



AGENDA

RETIREMENT BOARD MEETING

SPECIAL MEETING
9:00 a.m.

July 31, 2014

Retirement Board Conference Room
The Willows Office Park
1355 Willow Way, Suite 221
Concord, California

THE RETIREMENT BOARD MAY DISCUSS AND TAKE ACTION ON THE FOLLOWING:

1. Pledge of Allegiance.
2. Accept comments from the public.
3. Discussion with Cortex Applied Research and staff regarding Investment Consultant Request for Proposal.
4. Miscellaneous
 - a. Staff Report
 - b. Outside Professionals' Report
 - c. Trustees' comments

The Retirement Board will provide reasonable accommodations for persons with disabilities planning to attend Board meetings who contact the Retirement Office at least 24 hours before a meeting.

Investment Consultant Search Processes: Background Presentation

Prepared for:
Contra Costa County Employees' Retirement Association

July 31, 2014

Agenda

- Introduction & Background
 - Accountability
 - Performance
 - Fiduciary duty
 - Board effectiveness & decision traps
- Interview Findings
- Alternative models for using consultants
- Alternative consulting firm models
- CCCERA consultant search parameters

About Cortex

- Established in 1991 by Dr. John Por
- Tom Iannucci joined that same year
- Management consulting firm that specializes in the pension industry.
 - Board governance
 - Investment consultant searches
- Have worked with over 150 pension plans across North America

Fund Goals

- To be a *prudent, high-performance* investment organization over the *long-term*, both in terms of investment results and operational effectiveness.
- Cortex estimates that what separates superior *long-term* performance from simply average performance is only 15–40 basis points.
 - Clear/sound roles that promote strong accountability are prerequisites for success.

Background Concepts

- Accountability
- Pension fund performance
- Fiduciary duty
- Board effectiveness & decision traps

Accountability:

- *“The ability to account for one’s actions.”*
- To hold someone legitimately accountable:
 - Clear goals must be established.
 - Adequate resources and authority must be provided.
 - Specific pre-determined consequences must be established.
 - Overseer must have access to requisite information and reporting.

Adequate Resources & Authority

To be accountable, one must:

- Be granted adequate resources.
- Have the authority to make the key decisions that will impact success or failure.
 - e.g.; the authority to select one's team.

“If you’re pulling the strings, you can’t blame the puppet for a bad performance.”

Accountability

Retirement boards are ultimately responsible and accountable for the performance of the retirement system,

- Does not imply they must be accountable for every decision or activity.
- Different parties can be made responsible and accountable for different decisions or activities within the retirement system.

Fiduciary Duty of Prudence

Prudence is process:

- The Retirement Board has a duty to be prudent:
 - Appropriate processes, structures, and controls that consider the practices of other fiduciaries (generally accepted industry practices).
- Poor performance/outcomes are “*acceptable*” provided a prudent process was followed.
- The more complex the system, the more important it is for boards to focus on the process:
 - Attempting to manage the operational details is counter-productive and risky.

Effective & Prudent Delegation

- Prudence suggests roles (i.e. allocation of responsibilities) should be clear and documented.
- Trust law allows for delegation provided fiduciaries:
 - Select their delegates/agents
 - Provide clear parameters
 - Oversee them.
- But the law provides little direction as to *what* should be delegated.

Ideally...

- Boards should focus on policy, risk management, and oversight.
- Staff should focus on operations and performance maximization.

Effective Boards

1. Organize themselves well:

- Clear/sound/documented roles
- Sound policy frameworks
- Reporting and monitoring practices
- Build knowledge

2. Execute well:

- Professional
- Constructive
- Policy-focused
- Integrity
- Manage decision traps

Mount Everest – 1996

- Escalating commitment and the sunk cost bias
- Overconfidence bias
- Recency effect



Which Wine Do You Prefer?



