OCERS Board Policy

Investment Fee Policy

Purpose and Objectives

The purpose of OCERS' investment fee policy is to emphasize and balance the sometimes- disparate objectives of:

a. reducing the costs of investment operations to the lowest sustainable level available in competitive markets for top investment managers,

b. aligning the interests of OCERS and its stakeholders with the selected investment management firms we retain, as well as their key professionals who manage our portfolios and provide superior research,

c. securing the best available combination of skill, performance expectations, risk and cost for a given investment discipline, and

d. minimizing potential appearances of excessive fees to address the optics of public-sector investment funds that operate in a highly transparent community.

Administration and Accountability

a. Fee administration is ultimately a management responsibility -- subject to formally articulated board policies, guidance, accountability and ongoing oversight by the Investment Committee ("Committee"). Fees for investment-related services shall be negotiated by the Chief Investment Officer (CIO) with appropriate staff and legal support, in accordance with OCERS' policies and formal guidance from the Committee.

b. The resultant fee arrangements and related contractual terms shall be summarized regularly in periodic reports provided to the Committee. To assure transparency, highlights of newly negotiated contract terms shall be reported to the Committee as a consent-agenda "review and file" item, following execution of contracts by the CIO or designated official.

c. The CIO shall schedule an annual fee-review study session with the Committee to provide a recurring opportunity to revisit this policy, the prevailing fee structures of incumbent managers, relevant recent developments in the investment management industry, and potential opportunities for improvement of OCERS' policies and practices.

d. The CIO is authorized and encouraged to continue discussions with other public pension plan officials to explore the feasibility of cooperative efforts to obtain lower, more suitable fee levels from investment managers. This may include participation in limited-scope pension-fund partnerships or similar legal prudent structures to bundle assets invested in a single manager with other pension funds in order to obtain lower break- point pricing. Without necessarily endorsing each detailed element of the CIO's April 2013 working draft of a ("P4") public pension portfolio procurement platform, the Committee expresses its willingness to participate lawfully in such an arrangement subject to further legal and fiduciary review and policy deliberation, provided that sufficient interest is expressed by other public plans or investment officials. In the absence of a more formal network, the CIO is authorized to pursue strategies similar to those outlined in the P4 working draft in order to benefit the OCERS' portfolio, including "piggyback" strategies in which OCERS serves as either the host or the junior partner in cost-sharing structures that receive preferential fees, lower costs or better investment terms through aggregation of assets.

Role of the Institutional Pension-Class Shares

OCERS encourages widespread industry adoption of "P-class" shares of institutional investment funds to encourage materially lower fees for pension funds that invest in scale. OCERS would be supportive of multiple levels of P-share classes specifically for client plans that invest $50 million and $100 million, which could be contingent on several times those amounts of aggregate public pension investments with that manager.

Duties of the Consultants

a. OCERS' investment consultants are encouraged to actively promote the availability of fee discounts for those clients who can aggregate a significant amount of capital and enjoy "club pricing".

b. In presenting potential managers and especially short lists of managers for consideration, OCERS' consultants should provide as much relevant fee information as is practical to disclose and consider at that stage in a manager search, in the general context of price-to- value or benefit/cost analysis.

c. This directive does not suggest that fees alone should dominate manager searches, but seeks to assure that fee levels shall never become an afterthought or a fait accompli in the decision-making and contracting process.

Fee Review Process

a. Before making final recommendations, the investment staff and our consultants are expected to:

   i. explicitly discuss fees with all semi-finalists,

   ii. differentiate and evaluate firms with fees in mind, before short-listing and recommending prospective managers, and

   iii. obtain fee indications – including their willingness to negotiate meaningfully – from prospective managers before presentations to the Committee.

b. Before they are interviewed for due diligence or make a presentation to the Committee, prospective managers shall be given a copy of (or excerpts from) the OCERS fee policy and such further guidance regarding preferred fee structures as the CIO shall deem appropriate.

Preferences on Fees

Absent an evidently superior investment strategy and capability, or a discernible reason to expect materially superior investment performance from a competitor looking forward, OCERS will give selection preference to firms that offer the most advantageous fee structures including as many of the following elements as appropriate:

a. Lower overall fees than comparable competitors with equivalent expected return-and-risk profiles. In this context, highly competitive fixed fees that are also materially lower than the expected fees payable under performance-fee structures will be selected if there is high confidence in the manager's future performance expectations.

b. Performance-based fees and compensation structures that optimally align interests of the advisory firm, the portfolio manager, OCERS and our stakeholders will be selected over fixed fees with similar expected costs, or where expected performance is more uncertain or relatively volatile. However, if the manager offers both fixed fees and performance fees for the same product, this alignment of interests with OCERS should not be presumptive.

c. To prevent runaway fees in periods of extreme upside performance, performance-based fees with symmetrical structures, caps or decelerators are preferred over unlimited fees unless there is a high hurdle with no catch-up; absent such controls, a fixed fee may be more appropriate to avoid appearances of excessive fees in exceptional periods.

d. Multi-year fractional holdbacks or clawbacks are preferred for performance fees; client-friendly high-water marks are a bare-minimum requirement.

e. (i) Caps on variable fees as a percentage of OCERS net returns are preferred. (ii) Performance fees that could encourage a manager to "swing for the fences" are discouraged. Advisor profit participation rate factors exceeding 33 percent must be judged against this principle, even with a high hurdle.

f. Hurdle rates for performance fees should not be less than the total projected fees and normally should at least approximate the expected return and the marketed return of the strategy – thereby limiting compensation for below-target performance to a modest base fee.

g. (i) Base fees are preferred at levels conceptually sufficient to pay OCERS' proportional share of fixed costs and basic operating expenses, but not bonuses and internal performance compensation, owner profits or economic rent. (ii) Base fees that are comparable to the costs of traditional passive management, or less than forty percent [40%] of the firm's traditional fixed fees, would also qualify for preferred consideration.

h. The foregoing guidelines are intended to be directional and not absolute or formulaic.

