this exhibit.

Source: Prepared by legislative auditor's staff using LASERS' investment report for periods ending June 30, 2004.

LASERS Has a Higher Percentage of Alternative Investments Than Other Public Retirement Systems

Wilshire Consulting (Wilshire Associates Incorporated) publishes an annual survey of state retirement systems. In Exhibit 15 below, we compared LASERS' levels of alternative investments to averages obtained from the 2004 report of Wilshire Consulting. Exhibit 15 shows that when compared to other public retirement systems across the U.S., LASERS' percentage of private equity/hedge fund holdings (5.7%) was slightly higher than the average (4.68%) and median (3.9%). LASERS' alternative investments increased to 7.3% of the total portfolio, as of June 30, 2004.

Exhibit 15 Comparison of LASERS' Alternative Investment Holdings to Other Public Retirement Systems Through June 30, 2003*	
Retirement System	**Private Equity and Absolute Return Investments as Percentage of Total Portfolio**
LASERS	5.70
Average	4.68
High	18.0
Median	3.90

Note: *Some of the retirement systems' report dates included in these statistics were not as of June 30, 2003.
Source: Wilshire Consulting (Wilshire Associates Incorporated): 2004 Wilshire Report on State Retirement Systems.

We also compared LASERS to retirement systems that are similar in asset size to LASERS. Exhibit 16 shows a comparison of LASERS to these systems using data taken from the 2004 report of Wilshire Consulting. Of the seven systems, LASERS had the largest percentage of holdings in private equity and absolute return strategies. Montana's Board of Investments had nearly the same amount of private equity/absolute return holdings as LASERS. Three state systems own no private equity and absolute return investments.

Exhibit 16

Comparison of LASERS' Alternative Investment Holdings to Similar Sized Retirement Systems (as of June 30, 2003)

Retirement System	Private Equity and Absolute Return Investments as Percentage of Total Portfolio
LASERS	5.7
Indiana State Teachers' Retirement Fund	1.0
Missouri State Employees' Retirement System	2.9
Montana Board of Investments**	5.6
New Mexico Teachers' Retirement System	0.0
Oklahoma Teachers' Retirement System	0.0
West Virginia Investment Management Board**	0.0

Note: ** The Montana Board of Investments and West Virginia Investment Management Board administer several retirement systems in each of the two states.

Source: Wilshire Consulting (Wilshire Associates Incorporated): 2004 Wilshire Report on State Retirement Systems.

Does LASERS 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 LASERS may not always ensure that primary decision makers avoid conflicts of interest as well as the appearance of conflicts of interest. We found several instances where gifts were accepted by LASERS' staff, trustees, and consultant from investment managers, a possible violation of the Louisiana Code of Governmental Ethics. In addition, LASERS' trustees, staff, and consultant accepted meals from its investment managers, consultant, and custodian.

LASERS does employ policies and procedures to help ensure that investment managers and consultants avoid potential conflicts of interest. LASERS does not employ adequate policies or procedures to ensure disclosure and proper treatment of potential conflicts of interest with its consultant.

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

LASERS 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 LASERS' staff and trustees may have violated the Louisiana Code of Governmental Ethics by accepting gifts from investment managers hired by LASERS.

We asked LASERS' investment managers, custodian, and consultant to identify any items of economic value provided to staff and trustees at LASERS during the period from July 1, 2003, through September 30, 2004 (15 months). We also asked key staff members and trustees for a list of anything received from these investment professionals during the same time period. Based on the responses we received, we found that the LASERS staff and trustees received several different items including a cigar, hats, bottles of wine, and books. Exhibit 17 on the following page shows the values of all gifts received by LASERS' staff, who provided it, and on what date. While the dollar value of these gifts is only $701, 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).

Although some of LASERS' staff and trustees accepted gifts, LASERS does have policies and procedures concerning the ethics code. One policy requires training of board members regarding the ethics code; there is a policy to return gifts received; and notification letters are sent to investment managers regarding the ethics code. Also, LASERS requires that ethics statements be signed by key staff. However, some of these policies and procedures may not have been properly communicated to all parties involved.

In addition, we asked LASERS' investment managers, custodian, consultant, key staff, and trusteees to disclose any economic interests that trustees, LASERS' 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, LASERS' staff, or their immediate family members with any economic interests in the investment professionals hired by LASERS.

Exhibit 17

Gifts Received by LASERS' Personnel
(From July 1, 2003, Until September 15, 2004)

Provider	Recipients	Gift	Value	Date
Loomis Sayles	Robert Beale (staff)	Cigar	$8.78	7/7/2003
Chicago Equity Partners	Trustees/Staff	Candy Refills	$48.00	4/7/2004
Chicago Equity Partners	Robert Beale (staff)	Leather box with Stag's Leap Merlot	$139.95	12/15/2003
Aronson, Johnson & Ortiz	Robert Beale (staff)	3 Books	$184.85	7/03, 12/03, 1/04
Orleans Capital Management	Kathy Singleton, (trustee)	Flowers	$91.56	11/6/2003
Orleans Capital Management	Robert Borden (staff)	Poinsettia	$54.50	12/15/2003
Brandywine Asset Management	Louis Quinn (trustee)	50th Anniversary Gift - Champagne	$37.17	8/20/2004
Brandywine Asset Management	Trustees	Philadelphia Eagles Hats	$135.92	11/23/2003
Brandywine Asset Management	Louis Quinn (trustee)	Golf Tournament Entrance Fees	Unknown	unknown
Total			**$700.73**	

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

LASERS' staff and trustees are involved in screening, selecting, monitoring, and evaluating the investment managers hired by LASERS. Therefore, any gifts received by LASERS' staff and trustees from the investment managers could be viewed as attempts to influence LASERS' 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 LASERS from contracting with any investment manager, consultant, or custodian of which a trustee or key staff member or a member of their immediate family has a substantial economic interest (R.S. 42:1113).

