

**ANNUAL
REPORT**
2001

July 1, 2000 to June 30, 2001

***CITY OF LOS ANGELES
DEPARTMENT OF FIRE
AND POLICE PENSIONS***

***FIRE AND POLICE
PENSION SYSTEMS***

Department of Fire and Police Pensions

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2001 Annual Report

July 1, 2000 to June 30, 2001

Gary Mattingly
General Manager

Edward Griffiths
*Assistant Manager,
Benefits*

Rhonda Peterson
*Assistant Manager,
Administrative Services*

Donna Weisz Jones
Assistant City Attorney

Tom Lopez
Chief Investment Officer

Table of Contents

<i>Governing Bodies</i>	<i>2</i>
<i>General Manager's Letter</i>	<i>3</i>
<i>System Investments</i>	<i>5</i>
<i>Actuarial Valuation</i>	<i>11</i>
<i>Budget</i>	<i>19</i>
<i>Auditors' Report</i>	<i>23</i>
<i>Membership Statistics</i>	<i>39</i>
<i>Active Membership</i>	<i>42</i>
<i>Retired Membership</i>	<i>44</i>
<i>Legal Summary</i>	<i>51</i>
<i>Summary of Pension Plan Benefits</i>	<i>55</i>
<i>Milestones</i>	<i>69</i>

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

Alex Padilla
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

Nick Pacheco
Fourteenth District

Rudy Svorinich, Jr.
Fifteenth District

BOARD OF PENSION COMMISSIONERS

Gay L. Harwin, President

Steven J. Silberman
Vice President

Sam Diannitto
Commissioner

George Aliano
Commissioner

Charles B. Isgar
Commissioner

Mike Carter
Commissioner

David H. Kim
Commissioner

Thomas A. Dawson
Commissioner

Louis F. Moret
Commissioner

June 30, 2001

The Honorable James K. Hahn, Mayor
Honorable Members of the City Council

In accordance with Section 216 of the Los Angeles Charter, I am submitting the Annual Report of the Department of Fire and Police Pensions for the fiscal year ended June 30, 2001. 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.

Although the System's overall investment performance was down 10% for the fiscal year 2000-2001, the annualized return for the past five years was 11.06%. Total system assets are \$11.382 billion. The funding of pension benefits increased to 118.9%, a 3.9% improvement. During the same period, the funding of health subsidy benefits increased to 68.3%, an increase of 4.1%.

A 0.5% decline in active membership brought the total to 12,322. Pensioners currently number 11,658, a 0.4% increase. The average monthly benefit paid to pensioners rose to \$3,269, a 6.5% increase from the previous year.

Significant benefit changes were approved in 2001. A Tier 5 will become effective January 1, 2002 and will increase the maximum pension benefit from 70% to 90% of salary.

The City Council was given authority to establish by ordinance a cost neutral deferred retirement option plan (DROP) to offer an incentive to sworn employees, who are eligible to retire, to continue to work. Negotiation of the plan details is continuing.

A dental subsidy for retirees has also been negotiated and will be enacted by City Council ordinance.

Respectfully submitted,

GARY MATTINGLY
General Manager

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System Investments

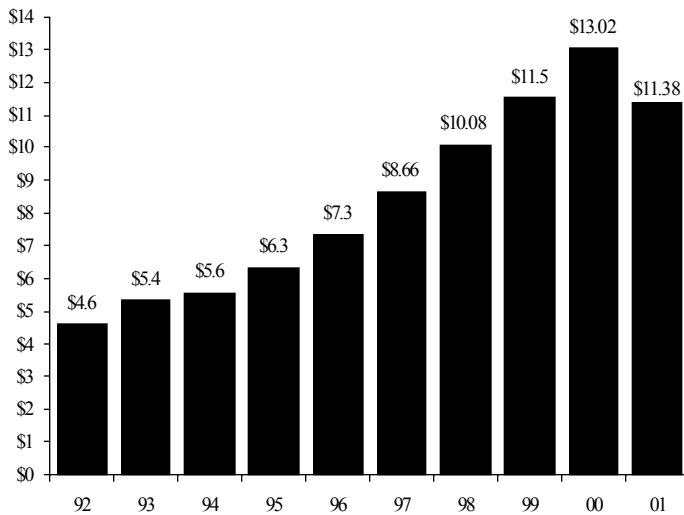
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Summary of Investment Activities

Introduction

During the past five years, the System's assets have grown from \$7.335 billion to \$11.382 billion. The Fund shrank by \$1.641 billion for the year ending June 30, 2001.

