

## **LACERA'S INVESTMENT PORTFOLIO**

At the Los Angeles County Board of Supervisors meeting on October 7, 2008, your Board requested information regarding LACERA's investment program given the ongoing financial crisis. In response, this report provides the Board of Supervisors (Board) with information on LACERA's investment program.

As of September 30, 2008, LACERA's *preliminary* total fund market value was \$35.1 billion. As a long-term investor, LACERA's investment portfolio is broadly diversified across investment categories (e.g., stocks, bonds, and real estate) as well as within each category (e.g., individual stocks or properties). Nonetheless, the Fund is not immune to stock market volatility. While the Fund has sustained losses from exposure to individual securities, the larger losses stem from the overall stock market decline.

As of June 30, 2008, the Plan's *preliminary* funding ratio was 95 percent according to LACERA's actuary, Milliman USA. Unrealized (or realized) losses sustained after this measurement date are not calculated in the Plan's funded status but will be included in the valuation process in June 2009. Importantly, LACERA remains a well-funded Plan. The current financial crisis has not impaired the Fund's ability to pay benefits or achieve its long-term investment objectives.

The remainder of this report discusses the Fund's investment objectives and provides context for LACERA's investment decisions. This report also includes LACERA's long-term performance and a snapshot of recent performance.

## **LACERA'S INVESTMENT POLICY**

LACERA's Board of Investments (BOI) formally reviews its allocation to various investments such as stocks, bonds, and real estate every three to five years. This process is known as an asset-liability study and assists the BOI with establishing an Asset Allocation Policy for the Fund. Academic studies indicate that approximately 90 percent of the return and risk profile of an investment program is determined by the asset allocation policy. Historically, approximately 80 percent of the benefits paid by LACERA are funded through investment earnings generated by the Asset Allocation Policy.

The asset-liability modeling process examines forecasted returns, volatility, and the diversification benefits of each investment (or asset class). This model simulates multiple investment allocation scenarios and calculates various risk and return tradeoffs for each alternative. The analysis also determines the impact each asset allocation scenario will have on LACERA's funded ratio and employer contributions. LACERA's general consultant, Wilshire Associates, performs the asset-liability study.

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LACERA's Asset Allocation Policy has the following three objectives:

- 1) Earn a 7.75 percent return while minimizing risk
- 2) Obtain a 100 percent funded ratio
- 3) Minimize employer (and employee) contributions

LACERA's BOI carefully considers the interaction between these three objectives when establishing its Asset Allocation Policy. The 7.75 percent return objective is expected to be earned over a long-term investment horizon. It is anticipated when establishing an Asset Allocation Policy that in some years the Fund will out perform this return objective and in other years it may under perform.

LACERA's BOI last reviewed the Fund's Asset Allocation Policy in June 2005. **TABLE 1** displays LACERA's current target Asset Allocation Policy, the actual allocations, and the June 30, 2008 market values:

**TABLE 1**

<b>Asset Class</b>	<b>Target Asset Allocation</b>	<b>June 30, 2008 Actual Allocation</b>	<b>June 30, 2008 Market Values (\$ millions)</b>
U.S. Stocks	30%	29.5%	\$11,269.2
Non-U.S. Stocks	21%	21.3%	\$8,152.9
Private Equity	7%	8.3%	\$3,171.7
Bonds	28%	28.5%	\$10,917.3
Cash	2%	0.5%	\$173.8
Real Estate	10%	10.4%	\$3,981.4
Commodities	2%	1.5%	\$574.7
<b>TOTAL</b>	<b>100%</b>	<b>100%</b>	<b>\$38,241.0</b>

The following discussion summarizes the role of each asset class in LACERA's Asset Allocation Policy. It also includes Wilshire Associates' forecasted ten-year return expectations for each asset class<sup>1</sup>.

*U.S. Stocks (return assumption 8.25 percent)* are considered instrumental in the Fund achieving its long-term return objective of 7.75 percent. While stocks are volatile, this volatility typically rewards investors over longer time periods. Institutional investors accepting this volatility recognize the role that stocks play in accomplishing their long-term return objectives. Without stock market returns, the Fund's return assumption would require a downward adjustment, thereby resulting in higher employer contributions.

