METROPOLITAN GOVERNMENT OF NASHVILLE AND DAVIDSON COUNTY

OFFICE OF INTERNAL AUDIT

Professional Audit and Advisory Service

FINAL REPORT

Follow-Up Audit of Metropolitan Employee Benefit Board Pension Investments

Date Issued: July 29, 2009

Office Location and Phone Number

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Nashville, Tennessee 37201

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The Metropolitan Nashville Office of Internal Audit is an independent audit agency reporting directly to the Metropolitan Nashville Audit Committee

EXECUTIVE SUMMARY
July 29, 2009

Results in Brief	Recommendations
A renewed follow-up audit concerning the implementation status of the April 2000 *Metropolitan Employee Benefit Board Pension Plan* audit recommendations was completed. 1. Were recommendations outlined in the performance audit of *Metropolitan Employee Benefit Board Pension Investments* issued on April 30, 2000, implemented and still effective? Yes. All significant recommendations were implemented and still effective.	Seven (7) carry-forward recommendations related to issues indentified from the prior audit report were included for the Investments Committee's information. • Update the Statement of Investment Policy to reflect the current utilized bond index, Barclay's Capital Aggregate Bond Index. • Include analysis of net-of-fee performance comparisons in Quarterly Reports to supplement the current gross-of-fee analysis. • Define Investments Committee minimum investment/finance expertise requirements. • Improve Investments Committee financial disclosure and conflict of interest policy acknowledgement. • Update the Metro general ledger with pension investment activity within 30 days of statement receipt. • Periodically review terms and conditions of investment manager contracts. • Include risk return analysis for all investment managers.

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INTRODUCTION

AUDIT PURPOSE

A renewed follow-up concerning the implementation status for the April 2000 *Metropolitan Employee Benefit Board Pension Plan* audit was conducted to determine if implemented recommendations were still working effectively. Previously, in 2003, the Finance Department Division of Internal Audit determined all recommendations were implemented. The significance of the issues in the original report and the magnitude of the market value for the pension and deferred compensation plans merited a renewed follow-up audit. The pension plan's market value was $1.6 billion as of December 31, 2008 and the deferred compensation plan's market value was $117 million as of March 31, 2009.

BACKGROUND

The Metropolitan Government of Nashville and Davidson County Employee Benefit Pension Plan (the Plan) is the primary source for funding employee disability and pension benefits for 12,987 active employees, 5,162 pensioners and 949 disabled employees. Metro provides a defined pension income benefit for employees eligible for a pension. This amount supplements benefits an employee may receive from social security. Average annual pension benefits were $11,670, $10,427 and $20,148 for current disabled, general government, and fire and police pensioners respectively.

The MetroMax 457 deferred compensation plan had 6,381 participants as of March 31, 2009.

The Plans Investments Committee regulates and determines all matters dealing with investment of funds committed to the defined benefit pension and MetroMax 457 deferred compensation plans. The Investments Committee engages an investment consultant and investment managers in order to manage investments effectively and achieve competitive return while maintaining appropriate levels of diversification and risk. The Statement of Investment Policy is the governing document for the Plan, and outlines the objectives of the Plan. The overall objective of the Plan is to outperform a composite of unmanaged market indices. The Plan has not been immune from the recent economic crisis with a Fourth Quarter 2008 loss in market value held to $251.1 million. The Plan's *Quarterly Performance Report through December 31, 2008* stated:

> *"Overall Total Composite performance exceeded the Policy Index during the fourth quarter of 2008, as the Benefit System returned negative 13.1% versus the negative 13.8% Policy Index return."*

OBJECTIVE AND CONCLUSION

The Metropolitan Office of Internal Audit (OIA) contracted with KPMG LLP to renew previous follow-up efforts for the April 2000 audit of the *Metropolitan Employee Benefit Board Pension Plan*.

1. Were recommendations outlined in the performance audit of Metropolitan Employee Benefit Board Pension Investments issued on April 30, 2000, implemented and still effective?

   Yes. All significant recommendations were implemented and still effective. The OIA determined that of the 43 recommendations included in the audit report, 36 were implemented, two (2) were partially resolved, one (1) was not resolved and three (3) lacked documentation to support prior corrective action efforts. Details of the audit work performed can be found in the KPMG report to the OIA (see Attachment B.)

   Exhibit 6 - Summary of Audit Recommendation Follow-up

Status	Number	Percent
Implemented	36	86
Partially Resolved	2	5
Not Resolved	1	2
Unable to Address	3	7
Total	42	100

   The issues not fully implemented are summarized in the Results of Follow-Up Audit Section of the report (page 3) for the Investments Committee's consideration.

RESULTS OF FOLLOW-UP AUDIT

Summary of Significant Resolved Issues

All of the following significant issues included in the April 13, 2000 audit report have been resolved.

A. The Investments Committee has established an investment consulting arrangement with inherent conflicts of interest, then has relied exclusively on the consultant for advice to manage Metro's pension investments. The consultant has not been providing the Investments Committee with all of the information the Investments Committee needs to fulfill it's responsibility to manage pension investments.

- Metro's investment consultant is not independent and has provided the Investments Committee with misleading information, resulting in Investments Committee decisions that generated higher commissions.
- The Investments Committee has been relying solely on the advice of a consultant with an inherent conflict of interest to advise them on how to manage pension fund investments.
- The investment consultant does not adequately report pension investment performance to the Investments Committee.

<u>*Current Status:*</u>
Soft dollar commissions to pay for consultant advisory services are no longer practiced. The current investment consultant, Segal Advisors, compensation is an all-inclusive fixed cost of $230 thousand per year. This fees arrangement does allow for more objectivity in the consideration of investment options, such as passive investments.

Metro hired a Chief Investment Officer in 2003 who provides decision analysis and commentary for recommendations initiated by the investment consultant.

Quarterly reporting of the Plan's investment performance has been improved by the following practices:

- *A static policy benchmark comparison is provided.*
- *Investment managers estimated annual fees are provided.*
- *Risk analysis are provided for all investments except real estate after three years of historic data is available.*
- *Plan's asset classes and manager allocation weights for the prior period are presented for comparison.*
- *An extended total fund performance horizon is provided, over 15 years.*

B. The Investments Committee has not taken adequate steps to ensure that the contracts surrounding pension fund management have been procured in a manner to provide the maximum value at an appropriate cost.

Current Status:
The investment consultant contract was put out for public bid in 2000 and again in 2005. The current investment consultant, Segal Advisors, compensation is an all-inclusive fixed cost of $230 thousand per year. See Attachment B, pages 22 to 23 for more details.

C. The Investments Committee's investments in real estate, venture capital and other alternative investments are made without appropriate analysis and are not adequately monitored.

Current Status:
As of December 31, 2008, decisions to pursue such investment opportunities are subject to the same procedures as all investment decisions.

The investment consultant, Segal Advisors, covers all of the assets classes in the Plan including real estate, venture capital and alternative investments. Their Quarterly Performance Reports include information on these types of investments facilitating the Investments Committee's monitoring of these investments types. See Attachment B, pages 41 to 44 for more details.

D. The employee deferred compensation plans have not been monitored, and several of the options are performing poorly.

Current Status:
The Investments Committee is currently overseeing the MetroMax 457 Deferred Compensation Plan to determine if current investment options are still meeting performance criteria. See Attachment B, page 45 for more details.

Partially Resolved Issues

IIIA-2: Investments Committee members are not required to sign a conflict of interest form. (See Attachment B, page 26.)

IVA-4: The section on the "Consultant to the Investments Committee" in the investment manager contracts clearly states that the consultant is the Phillips Group of Paine Webber. (See Attachment B, page 31.)

Not Resolved Issue

IIIA-4: There were no procedures to ensure that investment balance totals reported on the general ledger, the State Street and Northern Trust reports, and the Paine Webber quarterly performance reports were in agreement. (See Attachment B, page 28.)

Unable to Address

The Metro Office of the Treasurer was unable to locate the asset allocation study conducted in 2001 by Segal Advisors that was originally used to justify the current asset allocation. Due to the time elapsed since 2001, retention of this study was not required. An evaluation of the completeness of corrective action for issues IIB-3, IIB-4 and IIB-5 could not be fully determined because this study was not available. Documentation was available for the September 2006 asset allocation update; however, no changes were made to the allocation based on this study. (See Attachment B, page 16.)

KPMG was able to compare the current asset allocation per the Investment Policy to published values. Based on this comparison, the December 31, 2008 allocation appears relatively consistent with the Investment Policy target and other similar plans. (See Appendix B, page 15, table 4.)

CARRY-FORWARD RECOMMENDATIONS

The recommendations below are for carry-forward issues indentified in the prior audit report and are for the Investments Committee's information and do not require a written response.

A - Update Statement of Investment Policy to Reflect Current Bond Index

Revise the Statement of Investment Policy to replace the Lehman Brothers Index with Barclay's Capital Aggregate Bond Index.

Office of Treasurer Comments:
The next Investment Policy update will include the change from Lehman to Barclay's.

B – Include Analysis of Net-of-Fee Performance in Quarterly Reports

In the Quarterly Performance Reports, include an analysis of net-of-fee performance comparisons versus the appropriate benchmarks in addition to the current gross-of-fee analysis. This will allow the Investments Committee to properly analyze the performance of investment managers, and will facilitate appropriate consideration of passive investments.

Office of Treasurer Comments:
The Investments Committee receives complete industry standard disclosure of performance and investment manager fees. Further, the operational report discloses total investment manager fees both as dollars and as basis points with four years of history. Additional reporting is unnecessary and would not provide additional actionable information to the Investments Committee.

C – Define Investments Committee Expertise Requirements

Implement additional requirements regarding the composition of the Investments Committee whereby certain members are required to possess appropriate investment and/or financial expertise.

Office of Treasurer Comments:
This would require a Metro Charter change and is outside the authority of the Investments Committee and the Office of the Treasurer.

D – Improve Investments Committee Financial Disclosure and Conflict of Interest Policy Acknowledgement

Require members of the Investments Committee to complete and sign financial disclosures and conflict of interest forms every year.

Office of Treasurer Comments:
The Investments Committee is considering a specific ethics policy, based on recognized industry standards, which provides additional guidance regarding fiduciary responsibilities. Also as noted, the members of the Investments Committee are subject to *Section 2.222 Standards of Conduct, Disclosure of Interest, and Enforcement of the Metropolitan Code*, which does not require them to make annual disclosures.

E – Update the Metro General Ledger with Pension Investment Activity Within 30 Days of Statement Receipts

Revise the procedures surrounding pension investment accounts to require activity, as reported by the custodian, to be recorded to the general ledger within 30 days of statement receipt.

Division of Accounts Comments:
Division of Accounts agrees with this finding and recommendation. In checking the EnterpriseOne financial accounting system, the December 2008 investment balance updates posted on March 26, 2009. Our internal policy is to have these balances updated within 45 days of receipt of the custodian statements. The December 2008 balances were posted a couple of weeks late, and we agree that we should follow the 45 day policy. Since the general ledger balances are not used for monitoring investment performance or for reporting investment balances at any time other than June 30, we feel 45 days after the receipt of statements is appropriate.

F – Periodically Review Investment Manager Contracts

Implement provisions whereby the terms and conditions of investment manager contracts, including fee arrangements, are reviewed, evaluated, appropriately updated, and approved by both management and the Investments Committee on a regular basis, at a minimum every five years.

Office of Treasurer Comments:
Conditions of contracts are updated as necessary.

G - Include Risk Return Analysis for all Investment Managers

In the Quarterly Performance reports, include risk return analysis for all investment managers.

Office of Treasurer Comments:
Current risk return reporting is based on industry standard. It is industry standard to begin reporting this type information after three years of history are available for the investment. Real estate investments are valued quarterly and the only difference in performance and risk is related to the cost and effect of leverage. Performance reports will include appropriate risk

information after three years of data are available for all investment categories except real estate. The comparison for real estate does not add useful, actionable information.