Confirmation Bias

- Decision-makers overestimate the value of information that supports their expectations.
- Evidence is not weighed properly.
 - e.g. Believing that all is well means you ignore information that would suggest there is a problem.
 - e.g. Believing that things always go wrong means you see a problem in everything.

(Schwenk, 1984)

The Anchoring Bias

- The tendency for people to base their judgments too heavily on initial, anchoring pieces of information.

Strategic Decision-Making is Harder Still

- Strategic decision-makers don't have many opportunities to learn from their mistakes.
- Why? Because decision outcomes are belated and often ambiguous.

Unique Challenges of Public Fund Boards

- Board composition
- Board turnover
- Public meeting laws

Interview Findings

Interview Findings

The Board:

- Wishes to be highly engaged in investment decision-making
- Enjoys learning
- Is committed to fulfilling its fiduciary duties
- Appreciates strong debate among staff/IC
- Expects to resolve any disputes between staff/IC
- Enjoys exercising full investment discretion
- Is comfortable with sole accountability for the investment program
- Values independent advice
- Feels manager selection is paramount

Interview Findings:

Priority attributes of Investment Consultant:

- Trustworthy
- Personable
- Strong communication skills
- Able to gain/maintain confidence of entire Board
- Skilled at manager due diligence
- Independent advice

Key Objectives

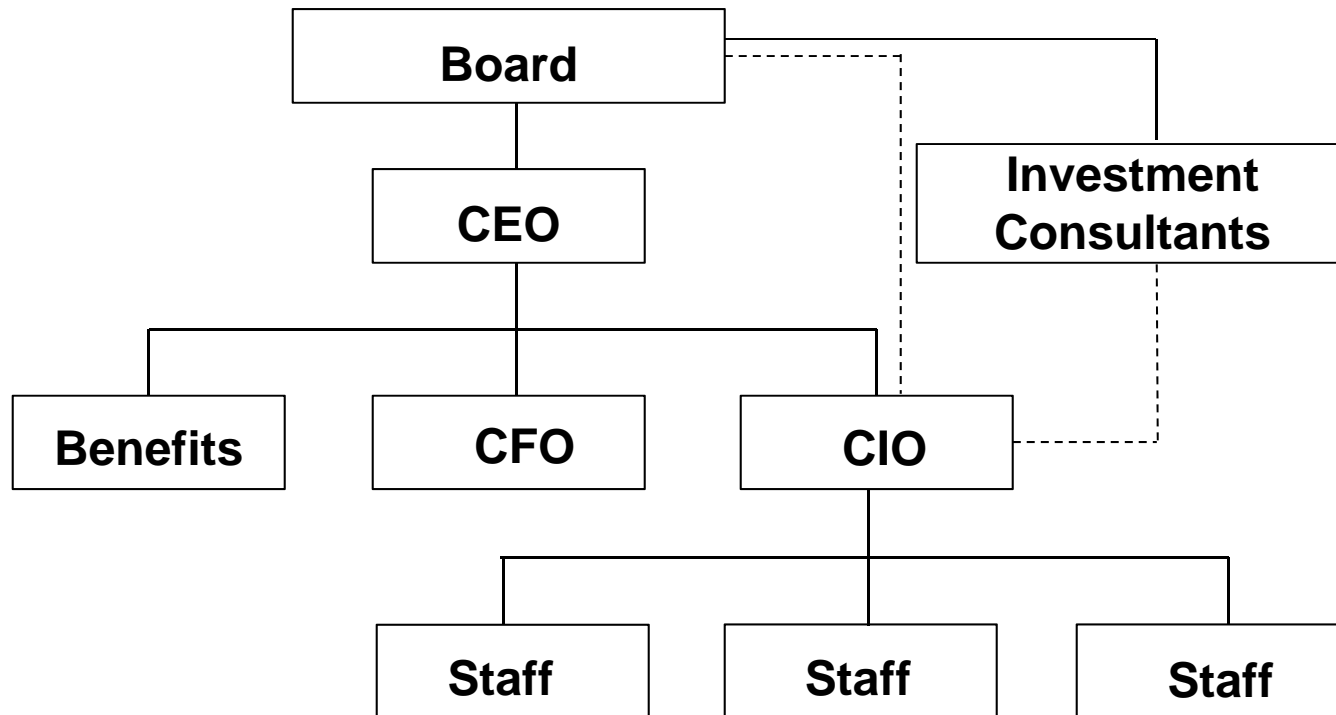
- Debate among staff and IC
- Independent advice
- Board engagement in investment decisions
- Learning opportunities
- Fiduciary duty