Recommendation 5: LASERS 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, LASERS 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 LASERS' staff and the provisions of the code to all investment managers.

Management's Response: LASERS agrees with this recommendation, and did request an opinion in 1997 from the Board of Ethics regarding the receipt of gifts from vendors. LASERS has taken several proactive measures to communicate information regarding gift prohibitions to its Board, staff, and vendors. LASERS believes there are several items noted in Exhibit 17 of the report that are not within the gift prohibitions contained in the Ethics Code. In the future, all gifts will be returned, and the vendor sending the gift will be requested not to do so again.

Recommendation 6: LASERS 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.

Management's Response: LASERS agrees with this recommendation, and will reinforce its existing policies to emphasize the requirement that all staff avoid conflicts of interest. LASERS currently has a policy that provides for the disclosure of any conflicts of interest or appearance thereof as part of its Board Governance Monitoring and Reporting Policy. With respect to the appearance of conflicts of interest regarding meals, LASERS agrees with the Board of Ethics that this activity is ethical and does not conflict with the provisions of the Ethics Code.

LASERS' Staff, Trustees, and Consultant Have Accepted Meals From LASERS' Investment Managers, Consultant, and Custodian

Senate Concurrent Resolution (SCR) No. 14 of the 2004 Regular Legislative Session provides that the legislature is concerned about any impropriety which may occur between 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 between investment consultants, advisors, managers and board members of the systems. Accordingly, we asked trustees, key LASERS' staff, and all of LASERS' investment advisors to inform us of meals paid for by investment advisors during the period from July 1, 2003, through September 30, 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 LASERS' investment managers, custodian, consultant, trustees, and key staff, during the 15-month period from July 1, 2003, through September 30, 2004, trustees, staff, and consultant accepted meals from investment managers, consultant, and custodian valued at approximately $56,541. See Appendix C on pages 57-63 for more detailed 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 ethics code; however, they represent a potential conflict of interest for trustees and key staff. LASERS' trustees and key staff are involved in screening, selecting, evaluating, and replacing the investment managers, consultant, and custodians who work for LASERS. Therefore, meals provided by investment managers, consultants, and the custodian could be viewed as attempts to influence LASERS' oversight decisions. By addressing such situations, we are complying with the intention of SCR No. 14. The providers, recipients, total cost, and dates of the meals are shown in Appendix C on pages 57-63.

LASERS does have a board governance policy in place that automatically starts a "blackout period" in which a potential manager may not have any contact with any member of the board outside of board and committee meetings once that manager has been named a finalist in the selection process. The "blackout" begins as soon as the finalists for the open position are named and does not end until the final selection has been made of who will get the contract. If a manager is found to be in violation of the blackout period, he/she may forfeit its eligibility as a finalist. Other than this "blackout period," there is no limit on the frequency and dollar value of meals accepted by LASERS' trustees and staff.

Recommendation 7: LASERS should set policies regarding the frequency and dollar value of meals accepted by staff, trustees, and consultants from investment managers, custodians, and consultants.

Management's Response: LASERS agrees with this recommendation, and will develop a policy regarding this matter in accordance with the Code of Governmental Ethics. LASERS obtained an opinion in 1997 from the Board of Ethics (Ethics Board Docket No. 97-508) concerning the Board of Trustees accepting meals or gifts from vendors. This opinion noted that there is an exception to the definition of "thing of economic value" (R.S. 42:1102(22)) for food and drink consumed while the personal guest of some person.

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

LASERS does employ policies or procedures to help ensure that investment managers avoid potential conflicts of interest. During the selection process, LASERS requires disclosures related to conflicts of interest from investment managers. It also requires investment managers to provide copies of their own code of ethics as additional controls to guard against conflicts of interest by investment managers.

LASERS requires disclosures by investment managers regarding business affiliations, relationships with the brokers they use for trades, and client referral fees they may pay to consultants. LASERS also requires that all investment managers give an annual hard or soft dollar use report before the board within 45 days of the end of the year. The policies and procedures used by LASERS help prevent conflicts of interest or the appearance of conflicts of interest for the investment managers hired by LASERS.

LASERS Could Strengthen Controls on Disclosure and Treatment of Potential Conflicts of Interest by Its Consultant

LASERS does not employ adequate policies or procedures to ensure disclosure and proper treatment of potential conflicts of interest with the consultants it hires. We found that the consultant has received gifts from LASERS' investment managers. During the period from July 1, 2003, through September 30, 2004, these gifts of investment-related books, conference functions, and candy refills for a gumball machine had an estimated total value of $430.

However, LASERS has put some controls in place regarding potential conflicts of interest by its consultant. In LASERS' current consultant contract, there are provisions regarding disclosure of conflicts of interest, independence, and ethics compliance. In addition, the contract prohibits the consultant from receiving additional compensation for the services it provides to LASERS. This provision prohibits the consultant from receiving referral fees.

In a ruling dated January 8, 2004, the Louisiana Board of Ethics determined that the consultant for another state retirement system was a "public employee" of the retirement system as defined in the Louisiana Code of Governmental Ethics (Docket No. 2002-556). The ethics code prohibits public employees from accepting gifts from anyone with a contractual or other business relationship with the public employee's agency. Recent legislation (Act 686 of 2004) requires investment managers and consultants to disclose conflicts of interest to public retirement systems.