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<sup>1</sup> Source: Wilshire Consulting, "2008 Asset Allocation Return and Risk Assumptions," January 28, 2008.



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The U.S. stock market is broadly recognized as fairly efficient. As such, LACERA's U.S. stock market exposure is primarily through index funds that are expected to generate performance results consistent with market returns while incurring no additional market risk<sup>2</sup>.

***Non-U.S. Stocks (return assumption 8.25 percent)*** are also considered instrumental in achieving the Fund's return objective. These markets are also volatile, however, they provide some diversification benefits relative to U.S. stocks. In addition, without the return expectation of non-U.S. stocks, the Fund's return assumption may require a downward adjustment.

***Bonds (return assumption 5.0 percent)*** provide diversification and are generally viewed as secure investments given the lower risk profile relative to stocks. LACERA's bond portfolio includes treasury bonds, mortgage-backed securities, and corporate bonds (both investment grade and high yield).

An investment strategy relying exclusively on bonds will not enable the Fund to meet LACERA's 7.75 percent return assumption (assuming a low interest rate environment). To enhance returns in this asset class, LACERA retains active investment management firms that are expected to out-perform the broad market benchmark (e.g., Lehman Aggregate Index) while marginally increasing the Fund's risk profile. Strategies employed for this level of risk include over-weighting corporate bonds and mortgage-backed securities relative to the broad bond index.

***Real Estate (return assumption 6.5 percent)*** provides diversification relative to other Fund investments. Real estate investments are illiquid and have long-term investment horizons. As a "real asset," real estate can also serve as an inflationary hedge for the Fund. LACERA's real estate portfolio is conservatively invested, with approximately 75 percent of the portfolio relying on income as opposed to price appreciation. While leverage may be used to enhance returns, LACERA employs a nominal amount of leverage for its real estate portfolio.

***Private Equity (return assumption 11.25 percent)*** investments are used to enhance returns relative to LACERA's stock (public market) investments. Private equity funds are also illiquid investments. Investors are rewarded for this illiquidity with higher expected returns. LACERA's general consultant's return expectation is three percent higher for this asset class than U.S. stocks (8.25 percent). These investments include both leveraged buyouts and venture capital funds.

***Commodities (return assumption 4.25 percent)*** strategies are employed for diversification purposes. Like real estate, commodities also serve as a hedge against inflation.

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<sup>2</sup> Approximately 70 percent of LACERA's U.S. stock market exposure is in index funds managed by Barclays Global Investors (BGI).



*Cash (return assumption 3 percent)* is required to fund monthly benefit payments, expenses, and investment obligations. A small amount of transactional cash may also be held by LACERA's investment managers.

Finally, LACERA's entire investment portfolio is managed by external, third-party investment management firms. It is broadly diversified within each asset class to minimize the risk of a large loss from any single exposure (i.e., one stock or one building). Notwithstanding the Fund's broad diversification policy, LACERA, like all institutional investors, can be positively or negatively impacted by large price movements in the stock market.

## TOTAL FUND PERFORMANCE RESULTS

LACERA's total fund performance results are reported quarterly to the BOI approximately six weeks after the quarter-end. In addition, the BOI receives stock, bond, and commodity performance results (on a monthly basis) approximately three weeks after month-end. Real estate and private equity returns are calculated quarterly, with a three-to-six month reporting lag time relative to the public market asset classes.

### *Performance Results through June 30, 2008*

LACERA's most recent total fund performance was reported to the BOI on August 13, 2008. **TABLE 2** displays LACERA's total fund results (yellow highlight), over various time horizons, for the fiscal year ended June 30, 2008.

