

Department of Pensions

360 East Second Street ■ Suite 600 ■ Los Angeles ■ California ■ 90012

Electronic Mail: pensions@fppen.lacity.org

Web Site: <http://www.ci.la.ca.us/pen>

1999 Annual Report

July 1, 1998 to June 30, 1999

Gary Mattingly

General Manager

Edward Griffiths

Assistant Manager, Benefits

Tom Lopez

Chief Investment Officer

Donna Weisz Jones

Assistant City Attorney

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MAYOR
Richard J. Riordan

City Attorney
James Kenneth Hahn

Controller
Rick Tuttle

CITY COUNCIL

John Ferraro, *President*
Joel Wachs, *President Pro Tempore*

Mike Hernandez
First District

Joel Wachs
Second District

Laura Chick
Third District

John Ferraro
Fourth District

Michael Feuer
Fifth District

Ruth Galanter
Sixth District

Richard Alarcon
Seventh District

Mark Ridley-Thomas
Eighth District

Rita Walters
Ninth District

Nate Holden
Tenth District

Cindy Miscikowski
Eleventh District

Hal Bernson
Twelfth District

Jackie Goldberg
Thirteenth District

Richard Alatorre
Fourteenth District

Rudy Svorinich, Jr.
Fifteenth District

BOARD OF PENSION COMMISSIONERS

Gay L. Harwin, President

Steven J. Silberman
Vice President

David H. Kim
Commissioner

Mike Carter
Commissioner

Louis F. Moret
Commissioner

Charles B. Isgar
Commissioner

Fredrick A. Tredy
Commissioner

June 30, 1999

The Honorable Richard J. Riordan, Mayor
Honorable Members of the City Council

In accordance with Section 64 of the Los Angeles Charter, I am submitting the Annual Report of the Department of Pensions for the fiscal year ended June 30, 1999. This annual report includes the System's financial statements audited by an independent audit firm and the actuarial valuation summary prepared by the System's actuary.

During the 1998-99 Fiscal Year, the Investment Program gained \$1.586 billion, reflecting an annual rate of return of 16.04%. Total system assets have grown to \$11.506 billion. For the first time, the System's pension plans are fully funded. Favorable investment and actuarial experience increased the funding of pension benefits to 104.7%, an 11.2% improvement. During the same period, the funding of health subsidy benefits increased to 66.5%, a 12.3% improvement.

A 1.6% decline in active membership brought the total to 12,595. Pensioners currently number 11,370, a 2.4% increase. The average monthly benefit paid to pensioners rose to \$2,949, a 4.1% increase from the previous year.

On the benefits side, Article XXXV, Plan II became effective for all new sworn employees hired after July 1, 1998, adding a fourth tier to the System's pension plans. In December 1998, a new active member information system was implemented. This information system automates a variety of calculations and provides a central location for active members' records.

A new asset allocation plan was adopted in December 1998, to further optimize asset growth. In June 1999, a manager retention policy was adopted to further the goal of generating superior, long-term investment performance. It is anticipated that the new asset allocation plan and the manager retention policy will facilitate the continuing growth of assets to meet the demands of the system.

Respectfully submitted,

GARY MATTINGLY
General Manager

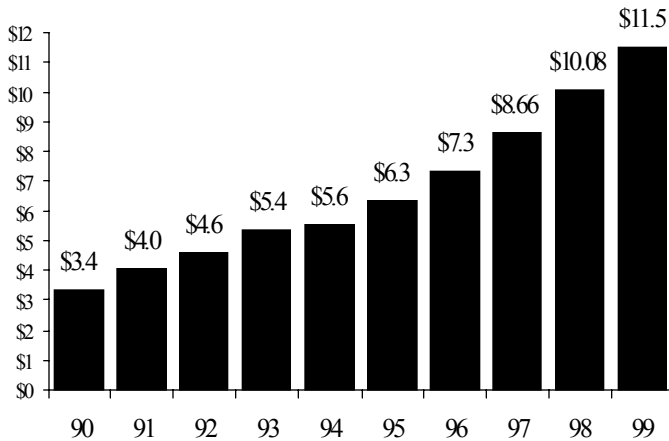
System Investments

Summary of Investment Activities

Introduction

During the past five years, the System's assets have grown from \$5.521 billion to \$11.506 billion. The investment program produced a gain of \$1.586 billion for the year ending June 30, 1999.