Recommendation 8: LASERS should develop and implement policies and procedures for the disclosure and treatment of conflicts of interest and the appearance of conflicts of interest with current and prospective investment managers, custodians, and consultants.

Management's Response: LASERS agrees with this recommendation. LASERS' consultant and investment managers are required to abide by Act No. 686 of the 2004 Regular Session. LASERS has other procedures to assist in uncovering conflicts of interest with prospective investment managers. For example, LASERS' requests for proposal ask potential investment managers about conflicts of interest with LASERS' trustees or staff members. Investment managers must also complete a due diligence questionnaire during the selection process. This questionnaire captures certain information concerning a potential manager's conflicts of interest with LASERS' trustees, staff, external auditor, consultant and custodian.

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 LASERS' investment activities from fiscal year 2002 through December 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 LASERS' 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 three surveys. We examined how LASERS and its board of trustees selected and monitored investment managers, their 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 2004. We examined relationships among the LASERS' 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, information concerning the four state retirement systems, and information concerning alternative investments
- Held an entrance conference with LASERS on August 4, 2004
- Obtained investment return information from LASERS' investment consultant and interviewed the consultant concerning this information
- Reviewed LASERS' asset allocation study prepared by its consultant
- Obtained three surveys of pension plans that provided data on fees

- Determined the fees LASERS currently pays by reviewing the contracts and invoices for money managers, the consultant, and the custodian

- Compared the survey fee estimate data to the fees paid by LASERS

- 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 money managers, consultants, and custodians

- Met with LASERS' management to discuss criteria and interviewed LASERS' management and reviewed LASERS 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

- To review alternative investments' fair market values, obtained a listing of all alternative investment assets owned by LASERS, and assets owned by the Teachers' Retirement System of Louisiana to determine if the same asset was held by more than one alternative investment manager

- Reviewed state ethics law and all of LASERS' written policies for ethics work

- Developed criteria using the GFOA, the AIMR, and state laws

- Drafted and sent representation letters to LASERS' staff, trustees, money 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

Comparable Benchmark Indices

LASERS Asset Classes and Comparable Benchmark Indices	
Asset Class	**Comparable Benchmark Index**
Domestic Large Cap Growth Equity	**S&P 500 Barra Growth Index -** A capitalization-weighted index of all stocks in the S&P 500 Index that have high growth price-to-book ratios.
International Large Cap Growth Equity	**Citigroup PMI Growth EX-US Index -** A top down, float capitalization-weighted index comprised of developed markets throughout the world, excluding the United States. Based on available market capitalization, it includes the top 80% of available capital from these developed markets. It includes stocks determined to be growth stocks based on 5-year historical EPS growth rate, 5-year historical sales per share growth rate, and 5-year average internal growth rates.
Domestic Large Cap Value Equity	**S&P 500 Barra Value Index -** A capitalization-weighted index of all stocks in the S&P 500 Index that have low value price-to-book ratios.
International Large Cap Value Equity	**Citigroup PMI Value EX-US Index -** A top down, float capitalization-weighted index comprised of developed markets throughout the world, excluding the United States. Based on available market capitalization, it includes the top 80% of available capital from these developed markets. It includes stocks determined to be value stocks based on price to book, price to sales, price to cash flow, and dividend yield.
Domestic Mid-Cap Equity	**S&P Mid Cap 400 Index -** A capitalization-weighted index that measures the performance of the mid-range sector of the U.S. stock market.
Domestic Small Cap Growth Equity	**S&P Small Cap 600 Barra Growth Index -** A capitalization-weighted index of all the stocks in the S&P Small Cap 600 Index that have high price-to-book ratios.
International Small Cap Growth Equity	**Citigroup EMI EPAC Index -** A top down, float capitalization-weighted index comprised of European, Asian, and Pacific markets. Based on available market capitalization, it includes the lowest 20% of available capital from these markets.
Domestic Small Cap Value Equity	**S&P Small Cap 600 Barra Value Index -** A capitalization-weighted index of all the stocks in the S&P Small Cap 600 that have low price-to-book ratios.
Emerging Markets Equity	**MSCI Emerging Markets Free Index -** Covers 28 emerging market country indices. Designation as an emerging market is determined by a number of factors. MSCI evaluates factors such as gross domestic product per capita; local government regulations that limit or ban foreign ownership; the regulatory environment; perceived investment risk; or a general perception by the investment community that the country should be classified as "emerging."
Investment Grade Bonds (Fixed Income)	**Lehman Brothers Aggregate Index -** A market capitalization weighted index of investment-grade fixed-rate debt issues, including government, corporate, asset-backed, and mortgage-backed securities, with maturities of at least one year.

