DEBRA K. DAVENPORT, CPA
AUDITOR GENERAL

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

MELANIE M. CHESNEY
DEPUTY AUDITOR GENERAL

March 29, 2016

The Honorable John Allen, Chair
Joint Legislative Audit Committee

The Honorable Judy Burges, Vice Chair
Joint Legislative Audit Committee

Dear Representative Allen and Senator Burges:

Under contract with the Office of the Auditor General, Gallagher Fiduciary Associates, LLC, completed an initial followup of the Arizona State Retirement System (ASRS) regarding the implementation status of the 17 audit recommendations presented in the Independent Operational Review of the ASRS Investment Strategies, Alternative Asset Investment Procedures, and Fees Paid to External Investment Managers released in August 2015 (Auditor General Report No. 15-CR2). As the attached grid indicates, all 17 recommendations have been implemented.

Unless otherwise directed by the Joint Legislative Audit Committee, this concludes our follow-up work on the ASRS' efforts to implement the recommendations from the August 2015 Independent Operational Review.

Sincerely,

Dale Chapman, Director
Performance Audit Division

DC:ka
Attachment

cc: Paul Matson, Director
Arizona State Retirement System

Arizona State Retirement System Board of Trustees

2910 NORTH 44th STREET • SUITE 410 • PHOENIX, ARIZONA 85018 • (602) 553-0333 • FAX (602) 553-0051

Independent Operational Review of the Arizona State Retirement System's Investment Strategies, Alternative Asset Investment Procedures, and Fees Paid to External Investment Managers

Auditor General Report No. 15-CR2
Initial Follow-Up Report

Recommendation	Status/Additional Explanation
Task 1.b: Compare the ASRS' investment strategies and objectives to best practice, including, but not limited to, industry standards	
1. The ASRS should continue to maintain and update an investment policy statement for the Fund.	**Implemented at 6 months**
2. The assumed actuarial interest rate has not changed over the last ten fiscal years; Gallagher recommends that the ASRS discuss the 8.0% actuarial rate annually with the actuary to ensure that it is appropriate given current asset allocation and projected rates of return. ASRS should maintain a long-term perspective to avoid unwarranted changes to the actuarial rate.	**Implemented at 6 months**
Task 1.c: Determine the processes the ASRS uses to monitor how well its investment strategies and objectives are performing and guide it toward meeting its expected rates of return	
Gallagher recommends that the ASRS ask NEPC to include consecutive calendar year performance for the most recent ten years in the quarterly IPR.	**Implemented at 6 months**
Task 1.h: Determine the causes for any underperformance, including any procedures or requirements that limit the ASRS' investment strategies	
The ASRS should continue to monitor performance of the Fund and the underlying strategies, including adjusting its asset allocation and restructure asset classes as appropriate and reasonable.	**Implemented at 6 months**
Task 2.a: Identify the processes and other controls the ASRS uses for selecting, developing terms and conditions for, monitoring, and valuing investments, and terminating alternative investment manager contracts	
1. Gallagher recommends that the ASRS conduct a thorough review and update of the Strategic Investment Policy at least annually (and more frequently if needed). The current version has been in place for more than 2 years.	**Implemented at 6 months**

Recommendation	Status/Additional Explanation
2. In order to gain additional confidence in valuations, the ASRS should sample a greater number of partnerships. Sampling should include sufficient partnerships to represent at least 50% of the market value of the total alternative investment portfolio.	**Implemented at 6 months**
Task 2.b: Determine whether the ASRS used the identified processes and controls for alternative investment contracts the ASRS entered into during fiscal years 2005 through 2014	
1. Gallagher recommends including sourcing information and screening criteria in the final investment memo for each partnership. These are active parts of the investment process. It would also be beneficial to document where each opportunity came from and what characteristics drove the team to undertake additional due diligence.	**Implemented at 6 months**
2. Gallagher recommends that all specialty consultants adopt Meketa's practice of incorporating the due diligence checklist, as presented in Appendix 1 of SIP006, into their recommendations. The checklist provides a tangible record that due diligence has been performed as prescribed by the consultant, which should give the Private Markets Committee additional confidence in considering the recommendations made by the consultant. Making the checklist a standard practice will also help to ensure consistency across the evaluation of each potential investment.	**Implemented at 6 months**
3. The ASRS should continue the independent reviews of Asset Class Committee meetings by NEPC and record NEPC's reviews in a single document for ease of review and monitoring. NEPC's independent verification that the process has been followed for each investment serves as an important check and balance to ensure that every investment has been vetted properly.	**Implemented at 6 months**
Task 2.c: Determine if the ASRS collects and utilizes monitoring data to improve subsequent contracts	
1. The ASRS should continue to utilize both firms in the legal review of fund terms and documents, as appropriate	**Implemented at 6 months**
2. While both firms have appeared to serve the ASRS well, a documented, periodic review of each service provider can help ensure that the firms continue to serve in the best interest of the Plan. We recommend that such a review be conducted at least every three years.	**Implemented at 6 months**

Recommendation	Status/Additional Explanation
Task 2.d: Compare the ASRS' processes and other controls for selecting, monitoring, and terminating alternative investment manager contracts and valuing investments to best practices, including, but not limited to, industry standards	
1. As listed in Section 2.b, Gallagher recommends the inclusion of sourcing and screening information in final due diligence materials on each fund.	**Implemented at 6 months**
2. A periodic review of all service providers (both investment advisors and legal representation) would help to ensure that the ASRS continues to receive high-quality guidance and advice at a reasonable cost. We recommend that these reviews be conducted at least every three years.	**Implemented at 6 months**
Task 3.a: Identify the processes and other controls the ASRS uses for accepting and/or negotiating external investment manager fees	
The ASRS has a well-considered approach to negotiating investment fees that should be equally well articulated in the documented procedures for selecting investment managers. Gallagher recommends adding an Appendix to SIP006 that explicitly outlines the objectives and preferences for fee negotiations.	**Implemented at 6 months**
Task 3.b: Determine whether the ASRS used the identified processes and controls for accepting and/or negotiating external investment manager fees for contracts the ASRS entered into during fiscal years 2005 through 2014	
The documented procedures mentioned in Section 3.a should include a standard method for documentation of fee negotiations. The documentation should include, at a minimum, the proposed fees from the manager before negotiation, the ASRS proposed fee structure, the final agreement, and be signed by the person(s) responsible for the negotiation.	**Implemented at 6 months**
Task 3.c: Compare the ASRS' processes and other controls over setting external investment manager fees to best practices, including, but not limited to, industry standards	
The ASRS' procedures are well aligned with best practices with the exception of having a dedicated fee negotiation team that must report on all proposed investments before a deal is executed. Gallagher recommends implementing a formal report on fee negotiations to be completed prior to the execution of each investment agreement.	**Implemented at 6 months**

Recommendation	Status/Additional Explanation
Task 3.d: Identify the reasons for and impact of any inadequate processes or other controls	
Gallagher recommends the documentation of fee negotiations should include acknowledgement of where the manager fee ranks compared to an appropriate peer group. Above-median fees should be justified by the perceived ability of the manager to add value over the appropriate benchmark.	**Implemented at 6 months**