Alternative Models for Using Consultants

Traditional Industry Consulting Model

- Consultants (general and specialty) serve both the Board and the staff jointly.
- Consultants are at least as dominant in the organizational decision structure as the staff, often more so.
- Primary duties include assistance with asset allocation, policy development, due diligence, manager selection, research, education.
- A prudence defense.

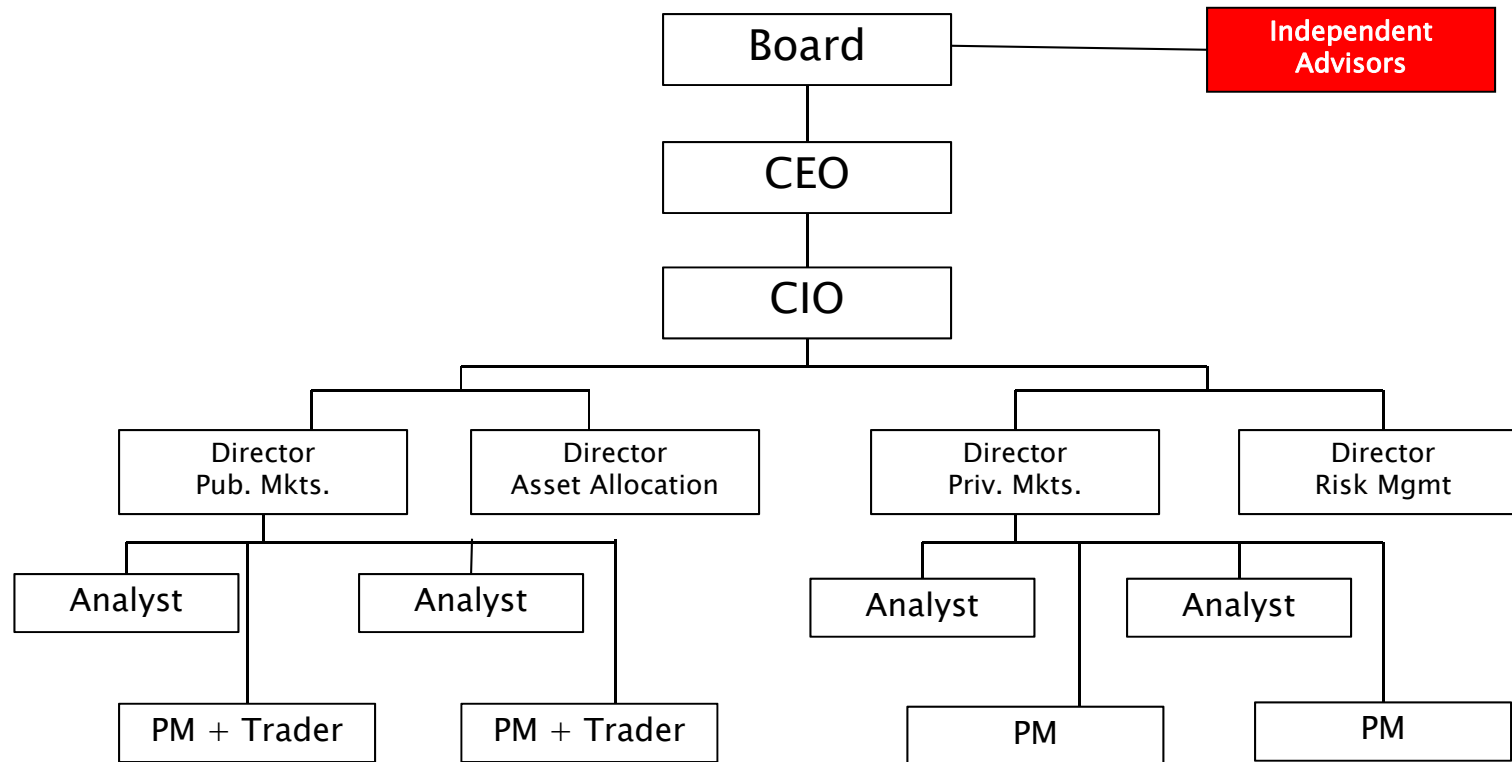
Traditional Model