MARKET VALUE GROWTH OF SYSTEM ASSETS (In Billions)



Investment Environment

The bond market (*Salomon Bros. Broad Investment Grade Index*) produced a positive return of 11.26 percent for the year ending June 30, 2001. Large company stocks (*S&P 500*) returned a negative 14.83 percent. Small company stocks (*Russell 2000 Index*) returned .57 percent. International stocks (*Morgan Stanley EAFE Index*) returned less than the domestic indexes, at negative 23.62 percent. Real Estate, as measured by the National Council of Real Estate Investment Fiduciaries Index (*NCREIF Classic Property Index*) returned 11.50 percent.

Investment Performance

The investment objectives of the total Fund, over a full market cycle (usually 5 to 7 years), is to earn a return on investments matching or exceeding the required actuarial rate of return and investment performance above the median of a sampling of public funds.

For the past five years, the System's annualized return of 11.06 percent was more than four times the annualized rate of inflation of 2.52 percent. For the one-year period, the System's overall investment performance was down 10.00 percent.

The System's performance was above the median compared with other public funds (Frank Russell Public Fund Universe) over the past three and five years. The Fund was ranked in the 24th percentile for the three-year period ending June 30, 2001, and 27th for the five year-year period. For this past year, the System returned a negative 10.00 percent (95th percentile) versus the public fund median of negative 5.79 percent. The Plan's overall under-performance this year is primarily attributable to the under-performance of the System's stock and bond portfolios.

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 Cap Stocks	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. As-

sets are periodically rebalanced to adjust for these movements.

As of June 30, 2001, the net asset values were as follows:

ASSET CLASS	MARKET VALUE (In \$ Millions)	PERCENT
Stocks	\$ 6,413.7	56.35
Bonds	2,872.9	25.24
Real Estate	867.6	7.62
Alternative Investments	376.7	3.31
Cash Equivalents	<u>851.8</u>	<u>7.48</u>
Total	\$ 11,382.7	100.00

Investment Activities

The manager changes for the year included the termination of one bond manager and one equity manager and the hiring of two equity managers, a manager search consultant and a performance measurement consultant. Administrative actions included the rehiring of five fixed income managers and two equity managers.

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 Agoura, CA, Indianapolis, IN, and Sacramento, CA; apartments in Minneapolis, MN, Atlanta, GA, Chicago, IL, Las Vegas, NV and Fairfield, CA and warehouse flex/office in Round Rock, TX. Properties sold by the fund included office buildings in Minneapolis, MN and Omaha, NE.

Proxy Voting

The System votes all domestic and available international proxy ballots. Staff voted 744 corporations' proxies and corporate consents in Fiscal Year 2000-2001. The international equities managers vote the proxies for their portfolios in accordance with the Board's proxy guidelines, and cast a total of 303 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>
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%
1999-00	64.45%	22.53%	5.55%	2.65%	4.82%
2000-01	56.35%	25.24%	7.62%	3.31%	7.48%

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>
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%
1999-00	17.91%	26.93%	3.90%	15.0%	42.14%	16.30%	2.87%
2000-01	-17.88%	-19.49%	2.35%	12.80%	1.58%	-10.00%	2.98%

*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
Boston Partners
Brown Capital Management
CIC Asset Management
Daruma Asset Management
Delta Asset Management
Frontier Capital Management
Loomis Sayles & Company, L.P.
Trust Company of the West

BOND MANAGERS

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

INTERNATIONAL STOCK MANAGERS

Brandes Investment Partners
Invista Capital Management
Marvin & Palmer Associates, Inc.
Montgomery Asset Management LLP
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

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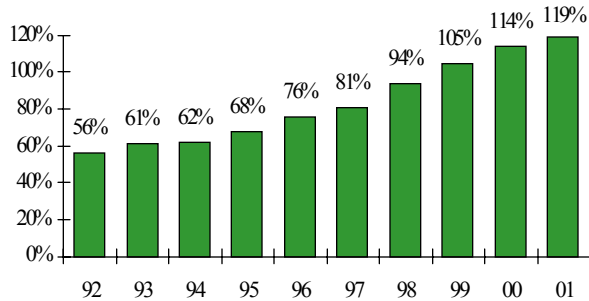
Actuarial Valuation Summary

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 Section 1210 (Fire and Police Pension Plans General Provision section) for Tier 1 (formerly Article XVII), Tier 2 (formerly Article XVIII), Tier 3 (formerly Article XXXV, Plan 1) and Tier 4 (formerly Article XXXV, Plan 2). 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 Fire and Police Pension Commissioners. The last study was adopted by the Board in December 2001. This ex-

perience study covered the period beginning July 1, 1998 to June 30, 2001. An example of projected mortality is as follows:

Average Life Expectancy for Retirees

Service Retiree (Age = 65)	17.3 years
Disabled Retiree (Age = 60)	18.2 years
Surviving Spouse (Age = 70)	16.6 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%

(**Tier 3 and Tier 4 are 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 Fire and Police 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 page 13), the balance of -\$1.88 billion is considered the unfunded actuarial liability. The unfunded liability for health subsidy benefits for all plans combined is \$266 million (see page 14).

