MEMORANDUM

DATE: July 6, 2005

TO: OPERS Retirement Board Members
Laurie Hacking - Executive Director

CC: Jenny Hom, Interim Director - Investments

FROM: Greg Uebele, Senior Investment Officer - Private Equity/Real Estate (Interim)

RE: Real Estate/Private Equity Advisor Model

Purpose
Staff and Ennis Knupp + Associates (EKA) discussed the possibility and implications of consolidating the specialist (private equity and real estate) policy and strategy advisory functions with EKA at the last Investment Committee meeting. This topic was originally discussed at the April Investment Committee and at that time, the Trustees directed the staff to develop a plan to consolidate the specialist policy and strategy advisory services with the general advisor, EKA. This memo seeks to address the questions and issues that arose during the June Investment Committee.

Background
In February, the Investment Committee authorized the extension of the Pacific Corporate Group (PCG) advisory agreement for up to one year with the understanding that in the coming months, the staff would bring the private equity advisory requirements to the Investment Committee for further deliberation.

Similarly, in April the Investment Committee authorized an extension to The Townsend Group (TTG) advisory agreement for up to one year, again with the proviso that the staff would bring the advisory requirements to the Investment Committee for further deliberations.

Separately during the April Investment Committee meeting, the staff presented a review of the private equity program highlighting the changed advisory needs since the February 2002 contract inception with PCG. As described, the private equity advisor (and by extension the real estate advisor) works very closely with the staff and yet reports directly to the Board. This structure creates a potential agency issue whereby Trustees may question whether the specialist policy and strategy advisory services they receive are truly unbiased due to the close and extensive interactions with the staff. The Trustees expressed a desire to consolidate the private equity and real estate policy and strategy advisory services with the general consultant in order to mitigate this potential agency issue and provide a better total fund perspective on policy and strategy.
During the June Investment Committee meeting, two significant unresolved considerations were raised. First, the Trustees weighed their desire to consolidate their specialist policy and strategy advisory requirements with the general advisor to mitigate potential agency issues versus keeping them separate to have more perspectives and make more informed decisions. Secondly, although the staff worked with EKA in preparing their policy and strategy consolidation proposal, the proposed scope of work was larger than the staff expectations resulting in a material difference in net costs and confusion on proposed advisory requirements versus those existing with the specialist advisors.

Further Considerations
Existing Policy and Strategy Advisory Services
To date, the staff has presented largely conceptual considerations regarding the possibility of consolidating the specialist policy and strategy advisory services with the general advisor. The end products of the policy and strategy work are the associated policies and respective strategy sections in the annual Investment Plan. Upon reflection, it may be helpful to step back and review details of the existing policy and strategy advisory requirements.

Attachments A, C and D show the scope of work sections from the EKA, PCG and TTG agreements. Item A8 of the EKA agreement states that they will ‘Perform each and every duty set forth in the PERS’ Request for Proposal dated March 1, 2001’ and thus this section of the RFP is included in Attachment B. The following paragraphs highlight the policy and strategy components from the respective agreements.

Ennis Knupp + Associates - General
The EKA agreement predates those of PCG and TTG and thus it did not contemplate the addition of specialist advisors. While this agreement has been revised from time to time, it has never been modified to acknowledge any separation of advisory requirements between advisors to the Board. Furthermore, the EKA agreement makes no distinctions between policy and strategy services at the fund or asset class levels. Thus, one may infer that EKA requirements include oversight of all investment policies and strategies.

Item A7 addresses the requirement for policy assistance while the strategy requirements are addressed through A8 and the March 1, 2001 RFP.

Pacific Corporate Group - Private Equity
Assistance with strategic planning is explicitly required through item 1 and policy advice is inferred through items 1 and 10.

The Townsend Group - Real Estate
The TTG scope of work is separated into an initial program review and post-review efforts. The program review explicitly requires policy and strategy efforts through items A1-4. Item B3 infers ongoing assistance with policy and B15 explicitly requires assistance with ongoing strategy.

Thus, a literal interpretation of our advisory agreements confirms that the Board currently receives private equity and real estate policy and strategy advice from the generalist and respective specialist advisors. As a practical matter, this is evidenced through their coordinated participation in policy and Investment Plan reviews and associated approval memos.
Degrees of Advice
While the staff prepares and coordinates revisions, policies are wholly within the purview of the Investment Committee and the Board. The specialist advisors are at least as qualified as the general advisor regarding their respective asset class policies, but the general advisor is more qualified to advise on the appropriateness of these asset class policies within the context of the total fund.