LASERS Asset Classes and Comparable Benchmark Indices	
Asset Class	**Comparable Benchmark Index**
High Yield Bonds (Fixed Income)	**Credit Suisse First Boston High Yield Index -** An unmanaged, trader priced index constructed to mirror the characteristics of the high yield bond market. The index includes issues rated BB and below by S&P or Moody's with par amounts greater than $75 million. Preferred issue, U.S. dollar dominated foreign issues and 144A securities meeting the above conditions are also included. **Lehman Brothers High Yield $200 Million Very Liquid Index -** An index that represents a diversified index of 300 of the most liquid and tradable BB and B rated issues in the 1,300 Lehman Brothers High Yield Index.
Mortgages (Fixed Income)	**Lehman Brothers Mortgage Index -** A market capitalization-weighted index of 15 and 30-year fixed rate securities backed by mortgage pools of the Government National Mortgage Association, Fannie Mae and the Federal Home Loan Mortgage Corporation, and balloon mortgages with fixed-rate coupons.
Global Bonds (Fixed Income)	**Citigroup World Government Bond Index -** Includes the 18 government bond markets. Market eligibility is determined based on market capitalization and investibility criteria. A market's eligible issue must total at least U.S. $20 billion, for three consecutive months for the market to be considered eligible for inclusion.
Private Equity (Alternatives)	**Nominal Benchmark 17% -** LASERS-derived benchmark.
Hedge Funds (Alternatives)	**Nominal Benchmark 13% -** LASERS-derived benchmark
Real Estate	**NCREIF Custom Property -** A large database that consists of equity and leveraged properties that are reported on an unleveraged basis. Calculations are based on quarterly returns of individual properties before deduction of asset management fees. Property types include Apartment, Industrial, Office, and Retail.
Cash Equivalents	**91 Day T-Bill -** A negotiable debt obligation issued by the U.S. Government and backed by its full faith and credit having a maturity date of 91 days.

Source: Prepared by legislative auditor's staff using information obtained from the Second Quarter 2004 Investment Performance Report handed out at the August 26, 2004, LASERS Investment Committee Meeting, www.ncreif.com and www.investorwords.com.

Meals Provided to LASERS' Trustees, Key Staff, and Consultant

Provider	Recipients	Value	Date
NEPC	Robert Borden (staff)	$25.00	July 2003
Templeton Investment	Consultant	$421.23	July 2, 2003
Orleans Capital	Benny & Gwen Harris (trustee)	$126.30	July 16, 2003
Goldman Sachs	Robert Borden (staff), Kathy Singleton, Benny Harris & Guest, Virginia Burton & Guest (trustees)	$400.00	July 18, 2003
Delaware	Robert Borden, Robert Beale (staff), Cynthia Bridges, Virginia Burton, Pamela Davenport, Benny Harris, Kathy Singleton, Cheryl Turner, Sona Young (trustees)	$1,318.22	July 24, 2003
Delaware	Robert Borden (staff)	$180.00	July 25, 2003
SSGA	Cynthia Bridges, Virginia Burton & spouse, Kathy Singleton, Benny Harris & spouse (trustees), Cindy Rougeou, Robert Borden, Robert Beale, Troy Searles (staff)	$840.00	July 25, 2003
State Street Bank	Robert Borden & Robert Beale (staff)	$218.00	July 30, 2003
Goldman Sachs	Robert Borden, Jennifer Rayburn (staff); Kathy Singleton (trustee); Lynn Singleton (guest)	$69.50	August 1, 2003
NEPC	Virginia Burton (trustee), Robert Borden (staff)	$69.73	August 2003
SSGA	Consultant	$50.00	August 2003
Arnold and S. Bleichroeder	Robert Borden, Germaine Gross, Jennifer Rayburn (staff); Pam Davenport, Benny Harris, Kathy Singleton, Virginia Burton, & guests (trustees)	$1,769.71	August 2, 2003

Provider	Recipients	Value	Date
Goldman Sachs	Jennifer Rayburn, Robert Borden (staff); Glenn Johnson and 2 others	$352.79	August 3, 2003
Loomis Sayles	Robert Borden, Jennifer Rayburn (staff)	$118.04	August 3, 2003
Loomis Sayles	Virginia Burton, Benny Harris, Kathy Singleton (trustees)	$218.16	August 4, 2003
Goldman Sachs	Robert Borden & Guest (staff), Kathy Singleton, Benny Harris & Guest, Virginia Burton & Guest (trustees)	$766.80	August 9, 2003
Aronson, Johnson, & Ortiz LLP	Trustees & Staff	$3,038.08	August 21, 2003
NEPC	Robert Borden (staff)	$38.02	September 2003
Goldman Sachs	Robert Beale (staff) & Paul Connors (Connors & Associates)	$110.58	September 14, 2003
Loomis Sayles	Robert Borden and Robert Beale (staff)	$19.34	September 14, 2003
Loomis Sayles	Robert Borden, Abby Roshto, Cindy Rougeou, Robert Beale, Germaine Gross, Jennifer Rayburn, Byron Henderson, Stephen Mann, Sue Ellen Lewis (staff); Cynthia Bridges, Virginia Burton, Pam Davenport, Lori Pierce, Kathy Singleton, Cheryl Turner, Sona Young, Shirley Grand (trustees)	$917.20	September 14, 2003
Delaware	Kathy Singleton (trustee)	$46.56	September 15, 2003
Goldman Sachs	Robert Beale and Stephen Mann (staff)	$48.00	September 15, 2003
Goldman Sachs	Robert Borden & Robert Beale (staff)	$139.91	September 15, 2003
Loomis Sayles	Cheryl Turner (trustee)	$10.28	September 15, 2003