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 Tier 1 and Tier 2 is scheduled to end on June 30, 2037.

Tier 1 is amortized as a level dollar amount. Tier 2 is amortized as a level percent of all system members' (Tiers 1, 2, 3 and 4 combined) salaries. Tier 3 and Tier 4's amortization 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 2002-2003

(As a percentage of plan members' salaries)

Tier 1 (Article XVII)	17.548%
Tier 2 (Article XVIII)	21.016%
Tier 3 (Article XXXV, Plan 1)	12.826%
Tier 4 (Article XXXV, Plan 2)	11.875%

Unfunded Liability Contribution Requirements Recommended 2002-2003

Tier 1 (Article XVII).....	\$26,453,474
Tier 2 (Article XVIII).....	-10.156% of total payroll of Tiers 1, 2, 3 & 4
Tier 3 (Article XXXV, Plan 1).....	-5.680% of Tier 3 payroll
Tier 4 (Article XXXV, Plan 2).....	-4.315% of Tier 4 payroll

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 30, 2001 actuarial valuation included medical trend rate increases of 7.25% for pre-65 premiums and 7.5% for post-65 premiums in 2001; both decreasing gradually to 6.5% in 2005 and thereafter. Using the same actuarial methods for pension benefits, the Actuarial Balance Sheet for health subsidy benefits is shown on page 14.

The contributions suggested to fund the health subsidy plan are:

**Entry Age Normal Cost Contribution Requirements
Recommended 2002-2003**

(As a percentage of plan members' salaries)

Tier 1 (Article XVII)	0.154%
Tier 2 (Article XVIII)	1.240%
Tier 3 (Article XXXV, Plan 1)	2.867%
Tier 4 (Article XXXV, Plan 2)	3.052%

**Unfunded Liability Contribution Requirements
Recommended 2002-2003**

Tier 1 (Article XVII).....	\$964,977
Tier 2 (Article XVIII).....	1.738% of total payroll of Tiers 1, 2, 3 & 4
Tier 3 (Article XXXV, Plan 1).....	-1.425% of Tier 3 payroll
Tier 4 (Article XXXV, Plan 2).....	-1.249% of Tier 4 payroll

Valuation of Pension Benefits Actuarial Balance Sheet As of June 30, 2001

ASSETS					
	Tier 1	Tier 2	Tier 3	Tier 4	All Plans Combined
1. Applicable Assets	\$ (4,680,892)	\$9,773,505,573	\$1,504,549,601	\$ 562,174,657	\$ 11,835,548,939
2. Present Value of Future Member Contributions	0	46,194,976	384,012,165	190,375,042	620,582,183
3. Present Value of Future Contributions by the City for:					
a. Entry Age Normal Costs	46,845	273,957,451	656,608,867	306,158,647	1,236,771,810
b. Unfunded Actuarial Accrued Liability	282,698,501	(1,787,509,819)	(282,294,549)	(94,386,611)	(1,881,492,478)
4. Total Assets	\$278,064,454	\$8,306,148,181	\$2,262,876,084	\$964,321,735	\$11,811,410,454

LIABILITIES					
	Tier 1	Tier 2	Tier 3	Tier 4	All Plans Combined
5. Present Value of Benefits Already Granted					
a. Service Retirements	\$ 65,914,955	\$ 4,098,601,979	\$ 18,836,642	\$ 0	\$ 4,183,353,576
b. Disability Retirements	74,602,304	1,238,279,259	72,568,118	0	1,385,449,681
c. Survivors and Dependents	136,699,267	566,335,805	27,073,221	0	730,108,293
d. Total	\$ 277,216,526	\$ 5,903,217,043	\$ 118,477,981	\$ 0*	\$ 6,298,911,550
6. Present Value of Benefits to be Granted					
a. Service Retirements	\$ 778,923	\$ 1,999,038,542	\$ 1,734,612,682	\$ 780,289,023	\$ 4,514,719,170
b. Disability Retirements	65,700	386,917,921	297,003,277	161,983,513	854,970,411
c. Survivors and Dependents	3,216	16,404,116	47,226,096	21,360,846	84,994,274
d. Total	\$ 847,839	\$ 2,402,360,579	\$ 2,087,842,055	\$ 963,633,382	\$ 5,445,683,855
7. Refund of Employee Contributions	\$ 89	\$ 570,559	\$ 65,556,048	\$ 688,353	\$ 66,815,049
8. Total Liabilities	\$ 278,064,454	\$ 8,306,148,181	\$ 2,262,876,084	\$ 964,321,735	\$ 11,811,410,454