As with the other asset classes, the private equity and real estate staff are highly qualified and responsible for establishing the strategies and achieving the established performance objectives. Due to the unique characteristics of private investments, specialized advisory firms have evolved to provide services including strategic advice. These specialist advisors generally have deep domain experience and proprietary data that are not easily replicable. For the most part, general advisors do not have this same depth of specialized expertise. Thus, specialist advisors are more capable of assisting with the development of detailed strategic planning while general advisors are better suited to opine on the appropriateness of the strategies within the policy framework as they do with the other asset classes.

Potential Agency Issues
The staff recognizes the potential agency issue concerns of the Trustees. Since it is imperative that the staff work closely with the specialized advisors (and in fact with the general advisor too), these potential agency issues will exist so long as the Trustees seek independent opinions from these advisors. All Investment advisors are fiduciaries to OPERS and the Trustees have access to them regardless of explicit or implicit reporting requirements within the agreements.

Multiple Advisory Perspectives
It is difficult to weigh the added value from multiple policy and strategy advisory services against the associated potential agency issues. Thus notwithstanding the costs and implementation differences, the Trustees’ selection of a desired advisory model may be largely subjective. Provided that the staff is still permitted to engage specialist advisors for due diligence and other requirements as needed, the staff is indifferent to the policy and strategy advisory model. It will be helpful however, to clearly articulate the expected policy and strategy advisory roles and responsibilities in order to effectively execute the Trustees’ plans.

Scope of Work and Costs
Before the June Investment Committee meeting, the staff worked with EKA to develop and refine a proposal to consolidate the specialist policy and strategy advisory services with EKA. As you recall, there were expectation differences between EKA and the staff that resulted in wide variances in the scope of work and associated costs.

In retrospect, we failed to appreciate the ambiguity of the associated policy and strategy advisory roles and responsibilities. Should the Trustees desire to pursue the consolidated policy and strategy advisory model, clear requirements expectations should be established before considering the advisor qualifications and net costs. If the costs are material, we may consider re-bidding the general advisor agreement to ensure compliance with the OPERS Purchasing and Competitive Selection Process for Goods and Services.

Options
As discussed in April and June, the staff is prepared to implement any policy and strategy advisory model that the Trustees desire. As a reminder, the staff is actively evaluating the private equity and real estate advisory requirements and will bring these topics as discussion
items at upcoming Investment Committee meetings. The following advisory model options are presented for your consideration.

1. Continue with the existing advisory services model.
   - Potential agency issue remains unchanged.
   - No cost impact.
   - Multiple sources of policy and strategy advice.
   - Allows time to consider the staff’s private equity and real estate advisory requirements.

2. Consolidate the policy and strategy advisory roles with the general advisor.
   - Reduced potential agency issues.
   - Possible cost impact.
   - One source of policy and strategy advice.
     (The specialist advisors could be required to provide policy and strategy services as requested.)

3. Defer the consolidation until the general advisory services are re-bid
   - Potential agency issue remains unchanged in the near term.
   - No near term cost impact.
   - Multiple sources of policy and strategy advice in the near term.
   - Allows time to consider the staff’s private equity and real estate advisory requirements.
   - Allows for a comprehensive assessment of general advisor capabilities and costs.

**Next Steps**
Staff is prepared to implement the policy and strategy advisory services requirements as directed. Please note that the private equity staff is prepared to consider specific staff advisory needs at an upcoming Investment Committee meeting in order to issue a Request for Proposal and complete an agreement before the existing agreement with PCG expires in February. Similarly, the real estate staff is preparing to discuss their advisory needs in the Fall in order to complete a re-bidding of the required services before the TTG agreement expires in April.
II. SCOPE OF WORK

A. Contractor shall provide the following for PERS

1. Prepare quarterly reports summarizing the investment performance of PERS’ total fund and each and every manager of said fund prior to the 40th business day after quarter end. Said reports shall include:
   a. An analysis of the then current environment of the financial markets.
   b. A review of the performance of the major market indexes over the trailing quarter.
   c. An analysis of the asset allocation of PERS’ then current investment program.
   d. Complete return analysis for PERS’ total fund and the constituents thereof.
   e. A review of the investment results of each and every of PERS’ portfolios in the context of said portfolios’ objectives and benchmarks.
   f. Specific commentary on the factors affecting the performance of PERS’ portfolios.