Provider	Recipients	Value	Date
SSGA	Kathy Singleton & spouse, Benny Harris & spouse (trustees); Cynthia Rougeou, Abby Roshto, Robert Beale, Cheryl Turner, Troy Searles (staff)	$968.00	September 15, 2003
Loomis Sayles	Robert Borden, Germaine Gross, Jennifer Rayburn, Abby Roshto, Byron Henderson, Stephen Mann, Sue Ellen Lewis, Robert Beale, Cindy Rougeou (staff); Cynthia Bridges, Virginia Burton, Pamela Davenport, Kathy Singleton, Cheryl Turner, Lori Pierce, Sona Young, Shirley Grand (trustees)	$142.80	September 16, 2003
Erasmus	Jerry Polk (staff)	$74.48	September 16, 2003
Co-hosted by Goldman Sachs and Templeton Investment	Robert Beale, Robert Borden, Carter Bailey, Cathy Alsop, Marjorie Karlton, Troy Searles (staff); Virginia Burton, Senator Lambert Boissiere, Jr., Kathy Singleton, Cynthia Bridges (trustees)	Goldman Sachs $793.13 Templeton $1,522.86	September 16, 2003
Aronson, Johnson, & Ortiz LLP	Troy Searles (staff)	unknown	September 21, 2003
Brandywine Asset Management	Trustees	$51.45	September 26, 2003
Erasmus	Robert Borden (staff)	$42.52	September 26, 2003
Nicholas-Applegate Capital Management	Trustees & Staff	$1,443.58	October 6, 2003
Loomis Sayles	Consultant	$51.61	October 7, 2003
Nicholas-Applegate Capital Management	Trustees & Staff	$98.36	October 7, 2003
Goldman Sachs	Sona Young (trustee)	unknown	October 16, 2003
Brandywine Asset Management	Kathy Singleton & Spouse (trustee)	$472.91	October 17, 2003
Orleans Capital	Cheryl Turner (trustee)	$24.30	October 20, 2003
Orleans Capital	Robert Borden (staff)	$31.66	October 21, 2003

Provider	Recipients	Value	Date
Westfield Capital	Trustees/Staff	$1,097.09	October 23, 2003
Brandywine Asset Management	Sona Young (trustee)	unknown	October 25, 2003
Loomis Sayles	Robert Borden (staff), Virginia Burton, Benny Harris, Kathy Singleton (trustees); Frank Jobert	$603.40	November 16, 2003
Goldman Sachs	Robert Borden & Robert Beale (staff)	$130.82	November 18, 2003
LSV	Trustees & Staff	$2,500.00	November 20, 2003
Brandywine Asset Management	Trustees & Staff	$90.35	November 24, 2003
Brandywine Asset Management	Trustees & Staff	$170.42	November 25, 2003
Loomis Sayles	Consultant	$47.69	December 3, 2003
State Street Bank	Celeste Funderburk, Troy Searles, Stephen Mann, Jerry Polk, Jennifer Rayburn (staff)	$255.00	December 9, 2003
Goldman Sachs	Robert Beale (staff)	$29.00	December 18, 2003
Co-hosted by: Brandywine Asset Management, Chicago Equity Partners, Erasmus, Goldman Sachs, Williams Capital	Trustees & Staff	$955.16 each, and Williams Capital $1,016.16	December 18, 2003
NEPC	Robert Borden & Guest, Robert Beale (staff)	$238.88	January-2004
Kellner Dileo Cohen & Co.	Trustees & Staff	$3,693.94	January 22, 2004
NEPC	Robert Borden & Robert Beale (staff)	$252.63	February-2004
Goldman Sachs	Kathy Singleton (trustee)	$160.80	February 10, 2004
SSGA	Cynthia Rougeou (staff)	$66.58	February 10, 2004
Goldman Sachs	Robert Borden, Robert Beale & spouse (staff)	$363.76	February 11, 2004
Delaware	Robert Borden, Robert Beale (staff); Cynthia Bridges, Virginia Burton, Benny Harris, Kathy Singleton (trustees)	$553.20	February 17, 2004
SSGA	Cheryl Turner, Benny Harris (trustees)	$41.00	February 17, 2004

Provider	Recipients	Value	Date
Co-hosted by: Goldman Sachs, SSGA, Templeton Investment, Thomson Horstmann & Bryant (THB)	Robert Borden, Robert Beale, Cathy Alsop (staff); Senator Lambert Boissiere, Jr. and wife, Kathy Singleton, Virginia Burton, Sheryl Ranatza and husband, Benny Harris (trustees)	Goldman Sachs $538.10, SSGA $553.73, Templeton $548.23, THB $176.46	February 18, 2004
Orleans Capital	Virginia Burton (trustee)	$34.58	February 19, 2004
Loomis Sayles	Leonard Augustus, Robert Beale, Robert Borden, Jeanette Eckert, Germaine Gross, Keith Hall, (staff); Cynthia Bridges, Virginia Burton, Connie Carlton, Barbara McCann, Kathy Singleton (trustees)	$1,724.70	February 26, 2004
NEPC	Robert Beale (staff)	$128.28	March 2004
NEPC	Cheryl Turner (trustee)	unknown	March 2004
State Street Bank	Cheryl Turner (trustee)	unknown	March 2004
Orleans Capital	Barbara McCann (trustee)	$24.43	March 4, 2004
SSGA	Robert Beale (staff)	$75.00	March 14, 2004
Adams Street Partners	Staff, Board Members & Consultant (30 people)	$1,232.87	March 24, 2004
Templeton Investment	Sheryl Ranatza (trustee) and 4 others	$327.64	March 27, 2004
NEPC	Robert Borden & Robert Beale (staff)	$50.00	April 1, 2004
NEPC	Robert Borden & Robert Beale (staff)	$67.50	April 1, 2004
NEPC	Robert Beale & spouse (staff)	$67.36	April 1, 2004
NEPC	Trustees	$2,076.83	April 1, 2004
NEPC	Robert Borden (staff)	$52.29	April 1, 2004
Williams Capital/ Artis Terrel	Cheryl Turner (trustee)	unknown	April 1, 2004
Co-hosted by: K2 & PAAMCO	Trustees & Staff, Consultants (35 people)	$1,293.61 each	April 21, 2004
Goldman Sachs	Robert Beale & spouse (staff)	$214.31	April 30, 2004