GENERAL AUDIT INFORMATION

STATEMENT OF COMPLIANCE WITH GAGAS

We conducted this follow-up audit from February to April 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our observations and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our observations and conclusions based on our audit objectives.

SCOPE AND METHODOLOGY

The audit period focused primarily on the pension investment portfolio and the deferred compensation plan as of December 31, 2008 and performance on the governance processes in place during the time of the audit. Certain analyses required the consideration of performance and operations outside that time period.

The methodology employed throughout this audit was one of objectively reviewing various forms of documentation, including written policies and procedures, financial information and various forms of data, reports and information maintained by the Metro Office of the Treasury. Management, administrative and operational personnel, from Metro's Office of the Treasurer and other stakeholders were interviewed, and various aspects of the NGH were directly observed.

CRITERIA

Implementation status of recommendations included in the *Metropolitan Government of Nashville and Davidson County Employee Benefit Board Pension Plan* audit report issued on April 13, 2000.

STAFF ACKNOWLEDGEMENT

Metro Office of Internal Audit
Mark Swann, CPA - Texas, CIA, CISA – Metropolitan Auditor
Carlos Holt, CIA, CFE, CGAP - Audit Manager

KPMG LLP

APPENDIX A. MANAGEMENT RESPONSE

- Management's Response Starts on Next Page -

METROPOLITAN GOVERNMENT OF NASHVILLE AND DAVIDSON COUNTY

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MAYOR

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July 28, 2009

Mr. Mark Swann
Director
Office of Internal Audit
222 3rd Avenue North, Suite 401
Nashville, TN 37201

RE: Audit of Metropolitan Nashville Employee Benefit Board Pension Investments

Mark
Dear Mr. ~~Swann~~:

This letter is to acknowledge receipt of the report entitled, "Audit of Metropolitan Nashville Employee Benefit Board Pension Investments." We have reviewed and evaluated all of the observations and recommendations in the report. We accept the recommendations in the report and will implement recommendations as appropriate.

The City would like to express its appreciation for the quality of the work performed by your office and the professionalism shown throughout the process.

Sincerely,

Richard M. Riebeling
Director of Finance

Copy: Gene Nolan
Lannie Holland
Kim McDoniel

APPENDIX B. KPMG FOLLOW-UP AUDIT REPORT

Follow-Up Report on the Metropolitan Employee Benefit Board Pension Investments as of December 31, 2008
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METROPOLITAN GOVERNMENT OF NASHVILLE AND DAVIDSON COUNTY, TENNESSEE

Follow-Up Report on the Metropolitan Employee Benefit Board Pension Investments

As of December 31, 2008

KPMG

CONTENTS

KPMG

I. INTRODUCTION

A. BACKGROUND, OBJECTIVES AND SCOPE

BACKGROUND

On April 13, 2000, the Office of Internal Audit of the Metropolitan Government of Nashville and Davidson County ("Metro") issued a report on the Metropolitan Employee Benefit Board Pension Investments ("the Report,") with assistance provided by KPMG Investment Consulting Group. The scope of the work was largely focused on the pension investment portfolio and the deferred compensation plan as of September 30, 1999. The Report identified 42 issues and 40 recommendations relating to the operation and performance of the Employee Benefit Pension Plan. Issues were identified in the following areas:

- investment policies and procedures;
- monitoring and reporting functions;
- contracts and agreements;
- performance reporting;
- real estate / venture capital; and
- deferred compensation.

Based upon the Report, the Office of the Treasurer, in conjunction with the Investment Committee of the Employee Benefit Board, implemented revised processes in order to address the issues identified. Considering the significant asset value of the Metro Employee Benefit Pension Plan, the impact on current and future annuitants, and the recent change in the Metro internal auditing reporting structure, it was deemed beneficial to refresh prior internal audit follow-up efforts. Follow-up procedures were performed to assess the current implementation status of the recommendations or whether the underlying identified issues continue to exist.

OBJECTIVES

KPMG performed detailed procedures to determine if the specific issues identified in the Report described above have been adequately resolved. KPMG's detailed procedures and analysis primarily focused on operational issues surrounding the Metropolitan Government of Nashville and Davidson County Employee Benefit Pension Plan ("the Plan.") Further recommendations included throughout this report are either focused on rectifying previously identified issues that still remain or are considered observed best practices. These recommendations are aimed at helping to improve the overall management of the Plan.

SCOPE

The scope of the work performed was focused on the pension investment portfolio and the deferred compensation plan as of December 31, 2008, and the calendar year then ended. However, certain analyses required the consideration of performance and operations outside that time period; such analyses and the time periods considered are discussed in subsequent paragraphs below.

In conducting our work, we objectively reviewed various forms of documentation, including written policies and procedures, financial information, contracts and agreements with outside vendors, Investment Committee minutes, performance reports and other documents pertaining to the Plan. Additionally, we interviewed various members of the Metropolitan Government of Nashville and Davidson County, primarily in the Office of the Treasurer.

KPMG relied upon information supplied by Metro and its employees. KPMG did not independently verify all information provided by these sources or conduct a financial statement audit under generally accepted accounting principles. While documentation from third-party vendors was reviewed in the course of our work, all documentation was obtained directly from Metro employees. KPMG has no responsibility for the accuracy of the information provided by Metro or any other entity.

Certain work, primarily with regard to issues with investment manager contracts, was performed within certain scope limitations. For this work, we performed procedures over the largest ten investment managers as of December 31, 2008 (as outlined in the "*Investment Manager*" section below). These ten investment managers hold over 90% of the Plan assets as of December 31, 2008, which was considered sufficient coverage to evaluate effectively the previously identified issues.

B. OVERVIEW OF THE PENSION PLAN

PLAN OVERVIEW

The Metropolitan Government of Nashville and Davidson County Employee Benefit Pension Plan is maintained in order to provide benefits for participants and beneficiaries in accordance with the provisions of the Employee Benefit System. This defined benefit pension plan is administered by the Investment Committee of the Plan ("the Committee"). The Committee engages an investment consultant and investment managers in order to manage effectively investments and achieve competitive returns while maintaining appropriate levels of diversification and risk.

The Statement of Investment Policy ("the Policy") is the governing document of the Plan, and outlines the objectives and policies of the Plan. The Policy was last updated in August of 2006. It defines the relevant benchmarks against which the Plan is measured at both the total portfolio level and for each asset class. The overall objective of the Plan is to outperform a composite of unmanaged market indices.

ASSET ALLOCATION

As of December 31, 2008, the Plan was valued at approximately $1.6 billion and was segregated into the following asset classes[1]:

ASSET CLASS	RANGE TARGET ALLOCATION	MOST EFFICIENT TARGET ALLOCATION	MARKET VALUE	PERCENTAGE OF PLAN
Domestic Large Cap Equity[2]	30-40%	35%	$ 478,256,757	29.46%
Fixed Income	25-35%	30%	$ 494,236,305	30.44%
International Equity	10-20%	15%	$ 244,018,457	15.03%
Domestic Small Cap Equity	5-15%	10%	$ 169,067,475	10.41%
Real Estate	4-10%	7%	$ 133,909,878	8.25%
Alternative Investments[3]	0-5%	3%	$ 57,297,701	3.53%
Cash Equivalents	0-3%	0%	$ 46,709,529	2.88%
TOTAL		100%	$1,623,496,102	100%

Table 1: Plan asset allocation as of December 31, 2008.

The Policy dictates the approved asset allocation of the Plan. The asset allocation targets are considered the most efficient mix to meet the Plan's objectives with respect to risk and return. The target is determined based upon asset allocation studies and is revised as determined necessary. Rebalancing of the Plan and adherence to the asset allocation target ranges is coordinated by the Office of the Treasurer and the investment consultant (Segal Advisors as of December 31, 2008.)

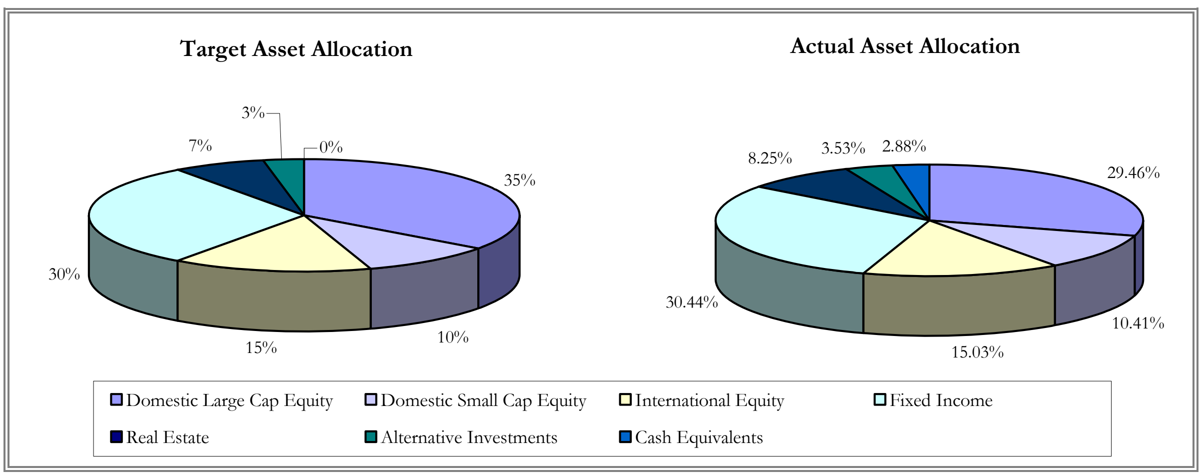

Table 2: Target compared to actual asset allocation as of December 31, 2008.

[1] Information in this table extracted from the December 31, 2008 Segal Advisors Quarterly Performance Report.
[2] Includes "Large Cap U.S. Equity" and "Mid Cap Equity" classes from the Segal Advisors Quarterly Performance Report.
[3] Includes "Private Equity" and "Alternative Investment" classes from the Segal Advisors Quarterly Performance Report.

Each asset class is measured against a determined benchmark, as outlined in the Policy. Each asset class is expected to achieve an annualized rate of return which meets or exceeds its respective benchmark before fees are deducted. The volatility of each asset class (excluding alternative investments) is not expected to materially exceed the volatility experienced by its respective benchmarks. Investment results are evaluated over three- to five-year market cycles, and investments are rebalanced as warranted.

The determined benchmarks and expected results, as outlined in the Policy, are as follows:

- Active Large Capitalization Equity Investment portfolios are expected to exceed the rate of return of the respective Russell 1000 style indices by 1.0%;

- Passive Large Capitalization Equity Investment portfolios are expected to track the rate of return of the S&P 500 Index;

- Domestic Small Capitalization Equity Investment portfolios are expected to exceed the rate of return of the respective Russell style indices (Russell 2000 growth and Russell 2500 value) by 1.5%;

- International Equity Investment portfolios are expected to exceed the rate of return of the MSCI ACWI Ex. U.S. Index by 1.5%;

- Active Fixed Income Investment portfolios are expected to exceed the rate of return of the Lehman Brothers Aggregate Bond Index by 0.5%;

- Structured Fixed Income Investment portfolios are expected to exceed the rate of return of the Lehman Brothers Aggregate Bond Index by 0.2%;

- Real Estate Investment portfolios are expected to exceed the rate of return of the National Council of Real Estate Investment Fiduciaries (NCREIF) Index by 1.0%; and

- Alternative Investment portfolios are expected to exceed the rate of return of the S&P 500 Index by 4.0%.

The Plan's total return is expected to achieve an annualized rate of return that exceeds the rate of return produced by the Blended Index (the return of each benchmark taken against the target allocation; i.e., 35% S&P 500 Index, 10% Russell 2000 Index, etc).

INVESTMENT COMMITTEE

The Investment Committee is comprised of four members, the Director of Finance and three members of the Employee Benefit Board, appointed by the Mayor. The Committee is responsible for providing oversight and determining all matters dealing with the investments of the Plan, and has full and complete control over all investment decisions, subject to the Metro Charter and the Statement of Investment Policy. In addition to having the ultimate authority over Plan investments, the Committee is authorized to employ suitable agents and counsel, and to direct such agents, either directly or through the Office of the Treasurer, on investment decisions.