MARKET VALUE GROWTH OF SYSTEM ASSETS (In Billions)



Investment Environment

The bond market (*Salomon Bros. Broad Investment Grade Index*) produced a positive return of only 3.12 percent for the year ending June 30, 1999. Large capitalization stocks (*S&P 500*) achieved an outstanding 22.76 percent return. Smaller capitalization stocks (*Russell 2000 Index*) returned only 1.5 percent. International stocks (*Morgan Stanley EAFE Index*) returned 7.59 percent. Real Estate, as measured by the *Russell-National Council of Real Estate Investment Fiduciaries Index (NCREIF Classic Property Index)* continued its recover from the real estate recession with a 13.6 percent return.

Investment Performance

The investment objectives of the System, over a full market cycle (usually 3 to 5 years), are a return of at least two percent above the consumer price index per year and above median investment performance for public funds.

For the past five years, the System's annualized return of 16.19 percent was more than six times the inflation measurement increase of 2.34

percent. For the one year period, the System's overall investment performance was up 16.04 percent and outpaced the Consumer Price Index increase of 1.96 percent.

The System's performance was above median compared with other public funds (*Trust Universe Comparison Service [TUCS]*) over the past three years. For this past year, the System returned 16.04 percent vs. 10.42 percent for the public funds universe, and returned 17.30 percent for the past 3 years vs. 16.04 percent for the public funds universe. Our above median performance this year is mainly attributable to the weighting and performance of the System's stock managers.

Asset Allocation Decisions

Our asset allocation plan establishes the blueprint for investing the System's assets in stocks, bonds, real estate and cash equivalents over a three to five year period. This plan is the single most important factor in managing risk and achieving investment returns necessary to fund benefits.

The Board adopted the following asset class targets on December 17, 1998, pursuant to a recommendation by R.V. Kuhns, the Board's asset allocation project consultant.

Domestic Equity	35.2%
U.S. Small Caps	8.8%
International Equity	11%
Domestic Bonds	20%
High Yield Bonds	6%
Real Estate	8%
Alternative Investments	5%
Emerging Markets	3%
Cash Equivalents	3%

The actual asset class percentages of the System will vary from target allocations due to inflows (such as City and member contributions), outflows (such as pension payments) and the movements of the securities markets. Assets are periodically rebalanced to adjust for these movements.

As of June 30, 1999, the asset values were as follows:

ASSET CLASS	MARKET VALUE (In \$ Millions)	PERCENT
Stocks	7,188.88	62.5
Bonds	2,872.92	25.0
Real Estate	508.51	4.4
Alternative Investments	179.13	1.6
Cash Equivalents	756.08	6.5
Total	<u>11,505.52</u>	

Investment Activities

The manager changes for the year included the termination of one small cap manager, one bond manager, and one real estate manager; and the hiring of two international equities managers and two small cap equities managers. Administrative actions included the rehiring of our custodial bank, three real estate managers, one international manager, three equities managers, two emerging bond managers, our real estate consultant, and one passively indexed equities manager.

Most of the System's assets are managed by investment managers who try to outperform a market index. The System has one large equity account that is a Standard and Poor's 500 Index fund whose performance matches that index. A list of our managers is at the end of this section.

The real estate acquisition program continued with the purchase of office buildings in Portland, Oregon; Arden Hills, Minnesota; and Austin, Texas. The Anasazi land parcel in Paradise Valley, Arizona, was developed with the first tenants occupying the building in March. Several properties were sold, including a shopping center in Pasadena, Texas, and an office building in New York City. The shopping centers in Brookfield, Connecticut, and Old Bridge, New Jersey, were turned over to the management of Urdang & Associates in December.