**TABLE 2**

	2 <sup>nd</sup> Qtr	Annualized				
		1 Yr	3 Yrs	5 Yrs	7 Yrs	10 Yrs
U.S. Stocks	-1.5%	-14.1%	4.5%	8.1%	3.1%	3.9%
Russell 3000	-1.7	-12.7	4.7	8.4	3.2	3.5
Non-U.S. Stocks	-1.0	-6.4	16.0	19.0	11.1	8.6
MSCI ACWI X U.S.	-1.1	-6.6	15.7	18.9	11.0	7.4
Bonds	-0.5	5.3	4.2	4.6	5.9	5.9
Bonds Custom Index	-0.9	6.6	4.3	4.3	5.7	5.6
Lehman Aggregate Bond Index	-1.0	7.1	4.1	3.9	5.4	5.7
Real Estate	1.4	12.2	17.6	15.6	12.9	12.7
Real Estate Target Return	2.0	8.0	8.0	8.0	8.0	8.0
Private Equity	4.0	23.6	27.0	24.5	10.9	17.6
Private Equity Target Return	2.8	11.2	11.2	11.2	11.2	11.2
Commodities	16.8	42.9	--	--	--	--
DJ-AIG Commodity Index	16.1	41.6	--	--	--	--
<b>Total Fund (Gross of Fees)</b>	<b>-0.1</b>	<b>-1.4</b>	<b>10.0</b>	<b>11.4</b>	<b>7.4</b>	<b>7.2</b>
<b>Total Fund (Net of Fees)</b>	<b>-0.1</b>	<b>-1.5</b>	<b>9.7</b>	<b>11.2</b>	<b>--</b>	<b>--</b>
<b>Total Fund Policy Benchmark</b>	<b>-0.4</b>	<b>-1.6</b>	<b>8.2</b>	<b>10.1</b>	<b>--</b>	<b>--</b>



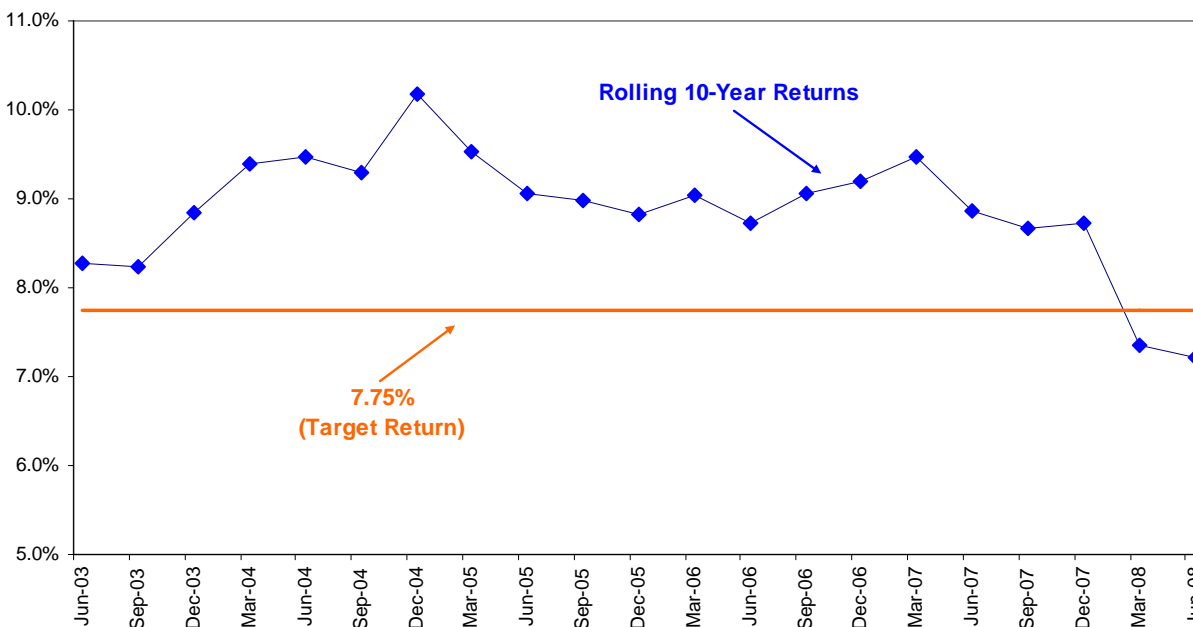
As shown, LACERA’s total fund performance ranges from positive returns to slightly negative returns depending on the time period reviewed. Over longer-time periods (seven- and ten-years) the performance results were slightly below the long-term return assumption of 7.75 percent. One challenge associated with point-in-time returns is they do not explain the complete investment return picture because they are truncated on specific dates (e.g., month-end, quarterly, etc.).