*Included within Tier 3 Liabilities

Valuation of Health Subsidy Benefits Actuarial Balance Sheet As of June 30, 2001

ASSETS					
	Tier 1	Tier 2	Tier 3	Tier 4	All Plans Combined
1. Applicable Assets	\$ 4,691,167	\$311,120,667	\$187,844,352	\$ 70,188,004	\$ 573,844,190
2. Present Value of Future Contributions by the City for:					
a. Entry Age Normal Costs	226	11,824,999	120,749,306	68,649,868	201,224,399
b. Unfunded/(Surplus) Actuarial Accrued Liability	10,312,351	305,852,956	(34,521,961)	(15,199,592)	266,443,754
3. Total Assets	\$15,003,744	\$628,798,622	\$274,071,697	\$123,638,280	\$1,041,512,343

LIABILITIES					
	Tier 1	Tier 2	Tier 3	Tier 4	All Plans Combined
4. Present Value of Benefits Already Granted	\$ 14,935,678	\$ 449,242,624	\$ 5,359,194	\$ 0*	\$ 469,537,496
5. Present Value of Benefits to be Granted					
a. Actives Eligible to Retire	68,066	179,477,406	2,896,829	12,309,740	194,752,041
b. Other Actives	0	78,592	265,815,674	111,328,540	377,222,806
c. Total	68,066	179,555,998	268,712,503	123,638,280	571,974,847
6. Total Liabilities	\$15,003,744	\$628,798,622	\$274,071,697	\$123,638,280	\$1,041,512,343

*Included within Tier 3 Liabilities

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Department Budget

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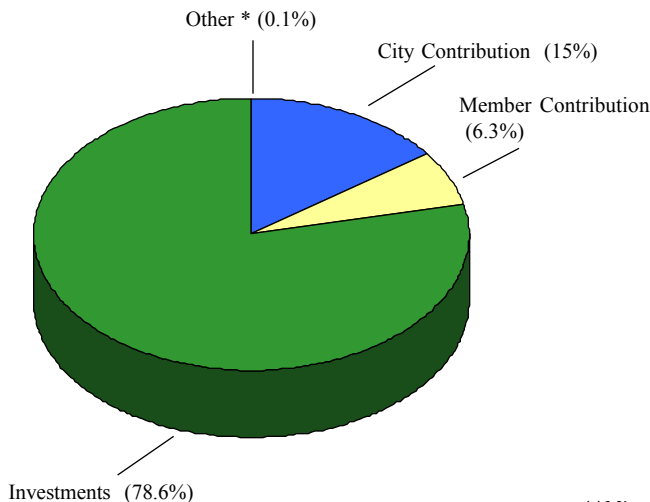
Department Budget

Receipts	Budgeted 2000-01	Actual 2000-01
City Contribution	\$ 138,433,173	\$ 138,433,173
Member Contributions	60,137,235	58,182,993
Earnings on Investments	350,000,000	446,920,200
Gain on Sale of Investments	--	275,899,761
UFLAC Settlement	500,000	500,000
Miscellaneous	660,000	409,061
Total Receipts	\$ 549,730,408	\$ 920,345,188

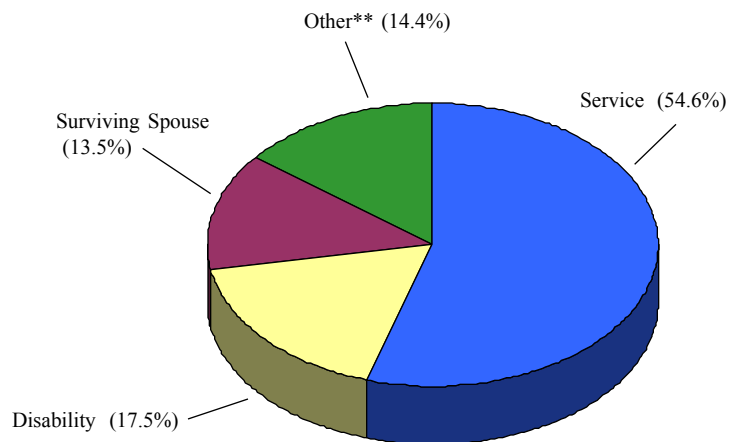
Expenditures	Budgeted 2000-01	Actual 2000-01
Service Pensions	\$ 290,834,000	\$ 281,782,026
Disability Pensions	95,014,000	90,369,728
Surviving Spouses' Pensions	76,064,000	69,499,610
Minors'/Dependents' Pensions	2,250,000	1,354,751
Refund of Member Contributions	4,500,000	5,749,455
Health Insurance Subsidy	25,000,000	24,999,727
Medicare	2,020,000	2,680,967
Investment Management Expense	35,640,900	33,696,037
Administrative Expense	7,486,150	5,951,628
Total Expenditures	\$ 538,809,050	\$ 516,083,929

Increase in Fund Balance **\$ 10,921,358** **\$ 404,261,259**

RECEIPTS



EXPENDITURES



*UFLAC Settlement and Miscellaneous

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