Additional Guidance

a. Where fixed and (constrained or symmetrical) performance-based fees are similar in expected costs, OCERS will prefer a performance-based fee in order to better align interests, unless there are compelling reasons to the contrary.

b. On the other hand, where fixed fees are discounted and found to be highly competitive for accounts our size, and are clearly less than the expected level of performance-based fees on the basis of the manager's historical record or portrayal of expected returns, then fixed fees should be given preference.

c. Likewise, there may be times when the costs or complexity of establishing separate accounts to customize an otherwise-preferable fee structure outweigh the benefits; undue complexity adds compliance risks that generally should be avoided.

d. Within these bright-line guidelines, and subject to the general directional guidance provided in Preference On Fees Section, the CIO shall exercise best professional judgment and discretion in the selection and negotiation of the most appropriate and beneficial fee structure for OCERS, on a situational basis.

e. Contracts may use both types of fee structures in a blended fee or a bifurcated account structure, where there is not an obviously preferable method and this arrangement can be implemented economically.

Duties of Incumbent Managers

Each incumbent manager appearing before the Investment Committee or the Manager Monitoring Subcommittee shall be presented in advance a copy of this fee policy and asked to discuss expressly how its fees could be reduced or re-aligned to better conform to this policy.

Reporting

a. Under the direction of the CIO, the Investments staff shall briefly document the rationale for the fee structure selected or negotiated in a memo to the file retained in the records of the Investments Division along with a copy of the signed contract documents.

b. Accuracy of performance fee billings shall be reviewed by the investments and financial staff, and periodically audited by the internal auditor.

Policy Review

This policy shall be reviewed every three years by the Governance Committee and may be amended by the Board of Retirement at any time.

Policy History

The Retirement Board adopted this policy on April 24, 2013. The policy was revised on January 27, 2016.

Secretary's Certificate

I, the undersigned, the duly appointed Secretary of the Orange County Employees Retirement System, hereby certify the adoption of this policy.

Steve Delaney

1/27/2016

Steve Delaney
Secretary of the Board

Date

Fee Policy Appendix A:

Performance-Fee Hurdles

For alternatives investment managers including hedge funds and other advisors to funds that receive carried interest or performance fees, OCERS policy is to hereafter generally seek a performance hurdle unless no viable alternative can be found for that manager's mandate. To implement this policy, the CIO shall consider the following Investment Committee guidance:

A. Principles:

   a. It is not OCERS' intention that the "fee tail will always wag the performance dog" but the lack of a fee hurdle represents a formidable drag on net realized returns to OCERS that cannot be ignored in light of the inherent uncertainty of future returns

   b. Absent a low fixed fee, OCERS prefers to engage "alternatives" investment managers with performance-fee hurdles. Hard hurdles are strongly preferred over soft hurdles unless there are compelling differences in formulas.

      i. All else equal, OCERS will seek to avoid managers with soft-hurdle "catch-up" ratios of 100% and strongly discourages general partner catchup percentages exceeding 60%, as a statement of policy.

   c. For all prospective managers proposing a hurdle, the CIO shall provide the Committee summaries that include a fee table showing the fee drag at various levels of gross return, in both percentage and dollar terms for the mandate size proposed.

   d. The expected returns of managers without hurdles will be adjusted by the CIO to account for their fee drag in all comparisons presented to the Committee.

   e. The CIO and/or the general consultant shall present strategic alternatives to the Committee for any underperforming asset category that is populated predominantly by managers lacking performance hurdles.

   f. All managers proposing or receiving performance fees must declare their expected or target net and gross return, which will be used to evaluate their "alpha" contribution to the portfolio and the composite for their asset category.

B. Incumbent managers of alternative investments shall be informed of the OCERS preference for performance-fee hurdles.

   a. Managers without a hard hurdle shall be required to provide a net-return annualized performance target no later than March 31, 2016.

   b. The CIO's annual fee report shall include a table showing by decision-relevant category what level (in bps) and percentage of managers' overall fees and performance fees was attributable to performance above their performance target, and above their comparable peer group average.

c. Managers failing to institute a fee hurdle after calendar year 2016 shall be placed automatically on Watch status if their performance fails to meet a declared performance expectation and a peer performance average over a two, three or five year period. If appropriate, the CIO may elect to present competing managers for that portfolio slot to the manager monitoring subcommittee for comparison and a possible replacement recommendation to the Committee.

C. Prospective managers of alternative investments shall be evaluated on the basis of their proven, sustainable and expected returns net of fees and their risk profile.

a. To support deliberations, the CIO and staff shall provide the Committee with comprehensive tables showing the gross and net returns of a proposed new manager over a spectrum of possible investment returns including (at minimum) the manager's worst negative return, zero, the target/expected return and one standard deviation above the target/expected return.

b. For finalist managers without performance fee hurdles, at least one manager with a hurdle shall also be presented to the Committee as an alternative, if feasible.

c. Semi-finalist and finalist managers with appropriate fee hurdles shall be given a clear preference in selection over managers with no hurdles, absent a compelling investment thesis based on risk-adjusted expected returns net of all fees and expenses.