The Committee employs an investment consultant (Segal Advisors) to assist them in directing the Plan and advising them on a variety of issues, including asset allocation, manager search and selection, performance reporting and general oversight. The Office of the Treasurer generally coordinates the day-to-day investment related activities on behalf of the Committee.

THE OFFICE OF THE TREASURER

The Metro Office of the Treasurer works in conjunction with the Committee and the Investment Consultant to direct the investments of the Plan. The Office of the Treasurer works closely with the Investment Consultant in developing asset allocation and investment strategies, setting investment guidelines and objectives, monitoring investment performance, performing asset / liability studies, and selecting investment managers. Recommendations made to the Committee by the Investment Consultant are done so only with the endorsement of the Office of the Treasurer. The Metropolitan Treasurer and the Metropolitan Chief Investment Officer serve as the primary liaisons between the Committee and the Investment Consultant.

INVESTMENT CONSULTANT

Since the third quarter of 2000, Segal Advisors ("Segal," or "the Consultant") has served as Metro's investment consultant. The consultant provides pension investment consulting services, specifically with regard to:

- financial planning services, including asset / liability studies, asset allocation studies, review of investment policies, review of investment strategies, and review of investment risks;

- analytical review of performance measurement and evaluation services, including attendance at meetings of the Committee and the presentation of a performance report to the Committee at least quarterly;

- education and research services, including providing information to the Committee regarding issues, trends, and practices for consideration and providing technical advice as requested concerning miscellaneous problems and questions that may arise relative to investments, the financial markets in general, or any other topic of fiduciary responsibility;

- investment manager search services, including utilizing various criteria determined at the initiation of the search process to produce a potential list of managers for review by the Committee; and

- other services as required.

Segal Advisors, the investment-consulting affiliation of The Segal Company, is registered with the Securities & Exchange Commission as an investment advisor under the Investment Advisors Act of 1940, and has offered independent investment consulting services since 1969.

INVESTMENT MANAGERS

As of December 31, 2008, the Plan employs 19 investment managers. The investment managers are selected by the Committee, under advisement of the Investment Consultant and the Office of the Treasurer, based upon various criteria including a manager's performance record, risk profile, stability of the organization, qualifications of investment professionals, and investment manager fees.

The selection of investment managers is not subject to Metro's general procurement process. The investment managers are instead selected through a manager search, initiated by the Committee and conducted by the Investment Consultant. This search process generally results in three or four finalists; these finalists are presented to the Committee, who ultimately makes the selection. The Office of the Treasurer also serves in an advisory role during this process, and investment managers presented to the Committee for recommendation are done so only with the endorsement of the Office of the Treasurer.

As of December 31, 2008, the Plan assets were managed by the following investment managers[4]:

ASSET MANAGER	MARKET VALUE	PERCENTAGE OF PLAN
Northern Trust Global Investments	$ 316,065,481	19.47%
Neuberger Berman	$ 264,294,179	16.28%
PIMCO	$ 248,179,163	15.29%
Nicholas Applegate	$ 170,353,706	10.49%
Aronson & Partners	$ 96,771,319	5.96%
Lazard Freres	$ 79,014,401	4.87%
Insight Small Growth	$ 74,972,445	4.62%
Mellon Equity	$ 73,378,203	4.52%
Flippin, Bruce & Porter	$ 70,046,837	4.31%
JP Morgan Real Estate	$ 68,364,553	4.21%
Prudential Real Estate	$ 65,545,325	4.04%
Insight Mid Growth	$ 20,439,472	1.26%
Alternative	$ 18,780,241	1.16%
Pantheon IV	$ 18,149,921	1.12%
Uninvested Cash Account	$ 13,773,317	0.85%
Harbour Vest VIII	$ 9,337,578	0.58%
Pantheon VII	$ 6,669,209	0.41%
PIMCO Distressed	$ 5,000,000	0.31%
Pantheon Europe	$ 4,360,752	0.25%
TOTAL	$1,623,496,102	100%

Table 3: Plan manager allocation as of December 31, 2008.

The Committee allows the investment managers full discretion within the scope of the mutually agreed upon investment guidelines as set forth in the Policy and the investment manager contracts. Each investment manager's performance is reviewed regularly, on at least a quarterly basis.

II. INVESTMENT POLICIES AND PROCEDURES

A. INVESTMENT POLICY STATEMENT AND MANAGER GUIDELINES

ISSUE IIA-1: The wording for minimum qualifications in Section II H (Investment Manager Qualifications) is vague and can be misinterpreted.

RECOMMENDATION: Clarify the language on firm assets and manager experience, or remove this section from the investment policy and specify minimum criteria while conducting each manager search.

BACKGROUND

In the Report, it was noted that the Statement of Investment Policy had a section concerning minimum levels of experience and minimum levels of assets under management for investment managers. It was noted that it is unusual to have this type of statement in the main section of the Policy, and the wording describing minimum levels of assets under management and experience could be interpreted in various ways. Additionally, including this wording in the Policy would result in the Committee being in technical breach of the Policy should a manager ever be retained who does not meet all the criteria.

CURRENT STATUS

Issue has been resolved.

Based upon review of the Statement of Investment Policy, the Policy no longer has a section concerning minimum levels of experience and minimum levels of assets under management for investment managers. Rather, the Policy only states:

> "*The Investment Committee will engage the services of Investment managers who possess the necessary specialized resources and expertise to assure that the Fund has the highest probability of achieving competitive results at appropriate levels of risk.*"

While investment manager experience is certainly considered when investment managers are selected, the vague, ambiguous wording regarding minimum experience levels for investment managers has been removed from the Policy.

[4] Information in this table extracted from the December 31, 2008 Segal Advisors Quarterly Performance Report.

ISSUE IIA-2: There is no total fund comparison versus a static policy benchmark.

RECOMMENDATION: Adopt a formal static policy benchmark. The total fund return of the plan should be compared versus this benchmark in addition to the dynamic index. This static benchmark should reflect the target asset allocation weights adopted by the Board with appropriate indices chosen for each asset class. However, the weights of each asset class, and the indices within the static policy benchmark will not change over time unless the board authorizes a change in asset allocation targets.

BACKGROUND

In the Report, it was noted that the investment consultant at that time, PaineWebber, did not compare Metro's performance to a static policy benchmark. Rather, the consultant utilized a “dynamic index,” which represented benchmarks chosen for each asset class weighted by the actual asset class percentage. While the dynamic index is a good benchmark for measuring the role of active management versus passive management, this benchmark did not measure the effect of Metro's allocation policies. Without a comparison to a static benchmark, the Committee did not have the information needed to determine if their asset allocation decisions added value to the Plan.

CURRENT STATUS

Issue has been resolved.

Based upon review of the Statement of Investment Policy, the Policy does reference a static policy benchmark:

> “*The System's total return is expected to achieve an annualized rate of return that exceeds the rate of return produced by the Blended Index (35% S&P 500 Index, 10% Russell 2000 Index, 15% MSCI ACWI Ex. U.S., 30% Lehman Brothers Aggregate Index, 7% NCREIF, 3% S&P 500 plus four percentage points) before fees are deducted.*”

The weighting utilized is the target asset allocation, not the actual asset class percentage. A static policy benchmark has been formally adopted.

KPMG notes that the Policy makes reference to the Lehman Brothers Aggregate Index. Since Lehman's bankruptcy filing in September of 2008 and subsequent purchase of the Lehman Brothers North American division by Barclays, this commonly used index has been rebranded as Barclay’s Capital Aggregate Bond Index. The Policy should be revised to reflect this change.

Reports from Segal Advisors appropriately reflect this change.

RECOMMENDATION 2008-01: Revise the Statement of Investment Policy to replace the Lehman Brothers Aggregate Index with Barclay’s Capital Aggregate Bond Index.

ISSUE IIA-3: All of the portfolio performance comparisons of the fund, including both total fund and asset class level returns, are calculated gross of fees and do not reflect the cost of investment management fees.

RECOMMENDATION: Include an analysis of net fee performance comparisons versus the appropriate benchmarks in addition to the current gross of fee analysis.

BACKGROUND

In the Report, it was noted that all of the portfolio performance comparisons in the Statement of Investment Policy assume that returns are shown gross of investment manager fees. Gross-of-fee returns are usually used in a peer group analysis, since peer group returns are also shown gross of fees. However, it is also important for Metro to display returns net of fees when comparing their performance versus a comparable benchmark. Investment managers are selected based on their ability to outperform a comparable benchmark; therefore, a manager should be measured against a predetermined benchmark with their fees deducted from the total return calculation. If an investment manager cannot outperform their predetermined benchmark after being compensated for their investment skills, then the fund might be better off moving to a passive investment alternative.

CURRENT STATUS

Issue has been partially resolved.

Based upon review of the Statement of Investment Policy, the Policy does not contemplate an analysis of net-of-fee performance comparisons versus the comparable benchmarks. In the “Investment Objectives” section of the Policy, the applicable benchmarks are outlined for each asset class, as well as the static benchmark for the total Plan. However, each benchmark described (including the benchmark for the total Plan) refers to comparison against performance “*before fees are deducted*.”

Based upon review of the Quarterly Performance Reports (presented by Segal to the Committee), KPMG notes that performance data (both at the investment manager and total Plan levels) is shown gross of fees. There is, however, a table in each report which shows estimated annual fees (based on actual fee schedules and average asset levels) for each investment manager. While net-of-fee performance information could be derived from the data provided in the reports, it is not explicitly presented.

RECOMMENDATION 2008-02: In the Quarterly Investment Reports, include an analysis of net-of-fee performance comparisons versus the appropriate benchmarks in addition to the current gross-of-fee analysis. This will allow the Investment Committee to properly analyze the performance of investment managers, and will facilitate appropriate consideration of passive investments.

ISSUE IIA-4: The statement regarding portfolio turnover in Section IV B 2(f) is ambiguous and unnecessary.

RECOMMENDATION: Remove this statement from the investment policy statement. Include portfolio turnover as one criteria, among others, that will be used in the manager search and selection process. In addition, turnover should be regularly monitored.

BACKGROUND

In the Report, it was noted that the Statement of Investment Policy stated that "*portfolio turnover will not be an evaluative factor, if other objectives are met*." It is highly unusual for this type of statement to be included in an investment policy. Normally, portfolio turnover is one criterion, among many, that is evaluated in the manager search and selection process. Typically, a consultant will be wary of managers who have a turnover ratio that is substantially higher relative to their peers; turnover may lead to excessive commissions and other transaction costs within the portfolio. If a manager has a superior performance record relative to their peers, then the issue of turnover may play less of a role; however, the inclusion of this statement in the Policy allows a manager to have high turnover with average performance. The phrase "*if other objectives are met*" is very ambiguous and is open to interpretation.

CURRENT STATUS

Issue has been resolved.

Based upon review of the Statement of Investment Policy, KPMG notes that the Policy no longer has a section concerning specific evaluative factors used in the investment manager selection process. Rather, the Policy only states:

> "*The Investment Committee will engage the services of Investment Managers who possess the necessary specialized resources and expertise to assure that the Fund has the highest probability of achieving competitive results at appropriate levels of risk.*"

Based upon review of the Segal Advisors investment manager selection process description, portfolio turnover does appear to be a factor in investment manager selection (the description explicitly states that "*changes in assets*" is considered), and that this factor is considered against and in conjunction with many other quantitative and qualitative factors.

The Policy also states:

> "*The Investment Managers are expected to communicate or meet with the Metropolitan Treasurer and Investment Consultant to review the portfolio and to discuss investment results in the context of these guidelines periodically upon request. At all times, however, the Investment Managers are encouraged to have open communication with the Metropolitan Treasurer and Investment Consultant on all significant matters pertaining to investment policies and the management of the System's assets.*"

The Policy includes these guidelines which indicate the monitoring process of the investment managers. Each investment manager must sign the Policy, indicating its intention to abide by the restrictions and guidelines set forth in the Policy.