2. Conduct ongoing discussion with PERS’ investment managers. These discussions shall focus on, but not be limited to, the manager’s investment performance, changes of ownership, retention of professional staff, fee changes and new products.

3. Communicate to PERS any important development discovered as a result of the monitoring, described in Sub Paragraph 2 of this Paragraph A, and any recommendations resulting therefrom.

4. Attend, as required by PERS, the monthly meetings of PERS’ Board.

5. Be available for phone consultation with PERS’ staff.

6. Make available to PERS, Contractor’s written research and memoranda relevant to PERS’ investment program.

7. Assist PERS with investment policy matters, asset liability studies, and investment manager searches. Said assistance with investment managers searches includes database screening, request for proposal construction and evaluation, subjective manager assessments and performance analysis.


9. Provide consulting services for the health care portfolio similar to the services provided for the PERS total fund. This will include, but are not limited to: separate performance reporting and manager monitoring (where necessary), an annual review of plan solvency including asset allocation review, review of staff annual plan, and consulting of a general nature on issues related to the health care plan.

10. Provide support to the Defined Contribution Plan. These services include but are not limited to work evaluating and selecting managers, consulting on plan design and performance reporting.

11. While Contractor shall work extensively with staff in providing the services listed in this agreement, Contractor recognizes that Contractor is accountable to and reports solely to the PERS Board of Trustees.
12. Make available to PERS the most current version of the Contractor’s risk budgeting software.

B. PERS shall:

Notify Contractor of any developments or changes that to PERS’ knowledge will affect the service provided by Contractor pursuant to this Agreement.

C. The parties agree that the following shall fall outside the scope of work set forth in the Section II:

1. Consulting on asset pools other than the defined benefit plan, the defined contribution plan and health care portfolio
2. Attendance at manager or due diligence visits
3. Assistance with recruiting or interviewing
4. Operational support of ongoing risk budgeting activities
5. Management of asset transitions
6. Other services not set forth in Paragraph II.A above the cost of which services exceeds ten thousand dollars ($10,000.00).
PERS is seeking a qualified firm to provide comprehensive investment consulting advice and services. The selected investment consulting firm will report directly to the Board of Trustees. The selected firm will work closely with the Board of Trustees and the PERS Investment Staff. The successful firm will demonstrate extensive experience and superior capability for providing those investment consulting services that are critical to the success of large, statewide pension systems.

In general, the successful firm will assist the Board in the on-going process of investment policy review and compliance, strategic investment planning and asset allocation decisions. The selected firm will provide to the Board an independent assessment of major Staff recommendations and proposed actions. The successful firm will also be responsible for providing timely, accurate, and meaningful performance reporting to the Board. A significant part of this reporting will include advising the Board on quarterly, annual, and long-term portfolio performance within the context of the long-term investment strategies adopted and implemented by PERS. The Board will rely primarily on Staff for investment support and recommendations. However, the firm will be asked to comment on Staff recommendations, where appropriate, and as requested by the Board. The firm will serve in a fiduciary capacity and will acknowledge in writing the firm’s fiduciary status, without qualification. In all cases, the firm and its consultants will offer its advice to PERS solely in the interest of the plan participants and beneficiaries of PERS.

Specifically, the successful firm will demonstrate superior experience and capability in the areas of investment policy development and compliance, asset allocation, and risk management. The successful firm will support staff’s efforts with respect to other matters described more fully below. PERS is seeking a general investment consultant to perform the following duties:

Policy Duties:

- Assist the Board in the on-going process of investment policy review and compliance, strategic investment planning, and asset allocation decisions.
- Provide to the Board and independent assessment of major Staff recommendations and proposed actions.
- Provide recommendations concerning long-term investment policy, investment objectives and strategy, including manager continuation policies and rebalancing policies.
- Provide recommendations concerning proxy voting policies and guidelines.
- Provide recommendations concerning risk management strategies.
Asset Allocation & Total Portfolio Duties:

- Conduct periodic (i.e., 3-5 years) asset allocation/asset liability studies. Since a comprehensive study was recently performed, it is expected that the first such study would not commence prior to 2003 or 2004.
- Provide asset class research, analysis, and recommendations.
- Provide an independent assessment of the use of real estate and alternative investment strategies as directed.
- Provide access to analytical software and tools with respect to asset allocation and total portfolio issues.
- Assist in monitoring system surplus or deficit funded status relative to current asset allocation.
- Provide recommendations concerning risk management strategies at the total portfolio level.
- Provide recommendations concerning securities lending strategies, upon request.
- Assist Staff in fee negotiations, as requested.
- Provide recommendations concerning brokerage issues, including directed brokerage, commission recapture, or low transaction cost trading strategies (cost containment strategies).

