Fiduciary Review of the Shelby County, Tennessee Retirement System

Investigation of Conflicts of Interest, Undisclosed Fees, and Malfeasance Related to the Shelby County Retirement System, by Benchmark Financial Services, Inc., December 21, 2006.

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I. Introduction

This report is intended to provide an in-depth analysis of many aspects of the Shelby County, Tennessee, Retirement System ("the Fund"). Our analysis focuses upon performance and operation issues surrounding pension investments, as well as conflicts of interest and undisclosed financial arrangements involving firms providing investment services to the Fund. In conducting the analysis we interviewed various persons involved with the Fund and others to gain an understanding of the decision-making process surrounding pension investments. We also reviewed material provided by the Fund, its employees and vendors related to the issues discussed herein. We have relied upon the information provided to us and have not independently verified the material. Given that all the relevant information and documentation has not been provided to us, we cannot be certain of all of the conclusions stated. It is therefore imperative that as many parties as possible knowledgeable regarding the matters reviewed scrutinize this report closely in order to determine whether it is accurate and whether there are any material omissions or misstatements. Furthermore, as a preliminary report it is not intended to be a comprehensive discussion of all potential issues. The report does not constitute legal, financial, accounting or tax advice

Key Finding

The Board of the Fund has been relying upon an investment consultant subject to myriad conflicts of interest. These conflicts, as well as the compensation derived by the investment consultant, have not been adequately disclosed. The review uncovered that the consultant has undisclosed arrangements with many of the Fund's managers and earns $4 million to $5 million a year in brokerage commissions.

and should not be relied upon as such. Where additional review is deemed advisable, we have so noted. Our recommendations are aimed at improving the overall management of the Fund's pension investment performance.

II. Executive Summary

Prompted by concerns regarding investment consultant conflicts of interest revealed in investigations involving public pensions in the cities of Nashville and Chattanooga, Tennessee, the Board of the Fund determined to undertake a review of its investment consultant and other vendors to the Fund. Our conclusion is that the Fund is not subject to the very same conflicts as these other public pensions but nevertheless issues have been identified that should be addressed.

The Board of the Fund has been relying upon an investment consultant subject to myriad conflicts of interest for objective advice regarding management of pension assets. These conflicts of interest, as well as the compensation derived by the investment consultant from money managers the consultant is responsible for evaluating for the Fund, have not been adequately disclosed to the Board. The review uncovered that the consultant has undisclosed brokerage arrangements with many of the Fund's managers and earns $4 million to $5 million a year in brokerage commissions.

As detailed throughout the report, the investment consultant's advice and recommendations regarding Fund investment policies and decisions has been found to be deficient. Remarkably, the Fund does not have an Investment Policy Statement, addressing fundamental issues such as manager qualifications and asset allocation. While most of the Fund's managers have been provided with documents detailing investment objectives and restrictions applicable to them, the Fund has no separate Manager Guidelines document to refer to regarding the guidelines applicable to all managers. A number of issues have been identified regarding the performance analyses the consultant provides to the Board. The contract between the consultant and the Fund does not stipulate the fiduciary standard of care to which the consultant will be held and does not detail the professional responsibilities or duties of the investment consultant. The conflicts of interest surrounding the consultant's business are exacerbated by the level of reliance the Board has placed upon the consultant. Although the Board makes all final decisions regarding investments, they do so in reliance on the professional advice of the consultant.

In addition to those conflicts of interest related to the consultant which are pervasive in the investment consulting industry nationally (as identified by the staff of the Securities and Exchange Commission in 2005), the arrangement with the investment consultant is subject to certain potential conflicts as a result of the extensive financial dealings of the consultant's minority owner in the Shelby County area.