ISSUE IIA-5: The derivative restriction under Section V (Fund Component Guidelines) is too vague and may lead to potential portfolio losses.

RECOMMENDATION: Revise the derivative restrictions to include additional financial instruments that are deemed as inappropriate investments for the Metro plan. Metro should work with its managers and consultant to create this additional list of instruments, and Metro should monitor its adherence.

BACKGROUND

In the Report, it was noted that the Statement of Investment Policy, in its discussion of derivative activity, covered basic derivatives ("*no futures, forward contracts or options activity*"), but did not address other derivatives which may lead to potential portfolio losses.

CURRENT STATUS

Issue has been resolved.

Based upon review of the Statement of Investment Policy, the Policy, in its discussion of derivative activity, states:

> "*The Investment Managers will not engage in investment transactions involving short sales, purchases on margin, derivative securities which provide leveraged exposure of the underlying index, precious metals, commodities or individual real estate holdings. However, use of currency futures, options or forward contracts to hedge international portfolio currencies is allowable. Covered call options are also allowable investments.*"

The Policy includes a specific list of prohibited investment transactions, as well as a relatively broad prohibition of "*derivative securities which provide leveraged exposure of the underlying index*" and thus appears to properly address derivative investments which may lead to potential portfolio losses. These prohibited transactions appear to be in line with the stated investment objective with regard to return and risk.

The Policy further states:

> "*The Investment Managers are expected to communicate or meet with the Metropolitan Treasurer and Investment Consultant to review the portfolio and to discuss investment results in the context of these guidelines periodically upon request. At all times, however, the Investment Managers are encouraged to have open communication with the Metropolitan Treasurer and Investment Consultant on all significant matters pertaining to investment policies and the management of the System's assets.*"

The Policy includes these guidelines which indicate the monitoring process of the investment managers. Each investment manager must sign the Policy. This indicates their intention to abide by the restrictions and guidelines set forth in the Policy.

B. ASSET ALLOCATION POLICY

ISSUE IIB-1: The target policy appears too aggressive given the risk objectives as defined in Section II C of the investment policy statement, and it does not address the plan's liabilities.

RECOMMENDATION: The role of risk must be formalized and incorporated into the asset allocation process. The asset allocation study needs to consider liabilities versus assets, plan demographics and the risk tolerance of the Board members. In addition, both asset allocation and performance reports should contain some analyses that display the risk profile of the fund.

BACKGROUND

In the Report, it was noted that the Statement of Investment Policy stated, "*in its overall investment strategy, [the Plan] is willing to forego potential return in strong markets for protection against a severe decline during weak markets.*" However, it appeared that, given the structure of the portfolio and the state of the financial markets at that time, the fund had taken on a substantial amount of risk relative to its stated objective.

CURRENT STATUS

Issue has been resolved.

Based upon review of the Statement of Investment Policy, the Policy, in its discussion of risk and volatility, states:

> *"The volatility of each portfolio (excluding alternative investments) is not expected to materially exceed the volatility experienced by their respective benchmarks."*

Based upon review of the most recent asset allocation study (conducted as of September 2006), the study does appropriately address risk in each portfolio.

Based upon review of the each Quarterly Performance Report for the 2008 calendar year, the reports also appear to appropriately address risk in the Plan.

KPMG also compared the current asset allocation (per the Policy) to published values. Based upon this comparison, the December 31, 2008 allocation appears relatively consistent with both the target (per the Policy) and other similar plans.

ASSET CLASS	METRO TARGET ALLOCATION	12/31/08 ACTUAL ALLOCATION	SOURCE 1[5]	SOURCE 2[6]
Domestic Equity	45.0%	39.87%	38.2%	35.8%
Fixed Income	30.0%	30.44%	27.6%	26.4%
International Equity	15.0%	15.03%	21.4%	17.3%
Real Estate	7.0%	8.25%	5.6%	7.3%
Alternative Investments	3.0%	3.53%	5.5%	11.7%
Cash Equivalents	0.0%	2.88%	0.0%	1.5%

Table 4: Asset allocation compared to other plans

Risk and volatility appear to be appropriately addressed in the Policy, asset allocation study, and Quarterly Performance Reports.

ISSUE IIB-2: The asset allocation study does not formally address risk.

RECOMMENDATION: The role of risk must be formalized and incorporated into the asset allocation process. The asset allocation study needs to consider liabilities versus assets, plan demographics and the risk tolerance of the Board members. In addition, both asset allocation and performance reports should contain some analyses that display the risk profile of the fund.

BACKGROUND

In the Report, it was noted that the Statement of Investment Policy stated, "*in its overall investment strategy, [the Plan] is willing to forego potential return in strong markets for protection against a severe decline during weak markets*." According to questionnaires completed by members of the Committee, the members' risk tolerance preferences were relatively low. However, it was noted that portfolio risk information was not presented to the Committee, neither as part of the asset allocation study nor as part of the Quarterly Performance Reports.

CURRENT STATUS

Issue has been resolved.

Based upon review of the most recent asset allocation study (conducted as of September 2006), the study does appropriately address risk in each portfolio.

[5] Information from Greenwich Associates Report, dated April 2008, "U.S. Institutions Rethink Traditional Asset Allocation Models." Statistics shown reflect the asset allocation of defined benefit public funds, universe 324 as of October 2007.
[6] Pension and Investments newspaper, dated January 26, 2009, "The P&I 1,000: Average Asset Mixes." Statistics shown reflect the asset allocation of defined benefit public funds, universe of the top 1,000 plans as of September 2008.

Based upon review of the each Quarterly Performance Report for the 2008 calendar year, the reports also appear to appropriately address risk in the Plan.

ISSUE IIB-3: The re-balancing of the portfolio's target policy, as recommended by PaineWebber in their latest asset allocation study dated October and December 1999, was not justified and only increased transaction costs.

ISSUE IIB-4: The Board's ultimate decision in setting the asset allocation policy for the calendar year 2000 was made without any justification or statistical merit.

ISSUE IIB-5: By only showing selective information, the most recent asset allocation study (October and December 1999) presented a misleading picture and led to sub-optimal decisions.

RECOMMENDATION: Require the consultant to present all asset allocation studies with consistent data and format, including analysis and the impact of transaction costs on any re-balancing recommendation. All decisions should be justifiable and have a sufficient financial and statistical basis to support Board decisions.

BACKGROUND

In the Report, it was noted that in 1999, the Committee made a decision to rebalance the portfolio’s target asset allocation based upon a presentation and recommendation by PaineWebber, the investment consultant at that time. However, KPMG noted that the proposed asset mix did not offer any incremental benefits to the current portfolio, and there was no compelling reason to warrant such a rebalance. In fact, the existing allocation had a higher expected return and a lower risk than the portfolio that was recommended and ultimately adopted. By presenting incomplete, inconsistent and even misleading information to the Committee, PaineWebber was able to persuade them to adopt a suboptimal target allocation, which diminished the overall position of the Plan’s investments and resulted in unnecessary transaction fees.

CURRENT STATUS

Unable to address.

In order to test the current status of this issue, KPMG would need to examine the last several asset allocation studies, including the study upon which the last rebalancing of the allocation was based. Based upon discussion with the Metro Treasurer and the Chief Investment Officer, the current asset allocation was based upon an asset allocation study conducted in 2001 by Segal Advisors. However, Metro was unable to locate this asset allocation study due to document retention limitations. Metro provided an updated asset allocation study as of September 2006; however, no changes were made to the allocation based upon this study. Therefore, KPMG was unable to assess whether the last rebalance was justified, and whether asset allocations are presented with consistent data and format, as only one was provided.

ISSUE IIB-6: The asset allocation study, by not always including all of the relevant asset classes of the plan, does not present a complete picture of the issues.

RECOMMENDATION: Each asset allocation study should include all of the relevant asset classes and must be consistent between different versions.

BACKGROUND

In the Report, it was noted that the asset allocation study, dated October 1999, did not include alternative investments as one of the inputs into the model. Alternative investments include venture capital and hedge funds. PaineWebber, the investment consultant at that time, was not technically responsible for alternative asset classes as defined in the Policy; however, alternative investments should be included in the asset allocation study.

CURRENT STATUS

Issue has been resolved.

KPMG compared the Statement of Investment Policy with the most recent asset allocation study (conducted as of September 2006) and notes that all asset classes (including alternative investments) were included in the study. By including alternative investments, the asset allocation study prepared by Segal Advisors presents a complete picture of the issues.

ISSUE IIB-7: The asset allocation reports do not include a formal recommendation.

RECOMMENDATION: Require the consultant to offer alternatives, recommendations and justifications for asset allocation recommendations in writing.

BACKGROUND

In the Report, it was noted that the asset allocation reports presented to the Investment Committee did not include a formal written recommendation from the consultant. The explanation of the alternative mixes and a final recommendation were presented orally at the Committee meetings. This lack of a formal conclusion and / or recommendation by the consultant left no audit trail and did not allow parties other than the Committee members to obtain a clear understanding of the Committee's decision making process.

CURRENT STATUS

Issue has been resolved.

Based upon review of the most recent asset allocation study prepared by Segal Advisors (conducted as of September 2006), the efficient frontier asset mix is formally presented. This is the Consultant's formal recommendation for asset allocation, and it was accepted by the Committee. The formal recommendation provided at September 30, 2006 determined that Metro was already utilizing the most efficient asset mix and no changes were made to the Policy.

C. INVESTMENT MANAGER SELECTION

ISSUE IIC-1: PaineWebber provides no initial documentation to the Board to select potential finalists for a search.

ISSUE IIC-2: PaineWebber provides only three managers in their initial recommendation to the Board.

RECOMMENDATION: The investment consultant should supply the Board with a formal hardcopy document on the managers they are recommending, including the criteria and methodology used in the search process.

RECOMMENDATION: The investment consultant should supply a list of potential managers that allows the Board sufficient choice. As an example, if there is a search for large cap growth managers, PaineWebber should supply five to ten semi-finalist managers. The Board could then choose three managers to interview from this list of semi-finalists.

BACKGROUND

In the Report, it was noted that, in its initial recommendation of managers for a search, PaineWebber usually presented three managers to the Committee. The presentation was completely oral; PaineWebber did not supply the Committee with any hardcopy documentation on manager qualifications. Without hardcopy documentation to examine, it was difficult - if not impossible - for the Committee to appropriately question PaineWebber and properly fulfill their oversight responsibilities.

In 2000, the manager selection process was as follows: PaineWebber conducted due diligence on the appropriate population of potential managers; PaineWebber presented approximately three managers to the Committee; the Committee interviewed these three potential choices and then made its selection.

CURRENT STATUS

Issues have been resolved.

KPMG notes that, based upon discussion with the Chief Investment Officer and review of the Quarterly Performance Reports, there was only one investment manager (PIMCO Distressed Mortgage Fund) that was both selected and funded during the 2008 calendar year. KPMG therefore expanded our testwork to include all investment managers who received initial funding in the 2008 calendar year, and performed testwork on the selection processes for these managers as well (Pantheon VII and Harbor Vest VIII). These managers were selected from a search occurring during 2006, with funding occurring in 2008. No managers selected during 2007 received funding during

2008. For the managers identified in the preceding paragraph, KPMG obtained and reviewed documentation provided to the Committee during the search process.

As of December 31, 2008, the manager selection process is much improved. Segal Advisors conducts preliminary due diligence on the appropriate population of potential managers. They narrow the managers down and conduct interviews of semifinalists (versus the Committee conducting interviews of finalists only, as was the case in 2000). Segal Advisors then selects the managers (usually three or four) which fit all criteria of the search and presents pertinent information to the Committee for final review and selection.