Recognizing the limitation of point-in-time returns, LACERA’s investment staff routinely prepares “rolling return” graphs for the BOI. Rolling return graphs display multiple return calculations for various points-in-time. This type of analysis allows the user to evaluate the effectiveness of the investment strategy because it “smoothes” the volatility over a longer-time period. Ultimately, it illustrates the results of the overall investment strategy during a longer-term investment cycle.

For example, **GRAPH 1** displays LACERA’s ten-year rolling return (calculated quarterly) for the last five years. Thus, each observation on the graph represents a ten-year total fund calculation for the corresponding date displayed.

**GRAPH 1**

**Total Fund Rolling 10-Year Returns**  
for periods ending 6/30/03 - 6/30/08



As shown, LACERA’s ten-year rolling returns are consistently above the 7.75 percent return assumption with the exception of the last two observations. This issue was recently broached with the BOI. As the strong investment returns of the last decade are dropped from the performance calculation, it will be difficult for LACERA to achieve, or maintain, its 7.75 percent return assumption (if market returns do not improve during this decade). The BOI is scheduled



to review this return assumption during its next triennial actuarial review in 2010. LACERA's 7.75 percent return assumption is consistent with many other public pension funds.

**Attachment A** displays LACERA's one year total fund performance for fiscal years 1993-2008. Not surprisingly, the one year return calculations exhibit more volatility than the ten year rolling investment return calculations.

***Preliminary Return Results through September 30, 2008***

**TABLE 3** displays returns for LACERA's major public market asset classes (U.S. and non-U.S. stocks and bonds) on a *preliminary* basis through September 30, 2008. Returns for LACERA's private equity and real estate investments are not yet available for this time period. For comparative purposes, each asset class benchmark is displayed. These are the benchmarks used by the BOI to evaluate portfolio performance.

**TABLE 3**  
**PRELIMINARY PUBLIC MARKET RETURNS**  
for the periods ended September 30, 2008

	Month	Quarter	Calendar Year	1 Yr. Annualized
U.S. Stocks	-9.5 %	-8.7 %	-19.2 %	-22.3 %
Russell 3000 Index	-9.4	-8.7	-18.8	-21.5
Non-U.S. Stocks	-15.4	-22.2	-29.4	-30.0
MSCI ACWI X U.S. IMI	-15.4	-22.2	-30.1	-30.6
Bonds	-3.4	-3.4	-3.2	-1.1
Bonds Custom Index	-1.8	-1.0	0.0	2.7

While the stock returns are in line with the benchmarks, they clearly demonstrate the volatility associated with stock market investing. This is an inherent risk of stock investing. These returns also reflect the losses incurred from individual securities such as Fannie Mae, Freddie Mac, and Lehman Brothers.

**CONCLUSION**

LACERA's BOI considers many factors when establishing the Fund's Asset Allocation Policy. These factors include earning a long-term investment return of 7.75 percent while minimizing risk, obtaining a 100 percent funded ratio, and minimizing employer (and employee) contributions. As a result, LACERA's BOI has adopted a broadly diversified Asset Allocation Policy as a reasonable and accepted method to achieve these multiple objectives.

Even though LACERA maintains a broadly diversified portfolio, the Fund will sustain losses during times of stock market volatility. Notwithstanding these losses, LACERA remains a well-funded Plan. The current financial crisis has not impaired the Fund's ability to pay benefits or achieve its long-term investment objectives.



**LACERA's Investment  
Portfolio Performance**

Fiscal Years Ended June 30

1993	13.4%
1994	4.3%
1995	15.5%
1996	16.6%
1997	17.6%
1998	15.0%
1999	13.1%
2000	15.7%
2001	-7.1%
2002	-6.9%
2003	3.3%
2004	16.4%
2005	11.0%
2006	13.2%
2007	19.1%
2008	-1.4%