A hedge fund of fund investment program recommended by the Fund's investment consultant that was approved by the Board in 2005 is especially problematic. As a result, the Fund now has $135 million or approximately 15% of its assets invested with over 120 largely unregulated high-risk money managers scattered throughout the world whose identities, securities holdings, trading costs and custodians are unknown. Substantial duplication of the underlying managers involved has been uncovered, as well potential non-compliance with the investment restrictions in the Administration and Trust Agreement of the Fund that should be researched further. The consultant has derived exponentially greater compensation from the Fund (approximately $387,000 versus approximately $85,000) as a result of this elaborate hedge fund of funds arrangement. The full extent of the consultant's compensation related to the hedge fund of funds managers, including the underlying managers (whose identities the Fund does not know) remains unknown.

The Fund's lack of manager qualifications incorporated into an Investment Policy Statement and the consultant's subjective method of evaluating venture capital investments subject that portion of the investment portfolio, with an approximate market value of $18.5 million as of September 30, 2006, to unnecessary risk. Total capital committed by the Fund to venture capital amounts to $45 million. Given the lack of readily ascertainable market values and illiquidity generally related to securities held in venture capital portfolios, as well as the conflicts of interest related to valuation of such portfolios, it is possible that the true value of the Fund's venture capital investments may be substantially less than indicated in the investment consultant's performance reports. That is, the venture capital losses may exceed those already reported. On the other hand, it is possible that the venture capital investments may, in time, perform satisfactorily.

Excessive turnover of and deficiencies related to the due diligence undertaken by the investment consultant of the Fund's managers, especially the alternative managers, suggests that the investment consultant's manager selection capabilities are lacking. It is likely that additional terminations of managers who were recommended by the consultant will be inevitable in the near future. The due diligence the consultant has provided to the Fund over the years regarding minority and local owned investment firms has not been adequate. The performance results related to many of these investments have been poor. Poor manager selection results in increased transaction costs, as well as investment underperformance.

A review of the Fund's contracts with its investment managers indicates numerous deficiencies that expose the Fund to avoidable risks. Through more effective, informed negotiation and use of "most favored nation" clauses in the Fund's contracts with its managers, the investment advisory fees the Fund pays it managers may be reduced. Fees may also be reduced through use of passive or index managers. The consultant's financial arrangements with money managers hired by the Fund create a conflict of interest that may impact effective fee negotiation.

Further investigation is required to determine the total undisclosed compensation the consultant has derived from the Fund's managers, including the 120 underlying managers involved in the hedge fund of fund program. It is recommended that the performance of the total Fund and its managers be reviewed and reformatted to provide the Board with additional analysis of the actual performance of the Fund.

According to Staff, "the Fund has performed well over a complete market cycle. For the trailing seven year period from 9/30/1999 to 9/30/2006 the pension plan has earned 7.4%, which places it in the top quartile of the Northern Trust Public Funds universe. The performance is 39 basis points ahead of the median plan, which at today's balance is $3 million a year over the average plan. This performance has in part contributed to the financial soundness of the plan which at 6/30/2006 had a funding ratio of 109%."

III. Administration and Trust Agreement of the Shelby County Retirement System

A. Administration of the Fund

According to the Administration and Trust Agreement of the Shelby County, Tennessee, Retirement System ("the Administrative and Trust Agreement" or "the Agreement"), a copy of which we have been provided with and have reviewed, the Fund, consisting of Plan A, Plan B, such other qualified retirement plans as the County shall establish, and the Trust, is administered by the Shelby County Retirement System Board of Administration and Trust ("the Board"). Currently the County has established Plans A, B and C.

The composition of the Board consists of 12 members, including the County Mayor (or his written designee); the Chairman of the County Commission (or his written designee); the Chairman of the County Commission Budget Committee; the County's Director of Administration and Finance; a popularly elected full-time County official; two County employees who are active participants with at least 10 years of participation in the Retirement System who shall be appointed by the County Mayor; two pensioned participants under the system who shall be appointed by the County Mayor and three citizens of Shelby County who shall be appointed by the County Mayor "who have demonstrated that they are knowledgeable in pension systems and who are not participants in the System."