Provider	Recipients	Value	Date
Goldman Sachs	Robert Beale & spouse (staff)	$445.00	April 30, 2004
NEPC	Robert Borden & Robert Beale (staff)	$167.28	May 2004
Bernstein, Litowitz Berger and Grossman	Consultant	$50.00	June 2004
Nicholas-Applegate Capital Management	Trustees & Staff	$66.10	June 2, 2004
Goldman Sachs	Robert Borden (staff)	$127.00	June 17, 2004
Loomis Sayles	Consultant	$100.00	July 1, 2004
NEPC	Robert Borden, Jerry Polk, Stephen Mann, Celeste Funderburk, Troy Searles, Alisa LaCombe, Justin Pugh, Laney Simar (staff)	$256.45	July 2004
Orleans Capital	Trustees/staff	$2,070.49	July 22, 2004
LSV	Consultant	$50.00	August 1, 2004
NEPC	Robert Beale (staff) & John Broussard (trustee)	$88.97	August 2004
Brandywine Asset Management	Virginia Burton & Family, Connie Carlton (trustees); Doug Bachman, Cynthia Rougeou (staff)	$642.94	August 6, 2004
Chicago Equity Partners	Connie Carlton (trustee)	unknown	August 6, 2004
Erasmus	Jerry Polk (staff)	$33.00	August 6, 2004
Chicago Equity Partners	Connie Carlton (trustee); Cindy Rougeou, Doug Bachman (staff)	$271.40	August 7, 2004
Brandywine Asset Management	Connie Carlton & Guest (trustee)	$138.00	August 8, 2004
Erasmus	Robert Borden, Jerry Polk (staff)	$166.10	August 10, 2004
Westfield Capital	Consultant	$36.72	August 22, 2004
Thomson Horstmann & Bryant	Robert Beale (staff)	$339.29	August 24, 2004
Harbourvest Partners	Investment Committee (trustees)	$2,104.64	August 25, 2004

Provider	Recipients	Value	Date
TCW	Connie Carlton & spouse, Louis Quinn & Spouse, John Broussard & spouse, Virginia Burton & spouse, (trustees); Laura Gail Sullivan, Robert Borden, Robert Beale & Spouse (staff); Consultant, and other staff	$2,301.46	August 26, 2004
Artis Terrel	Cheryl Turner (trustee)	unknown	September 2004
Huff	Consultant	$20.00	September 1, 2004
TCW	Robert Borden (staff)	$33.03	September 2, 2004
Loomis Sayles	Jennifer Templet (staff)	unknown	September 12, 2004
SSGA	Robert Beale, Robert Borden, Cynthia Rougeou, Abby Roshto (staff); Kathy Singleton & spouse, Benny Harris & spouse, Lori Pierce (trustees)	$764.96	September 12, 2004
Brandywine Asset Management	Robert Beale, Doug Bachman, Cynthia Rougeou (staff); Kathy Singleton & spouse, Connie Carlton & Guest, Lori Pierce (trustees)	$1,521.96	September 13, 2004
Williams Capital	Jerry Polk (staff)	$20.00	September 24, 2004
Brandywine Asset Management	Trustees & Staff	$2,085.99	September 25, 2004
Total		$56,540.78	

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

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MANAGEMENT'S RESPONSE

LOUISIANA STATE EMPLOYEES' RETIREMENT SYSTEM
P.O. BOX 44213 • BATON ROUGE, LOUISIANA 70804-4213
8401 UNITED PLAZA BLVD.
BATON ROUGE, LA 70809
VOICE: 225-922-0600
TOLL-FREE: 1-800-256-3000
www.lasers.state.la.us

March 23, 2005

Mr. Steve J. Theriot, CPA
Legislative Auditor
1600 N. Third Street
P. O. Box 94397
Baton Rouge, LA 70804-9397

Dear Mr. Theriot:

This correspondence is in response to the performance audit report on the Louisiana State Employees' Retirement System (LASERS). This audit was conducted in accordance with the requirements of SCR 14 of the 2004 Regular Legislative Session.

LASERS mission is to improve the financial security and quality of life of LASERS members and their families by utilizing qualified personnel adhering to the highest level of professional standards, prudent management of system assets and cost-effective administration. LASERS has had many accomplishments of which it is proud, and will utilize the recommendations your office has provided to enrich our efforts to make continuous improvement.

LASERS has taken initiatives to actively review its programs and operations. An Audit Division and an Audit Committee comprised of members of the Board of Trustees were created in 1994. Under direction of the Audit Committee, the Audit Division has completed numerous investment audits, including audits of LASERS' in-house portfolio, the investment consultant, the custodian bank and several portfolio managers. Any findings are monitored by the Audit Division until appropriate action is taken. As of this date, there are no outstanding findings.

LASERS' has always taken a proactive approach to conducting its operations in an effective and efficient manner. Some examples include:

- Utilizing an independent consultant to provide recommendations and guidelines for creating the internally managed portfolios before initiating the program
- Establishing an internal control questionnaire as part of the due diligence process when conducting investment manager searches
- Creating an investment manager survey to allow portfolio managers to self assess their compliance to LASERS' guidelines

- Participating in Cost Effectiveness Measurement (CEM) which helps us benchmark and compare all aspects of plan performance and costs to other pension systems

We appreciate the professionalism and courtesy your staff displayed during the conduct of this audit. If our office can be of further assistance to you in any matter, please feel free to contact us.