Investment Manager Oversight Duties:

- Support and provide on-going monitoring of internally and externally managed accounts (by asset class). Report to the Board, as necessary, concerning those accounts.
- Maintain a broad database of investment managers including their philosophies, styles, fee schedules, portfolio characteristics, firm characteristics, performance, and client base. The manager database should include equity, bond, and international, as well as real estate fund managers, alternative investment fund managers, and currency overlay specialists.
- Provide recommendations concerning manager allocation and structure. In the event the Board should engage in one or more manager searches during the contract term, assist Staff, as requested, with duties which may include but not be limited to, development of Requests for Proposals (RFPs), development of evaluation factors and methods, preparation of background material, interviewing managers, and making recommendations concerning the selection of managers. These tasks would be performed infrequently.
- Provide investment manager compliance monitoring, including compliance monitoring for the internally managed accounts.

Performance Measurement Duties

- Provide quarterly and annual, AIMR compliant performance evaluation reporting consistent with respective benchmarks/performance objectives (including style benchmarks), guidelines, and risk levels.
- Provide performance measurement, monitoring, attribution, style analysis, and risk analysis for 1) total portfolio, 2) all asset categories (including private
markets) 3) all individual external managers and 4) all portfolios managed internally by PERS Staff.

- Assist Staff in reviewing written guidelines with respect to establishing cause for placing an external manager on probation and in terminating an external manager if necessary. Prepare analyses on problem managers, as needed.
- Evaluate internal and external managers’ performance consistent with their benchmarks/performance objectives (including style benchmarks), guidelines, and risks undertaken. Rank managers, including internally managed accounts, against a relevant universe.
- Provide benchmark evaluation, implementation, and analysis, as requested.
- Compare total benchmark portfolio investment performance to custom policy benchmark to demonstrate the value added by active management (if any).
- Provide an evaluation of the value added specifically from the consulting advice provided by the firm.

**Training, Education and Client Relations Duties:**

- Attend regular monthly and special meetings of the Board. Regular monthly meetings are held in Columbus, Ohio on the third Tuesday of each month. In the future and as the consulting relationship becomes more established (e.g., within 6-9 months), it may be necessary for the consultant to attend Board meetings only quarterly with ad hoc special meetings at the Board’s request.
- Provide investment education and training to the Board and Staff on a periodic basis, as requested.
- Proactively advise the Board and Staff of new investment vehicles and techniques or major changes in existing practices within the industry and, upon request, prepare a comprehensive analysis and make recommendations concerning these activities.
- Participate in an annual planning session with Investment Staff.
- Provide assistance on special projects, as needed.
- Participate in ad hoc workshops on specific issues designated by the Board and Staff.
- Take an active role in planning and conducting the annual investment retreat. **Note:** The Board would like the selected firm to participate in their July 28-31, 2001 investment retreat which will be held in Springfield, Illinois.
- Respond in an agreed-upon and timely manner to Board member and/or Staff inquiries between meetings.
- Share all firm research, including white papers, and provide access to the research staff.
- Report any significant changes in the firm’s organizational structure and staffing in a timely manner to PERS.
- Make no changes to assigned consultant team without the express approval of PERS.

The investment consultant may also be asked to provide other services as required by the Board of Trustees and/or the Investment Staff.
II. SCOPE OF WORK

A. Contractor shall:

1. Assist with strategic planning with respect to PERS’ private market allocation.

2. With respect to each private equity proposal evaluated by the Consultant, furnish the Assistant Investment Officer – Private Equity a due diligence determination (i.e. an investment recommendation or no further interest) with respect to the proposal.

Said report will contain a summary of the proposed investment and describe the general partner’s background, track record and organization; the proposed investment strategy; the terms of the investment; the expected rate of return; the merits and risks of the investment; any issues and concerns surrounding the investment and how they might be resolved; and issues and provisions that should be subject to negotiation.