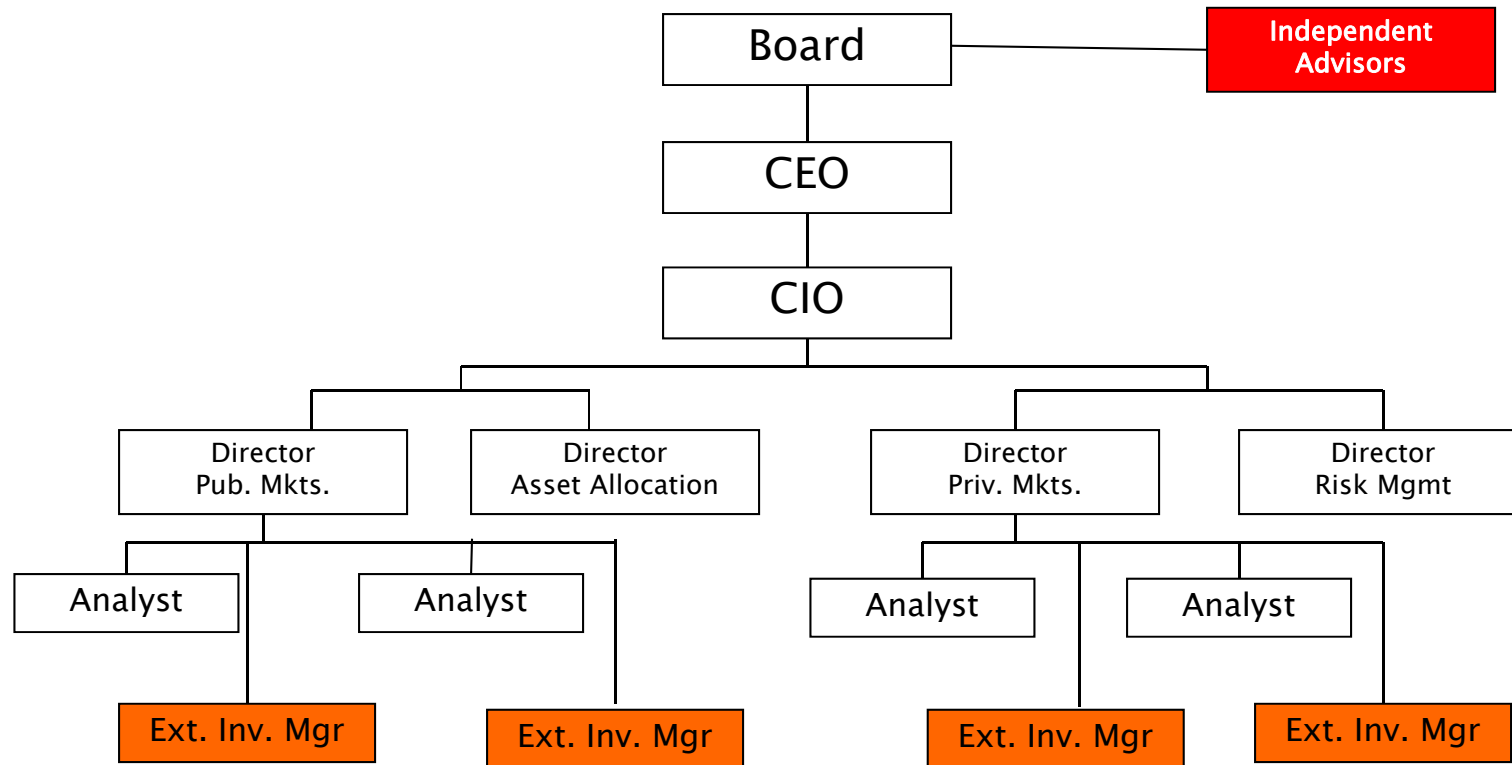
Classical Model

- Use of consultants is driven by one of two considerations:
 - Build vs. buy analysis by management:
 - Default is to build a capability unless it is more cost effective/beneficial to buy the capability externally
 - Independent advice to the Board:
 - Use independent consultants beholden to the Board whenever the Board requires truly independent advice or analysis.
- Board and staff each have own consultants.