In the commingled portion of the real estate portfolio, Heitman's Apartment Fund, Lend Lease's Asset Enhancement, and Sentinel's Apartment Fund are in liquidation and funds should be

completely returned to the Board by the end of the next fiscal year. The Board made a new investment in Lend Lease's Value Enhancement III after Value Enhancement I commenced its planned sale of assets.

The Board hired three emerging markets managers, effective July 1, 1999, to implement the new asset allocation plan adopted in December. Emerging markets are those lesser-developed countries outside of the Europe-Australasia-Far East Index developed by Morgan Stanley. The new plan calls for 3 percent of the Fund to be invested in emerging markets.

Proxy Voting

The System votes all domestic and available international proxy ballots. Staff voted 755 corporations' proxies and corporate consents in Fiscal Year 1998-99. The international equities managers vote the proxies for their portfolios in accordance with the Board's proxy guidelines, and cast a total of 186 proxy ballots.

The System votes affirmatively on preemptive rights, cumulative voting, and confidential voting; opposes anti-takeover measures and generally abstains on issues of a social, political, or environmental nature that have no expected economic impact on the System's assets. The System votes affirmatively on executive compensation bonus plans if the corporation's stock performance in the past year has exceeded the returns of both the Standard & Poor's 500 Index and an appropriate peer group index; supports the nomination of and affirmative vote for the appointment of independent directors to the Board of Directors; and directs an affirmative vote on measures proposed to place independent directors on compensation committees.

CHANGE IN ASSET MIX: LAST TEN YEARS

<u>Fiscal Year</u>	<u>Stocks</u>	<u>Bonds</u>	<u>Real Estate</u>	<u>Alternative Investments</u>	<u>Short Term Investments</u>
1989-90	52.4%	31.8%	5.9%		9.9%
1990-91	52.0%	32.7%	6.1%		9.2%
1991-92	51.7%	32.2%	5.6%		10.4%
1992-93	59.0%	26.4%	3.2%		11.4%
1993-94	58.6%	24.6%	5.8%		11.0%
1994-95	59.5%	27.9%	6.3%		6.3%
1995-96	59.2%	29.3%	6.9%		4.6%
1996-97	58.8%	30.3%	5.2%		4.9%
1997-98	60.62%	28.79%	3.91%	1.05%	5.63%
1998-99	62.48%	24.97%	4.42%	1.56%	6.57%

ANNUAL RATES OF RETURN

<u>Fiscal Year</u>	<u>Domestic Equities</u>	<u>International Equities</u>	<u>Fixed Income</u>	<u>Real Estate</u>	<u>Alternative Investments</u>	<u>Total Fund*</u>	<u>CPI**</u>
1989-90	14.9%		5.5%	7.4%		10.5%	4.7%
1990-91	5.2%	-9.90%	10.5%	-3.0%		4.8%	4.3%
1991-92	15.2%	6.16%	17.6%	-3.1%		14.0%	3.1%
1992-93	18.7%	11.81%	17.7%	-15.3%		16.0%	2.8%
1993-94	2.7%	22.11%	0.7%	9.4%		3.5%	2.5%
1994-95	25.6%	-0.37%	14.3%	14.5%		14.5%	3.0%
1995-96	25.3%	14.83%	7.8%	9.5%		14.6%	2.7%
1996-97	27.09%	12.70%	10.43%	13.9%		18.52%	2.30%
1997-98	23.07%	12.42%	11.84%	18.2%	10.77%	17.48%	1.69%
1998-99	25.53%	17.65%	2.44%	13.0%	12.46%	16.04%	1.96%

*Total fund includes short-term investments

**CPI is for the U.S. ending June 30th

INVESTMENT ADVISORS

STOCK MANAGERS

Alliance Capital Management
Amerindo Investment Advisors
Brown Capital Management
CIC Asset Management
Daruma Asset Management
Delta Asset Management
Frontier Capital Management
Loomis Sayles & Company, L.P.