3. Provide performance measurement and portfolio reporting including but not limited to:

   a. Evaluate each investment on a quarterly basis and provide a comprehensive quarterly report to include a portfolio overview followed by portfolio detail. Said report shall include:

      i. current status, to include commitment, date of initial investment, dollars invested, valuation at quarter-end, cumulative distributions received, total valuation (i.e., valuation plus cumulative distributions) and unfunded commitments. The financial statements issued by the partnerships will be the source of valuations for each investment and, where appropriate, the source of underlying portfolio information (e.g., company name, cost, value, location and business description). The consultant will evaluate the usefulness and appropriateness of the data identifying areas of concern.

      ii. internal rate of return since inception;

      iii. subjective evaluation and ranking of each partnership that takes into account organizational issues and General Partner turnover, quality of portfolio companies and performance of the fund versus similar funds of the same vintage year.

      iv. outlook for investment; and,

      v. action required, if any.

5. Present a comprehensive annual report to the PERS’ Investment Committee including but not limited to an assessment of strategy, policy compliance, portfolio composition and portfolio activity as described in Subparagraph (A)(3) of this Article II.

6. Appear before PERS’ Investment Committee as requested.

7. Provide ongoing training and educational opportunities to PERS’ investment staff and the Investment Committee members.

8. As directed by PERS, represent PERS in partnership meetings, negotiations and other matters necessary to the protection of the PERS’ investment interests.


10. Perform additional projects within the scope of Contractor’s expertise, as are reasonably requested by PERS.

11. Neither have nor exercise any discretionary control over any of PERS’ assets.

12. Act with respect to any transaction arising from or pertaining to this Agreement, or involving any interest of PERS, only under this Agreement and shall not receive any remuneration in connection with such transaction except under this Agreement. Subject to the provisions of this Agreement, Contractor shall be permitted, with full disclosure to PERS, to represent other clients evaluating investments, including investments evaluated for PERS hereunder. Further, Contractor shall fully disclose to PERS any existing or potential conflict of interest in the services performed by Contractor under this Agreement, including without limitation due diligence and research, upon which PERS may rely.
II. SCOPE OF WORK

A. Contractor shall in conjunction with an initial review of PERS’ real estate program:

1. Conduct comprehensive assessment of real estate strategy, managers, and investments.

2. Provide Board recommendations concerning real estate investment goals, policies, and procedures.

3. Work with staff to develop a long-term real estate strategic plan, which incorporates the Board’s perspective. Review annually, and update as necessary, the long-term plan referred to in Paragraph 7 of this Article II.

4. Work with staff to review, modify, and develop as appropriate a Real Estate Investment Policy and supporting policies covering all major facets of the Real Estate program. Such supporting policies include, but are not limited to; responsible contractor, leverage, manager evaluation, risk management, property valuation, benchmark, areas of investment, holding structures and legal theory for asset control.

5. Assist staff in the development and implementation of procedures to support policies and report to the Board concerning these internal processes as compared to other large institutional investors.

B. Contractor throughout the term of this Agreement or any extension thereof shall:

1. Review, evaluate, in a form suitable to PERS, and provide input to the Board concerning the functions retained by PERS’ staff.

2. Act as an independent advisor to PERS’ Board of Trustees (“Board”).

3. Provide a continuing assessment of the health, direction, and competitiveness of PERS’ real estate program.

4. Work cooperatively and constructively with other consulting organizations that PERS has retained.

5. Attend up to twelve (12) Board and or staff meetings or offsite visits, upon request.

6. Assist staff in the periodic evaluation of investment advisors. Said evaluation shall include, but not be limited to; performance, organizational stability, deal-flow fairness, fees and incentive arrangements, internal controls, risk control and diversification, contract review, potential conflicts of interest.

7. Assist staff in the identification, evaluation, and selection of new advisors.
8. Assist staff with the evaluation of real estate investment opportunities and appraisal process for current investments, as requested by PERS.

9. Provide performance measurement, monitoring, attribution, style analysis, and risk analysis for real estate investments.

10. Prepare a quarterly report of real estate performance and present report to Board.

11. Provide ongoing monitoring of advisor compliance with articulated policies, guidelines, contracts, and other provisions.

12. Evaluate and provide input to the Board and staff concerning the performance evaluation framework and benchmarks.

13. Evaluate and provide input to the Board and staff regarding the performance and overall cost of the real estate program.

14. Provide education to the Board on real estate as requested by PERS.

15. Assist staff, as requested, in the preparation of an annual investment plan.

16. Act with respect to any transaction arising from or pertaining to this Agreement, or involving any interest of PERS, only under this Agreement and shall not receive any remuneration in connection with such transaction except under this Agreement or as may be determined by mutual agreement of PERS and Contractor in writing in advance. Further, Contractor shall fully disclose to PERS any existing or potential conflict of interest in the services performed by the Contractor under this Agreement, including without limitation due diligence and research, upon which PERS may rely.