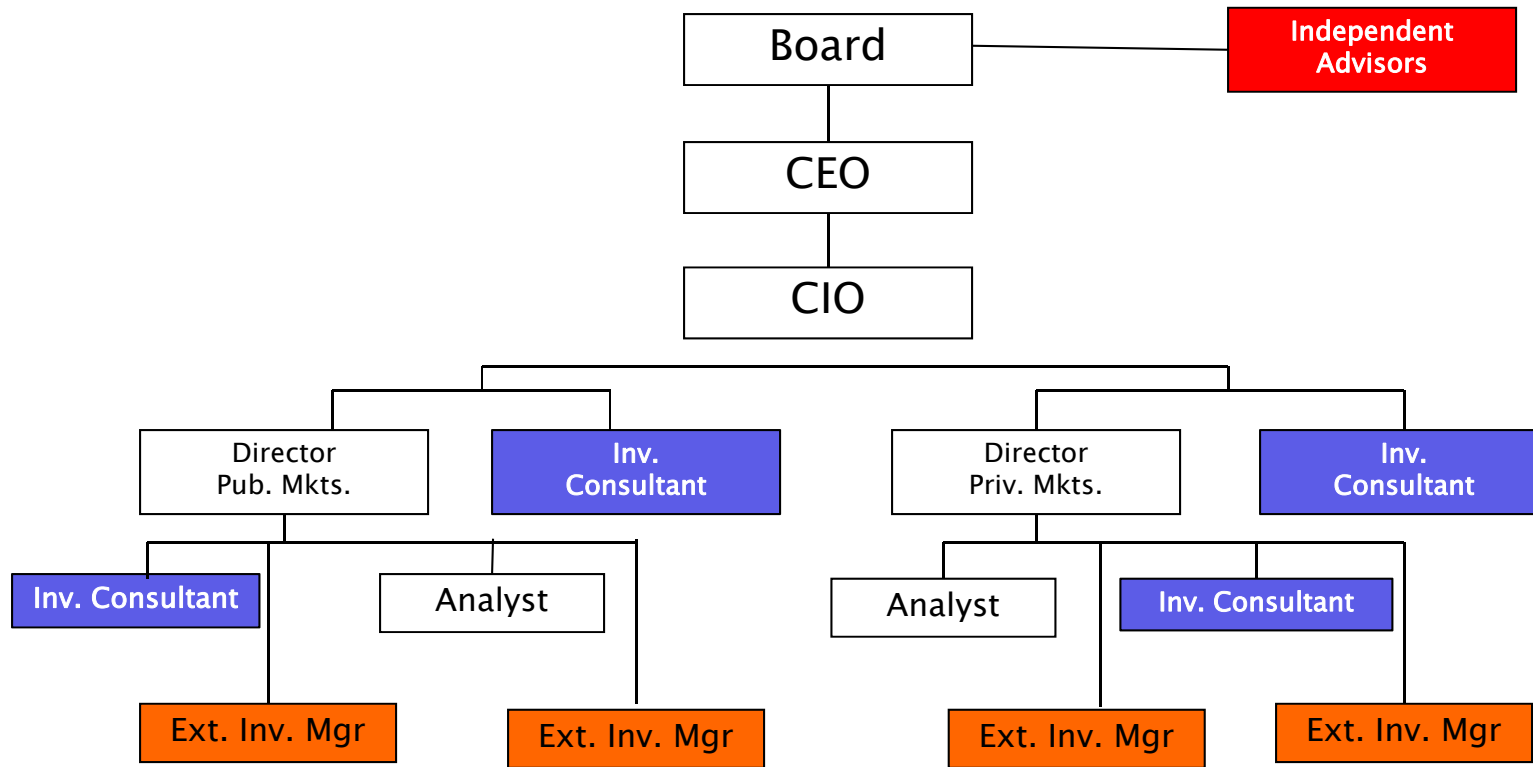
Full Internal



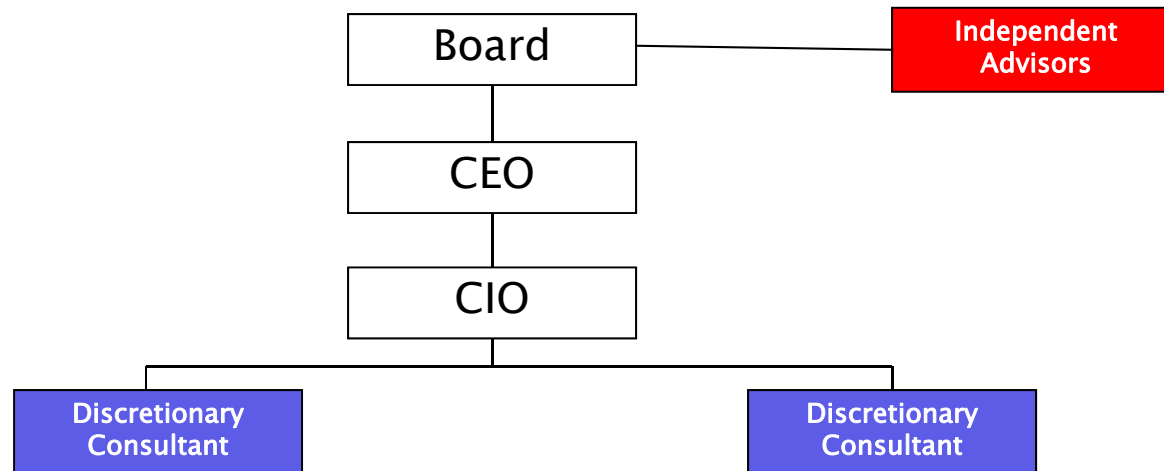
Level 1 Decision



Level 2 Decision



Level 3 Decision



Under the Classical Model

Consultants may play one of two roles:

- Independent advisory role:
 - Independent advice to the Board
 - Selected by, and accountable to, the Board
- Staff–support role within the operations:
 - Resource to staff to help carry out staff’s duties
 - Selected by, and accountable to, management
- Implications: Board and staff have separate consultants.

Alternative Consulting Firm Models

Consulting Firm Models

Three perspectives:

- Services offered
- Level of discretion
- Sources of revenue

Consultants may also work on a retainer basis or project basis.