The Agreement further provides that the Fund shall have an Investment Committee to analyze the credentials of, review the results of and recommend the hiring and firing of managers, as well as recommend asset allocations and cash flow needs. The Agreement states the County, upon recommendation of the Board, shall hire a Manager of Pension Administration who shall have day-to-day responsibility for managing the Fund. The County Mayor, upon recommendation of the Board, shall appoint a Manager of Investments who shall have day-to-day responsibility for managing the investments of the Fund. The Manager of Pension Administration is Waverly Seward and the Manager of Investments is David H. Pontius.

The Board has authority to engage professional advisors for the purpose of maintaining a soundly designed, administered, and financed retirement system. The Board has the authority to hire and fire investment managers, provided that such managers shall first have been recommended by the Investment Committee.

According to the documents we have been provided, since 1999 the investment consultant to the Fund has been Consulting Services Group, LLC ("CSG"), based in Memphis, Tennessee. Pursuant to an amendment to the contract between the Fund and CSG dated July 1, 2004, Alternative Investment Strategies ("AIS"), a division of CSG, has been providing advice pertaining to alternative investments and more specifically fund of funds investing in hedge funds. CSG is paid a hard dollar annual retainer for its services and additional hard dollar fees for services such as asset allocation studies and manager searches. CSG is paid an asset-based hard dollar fee for advice related to hedge fund of funds. The Fund's managers fall into three broad categories: traditional stock and bond managers; venture capital managers and hedge fund managers. All of the Fund's managers are considered active managers. Such managers have discretion to make investment decisions that deviate from the benchmark they are measured against, such as the S&P 500, in an attempt to outperform their benchmark. Apparently the Board has never hired any passive managers, whose goal is to match the index or benchmark return.

B. Investment Guidelines

Section VI of the Administration and Trust Agreement relates to investment of the Fund. Section 6.6 lists the specific assets in which the Fund may and may not invest and item (m) provides that the Fund may invest in other assets not listed, if approved individually by the Investment Committee, including private placements. Item (m) is not subject to any percentage limitation. Finally, the Section requires the Board to select an appropriate benchmark for each asset or group of similar assets. There is no requirement that the Board select a benchmark for the Fund.

C. Self Dealing and Conflicts of Interest

Section VIII of the Administration and Trust Agreement includes a prohibition against conflicts of interest and self-dealing involving any Board member or certain employees of the Fund. However, Board members and key employees are not required to sign a conflict of interest disclosure form. Without the ability to review the financial interests of the Board members and key employees and obtain their signed written representations that they do not have conflicts of interests with respect to plan investments, proper oversight is compromised. **The recommendation is that the Board members and key employees should be required to complete and sign disclosure and conflict of interest forms annually.**

IV. Investment Policy Statement and Manager Guidelines

The Fund does not have an Investment Policy Statement, addressing fundamental issues such as Manager Qualifications and Asset Allocation. The Fund has no separate Manager Guidelines document wherein the investment objectives and restrictions applicable to all managers are articulated, however, most of the managers have executed documents drafted by Staff of the Fund, referred to as Investment Policy Statements, which provide guidelines. Section 6 of the Administration and Trust Agreement is the sole written document which outlines the objectives and policies of the Fund. With respect to public funds, generally the Fund's investment consultant will assist in the drafting and maintaining of an Investment Policy Statement and Manager Guidelines. The Statement broadly addresses issues ranging from Delegation of Responsibilities and Manager Qualifications to Performance Standards.

The contract between the Fund and its investment consultant is remarkably brief with respect to the scope of services the consultant is expected to provide in return for its annual retainer. The contract is silent with respect to the necessity of and responsibility for these fundamental documents. Typically the contract between the investment consultant and the plan would include specific reference to the consultant's duties with respect to assisting in the drafting or development of an Investment Policy Statement and Manager Guidelines, as well as ongoing evaluation and updating of these documents in light of changes to the asset allocation and manager structure.