Sincerely,

Robert L. Borden, CFA
Executive Director

C LASERS Board of Trustees
Robert W. Beale, Chief Investment Officer
Jeanette Eckert, Audit Services Director

Management's Response to the Legislative Auditor's Report

Recommendation 1: LASERS should ensure that its investment manager's returns are presented net of management fees when it is reviewing investment managerial performance.

Management's Response: LASERS partially agrees with this recommendation. LASERS has always used gross-of-fee performance returns, and believes that this is the optimal way of reviewing performance. This belief is supported by the CFA Institute GIPS (Global Investment Performance Standards) which reads,

> "The Gross-of-Fees Return is defined to be the return on assets reduced by any trading expenses. It should also be reduced by non-reclaimable withholding taxes incurred during the period. Because the Gross-of-Fees Return includes only the return on assets and the associated cost of buying and selling those assets, it is the best measure of the firm's investment management ability and can be thought of as an "investment return". In addition, because fees are sometimes negotiable, presenting Gross-of-Fees Returns shows the firm's expertise in managing assets without the impact of the firm's or client's negotiating skills. Accordingly, firms are recommended to present Gross-of-Fees Returns."
> Source: cfainstitute.com, GIPS, *Fees Provisions For the GIPS Standards*, December 2003.

Reporting gross-of-fee performance returns is an industry standard, with the majority of LASERS peers reporting in the same manner. LASERS' performance reports clearly state that performance is gross-of-fees, with fee amounts provided to allow the reader to estimate the net-of-fee return. Actuarial valuations and contribution rates are calculated net-of-fees.

LASERS' current Custodian, State Street Bank, provides only gross-of-fee performance returns. However, LASERS is in the process of transitioning to a new Custodian Bank, Mellon Trust, with an effective start date of July 1, 2005. Mellon will provide gross-of-fee performance and is currently working with LASERS to develop a way to also report net-of-fee performance returns.

LASERS continues to believe that gross-of-fee performance information is optimal for reporting purposes. After transition to the new custodian, net-of-fee performance returns will be used for internal administrative purposes, due to the approximations made to calculate net-of-fee returns.

Recommendation 2: LASERS' written investment policy should ensure that the use of index funds as an alternative to active management is "formally and regularly" evaluated.

Management's Response: LASERS agrees with this recommendation. LASERS' evaluation of the use of index funds as an alternative to active management is the responsibility of LASERS' Board of Trustees, with assistance by both the Chief Investment Officer and Investment Consultant. LASERS' Statement of Investment Objectives states that,

> "The Chief Investment Officer [and Investment Consultant] shall assist the Board in developing and modifying policy objectives and guidelines, including the development of liability driven asset allocation strategies and recommendations on long term asset allocation and the appropriate mix of investment manager styles and strategies."
> <u>Source:</u> LASERS' Statement of Investment Objectives, Section III, Roles and Responsibilities, pages A5-A6.

Language will be added to this area of the Statement of Investment Objectives to require "formal and regular" evaluation of the items listed above.

Recommendation 3: LASERS 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: LASERS agrees with this recommendation. LASERS currently informally evaluates the performance of the Investment Consultant via frequent interaction both in person and over the telephone.

LASERS will incorporate formal annual Consultant Reviews as a responsibility of the Board of Trustees in LASERS' Statement of Investment Objectives. A policy will be developed to regulate an annual Consultant Review as well as the areas to be evaluated.

In addition, the Audit Division performs periodic audits of the investment consultant and presents the report to the Board of Trustees. Any findings are monitored by the Audit Division until appropriate action is taken. As of this date, there are no outstanding findings.

Recommendation 4: LASERS 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: LASERS agrees with this recommendation. LASERS currently informally evaluates the performance of the Investment Custodian. Anytime there is a problem or questions with the service being provided, the Chief Investment Officer or staff contacts the custodian for immediate clarification or correction. In addition, LASERS Investment Accounting Division reviews the monthly reconciliations performed by the investment manager of their records as compared to the custodian's records.

It should be noted that LASERS has just completed a comprehensive national request for proposal (RFP) for custodial services. This resulted in staff reviewing all major custody bank services and pricings available for global custody. LASERS has selected Mellon Bank and Trust as its new custodian effective July 1, 2005. This process has allowed LASERS to comprehensively evaluate the quality of the current custodian services as well as the state of the global custody market.

LASERS will incorporate formal annual Custodial Reviews as a responsibility of the Investment Division, reporting to the Board of Trustees, in LASERS' Statement of Investment Objectives. A policy will be developed to regulate an annual Custodian Review as well as the areas to be evaluated which will include the custodian's focus on custodial business and the bank's financial health.

In addition, the Audit Division performs periodic audits of the custodian and presents the report to the Board of Trustees. Any findings are monitored by the Audit Division until corrective action is taken or dismissed by management. As of this date, there are no outstanding findings.

Recommendation 5: LASERS 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, LASERS should strengthen policies and procedures to ensure that all staff adhere to the Louisiana Code of Governmental Ethics. This should clearly communicate the applicability of the ethics code to LASERS' staff and the provisions of the code to all investment managers.

