



ARIZONA STATE RETIREMENT SYSTEM

3300 NORTH CENTRAL AVENUE • PO BOX 33910 • PHOENIX, AZ 85067-3910 • PHONE (602) 240-2000
7660 EAST BROADWAY BOULEVARD • SUITE 108 • TUCSON, AZ 85710-3776 • PHONE (520) 239-3100
TOLL FREE OUTSIDE METRO PHOENIX AND TUCSON 1 (800) 621-3778
EMAIL ADDRESS: ASKMAC@AZASRS.GOV • WEB ADDRESS: WWW.AZASRS.GOV

Paul Matson
Director

August 12, 2015

Mark Melnychuk
Arthur J Gallagher & Co
3600 American Blvd West, Suite 500
Bloomington, MN 55431

Dear Mr. Melnychuk:

Below are the Arizona State Retirement System responses to the recommendations contained in the *Arizona State Retirement System (ASRS) Operational Review* report your firm prepared as a part of the Office of the Auditor General's performance audit and sunset review of the ASRS.

Task 1: Determine the Fund's investment performance during the past 10 fiscal years (2005 through 2014), identify the causes for and impact of any underperformance and make recommendations for improving the Fund's investment performance, as appropriate.

Task 1.b: Compare the ASRS' investment strategies and objectives to best practice, including but not limited to industry standards

1. Recommendation: The ASRS should continue to maintain and update an investment policy statement (IPS) for the Fund.

ASRS Response: The finding of Arthur J Gallagher & Co is agreed to and the audit recommendation will be implemented. Per the ASRS Governance Handbook, the ASRS Investment Committee reviews the IPS annually; modifications to the IPS require full Board approval.

2. Recommendation: 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.

ASRS Response: The finding of Arthur J Gallagher & Co is agreed to and the audit recommendation will be implemented.

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

1. Recommendation: Gallagher recommends that the ASRS ask NEPC to include consecutive calendar year performance for the most recent ten years in the quarterly IPR.

ASRS Response: The finding of Arthur J Gallagher & Co is agreed to and the audit recommendation will be implemented. The independent general investment consultant, NEPC, has commenced reporting annual calendar year performance in the ASRS quarterly Investment Performance Report. This information was included in the ASRS Q1-2015 Investment Performance Report.

Task 1.h: Determine the causes for any underperformance, including any procedures or requirements that limit the ASRS' investment strategies

1. Recommendation: The ASRS should continue to monitor performance of the Fund and the underlying strategies and adjust its asset allocation and restructure asset classes as appropriate and reasonable.

ASRS Response: The finding of Arthur J Gallagher & Co is agreed to and the audit recommendation will be implemented.

Task 2: Determine if the ASRS has adequate processes and other controls for selecting, monitoring, and terminating contracts with alternative investment managers and valuing these investments, identify the reasons for and impact of any inadequate controls and make recommendations for improving controls, as appropriate.

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. Recommendation: 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.

ASRS Response: The finding of Arthur J Gallagher & Co is agreed to and the audit recommendation will be implemented.

2. Recommendation: 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.

ASRS Response: The finding of Arthur J Gallagher & Co is agreed to and the audit recommendation will be implemented.

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. Recommendation: Gallagher recommends including sourcing information and screening criteria in the final investment memo for each partnership. These are active parts of the investment process, and it would be beneficial to document where each opportunity came from and what characteristics drove the team to undertake additional due diligence.

ASRS Response: The finding of Arthur J Gallagher & Co is agreed to and the audit recommendation will be implemented.

2. Recommendation: 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 the 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.

ASRS Response: The finding of Arthur J Gallagher & Co is agreed to and the audit recommendation will be implemented.

3. Recommendation: The ASRS should continue the independent reviews of Asset Class Committee meetings by NEPC. 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.

ASRS Response: The finding of Arthur J Gallagher & Co is agreed to and the audit recommendation will be implemented.

Task 2.c: Determine if the ASRS collects and utilizes monitoring data to improve subsequent contracts

1. Recommendation: The ASRS should continue to utilize both firms in the legal review of fund terms and documents, as appropriate.

ASRS Response: The finding of Arthur J Gallagher & Co is agreed to and the audit recommendation will be implemented.

2. Recommendation: 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.

ASRS Response: The finding of Arthur J Gallagher & Co is agreed to and a different method of dealing with the finding will be implemented. The ASRS review will be conducted to coincide with the procurement cycle.

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. Recommendation: As listed in Section 2.b, Gallagher recommends the inclusion of sourcing and screening information in final due diligence materials on each fund.

ASRS Response: The finding of Arthur J Gallagher & Co is agreed to and the audit recommendation will be implemented.

2. Recommendation: 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.

ASRS Response: The finding of Arthur J Gallagher & Co is agreed to and a different method of dealing with the finding will be implemented. The ASRS review will be conducted to coincide with the procurement cycle.

Task 3: Determine if the ASRS has adequate processes and other controls over external investment manager fees, identify the reasons for and impact of any inadequate processes and controls, and make recommendations for improving processes and controls, as appropriate.

Task 3.a: Identify the processes and other controls the ASRS uses for accepting and/or negotiating external investment manager fees

1. Recommendation: 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 outline the objectives and preferences for fee negotiations.

ASRS Response: The finding of Arthur J Gallagher & Co is agreed to and the audit recommendation will be implemented.

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

1. Recommendation: 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.

ASRS Response: The finding of Arthur J Gallagher & Co is agreed to and the audit recommendation will be implemented.

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

1. Recommendation: 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.

ASRS Response: The finding of Arthur J Gallagher & Co is agreed to and the audit recommendation will be implemented.

Task 3.d: Identify the reasons for and impact of any inadequate processes or other controls

1. Recommendation: 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.

ASRS Response: The finding of Arthur J Gallagher & Co is agreed to and the audit recommendation will be implemented subject to availability of appropriate peer data.

Sincerely,

Paul Matson
Director

cc: Ms. Debbie Davenport, Auditor General