BOND MANAGERS

Capital Guardian
GEM Capital Management
GW Capital
HCM Capital Management
LM Capital
Lend Lease
Lincoln Capital Management
Loomis Sayles & Company, L.P.
Magten Asset Management Corporation
Reams Asset Management
Smith, Graham & Company

INTERNATIONAL STOCK MANAGERS

Brandes Investment Partners
Invista Capital Management
Oechsle International Advisors, Ltd.

REAL ESTATE MANAGERS

AEW Capital Management
Heitman Capital Management
Lend Lease
Lowe Enterprises Investment Management
PSI Institutional Realty
Sentinel Real Estate Corporation
Urdang & Associates

ALTERNATIVE INVESTMENT MANAGERS

Abbott Capital Management
Hamilton Lane Advisors
Oaktree Capital Management
Trust Company of the West

Actuarial Valuation

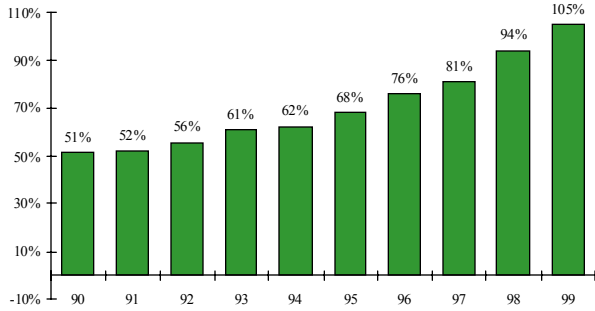
Actuarial Valuation Summary

Actuarial Valuations

Two actuarial valuations of the assets and liabilities of pension benefits are conducted annually. One study examines the pension benefits paid to members and their beneficiaries, the other study examines the health subsidies allocated to qualifying members. These studies evaluate the funding progress of the system and determine the annual contribution requirements.

The funded status of the pension system is examined over a span of several years to determine if funding progress is made. Satisfactory funding progress has occurred over the past ten years.

FUNDED STATUS (Pension Benefits-Actuarial Ratio)



How a Valuation is Conducted

The actuarial funding method used (Entry Age Normal Cost) is required by the Charter under Articles XVII (Sec. 186.2), XVIII (Sec. 190.09), and XXXV (Sec. 528). An actuarial valuation examines the membership of the pension system as currently constituted, then projects future liabilities using various assumptions.

Non-economic actuarial assumptions on mortality of members and spouses, probability of service retirement and disability, probability of termination prior to retirement, and probability of having a surviving beneficiary are created from studies made of the actual experience of the membership of the System. A new study is conducted every three years.

These assumptions are recommended by an actuary and adopted by the Board of Pension Commissioners. The last study was adopted by the Board in November 1998. This experience study covered the period beginning July 1, 1995 to June 30, 1998. An example of projected mortality is as follows:

Average Life Expectancy for Retirees

Service Retiree (Average Age = 66) 16.9 years
 Disabled Retiree (Average Age = 60) 18.5 years
 Surviving Spouse (Average Age = 74) 13.8 years

Economic assumptions are also studied, recommended by the actuary, and adopted by the Board. Economic assumptions in effect for this valuation period are:

Economic Assumptions

Annual Increase in the Consumer Price Index 5.0%**
 Annual Individual Salary Increase varies by age

Age	Annual Salary Increase
Under 25	10.00%
25-29	9.00%
30-34	8.00%
35-39	7.00%
40-44	6.00%
45-49	5.75%
50 and over	5.50%

Annual Increases in Total System Payroll 5.0%
 Annual Interest 8.5%
 (**Article XXXV is capped at 3%)

Pension Benefit Balance Sheet

Cost of living and individual salary assumptions are used to project the dollar amount of benefits to be paid. The total liability is then reduced to today's dollar terms using the interest assumption.