The revision of this policy is a vast improvement, as the investment consultant is typically more experienced and is highly qualified to conduct appropriate interviews and appropriately narrow the choices for the Committee. As further discussed below, the soft-dollar commission arrangement no longer exists with the investment consultant; therefore, the potential for compromised manager searches is limited. While the investment consultant still only presents three finalists to the Committee, Segal Advisors has conducted more steps in the evaluation process at this stage, with many more managers subject to interviews and other selection procedures. Each finalist presented to the Committee is considered an appropriate choice and has the endorsement of the investment consultant and the Office of the Treasurer.

With regard to Pantheon VII and Harbor Vest VIII (both initially funded in the first quarter of 2008), KPMG obtained and reviewed the formal manager search documentation prepared by Segal Advisors which was provided to the Committee. This search, for private equity fund managers, included three manager candidates: Pantheon VII, Harbor Vest VIII, and Hamilton Lane. The report describes the steps taken by Segal Advisors to narrow down the search to the three highlighted firms. It also presents information about each candidate, including an organizational overview, potential conflicts of interest, pending litigation, outline of key investment professionals, outline of compensation, turnover analysis, investment philosophy, funding status, fee description, and other data, both qualitative and quantitative. While only three candidates were presented to the Committee, the documentation describes that the search process began with preliminary due diligence on 19 potential managers, and due-diligence interviews (via face-to-face meetings / conference calls) on the 15 of these which the Consultant felt were best suited. The three managers presented to the Committee were all finalists that the Consultant strongly stood behind. Based upon review of the Committee minutes, the Committee held a "*lengthy discussion*" prior to making the selection. They ultimately selected to invest in both Pantheon VII and Harbor Vest VIII (although funding was not available until 2008).

With regard to PIMCO Distressed Mortgage Fund (initially funded in the fourth quarter of 2008), KPMG obtained and reviewed the formal manager selection documentation prepared by Segal Advisors and provided to the Committee. The Committee was evaluating whether to invest in distressed mortgage backed securities through PIMCO, one of its current fixed income investment managers, as was suggested by the Office of the Treasurer. Segal Advisors, therefore, upon request of the Committee, performed research on such securities and on PIMCO. Given the investment details and the current economic environment, there is little historical information of any relevance; however, Segal Advisors provided the Committee with information regarding the strength of the PIMCO organization, the depth of their resources, and the facts surrounding the investment. Per review of Committee minutes, it appears the Committee evaluated the information and applied appropriate consideration prior to making their selection. They ultimately decided to invest in PIMCO's distressed mortgage fund.

ISSUE IIC-3: The use of the most favored nation clause does not guarantee Metro the best fee quote.

RECOMMENDATION: Negotiate the lowest possible fee by:

(1) Comparing the fees paid by other clients who use the same or similar managers.

(2) Comparing managers to other Metro managers in the same asset class.

(3) Using fees as one of the screening and selection criteria in the manager search process.

(4) Continuing to monitor fees by including fee schedules and comparative information on fees in the quarterly performance report.

(5) Becoming more aggressive in fee negotiations with investment managers.

(6) Continuing to include the most favored nation clause.

BACKGROUND

In the Report, it was noted that, after an investment manager had been selected, a fee was negotiated essentially by asking the manager for the "*most favored nation clause*." This clause means that Metro receives the lowest fee that is given to other, similar portfolios managed by the investment manager.

This approach of negotiating fees has practical limitations that make it undesirable. There can be a wide interpretation in defining "similar" plans; additionally, this strategy precludes Metro from benefiting from investment managers that might be willing to discount fees to get into the public plan sector by including Metro on their client list. Metro also may not be benefiting from instances where the investment manager would give a fee break to a plan that uses them for multiple asset groups.

CURRENT STATUS

Issue has been resolved.

Based upon review of the Regulations to the Metropolitan Procurement Code ("the Code"), the selection of investment managers is not subject to Metro's general procurement process; rather, the Code states:

> "*The Investment Consultant shall conduct an appropriate search utilizing a database of sufficient size and scope as to assure practical competition and shall consider the appropriate qualifications and fees of the proposed Investment Managers within the overall risk parameters of the Committee's Investment Policy.*"

Based upon review of the Segal Advisors' investment manager selection process description, investment management fees are an area of focus in the search process. Additionally, once the manager is selected, Segal Advisors assists the client in "*setting up the new investment management arrangement... this would include negotiating the fee.*"

Metro included this third-party consultant in the negotiation process and, given Segal Advisors' qualifications and its involvement in the manager selection process from beginning to end, this represents an improvement in the fee negotiation process. Segal Advisors’ assistance in this negotiation process includes analysis and comparison of other clients and other managers.

Additionally, based upon review of the Quarterly Performance Reports, investment management fees are disclosed, by manager, in each quarterly report. The provision of this detailed and timely information allows for appropriate monitoring of management fees by the Committee.

ISSUE IIC-4: The use of a soft dollar commission arrangement does not allow PaineWebber to be objective in recommending passive investments.

RECOMMENDATION: Reconsider passive investments in an objective fashion. Include an analysis of the savings in both management fees and commission dollars from passive investments relative to active management.

BACKGROUND

In the Report, it was noted that PaineWebber was paid through soft dollar commissions. The commissions were generated through investment manager trading activity. Active managers generate significantly more transactions relative to passive managers, which lead to increased commission costs to the portfolio (and increased earnings for PaineWebber). From a commission standpoint, PaineWebber had nothing to gain from recommending passive investments. This arrangement made PaineWebber less than objective in their analysis of active versus passive investing. Their presentations to the Committee suggest that, in some cases, PaineWebber presented misleading information to discourage the use of passive investment in Metro's portfolio.

CURRENT STATUS

Issue has been resolved.

Based upon review of Metro’s contract with Segal Advisors, compensation is fixed. The contract states:

> “*Compensation: An all-inclusive fixed cost of $230,000.00 per year, to be billed on a quarterly basis in arrears.*”

This fixed compensation arrangement does allow for more objectivity in the consideration of passive investments.

As noted above, by presenting net-of-fee performance comparisons versus the appropriate benchmarks in addition to the current gross-of-fee analysis, it would further facilitate the consideration of passive investments. See Recommendation 2008-02 above.

D. ROLE OF THE INVESTMENT CONSULTANT

ISSUE IID-1: The consultant contract has never been put out for public bid since PaineWebber was hired as the sole consultant of the fund in 1991.

RECOMMENDATION: The consultant contract should be placed out to a public bidding process periodically issuing and reviewing RFPs. The RFP should be publicly advertised in an industry publication such as “Pension and Investments.”

BACKGROUND

In the Report, it was noted that PaineWebber had been the sole consultant to the Metro plan since 1991. Their contract had been extended numerous times by the Committee. From the hiring of PaineWebber in 1991 to the date of the Report (March 2000), the Committee had never put out a request for public bid for investment consultants.

The public bidding process serves a very important purpose. By reviewing other bids, the Committee can compare the services and fees of their current consultant versus other consultants.

CURRENT STATUS

Issue has been resolved.

The investment consultant contract was put out for public bid on April 18, 2000. KPMG obtained and reviewed the Solicitation for Professional Services (SPS 00-39). Segal Advisors was selected and was granted a five year contract.

The investment consultant contract was put out for public bid again on April 12, 2005. KPMG obtained and reviewed the Solicitation for Professional Services (SPS 05-45). Segal Advisors was again selected and was granted a five-year contract.

ISSUE IID-2: The use of soft dollar commissions to pay for consultant services creates numerous conflicts of interest.

ISSUE IID-3: The Investment Board has not analyzed PaineWebber's compensation.

RECOMMENDATION: Eliminate the payment of soft dollar commissions to pay for consultant advisory services, and more to a hard dollar fixed fee arrangement where the compensation is not excessive related to other public funds.

BACKGROUND

In the Report, it was noted that PaineWebber, Metro's Investment Consultant, was paid by Metro in soft dollar commissions. The various investment managers directed their trading activity through

PaineWebber (versus other brokers in their own networks) who then received a commission on the transactions. This arrangement was used to pay for the consulting services instead of Metro paying PaineWebber in hard dollars.

The contract prescribed that trades would be directed through PaineWebber at set fees until their contracted fee had been reached; if the commission fees generated did not amount to the contracted fee, then Metro would be obligated to pay PaineWebber the remaining amount. However, it was noted in the Report that PaineWebber was not notifying managers when their contracted compensation had been reached. In 1999, PaineWebber received approximately $1.4 million in commissions from this arrangement. Based upon research conducted by KPMG at that time, the mean fee for similar services paid by similarly sized public funds to their investment consultants was approximately $118,000.

The main objective in hiring an investment consultant is to receive objective, independent, third-party investment advice. The use of a soft dollar arrangement serves to impair the objectivity of the consultant. Under this arrangement, the consultant has a monetary stake in many of the decisions that are made on behalf of the pension plan. The ultimate goal in a soft dollar commission arrangement is to generate commissions from trading activity, which directly compensates the consultant. It is difficult for the consultant to be objective when their compensation is based on decisions that have a direct impact on their earnings.

It was also noted in the Report that the soft dollar commission arrangement had not been discussed by the Committee since 1991.

CURRENT STATUS

Issues have been resolved.

Based upon review of the contract for Segal Advisors, KPMG notes that compensation is fixed. The contract states:

> "*Compensation: An all-inclusive fixed cost of $230,000.00 per year, to be billed on a quarterly basis in arrears.*"

As noted above, the most recent contract has an all-inclusive fixed cost per year. The investment consultant contract was put out for bid in both 2001 and 2005 and the fees were discussed by the Committee during the selection processes, as appropriate.

ISSUE IID-4: The language describing PaineWebber's compensation is extremely convoluted and can be misinterpreted in numerous ways.

RECOMMENDATION: Present all consultant fees as fixed hard dollar fees stated in an unambiguous manner in the consultant contract.

KPMG

BACKGROUND

In the Report, it was noted that the language in the consultant contract used to describe the payment of commissions to PaineWebber was difficult to understand and was not consistent. Additionally, there was no cap on the consulting fee that Metro was obligated to pay PaineWebber. By reading the compensation section of PaineWebber's contract, it was extremely difficult to calculate their exact fee based on the language of the contract.

CURRENT STATUS

Issue has been resolved.

Based upon review of the contract for Segal Advisors, KPMG notes that compensation is fixed. The contract states:

> "*Compensation: An all-inclusive fixed cost of $230,000.00 per year, to be billed on a quarterly basis in arrears.*"

There is no convoluted or ambiguous language in the contract with regard to compensation.

III. MONITORING AND REPORTING FUNCTION

A. CURRENT STRUCTURE AND REPORTING

ISSUE IIIA-1: The Investment Board is too reliant on the consultant for investment advice and analysis.

RECOMMENDATION: A Chief Investment Officer or similar position with appropriate qualifications should be assigned the responsibility to report to the Board and to manage all aspects of the investment function, including independently evaluating recommendations and analysis presented by the consultant.

BACKGROUND

In the Report, it was noted that the Investment Committee and PaineWebber hold primary responsibility for the management of the Plan's investments, and the Committee had used the Executive Secretary as an additional resource. The Executive Secretary, under the Statement of Investment Policy, was to perform investment functions as requested by the Committee. In this capacity, the Executive Secretary had been the primary contact for PaineWebber and had been involved in performing various analytics for the Committee. However, the position of Executive Secretary did not require candidates to be qualified to perform investment analysis, and the former Executive Secretary did not have the qualifications and experience to perform that function. As a result, the Committee had depended on the advice of PaineWebber almost exclusively for managing pension investments. In effect, the Committee did not have any independent oversight over pension investments.

CURRENT STATUS

Issue has been resolved.

KPMG reviewed the Charter of the Metropolitan Government of Nashville and Davidson County, Tennessee ("the Charter."). KPMG noted that the Investment Committee is constituted, as provided in Section 13.04 of the Charter, to "*regulate and determine all matters dealing with investment of funds committed to the board and shall have complete control over all investments*." The Charter, however, does not dictate qualification requirements for Investment Committee members.