Services Offered

- General Investment Consultants:
 - Assistance to total fund including asset allocation, manager structure, due diligence, and manager selection, and performance reporting.
- Specialty investment consultants:
 - Asset class specialties:
 - Real estate and/or real assets
 - Private equity
 - Hedge funds
 - Due diligence specialists
 - Investment risk management
 - Performance measurement

Discretionary Models

- Non-discretionary consultants:
 - Provide advice and recommendations and perform operational tasks such as due diligence.
- Discretionary consultants:
 - Accept discretionary investment authority over any or all facets of the investment program:
 - Asset allocation, manager structure, manager selection/termination
 - Total fund, a sleeve of the total fund, or a designated asset class

Sources of Revenue

Revenue Sources	Clients	Possible Considerations
Investment consulting only	Pension funds	<ul style="list-style-type: none"> • Few/low potential conflicts of interest <ul style="list-style-type: none"> ◦ Well positioned to offer highly independent advice • Business model challenges: <ul style="list-style-type: none"> ◦ Staff retention ◦ Expertise ◦ Resources
Investment Consulting & related services/ products	Pension funds & investment managers	<ul style="list-style-type: none"> • Need for transparency regarding revenue from investment managers (e.g. conferences, fees for inclusion in databases, technology and research) • Implications for fee negotiations with invest. Managers
Investment & other consulting services	Pension funds	<ul style="list-style-type: none"> • Need to recognize motivation for cross selling • May offer convenience of one-stop solutions • May have investment manager clients for non-investment consulting services
Investment consulting & asset management	Pension funds & investment managers	<ul style="list-style-type: none"> • Potential for conflicts <ul style="list-style-type: none"> ◦ Motivation to market higher margin asset management services ◦ May affect relations with other investment managers ◦ Best execution • May offer advantages on resources and expertise • Transparency/disclosure is key

Optimal Revenue Model/Sources

- With exception of undisclosed conflicts of interest, conflicts are not necessarily good or bad.
- Every model has its advantages and disadvantages to clients.
- In any case:
 - The model should be transparent and understood.
 - Any conflicts or other issues should be managed/mitigated.

CCCERA's Consulting Model Parameters

Outstanding Issues

- Vision for the investment program in 5 years?
- How will staff and consultants fit into that vision?
 - Traditional model.
 - Classical model (build vs. buy).
- Confirm current search is to focus on general investment consulting services.
- Minimum qualifications.
- General evaluation criteria.

Five-year Vision

- What is the Board's vision the investment organization five years from now?
 - What kind of investment staff (larger, smaller, compensation program, authority, etc.)?
 - What internal core competencies will CCCERA have (i.e. key skill sets)?
 - Due diligence, asset allocation, tactical asset allocation, risk management, manager selection, etc.
 - What asset classes might we be emphasizing?
 - What role will consultants play in the mix?

No expectation that we have definitive answers today, but it is important to begin thinking about it.

Use of Consultants

- Which model shall we use as a guide?
 - Traditional model.
 - Classical model (build vs. buy).

Scope of Current Search

- Non-discretionary general investment consulting services:
 - Asset allocation
 - Manager structure
 - Manager due diligence and monitoring
 - Performance reporting
 - General research and assistance
- Asset class consultant services:
 - Real estate
 - Private equity

Who is the Primary Client?

- Consultant to serve as:
 - An extension of staff resources.
 - An independent source of advice to the Board to help the Board oversee staff.
 - A combination of the above.
- If Board has separate consultant?
 - Performance reporting.
 - Periodic independent assessments.
 - Retainer vs. ad hoc.

Minimum Qualifications

- Firm experience.
- Lead consultant experience.
- Minimum number of clients and assets under advisement.
- Insurance coverage.
- Registered as an independent advisor.

Evaluation Criteria

- Consulting methodologies
- Firm and consultant experience/expertise
- Firm resources
- Fees
- Independence and/or mechanisms to manage potential conflicts
- Other

Wrap Up & Next Steps

RFP Process – Next Steps

- Develop and approve RFP
- Advertise RFP and/or issue invitations
- Q&A
- Proposal submissions
- Cortex to tabulate proposals
- Due diligence (meetings, on-sites, references)
- Finalist interviews

Thank You ...

Questions & Discussion