Once the liabilities of the system are computed, the valuation study projects the member contributions expected to be received, which are reduced to today's dollar terms using the interest assumption. The individual salary assumptions are used to project the total member contributions. The Entry Age Normal Cost contribution, the amount the City would contribute for a hypothetical new entrant into the system, is calculated. This amount would theoretically be sufficient to fully fund a member's retirement on the date of retirement if all assumptions were realized and no benefit changes were made.

These potential future contributions are considered assets of the system, along with assets currently being invested by the Department of Pensions. For purposes of determining the contributions to the System, the current assets are now valued using a method that phases in, over five years, the unrealized and realized appreciation above that which is expected based upon the assumed rate of return.

As can be seen on the Actuarial Pension Benefit Balance Sheet (see p. 12), the balance of -\$434

million is considered the unfunded actuarial liability.

Unfunded Actuarial Liability

An unfunded actuarial liability can result from many variables. Often, benefit increases are credited to members while in the middle of their career, or even after they have retired. Since these benefit enhancements did not exist when the funding of the members' benefits began, contributions to fund these increased benefits were not made during all or part of the members' working career. An example of a benefit enhancement that occurred was the lifting of a 2% cap on cost-of-living increases. This applied to all members, active and retired, and created an immediate unfunded liability. The Milestones section of this report contains more examples of benefit changes.

The Entry Age Normal Cost actuarial method normally results in actuarial gains or losses, unless all actuarial assumptions are met each year. These actuarial gains or losses also result in decreases or increases in the unfunded actuarial liability.

Occasionally, the actuarial methodology itself is refined according to accepted actuarial practice. For example, salary increases were not utilized in the computations until the late 1970s. When this practice was included, it created an additional unfunded liability.

Finally, during a period in the history of the Pension System, the funding was on a pay-as-you-go basis, instead of an actuarial basis. When the system shifted to an actuarial basis, an immediate unfunded liability resulted.

Contribution Requirements Calculation

The contribution is comprised of two parts: (1) the Entry Age Normal Cost contribution and (2) the contribution to amortize the unfunded liability. The unfunded liability is amortized over a time period using a methodology prescribed in the Charter for each plan. The amortization period for Articles XVII and XVIII is scheduled to end on June 30, 2037.

Article XVII is amortized as a level dollar amount. Article XVIII is amortized as a level percent of all system members' (Articles XVII, XVIII, and XXXV combined) salaries. Article XXXV's am-

ortization basis is a level percentage of plan members' salaries over a continuous fifteen year cycle. Each year's actuarial gain or loss is amortized for fifteen years. Any gains or losses resulting from benefit changes are amortized over a thirty year period. Changes in the unfunded actuarial liability resulting from benefit changes are amortized over a thirty-year period. With this information, the actuary computes the contribution requirements for the City.

Entry Age Normal Cost Contribution Requirements Recommended 2000-2001

(As a percentage of plan members' salaries)

Article XVII	18.488%
Article XVIII	21.748%
Article XXXV	14.189%

Unfunded Liability Contribution Requirements Recommended 2000-2001

Article XVII	\$28,948,703
Article XVIII	(3.124%) of all system members' salaries
Article XXXV ...	(3.383%) of all Art XXXV members' salaries

Health Subsidy Valuation

The health valuation study utilizes the same actuarial assumptions as the study on pension benefits, with the addition of a medical inflation assumption. Currently, medical costs are increasing at a faster pace than inflation. Assumptions in the June 1999 actuarial valuation included graded medical cost increase rates of 8.0% for pre-65 premiums and 7.75% for post-65 premiums in 1999; both decreasing gradually to 6.5% in 2005 and beyond. Using the same actuarial methods for pension benefits, the Actuarial Balance Sheet for health subsidy benefits is shown on page 12.