As of December 31, 2008, the Committee is made up of the Director of Finance, who serves as Committee Chairman, and three members appointed by the Mayor. Although the other members are not required to have any investment background, the Director of Finance and one of the other members have an investment/finance background.

Section 8.102 of the Charter discusses the required qualifications of the Director of Finance, which includes at least five years of exceptional performance as a Comptroller of a large company. KPMG confirmed, based upon review of the Nashville government Web site, that the Director of Finance, who manages the investment function, appears to have met the minimum qualifications as described in the Charter. KPMG also reviewed the Committee minutes from 2008 and noted that the Committee Chairman and at least two other Committee members were present at each meeting.

KPMG notes that when any discussions took place regarding investment direction, the Consultant provided his/her analysis and the Committee decided whether to implement the plan based upon independent evaluation of the information provided by the consultants.

KPMG also notes that Metro hired a Chief Investment Officer (CIO) in 2003. Based on KPMG's review of the CIO's past experience with investment securities, financial modeling, and forecasting, he appears to possess the appropriate qualifications and skills. Upon review of the Committee minutes from 2008, KPMG noted that the CIO was present at almost every meeting, and took the lead in most discussions involving performance analysis and current and future strategies.

While improvements in this area have been made, given the significant authority of the Investment Committee, additional requirements regarding the qualifications of Committee members would improve the Committee's capabilities to adequately evaluate investment decisions.

RECOMMENDATION 2008-03: Implement additional requirements regarding the composition of the Investment Committee whereby certain members are required to possess appropriate investment and/or financial expertise.

ISSUE IIIA-2: Investment Board members are not required to sign a conflict of interest form.

RECOMMENDATION: Members of the Investment Board should be required to fill out and sign disclosure and conflict of interest forms every year.

BACKGROUND

In the Report, it was noted that many employees of the government who hold key positions are required to fill out and sign a financial disclosure form and a conflict of interest statement. However, members of the Investment Committee were not required to complete these forms.

CURRENT STATUS

Issue has been partially resolved.

Although Metro does not currently require Investment Committee members to sign disclosure and conflict of interest forms, all employees and members of all committees and boards of Metro are subject to Title 2 of the Metropolitan Code of Law, Chapter 2.222, Standards of Conduct, Disclosure of Interest, and Enforcement, which includes general ethical guidelines. Metro appears to have actively communicated these ethical guidelines to its employees, including members of the Committee.

Based upon discussion with the Chief Investment Officer, KPMG learned that a formal ethics policy, which provides further guidance to members regarding fiduciary responsibilities, is currently being created specifically for Investment Committee members. This policy is in the review process, and plans are in place for it to be implemented at some point in 2009. Given the broad nature of the Metro Ordinance, it would be beneficial for this additional policy to be implemented.

With the exception of the Director of Finance, the Investment Committee members, as they are neither Metro employees nor elected officials, are not subject to the disclosure provisions of the Metropolitan Charter and are not required to fill out annual disclosure statements. As individuals with significant influence and authority in the investment decisions of the Plan, it would be prudent for these members to disclose their direct and indirect interests to the Committee and to Metro.

RECOMMENDATION 2008-04: Require members of the Investment Committee to complete and sign disclosure and conflict of interest forms every year.

ISSUE IIIA-3: The consultant had been given the authority to initiate investment transactions for the Metro account.

RECOMMENDATION: The consultant should never have the authority to transfer Metro funds or to pre-approve manager trades. Their sole involvement in transfers should be to advise the Board on transfers they are recommending. This will allow the Board greater control over the movement of funds and minimize the risk of the misuse of funds.

BACKGROUND

In the Report, it was noted that from 1994 through July of 1999, Metro used Northern Trust as the custodian. The Committee approved a list of authorized personnel who could transfer funds, and PaineWebber, the investment consultant at that time, was on the list. In addition, there were several instances where managers would call PaineWebber to receive pre-approval on their trades, which was also highly unusual. Consultants are usually not authorized to transfer funds or initiate the transfer, given the potential conflict of interest.

CURRENT STATUS

Issue has been resolved.

KPMG obtained Segal's most recent Uniform Application for Investment Adviser Registration (Form ADV), which is filed with the SEC and provided to Metro. KPMG noted that the report states that Segal does not have "*discretionary authority over its clients' accounts regarding the 1) securities bought or sold, 2) amount of securities bought or sold, 3) broker or dealer to be used for a purchase or sale of securities, or 4) commission rates to be paid to a broker or dealer*."

ISSUE IIIA-4: There were no procedures to ensure that investment balance totals reported on the general ledger, the State Street and Northern Trust reports, and the PaineWebber quarterly performance reports were in agreement.

RECOMMENDATION: The pension investment general ledger balances and activity should be updated monthly based on the custodian reports. Drafts of quarterly performance reports should be reconciled to the custodian reports prior to the board meetings where investment performance is reviewed.

BACKGROUND

In the Report, it was noted that the general ledger pension investment balances had not been updated since July of 1999. In addition, there was a $9 million unexplained difference at September 30, 1999 among the custodian's statement, the Quarterly Performance Report, and the general ledger balance. While the difference was ultimately reconciled, it was noted that the lack of general ledger controls could result in undetected errors in the custodian reports, and information reported to the Committee may not be accurate if the performance reports do not agree to the custodian records.

CURRENT STATUS

Issue has not been resolved.

Procedures have not been implemented to agree the Quarterly Performance Reports to the custodian statements and the general ledger as recommended. Additionally, upon requesting the reconciliation of the custodian report to the general ledger for December 2008, KPMG was informed that, at the date of the request (March 27, 2009), December activity had not yet been booked in the general ledger. Had the procedure been in place to reconcile the Quarterly Performance Reports to the general ledger, the amounts would not have reconciled, as the activity is booked to the general ledger on a three- to four- month lag.

RECOMMENDATION 2008-05: Revise the procedures surrounding pension investment accounts to require activity, as reported by the custodian, to be recorded to the general ledger within 30 days of receipt of statement.

KPMG

IV. CONTRACTS AND AGREEMENTS

A. CONTRACT LANGUAGE AND COMPLIANCE

ISSUE IVA-1: The actions of the investment managers, in directing trades to PaineWebber and other brokers, do not match the language in their contracts or in PaineWebber's consulting contract.

ISSUE IVA-2: PaineWebber has not notified managers when their contracted compensation has been reached.

RECOMMENDATION: Eliminate the soft dollar commission arrangement. This arrangement causes potential conflicts of interest and increases the actual cost of trade executions. Instruct the managers to seek best price and execution for each trade.

BACKGROUND

In the Report, it was noted that PaineWebber, Metro's Investment Consultant, was paid by Metro in soft dollar commissions. The various investment managers directed their trading activity through PaineWebber (versus other brokers in their own networks) who then received a commission on the transactions. This arrangement was used to pay for the consulting services instead of Metro actually paying PaineWebber in hard dollars. Trades would be directed through PaineWebber at set fees until their contracted fee had been reached; if the commission fees generated did not amount to the contracted fee, then Metro would be obligated to pay PaineWebber the remaining amount.

Within the investment manager contracts, it stated, "*the investment manager shall place all transactions through PaineWebber unless transactions can be placed through third parties at a lower rate than generated at PaineWebber*." However, the consultant contract with PaineWebber indicated that all transactions would be placed through PaineWebber until their contracted compensation had been earned. Specifically, the contract stated, "*After the cap is achieved, PaineWebber will be placed in a competitive situation on all listed transactions, and must match or beat the commission rates of the other security dealers*."

While the investment manager contracts dictated that managers should execute all transactions at competitive rates and in the best interest of the fund, the majority of all transactions during the 1999 fiscal year (approximately 96%) were executed through PaineWebber at their rate of six cents a share; it is highly likely that some of these trades could have been executed at other brokerage firms at a lower commission rate.

PaineWebber was able to calculate the contracted compensation, but the investment managers were not aware when the consultant's fee had been earned. It was the responsibility of PaineWebber to notify the managers that their compensation had been earned, and thereafter, PaineWebber should have competed for all further transactions using competitive execution fees. However, PaineWebber representatives stated that the investment managers were obligated to seek best execution according to the language in their contracts and that there was no need for PaineWebber to notify managers when the fee had been earned.

CURRENT STATUS

Issues have been resolved.

Based upon review of the contract for Segal Advisors, compensation is now fixed. The contract states:

> "*Compensation: An all-inclusive fixed cost of $230,000.00 per year, to be billed on a quarterly basis in arrears.*"

ISSUE IVA-3: The category of the investment manager's mandates (ex. Large Cap Growth) as defined in each investment manager contract does not always match the categories in the Statement of Objectives (Section VII).

RECOMMENDATION: Change the wording in the contracts to clearly state which guideline category a manager should follow. For instance, Montag & Caldwell can still be classified as a Large Cap Growth manager but would use the Core Equity-Active guidelines. The classification of MBIA should be clearly defined. Metro should establish another guideline section for Cash Management in the investment policy statement. In addition, the language in the contract for MBIA should state that MBIA will follow the guidelines for a Cash Management mandate. Investment manager fees for MBIA as a cash manager should be lower.

BACKGROUND

In the Report, it was noted that within each investment manager contract, there was a specific paragraph that outlined the objectives of the manager. In this paragraph, each manager was designated to manage a specific style mandate (such as "Large Cap Growth"). The contracts generally stated, "*The Investment Manager shall manage the account in accordance with the 'Statement of Investment Objectives' and acknowledges that all investments by the Investment Manager will be restricted to those investment areas specifically designated to the type manager designated above and as further set out under Section VII of the 'Statement of Objectives'.*" One case in particular that was inconsistent was with the investment manager MBIA Capital. MBIA was originally hired as a cash manager. Under the headings of the Policy, they fell under the Fixed Income-Short and Intermediate Duration heading. However, some of the guidelines under the Policy were more aggressive than necessary for a cash manager to mandate. If MBIA used these guidelines, they could conceivably take substantially more risk than is warranted.

In cases where the asset class description in the investment manager contracts did not exactly mirror the classes described in the Policy, it could be difficult to determine which guidelines and benchmarks applied to which managers.

CURRENT STATUS

Issue has been resolved.

Neither MBIA Capital nor Montag & Caldwell are investment managers at December 31, 2008; therefore, the portion of the issue and recommendation relating to them is not applicable.

KPMG selected the ten largest managers to test whether the asset class description in the investment manager contracts are similar to the classes outlined in the Policy:

- Northern Trust Global Investments,
- Neuberger Berman,
- PIMCO,
- Nicholas Applegate,
- Aronson & Partners,
- Lazard Freres,
- Insight Small Growth,
- Mellon Equity,
- Flippin, Bruce & Porter, and
- JP Morgan Real Estate.

KPMG determined that the ten largest manager contracts either describe or effectively imply the classes outlined in the Policy.

ISSUE IVA-4: The section on the "Consultant to the Investment Board" in the investment manager contracts clearly states that the consultant is the Phillips Group of PaineWebber.

RECOMMENDATION: Replace the name of the consultant in future investment manager contracts with a generalized reference to the consultant.

BACKGROUND

In the Report, it was noted that each investment manager contract explicitly stated that the investment consultant was PaineWebber. If the Committee ever decided to switch to a new consultant, this section within each contract would need to be modified, creating an unnecessary administrative burden.

CURRENT STATUS

Issue has been partially resolved.

KPMG selected the ten largest managers to test whether there is a generalized reference to the consultant as recommended. The following six investment manager contracts make no reference to a specific investment consultant:

- Northern Trust Global Investments,
- Neuberger Berman,
- PIMCO,
- Insight Small Growth,
- Mellon Equity, and
- JP Morgan Real Estate.

The following four investment manager contracts specifically reference PaineWebber as the investment consultant:

- Nicholas Applegate,
- Aronson & Partners,
- Lazard Freres, and
- Flippin, Bruce & Porter.

These four contracts that still reference a specific investment consultant were formed before the 2000 Report was issued. These contracts have not been updated.