Aside from language relating to the consultant's obligations with respect to quarterly performance evaluations, the contract between the Fund and its consultant only states "A review of the adherence to the Client's stated investment guidelines as described in Client's Review of Investments, Policies and Procedures will also be part of the (*consultant's quarterly*) evaluation" and that the consultant "further agrees to conduct reviews of Client's existing goals and guidelines and make whatever recommendations it deems appropriate."

The above statements should encompass responsibility for an Investment Policy Statement (including Manager Qualifications) and Manager Guidelines since such important documents are regarded as fundamental to the management of pensions and cornerstones of the investment consultant's duties. However there is no specific reference to these items. Beyond the above quoted language, it appears that the scope of work the contract contemplates the consultant will provide for $50,000 annually is limited to quarterly performance reporting and reviews of incumbent managers. Other services, such as asset allocation studies and manager searches, are provided at additional cost.

An Investment Policy Statement usually begins with identification of the parties responsible for managing the assets in the Fund. Sections I, II and VI of the Administration and Trust Agreement indicate that the Board, the Investment Committee, certain key employees and investment managers retained by the Board shall be responsible for managing the Fund's assets. Section II of the Agreement authorizes the Board to hire professional advisors and investment managers. However, there is no language concerning minimum levels of experience required of professional advisors. There are no minimum experience, assets under management or investment performance requirements applicable to the investment managers hired by the Board to manage Fund assets in the Administration and Trust Agreement.

Another important section of an Investment Policy Statement should discuss the asset allocation strategy of the Fund, as well as define the target policy of the Fund. The purpose of the target policy is to clearly define which asset classes are to be included in the portfolio and the optimal allocation to each asset class. The target policy stated in the Investment Policy Statement is typically determined from an asset allocation study. The target for each asset class generally changes over time due to the conclusion reached in the periodic asset allocation studies. Some pensions conduct asset allocation studies annually, while others do so less frequently. The investment consultant to the Fund does produce on an annual basis asset allocation studies. However, decisions related to the findings of the asset allocation studies are not reflected in target policies within an Investment Policy Statement. A formal statement regarding the re-balancing strategies of the Fund, setting target ranges for each asset class within the portfolio should be included within the Investment Policy Statement.

An Investment Policy Statement should define the relevant benchmarks that the Fund will be measured against both at the total fund level and for each asset class. Many plans analyze performance against several benchmarks. Plans should also analyze performance against comparable peer group universes. Further, most plans will include a section in the Investment Policy Statement devoted to the risk objectives of the plan and the measurement of risk.

As mentioned earlier, Section 6.6 requires the Board to select an appropriate benchmark for each asset or group of similar assets. However there is no requirement that the Board select an appropriate benchmark for the Fund. The sole benchmark utilized by the consultant to measure performance of the Fund is a Total Fund Composite Index "comprised of market index proxies in the same ratio as the investment managers." There is no additional disclosure in the quarterly performance reports regarding the composition of the Total Fund Composite Index. The fact that the consultant does not utilize any index as a benchmark for the international and venture capital strategies in his performance reports raises additional questions regarding the composition of the Total Fund Composite Index. However, Staff has indicated that the international strategies are benchmarked to an EAFE Index and venture capital is benchmarked to the S&P 500 index. It is also unclear from the performance reports whether the portfolio performance comparisons of the Fund, including both total fund and asset class level returns, are consistently calculated net of all applicable investment management fees. In the case of hedge funds, performance is not reported net of the additional .25 fee paid to CSG. Staff has indicated that for audited financial statement and return purposes, performance is indicated net of all fees.

Asset class and manager guidelines for a plan may be included in the Investment Policy Statement or in a separate document. The role of the guidelines is to establish standards that specifically outline the types of investments that can be included or excluded in the portfolio. Usually each manager is provided with a copy of the guidelines for his specific mandate which is signed by both the manager and the plan. Section 6.6 does delineate permissible and impermissible investments for the Fund and some, but not all, of the Fund's managers have received copies of the Section, as evidenced by signed copies. However, as detailed below, there is both confusion regarding manager investment guidelines and conflicting language in the documents.