The contributions suggested to fund the health subsidy plan are:

Entry Age Normal Cost Contribution Requirements Recommended 2000-2001

(As a percentage of plan members' salaries)

Article XVII	0.219%
Article XVIII	1.256%
Article XXXV	2.966%

Unfunded Liability Contribution Requirements Recommended 2000-2001

Article XVII	\$425,623
Article XVIII	1.539% of all system members' salaries
Article XXXV	(1.088%) of Art XXXV members' salaries

Valuation of Pension Benefits

Actuarial Balance Sheet As of June 30, 1999

ASSETS				
	Fire & Police Pension System	New Pension System	Safety Members Pension Plan	All Plans Combined
1. Applicable Assets	\$ (2,127,018)	\$8,136,173,417	\$1,503,209,090	\$9,637,255,489
2. Present Value of Future Member Contributions	0	61,065,078	532,568,060	593,633,138
3. Present Value of Future Contributions by the City for:				
a. Entry Age Normal Costs	219,762	319,939,866	1,005,046,132	1,325,205,760
b. Unfunded Actuarial Accrued Liability	311,972,218	(525,076,213)	(220,515,097)	(433,619,092)
4. Total Assets	\$310,064,962	\$7,992,102,148	\$2,820,308,185	\$11,122,475,295

LIABILITIES				
	Fire & Police Pension System	New Pension System	Safety Members Pension Plan	All Plans Combined
5. Present Value of Benefits Already Granted				
a. Service Retirements	\$ 77,817,132	\$3,668,162,414	\$ 12,772,283	\$3,758,751,829
b. Disability Retirements	82,403,427	1,145,567,507	51,611,364	1,279,582,298
c. Survivors and Dependents	146,017,399	514,009,946	23,399,838	683,427,183
d. Total	<u>\$ 306,237,958</u>	<u>\$5,327,739,867</u>	<u>\$ 87,783,485</u>	<u>\$5,721,761,310</u>
6. Present Value of Benefits to be Granted				
a. Service Retirements	\$ 3,331,826	\$2,181,803,585	\$2,076,286,845	\$4,261,422,256
b. Disability Retirements	480,309	463,916,482	552,552,552	1,016,949,343
c. Survivors and Dependents	14,474	17,683,869	61,177,149	78,875,492
d. Total	<u>\$ 3,826,609</u>	<u>\$2,663,403,936</u>	<u>\$2,690,016,546</u>	<u>\$5,357,247,091</u>
7. Refund of Employee Contributions	\$ 395	\$ 958,345	\$ 42,508,154	\$ 43,466,894
8. Total Liabilities	\$ 310,064,962	\$7,902,102,148	\$2,820,308,185	\$11,122,475,295

Valuation of Health Subsidy Benefits

Actuarial Balance Sheet As of June 30, 1999

ASSETS				
	Fire & Police Pension System	New Pension System	Safety Members Pension Plan	All Plans Combined
1. Applicable Assets	\$ 6,654,518	248,279,303	\$ 188,558,349	\$443,492,170
2. Present Value of Future Contributions by the City for:				
a. Entry Age Normal Costs	1,628	12,945,674	173,355,540	186,302,742
b. Unfunded/(Surplus) Actuarial Accrued Liability	4,586,827	258,538,992	(40,052,410)	223,073,509
3. Total Assets	\$ 11,242,973	\$519,763,969	\$321,861,479	\$852,868,421