Management's Response: LASERS agrees that the Louisiana Code of Governmental Ethics does set forth certain gift prohibitions which are applicable to our agency, Trustees, staff and vendors. In fact in 1997 LASERS did, as you have recommended, request an opinion from the Board of Ethics regarding the receipt of gifts from vendors.

LASERS has taken several proactive measures to communicate information regarding gift prohibitions both to its Board, its staff and its vendors. LASERS has posted its Gift

Policy/Louisiana Ethics Code on its web site at www.lasers.state.la.us under the page called "About LASERS". The Section starts off with a very clear message---"No gifts for LASERS employees or trustees, please." Correspondence has been sent to investment managers advising them of the requirements of the Louisiana Code of Ethics.

Staff has been advised that when prohibited gifts are sent by a vendor, the gift should either be returned directly or given away to a charitable group. However, we do realize that when the gift is donated to a charitable group, the vendor sending the gift may not have been notified of its disposition.

With respect to the issue of gifts, there are several items noted in Exhibit 17 of your report that we believe are not within the prohibitions contained in the Code.

Exhibit 17 references an item that the intended recipient, in an effort to remain fully compliant with the Code, immediately gave away. Thereafter, in an abundance of caution, and prior to the issuance of this report, the individual reimbursed the vendor in full for that item, a leather box containing a bottle of wine. This individual has at all times acted in good faith. As you are aware, when an item is paid for in full it cannot by definition constitute a gift.

The gift exhibit contains reference to the receipt by a trustee of a golf tournament entrance fee. In fact, the trustee paid for this green fee himself by making a donation to the Baton Rouge Youth. It is our understanding that at the time, the vendor also made a donation to the Baton Rouge Youth, which would not constitute a gift to the trustee.

The report also cites a gift of three books to a staff member. These books have been returned to the vendor and we have received acknowledgement from the vendor for receipt of the items. Likewise, the vendor who sent flowers to a trustee is also being reimbursed for the full amount of the item. The report references a 50th anniversary gift that was given to a trustee. Please note that this item has also been paid for in full.

In the future, all gifts will be returned and the vendor sending the gift will be requested not to do so again. LASERS will be sending another letter to all vendors again reminding them of the zero tolerance policy on gifts. LASERS will seek to obtain an opinion of the Louisiana Board of Ethics relative to the issues raised herein where deemed appropriate. Additionally, any item listed in exhibit 17 attributable to any individual staff member is either being returned or paid for in full.

Recommendation 6: LASERS 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.

Management's Response: LASERS will reinforce its existing policies to emphasize the requirement that all staff avoid conflicts of interest. With respect to the appearance of conflicts of interest regarding meals, LASERS agrees with the Board of Ethics that this activity is ethical and does not conflict with the provisions of the Code.

LASERS currently has a policy that provides for the disclosure of any conflicts of interest or appearance thereof as part of our Board Governance Monitoring and Reporting Policy. LASERS Operational Guidelines for Internally Managed Portfolios states,

> "In order for employees of LASERS and direct members of their families to avoid such improprieties, in appearance or in fact, certain standards are to be followed as well as having the Investments Division staff sign an ethics statement. All members of the Investment Division are subject to the Louisiana Code of Governmental Ethics, R.S. 11:42:1002 et seq., AIMR's Code of Ethics and Standards of Professional Conduct, as well as all other applicable laws and regulations."

Recommendation 7: LASERS should set policies regarding the frequency and dollar value of meals accepted by staff, trustees, and consultants from investment managers, custodians, and consultants.

Management's Response: LASERS agrees to develop a policy regarding this matter in accordance with the Code of Governmental Ethics.

LASERS has been proactive in its review of this matter. In 1997 Executive Director James O. Wood requested an opinion from the Board of Ethics regarding the propriety of the members of the Board of Trustees accepting meals and/or gifts from vendors. The Board responded on August 4, 1997 and advised in **Ethics Board Docket No. 97-508** that Section 1115 of the Code of Governmental Ethics generally prohibits the Board Members from accepting any "thing of economic value" from any vendor of LASERS. Ethics also noted that the definition of "thing of economic value" found at Section 1102(22) creates an exception for food and drink consumed while the personal guest of some person and reasonable transportation which is incidental thereto. LASERS has complied with this ethics board opinion.

Recommendation 8: LASERS should develop and implement policies and procedures for the disclosure and treatment of conflicts of interest and the appearance of conflicts of interest with current and prospective investment managers, custodians, and consultants.

Management's Response: LASERS agrees with this recommendation. LASERS' Consultant and investment managers are required to abide by Act No. 686 as published by the Louisiana State Legislature during the 2004 Regular Session. This legislation requires that,

"Consultants and money managers shall provide full disclosure to public retirement or pension plan sponsors of conflicts of interest, including non-pension sponsor sources of revenue. Consultants also shall provide full disclosure of any payments they receive from money managers, in hard or soft dollars, for any services they provide, including but not limited to, performance measurement, business consulting and education."
Source: Act No. 686Senate Bill No. 835, Regular Session, 2004.

To assist LASERS in uncovering conflicts of interest with prospective investment managers, the Request for Proposal (RFP) asks about potential conflicts of interest with LASERS' Board of Trustees and/or staff members. A Due Diligence Questionnaire is also required to be completed by the managers during the selection process. The Questionnaire lists the names of key staff members, the Board of Trustees, LASERS' external auditor, Consultant, and Custodian, and specifically asks for a description of any relationship that exists with these individuals.

LASERS has as part of its formulary investment management contract a contractual requirement for investment managers to adhere to the Louisiana Code of Governmental.