The recommendation is that the Fund immediately develop an Investment Policy Statement and Manager Guidelines. Currently the Fund is operating without the most fundamental organizational guidelines. The existing informal decision-

making process greatly increases the risk that the Fund's investments may not perform optimally.

V. Investment Consultant

As mentioned earlier, since 1999 the investment consultant to the Fund has been CSG, based in Memphis, Tennessee. Pursuant to an amendment to the contract between the Fund and CSG, since July 1, 2004, AIS, a division of CSG, has provided advice pertaining to alternative investments and more specifically fund of funds investing in hedge funds.

The contract between the Fund and its consultant does not state a term. The 1999 contract has never been subject to competitive bidding; however, according to Staff the previous contracts with the consultant apparently were. Lack of regular competitive bidding is unusual but not unheard of for public funds. Many public funds are obligated under state law to re-bid contracts in an open environment periodically and even publish notification of the contracting opportunity. While there may be no requirement per se to place this professional services contract out to bid, the public bidding process would serve several useful purposes. By reviewing other RFP responses, the Board can compare the services and fees of their current consultant against others. The Board can learn about the scope of services other consultants provide, as well as industry and professional standards related to matters such as Investment Policy Statements and Manager Guidelines. It would also allow the Board to review how other consultants structure their fees. If other consultants offered lower fees, the Board could use this information to negotiate more effective with the current consultant, should it choose to remain with the firm. On the other hand, the Board could hear presentations of firms not subject to the numerous conflicts of interest related to CSG detailed below and become more fully informed as to the potential harm related to such conflicts.

The recommendation is that the Fund publicly seek competitive bids regarding a contract for investment consulting services.

A. Agreement with CSG/AIS

CSG Investment Advisory Services Agreement

We have reviewed the Letter of Agreement for Investment Advisory Services dated December 3, 1998 between the Fund and CSG. The agreement provides that it commences on January 1, 1999 and continues until terminated by either party. The contract provides that the Fund will pay CSG an annual fee of $50,000 per year with annual increases of 5% in year 4 and year 5. We have not reviewed the annual payments made by the Fund to CSG pursuant to the contract; staff indicates that the 5% annual increase has not applied in subsequent years. For the period from August 31, 2001 through August 31, 2006, the Fund has paid CSG $501,251.86 in hard dollar consulting fees. (Additional compensation CSG has derived from certain of the Fund's managers related to the Fund's accounts is detailed below; total compensation derived by CSG from the Fund's managers remains unknown.)

The contract does not expressly state that CSG is a fiduciary to the Fund with respect to the services it provides. Whether CSG is a fiduciary to the Fund is not determined by the wording of the contract, however, acknowledgement of such status in the contract puts the parties to the contract on notice at the inception of the relationship of the standard of care to which the consultant will be held. The contract does not address or contain any prohibitions or disclosure obligations regarding conflicts of interest involving the consultant. Given the fiduciary nature of the relationship, the level of reliance upon the consultant by the Board, and the significant conflicts of interest related to CSG's business operations as described below, these are significant omissions. CSG has provided the Fund with a document responding to some but not all of the questions regarding conflicts of interest included in a questionnaire recommended by Department of Labor and SEC in May 15, 2005. Deficiencies regarding CSG's questionnaire responses are discussed below.

The contract indicates that CSG will provide quarterly performance evaluations on the client's entire investable assets in a concise and easy to understand format. The evaluation will include a comparison of the investment performance of the Fund to that of relevant market indices and, where appropriate, peer group performance. A review of compliance with the client's stated investment guidelines as described in Client's Review of Investments, Policies and Procedures will also be part of the evaluation. CSG further agrees to conduct reviews of the Fund's existing goals and guidelines.