RECOMMENDATION 2008-06: Implement provisions whereby the terms and conditions of investment manager contracts, including fee arrangements, are reviewed, evaluated, appropriately updated and approved by both management and the Investment Committee on a regular basis, at a minimum every five years.

ISSUE IVA-5: The address in the section on the "Custodian Bank" of the investment manager contract is incorrect.

RECOMMENDATION: Remove the name of the custodian and the contact from investment manager contracts and have a generic reference to the custodian. In addition, the Investment Board should notify managers in the event of a custodian or custodian contact change.

BACKGROUND

In the Report, it was noted that in the investment manager contracts, the section on the relationship between the investment manager and the custodian listed the name of the custodian and the contact for all correspondence as Northern Trust (with the exception of the MBIA Capital contract.) At the time of the 2000 Report, State Street had replaced Northern Trust as the custodian. Explicit use of the custodian’s name and contact information could potentially cause problems in communication when the custodian changes.

CURRENT STATUS

Issue has been resolved.

KPMG selected and reviewed the ten largest investment manager contracts to determine whether each contract specifically states that the Committee will notify the managers of a change in the custodian in writing. All ten contracts did include this statement, as recommended.

ISSUE IVA-6: Some specific manager fees are ambiguous.

RECOMMENDATION:

1) Clarify the investment manager fee, and identify the individual who initialed the fee change. Confirm with the Board that the fee of 85 basis points is correct related to Edgewood.

2) Remove Point B showing an annual fee of 90 basis points for ARM Capital, and have the contracts resigned by both parties, as amended.

3) The aggregate total of assets managed by Nicholas Applegate is approximately $223 million. Given the original discount language, it would be appropriate for Metro to ask for a similar discount due to the large amount of assets managed by Nicholas Applegate.

BACKGROUND

In the Report, three different issues were noted:

1) Edgewood's management fee that was originally typed in the contract was changed in handwriting and initialed. Although the individual was probably an employee of the managing company who noticed the discrepancy, it was not dated or clear on the contract, and could have been changed after the Committee approved the contract.

2) ARM Capital had two stated management fees in the contract. One was an annual fee and the other was based on a sliding scale. Although Metro was correctly paying the manager based on the sliding scale fee, it was misleading to have both fees on the contract when the annual fee was not used.

3) In the Nicholas Applegate contract, there was a paragraph on the discounting of fees. The paragraph stated, if Nicholas Applegate manages aggregate assets greater than $75M for Metro, then the fees for the international account would be structured in the same manner as its Small to Mid Cap Growth portfolio (which they used to manage during the 1990's). Although the Small to Mid Cap portfolios were terminated in 1996, and it appears reasonable that the fees would then be based on the international contract, Nicholas Applegate did still manage an Emerging Markets portfolio. If a discount was applied to the

international contract based on the structure of the Emerging Markets portfolio, the potential annual savings could have been as much as $60,000.

CURRENT STATUS

Issue has been resolved.

Neither Edgewood nor ARM Capital are investment managers at December 31, 2008; therefore, the portion of the issue and recommendation relating to them is not applicable.

KPMG selected and reviewed the ten largest investment manager contracts. This included the Nicholas Applegate contract referred to above. Upon review of the most recent contract (formed in 1993) and supporting documents, the original fee arrangements were amended in 2001 (based on a letter signed by a Nicholas Applegate representative) to provide Metro with a lower fee in recognition of the significant amount of assets managed by them. The percentage was clearly stated and is applicable to all portfolios. As such, the fee arrangement appears to be properly revised and is unambiguous as of December 31, 2008.

For the other nine investment manager contracts, the fee arrangement is clear and consistent (unambiguous).

B. FEE ARRANGEMENTS

No issues were identified in this section of the previously issued Report.

C. FEE COMPARISON – INDUSTRY STANDARDS

ISSUE IVC-1: The use of some flat fee arrangements in the plan may cause Metro to pay higher fees than otherwise necessary.

RECOMMENDATION: Metro should re-evaluate fee arrangements with investment managers, specifically where managers charge a flat fee. In addition, Metro should consider passive investing, consolidating mandates by asset class and aggressively negotiating to reduce investment manager fees.

BACKGROUND

In the Report, it was noted that some investment managers were paid under a “flat fee” arrangement. Metro would pay a flat percentage (such as 75 basis points) of the total market value of the managed assets, unlike the graduated scale which involves paying a certain percentage that generally decreases as the market value of the account increases. While the flat fee percentage is still a function of the performance of the portfolio, it is possible that Metro could save money if certain managers were to restructure their fee arrangement to a graduated scale.

CURRENT STATUS

Issue has been resolved.

KPMG selected and reviewed the ten largest investment manager contracts to determine the current fee structure. The following fee arrangement outlined in these seven contracts used a graduated scale:

- Northern Trust Global Investments,
- Neuberger Berman,
- PIMCO,
- Nicholas Applegate,
- Insight Small Growth,
- Mellon Equity, and
- Flippin, Bruce & Porter.

The following three contracts still state that the investment manager is to be paid under a flat percentage arrangement, and there is no indication in the Committee minutes or in the individual contracts that this fee arrangement has been revised. However, based upon discussions with the Chief Investment Officer, the fee arrangements with these investment managers have been reviewed by the Committee and deemed to be appropriate:

- Aronson & Partners,
- Lazard Freres, and
- JP Morgan Real Estate.

It would be prudent for the Investment Committee to periodically reevaluate investment manager contracts, including the fee arrangements. See Recommendation 2008-06 above.

V. PERFORMANCE REPORTING

A. ADEQUACY OF PERFORMANCE REPORTING

ISSUE VA-1: The quarterly performance report does not include any analysis of risk.

RECOMMENDATION: Include risk-return analysis for all managers.

BACKGROUND

In the Report, it was noted that the Quarterly Performance Reports (presented to the Committee by the Investment Consultant) did not include any mention of risk at the total fund, asset class, or manager level. The report did not include a standard risk-return scatter diagram to display each manager's risk profile. A risk-return scatter diagram would help the Committee understand the level of risk each manager is taking in order to achieve performance returns.

CURRENT STATUS

Issue has been partially resolved.

KPMG reviewed the Quarterly Performance Reports for each quarter in the 2008 calendar year, and tested that risk-return analyses (specifically, in the format of a standard risk-return scatter diagram, as recommended) are presented for each investment manager, as follows:

ASSET MANAGER	RISK RETURN DIAGRAM	PERCENTAGE OF PLAN, 12/31/08
Northern Trust Global Investments	YES	19.47%
Neuberger Berman	YES	16.28%
PIMCO	**NO**	15.29%
Nicholas Applegate	YES	10.49%
Aronson & Partners	YES	5.96%
Lazard Freres	YES	4.87%
Insight Small Growth	YES	4.62%
Mellon Equity	**NO**	4.52%
Flippin, Bruce & Porter	YES	4.31%
JP Morgan Real Estate	**NO**	4.21%
Prudential Real Estate	**NO**	4.04%
Insight Mid Growth	**NO**	1.26%
Alternative	**NO**	1.16%
Pantheon IV	YES	1.12%
Cash Account	N/A	0.85%
Harbour Vest VIII	**NO**	0.58%
Pantheon VII	**NO**	0.41%
PIMCO Distressed (initially funded in Q4)	**NO**	0.31%
Pantheon Europe (initially funded in Q4)	**NO**	0.25%
TOTAL		100%

Table 5: Investment managers with risk-return analysis presented

Risk analyses are presented for 8 of the 19 investment managers in each Quarterly Performance Report. There is no mention of risk in the reports with regard to the other managers, and there is no risk analysis presented by asset group.

RECOMMENDATION 2008-07: In the Quarterly Performance Reports, include risk return analyses for all investment managers.

ISSUE VA-2: The quarterly performance report does not display Metro's historical asset allocation over time and does not compare the plan's current asset allocation to other similarly managed plans.

RECOMMENDATION: Include a comparison of Metro's current asset allocation to previous allocation policies and to other similarly managed plans. These comparisons should be included in the quarterly performance reports to the Board.

BACKGROUND

In the Report, it was noted that the Quarterly Performance Reports (presented to the Committee by the Investment Consultant) detailed the Plan's asset class and manager allocation weights, but did not compare the Plan's current allocation to historical allocation or to allocation weights of similarly managed plans, making it difficult for the Committee to maintain an awareness of the changes to its asset allocation policy and equity exposure over time, and of the allocation strategies of similarly managed plans.

CURRENT STATUS

Issue has been resolved.

KPMG obtained and reviewed the Quarterly Performance Reports for each quarter in the 2008 calendar year, along with the Cumulative Performance Comparison analyses that are distributed with the Quarterly Performance Reports. The reports include details of the Plan's asset classes and manager allocation weights, and show these allocations from the prior period for comparison. The supplemental analyses distributed with the reports also shows comparisons with other public plans.

ISSUE VA-3: Metro's total fund performance does not include real estate, venture capital or alternative asset classes.

RECOMMENDATION: The total fund return should include all investments within the plan.

BACKGROUND

In the Report, it was noted that the Quarterly Performance Reports (presented to the Investment Committee by the Investment Consultant) showed total fund performance data, but this measure did not factor in real estate, venture capital, or alternative asset classes. Since these asset classes were excluded from the total fund calculation, the Plan's overall performance was unknown.

CURRENT STATUS

Issue has been resolved.

Based upon review of Quarterly Performance Reports, the total Plan return includes all investments within the Plan, as recommended.

ISSUE VA-4: PaineWebber's quarterly performance reports only display five years of performance data.

RECOMMENDATION: Expand the performance comparisons to include longer time periods.

BACKGROUND

In the Report, it was noted that the Quarterly Performance Reports (presented to the Committee by the Investment Consultant) only showed total Plan performance data going back five years. This did not allow the Committee to fully analyze the Plan's performance over longer time periods. Additionally, as PaineWebber had been the Investment Consultant for approximately nine years, the inclusion of longer time periods in the reports would have allowed the Committee to more fully evaluate PaineWebber's asset allocation and manager selection recommendations.

CURRENT STATUS

Issue has been resolved.

KPMG reviewed the Quarterly Performance Reports for each quarter in the 2008 calendar year, and tested that each analysis shows total fund performance over an appropriate length of time (over 15 years). This includes showing data that pre-dates the current investment consultant, Segal Advisors, which has been the Investment Consultant since 2000.

ISSUE VA-5: The calculation of the dynamic index, as shown in PaineWebber's performance reports, is incorrect.

RECOMMENDATION: Correct the quarterly return in the performance reports.

BACKGROUND

In the Report, it was noted that, for the quarter ending September 1998, the calculated dynamic index in the Quarterly Performance Report (presented to the Committee by the Investment Consultant) was incorrect.

CURRENT STATUS

Issue has been resolved.

KPMG selected two quarters (the second and fourth quarters of 2008) and recalculated the composite rate of return (similar to the “dynamic index” utilized by PaineWebber) for the portfolio for these quarter. For this analysis, a variance of less than 0.1% was considered acceptable, which is likely attributable to rounding differences in the calculations.

	BEGINNING PORTFOLIO BALANCE	NEW MONEY	ENDING PORTFOLIO BALANCE	EARNINGS	KPMG CALCULATED RATE OF RETURN	SEGAL ADVISORS RATE OF RETURN	DIFFERENCE
Q2	$2,071,872,740	-	$2,075,724,508	$3,851,768	0.19%	0.18%	-0.01%
Q4	$1,874,599,369	($4,665,636)	$1,623,496,102	($246,437,631)	-13.15%	-13.13%	0.02%

Table 6: Calculation of composite rate of return

Variances are within an acceptable range.

B. ASSESSMENT OF PERFORMANCE

No issues were identified in this section of the previously issued Report.

VI. REAL ESTATE / VENTURE CAPITAL

A. REAL ESTATE / VENTURE CAPITAL

ISSUE VIA-1: The last bullet labeled number 9 under Section II B, Consultant(s) in the investment policy statement, assumed that the Investment Board has the necessary experience to make investment decisions on real estate, venture capital and other alternative investments.