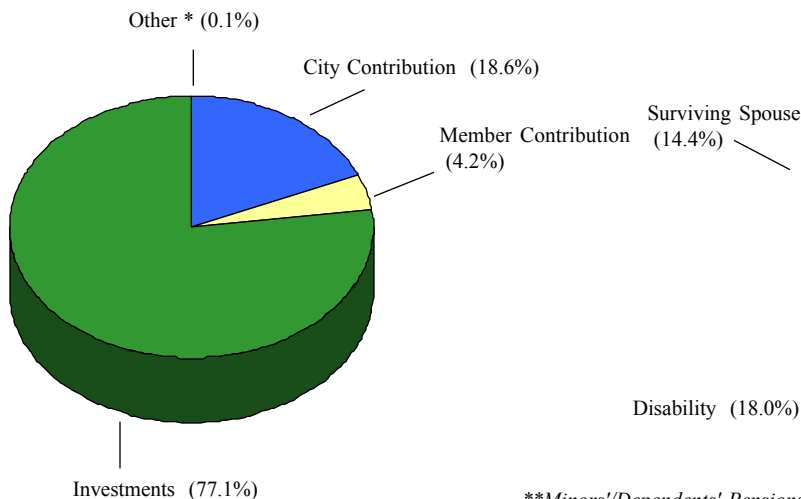
LIABILITIES				
	Fire & Police Pension System	New Pension System	Safety Members Pension Plan	All Plans Combined
4. Present Value of Benefits Already Granted	\$10,969,758	\$335,132,017	\$ 3,017,240	\$349,119,015
5. Present Value of Benefits to be Granted				
a. Actives Eligible to Retire	273,215	164,996,790	5,814,781	171,084,786
b. Other Actives	0	19,635,162	313,029,458	332,664,620
c. Total	<u>\$ 273,215</u>	<u>\$ 184,631,952</u>	<u>\$318,844,239</u>	<u>\$503,749,406</u>
6. Total Liabilities	\$11,242,973	\$519,763,969	\$321,861,479	\$852,868,421

Department Budget

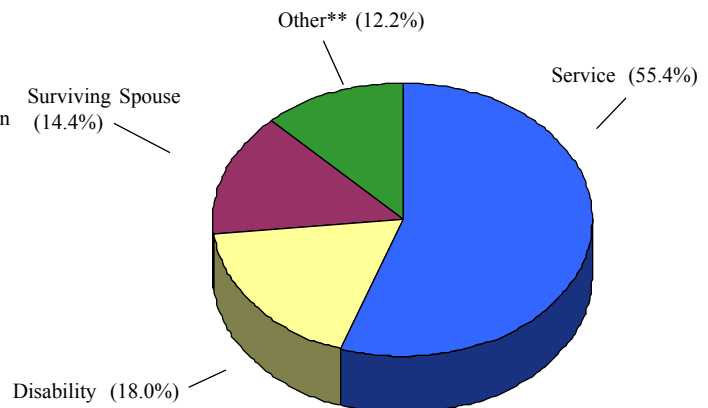
Department Budget

Receipts	Budgeted 1998-99	Actual 1998-99
Balance Available	\$ 769,650	\$ 0
City Contribution	247,888,665	247,888,665
Member Contributions	58,181,183	55,805,076
Earnings on Investments	325,000,000	379,294,840
Gain on Sale of Investments	--	648,051,891
UFLAC Settlement	500,000	500,000
Miscellaneous	650,000	725,079
Total Receipts	<u>\$632,989,498</u>	<u>\$1,332,265,551</u>
Expenditures	Budgeted 1998-99	Actual 1998-99
Service Pensions	\$261,360,000	\$250,805,918
Disability Pensions	87,480,000	81,564,522
Surviving Spouses' Pensions	69,120,000	65,047,298
Minors'/Dependents' Pensions	1,296,000	1,214,154
Refund of Member Contributions	4,000,000	4,157,672
Health Insurance Subsidy	15,697,000	16,963,567
Medicare	1,900,000	1,868,234
Investment Management Expense	25,572,500	26,609,343
Administrative Expense	6,503,850	4,829,886
Total Expenditures	<u>\$472,929,350</u>	<u>\$453,060,594</u>
Increase in Fund Balance	<u>\$160,060,148</u>	<u>\$879,204,957</u>

RECEIPTS



EXPENDITURES



*UFLAC Settlement and Miscellaneous

**Minors'/Dependents' Pensions, Refund of Member Contributions, Medicare, Health Insurance Subsidy, Investment Management Expense and Administrative Expense

Auditors' Report