RECOMMENDATION: There are four options available:

(1) Have the general consultant handle all of the asset classes in the plan including real estate, venture capital and alternative investments.

(2) Hire a specialist consultant just to handle real estate, venture capital and alternatives.

(3) Hire a senior investment analyst whose sole responsibility is to recommend and monitor real estate, venture capital and alternatives.

(4) Remove real estate, venture capital and alternatives from the plan over time, subject to liquidity constraints on the investments.

BACKGROUND

In the Report, it was noted that the outside consultant could provide opinions, but not necessarily recommendations or supporting data on real estate, venture capital, and other alternative investments for consideration by the Committee. The Committee was taking primary responsibility for making these investment decisions and the Consultant was used as a secondary source for providing opinions but not making investment decisions.

At the time, the Committee members generally lacked the necessary expertise to make such investment decisions. More than any other class of assets, real estate, venture capital and alternative investments require a high degree of investment expertise. Without a true objective third party advising the Committee, the Committee opened itself to criticism of potential conflicts of interest.

CURRENT STATUS

Issue has been resolved.

KPMG reviewed the Statement of Investment Policy and noted that the bullet referenced in the issue above (that stated the consultant could provide opinions but not recommendations for these asset classes) no longer exists. There is also no such limitation stated in the contract with Segal Advisors, the current investment consultant. Segal does handle all of the asset classes in the Plan including real estate, venture capital and alternative investments.

KPMG also notes that Metro hired a Chief Investment Officer in 2003. Based upon our review of the CIO’s past experiences with investment securities, financial modeling, and forecasting, the CIO appears to possess the appropriate qualifications and skills as described in the job description. Upon review of the Committee minutes from 2008, KPMG notes that the CIO was present at almost every meeting, and took the lead in most discussions involving performance analysis and current and future strategies.

ISSUE VIA-2: The statement on the location of real estate purchases (Section V, Bullet 2) creates a potential conflict of interest.

RECOMMENDATION:

(1) Include a statement in the investment policy which restricts the Metro fund from purchasing properties located in Davidson and surrounding counties to avoid any potential conflicts of interest.

(2) Include a statement in the investment policy that outlines the process involved in purchasing real estate. All recommendations concerning the purchase and the sale of real estate should be through an independent third party. This independent third party organization could be the general consultant or a consultant whose expertise is real estate.

(3) Conduct a study on the merits of using real estate within the portfolio.

BACKGROUND

In the Report, it was noted that under the guidelines for the alternative asset classes, real estate property could be purchased anywhere in the continental United States; however, preference was to be given to Tennessee projects of equal or higher investment merit. Although properties could be partially diversified within the state of Tennessee, the Investment Committee's strong preference to purchase real estate locally did not diversify the real estate portfolio. Nearly all purchases of real estate properties by the Committee were located in Nashville. Purchasing property locally or within the state without appropriate analysis or the input of a real estate consultant can lead to potential conflicts of interest and suboptimal investment decisions.

CURRENT STATUS

Issue has been resolved.

Section V, Bullet 2 referenced in the issue that states "*preference is given to Tennessee projects of equal or higher investment merit*" has been removed from the Policy. No such preference is given. Decisions to pursue real estate opportunities are subject to the same procedures as all other investment decisions.

Additionally, unlike PaineWebber, Segal does handle all asset classes in the Plan, including real estate. They also monitor real estate investments and include these assets in the Quarterly Performance Reports with the rest of the Plan. As real estate investments are now analyzed regularly in conjunction with the quarterly reports, a separate study on the impact of the real estate investments was not considered necessary.

Although Metro does not currently require Investment Committee members to sign disclosure and conflict of interest forms, all employees and members of all committees and boards of Metro are subject to the Metro Ordinance, which includes general ethical guidelines. Metro appears to have actively communicated these ethical guidelines to its employees, including members of the Committee.

Based upon discussion with the Chief Investment Officer, KPMG learned that a formal ethics policy, which provides further guidance to members regarding fiduciary responsibilities, is currently being created specifically for Investment Committee members. This policy is in the review process, and plans are in place for it to be implemented at some point in 2009. Given the broad nature of the Metro Ordinance, it would be beneficial for this additional policy to be implemented.

As previously noted, (see Recommendation 2008-04), KPMG does recommend that members of the Investment Committee be required to fill out and sign disclosure and conflict of interest forms every year.

ISSUE VIA-3: The Investment Board has purchased and/or considered the purchase of real estate, venture capital and alternative investments without sufficient due diligence.

RECOMMENDATION: Develop a clear systematic approach to evaluating potential real estate, venture capital and alternative investments with recommendations from an independent third party.

BACKGROUND

In the Report, it was noted that the Investment Committee did not use an independent third party to advise them with regard to real estate, venture capital, and other alternative investments. The only third-party advice the Committee had relied upon was the limited financial analysis done by the Committee's outside attorney. This outside attorney brought to the Committee's attention their need for an asset manager to advise the Committee, but the Committee instead continued to rely on their own experience in analyzing real estate investments.

The Report lists several examples where the Committee made questionable investment decisions without any systematic analysis of the investment, and even reinterpreted the investment guidelines to justify decisions.

CURRENT STATUS

Issue has been resolved.

As of December 31, 2008, decisions to pursue such investment opportunities are subject to the same procedures as all investment manager decisions.

Segal Advisors handles all of the asset classes in the Plan including real estate, venture capital and alternative investments. KPMG reviewed the Policy and related Segal contract noting that there is no restriction related to their involvement in these areas.

ISSUE VIA-4: The Investment Board has not sufficiently monitored real estate, venture capital and alternative investments.

RECOMMENDATION: Develop a series of reports, produced on a comprehensive and consistent basis, which allows the Board to analyze the performance of each of Metro's alternative investments at least quarterly.

BACKGROUND

In the Report, it was noted that after entering into alternative investments, the Committee had not maintained the necessary data to properly monitor Metro's investments in real estate, venture capital and alternative investments. Certain data that should have been readily available did not exist. Occasionally the investment managers had orally reviewed their portfolios at Committee meetings but not on a regular monthly or quarterly basis.

CURRENT STATUS

Issue has been resolved.

The Statement of Investment Policy has a section on Communications & Reporting. Per the Policy, investment managers shall issue a report at least quarterly, reviewing its progress, investment strategy and actions to the Metropolitan Treasurer and Investment Consultant. The investment managers are expected to communicate or meet with Treasurer and Investment Consultant on all significant matters pertaining to management of the Plan's assets.

Metro receives Quarterly Performance Reports from Segal Advisors that include information on real estate, venture capital, and alternative investments. KPMG reviewed the Committee minutes and noted that Segal Advisors gave a market update and reviewed the Quarterly Performance Reports at each quarterly meeting. These reports, which are produced on a comprehensive and consistent basis by Segal, allow the Committee to analyze the performance of each of Metro's alternative investments on a regular basis.

VII. DEFERRED COMPENSATION

A. DEFERRED COMPENSATION

ISSUE VIIA-1: Neither the Employee Benefit Board nor the Investment Board has been overseeing the 457 plan.

RECOMMENDATION: Formally move the responsibility for overseeing the 457 plan to the Investment Board. Re-evaluate the entire plan by analyzing fund options, performance, fees, and other components of the plan.

BACKGROUND

In the Report, it was noted that, while the Employee Benefit Board had the original responsibility for overseeing the MetroMax 457 Plan ("the 457 Plan"), they had not been properly overseeing the 457 Plan since its inception. Lack of oversight had contributed to suboptimal investment performance.

CURRENT STATUS

Issue has been resolved.

Based upon review of the most current MetroMax 457 Plan, the Investment Committee is currently overseeing the 457 Plan to determine if current investment options are still meeting performance criteria. KPMG also notes that the MetroMax 457 Plan was discussed and evaluated at each of the five Committee meetings conducted in 2008.

ISSUE VIIA-2: There are too many fund options available to participants.

RECOMMENDATION: Reduce the number of options for each asset class. Eliminate duplicate funds, funds that have similar mandates, and funds that have minimal assets.

BACKGROUND

In the Report, it was noted that the MetroMax 457 Plan forced participants to choose among 121 funds spread among various asset classes. Most participants in the 457 Plan have limited investment knowledge, and offering too many options likely confused and frustrated participants.

CURRENT STATUS

Issue has been resolved.

Based upon review of the most current MetroMax 457 Plan, the number of investment options decreased from 121 funds to only 19 funds. This reduction of funds helped to eliminate duplicate funds, funds with similar mandates, funds that have minimal assets, and provided more focused investment options for plan participants.

VIII. OVERVIEW OF RESULTS

A. SUMMARY OF RESULTS

The following table summarizes the results of our procedures:

	RESOLVED	PARTIALLY RESOLVED	NOT RESOLVED	UNABLE TO ADDRESS	TOTAL
Previous Issues Identified - 42	34	4	1	3	42
Approximate Percent of Total	81%	10%	2%	7%	100%

Table 7: Summary of results

The following four issues have been partially resolved:

- ISSUE IIA-3: All of the portfolio performance comparisons of the fund, including both total fund and asset class level returns, are calculated gross of fees and do not reflect the cost of investment management fees.

- ISSUE IIIA-2: Investment Board members are not required to sign a conflict of interest form.

- ISSUE IVA-4: The section on the "Consultant to the Investment Board" in the investment manager contracts clearly states that the consultant is the Phillips Group of PaineWebber.

- ISSUE VA-1: The quarterly performance report does not include any analysis of risk.

The following issue has not been resolved:

- ISSUE IIIA-4: There were no procedures to ensure that investment balance totals reported on the general ledger, the State Street and Northern Trust reports, and the PaineWebber quarterly performance reports were in agreement.

B. SUMMARY OF RECOMMENDATIONS

In addition, based upon results of our procedures, KPMG has made the following further recommendations:

- RECOMMENDATION 2008-01: Revise the Statement of Investment Policy to replace the Lehman Brothers Aggregate Index with Barclay's Capital Aggregate Bond Index.

- RECOMMENDATION 2008-02: In the Quarterly Performance Reports, include an analysis of net-of-fee performance comparisons versus the appropriate benchmarks in addition to the current gross-of-fee analysis. This will allow the Investment Committee to properly analyze the performance of investment managers, and will facilitate appropriate consideration of passive investments.

- RECOMMENDATION 2008-03: Implement additional requirements regarding the composition of the Investment Committee whereby certain members are required to possess appropriate investment and/or financial expertise.

- RECOMMENDATION 2008-04: Require members of the Investment Committee to complete and sign disclosure and conflict of interest forms every year.

- RECOMMENDATION 2008-05: Revise the procedures surrounding pension investment accounts to require activity, as reported by the custodian, to be recorded to the general ledger within 30 days of receipt of statement.

- RECOMMENDATION 2008-06: Implement provisions whereby the terms and conditions of investment manager contracts, including fee arrangements, are reviewed, evaluated, appropriately updated and approved by both management and the Investment Committee on a regular basis, at a minimum every five years.

- RECOMMENDATION 2008-07: In the Quarterly Performance Reports, include risk return analyses for all investment managers.

The details of procedures performed and results obtained that led to each of these further recommendations have been discussed above.

* * *

We have performed the procedures described above solely to evaluate whether the issues identified in the report dated March 31, 2000, issued by Internal Audit of the Metropolitan Government of Nashville and Davidson County on the Metropolitan Benefit Board Pension Investments, have been resolved as of December 31, 2008. This agreed-upon procedures engagement was performed in accordance with attestation standards established by the American Institute of Certified Public Accountants.

The sufficiency of the procedures is solely the responsibility of the specified users of this report. Consequently, we make no representation regarding the sufficiency of the procedures described above either for the purpose for which this report has been requested or for any other purpose.

We were not engaged to, and did not, conduct an audit, or an examination of internal control over financial reporting, the objective of which would be the expression of an opinion on its effectiveness. Accordingly, we do not express any such opinions. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of the Office of Internal Audit of the Metropolitan Government of Nashville and Davidson County, and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

May 21, 2009