CSG further agrees to perform asset allocation studies and to recommend appropriate actions to improve the efficiency of the Fund's portfolio by either increasing the expected return for a stated amount of risk or by achieving the same return with less risk or a combination of the two. An extra charge of $10,000 per study will apply to any such requested study. Should a change in manager result from the Performance Review or Asset Allocation Study referred to above, CSG agrees to perform manager searches for an extra charge of $7,500.

There is no language in the contract related to payment for services on a "soft dollar" basis or through brokerage commissions. The Board has apparently decided that consulting fees paid to CSG pursuant to the Investment Advisory Services Agreement and the First Amendment described below, should be made on a cash basis. According to Staff, the Board is also of the understanding that CSG is not receiving any brokerage compensation from any of the Fund's managers related to the Fund's account. Thus, any additional compensation derived by CSG from the managers related to the Fund's accounts, if any, would be unauthorized. Again, while there is evidence of additional undisclosed compensation, total compensation derived by CSG from the Fund's managers related to the Fund's accounts remains unknown.

B. First Amendment to CSG Investment Advisory Services Agreement

The First Amendment to the Investment Advisory Services Agreement was executed effective July 1, 2004 and relates to additional investment consulting services from CSG, i.e. advice pertaining to Alternative Investments and more specifically fund of funds investing in hedge funds. This agreement provides that CSG will be paid annually an additional asset based fee of 25 basis points on all hedge fund and hedge fund of funds investments. CSG agrees to develop an investment strategy pertaining to the identification, interviewing, selecting, hiring and ongoing monitoring of various combinations of hedge funds or hedge fund of funds. This strategy will provide for proper diversification among managers, strategies and disciplines. CSG will conduct manager searches for the implementation of the approved (i.e. recommended) investment strategy.

In conclusion, the contracts between the Fund and its consultant are deficient in several material respects. As mentioned earlier, the contracts fail to specify the fundamental duties of the consultant, such as assisting in the drafting of an Investment Policy Statement and Manager Guidelines. The contracts are also deficient in failing to expressly acknowledge the consultant's fiduciary status and require disclosure of any conflicts of interest.

The recommendation is that the contract between the Fund and its investment consultant be revised to detail the scope of the consultant's duties and the fiduciary standard of care to which he will be held; require conflicts of interest prohibitions and disclosure obligations; and address other emerging fiduciary concerns.

C. CSG Form ADV

Part I of CSG's Form ADV available on-line through the SEC's Investment Adviser Public Disclosure program indicates that the firm is a limited liability company organized under the laws of the state of Tennessee. The firm states in its filing that it has 11-50 employees and that all of these employees are registered representatives of a broker-dealer. As registered representatives, all employees of CSG are legally permitted to receive brokerage compensation. In Part II of its Form ADV, discussed below, CSG indicates it has 14 consultants who are principally responsible for investment reviews, each of whom have 6-20 accounts and are supported by teams which include other consultants or principals, analysts and trading personnel. The firm states that it had 101-250 investment advisory clients during its most recently completed fiscal year. With respect to types of clients, the firm indicates that 26-50% of its clients are high net worth individuals; 26-50% of its clients are charitable organizations. Pension and profits sharing plans and state or municipal government entities each represent 11-25% of its clients. While the latter may represent a minority of CSG's clients, given the probable size of such pension clients, in terms of assets under advisory this group may be a far greater percentage. In its Part I filing, the firm indicates that it has no criminal or disciplinary history that is required to be disclosed on the form.

Joe Meals, the Compliance Officer at CSG, states that D. Canale & Co. owns 18.49% of CSG and Mike Robinson (who according to the Wall Street Journal article below apparently is also an executive employed by D. Canale & Co.) owns 13.5%. Thus, these non-controlling parties have a combined ownership interest in CSG of approximately 32%. The remainder of the company stock apparently is owned by employees.

In response to our request, CSG provided Part II of Form ADV, which is not available on-line through the SEC. The Part II we received is a new document, dated June 6, 2005. Since Part IIs are no longer required to be filed with the SEC, we do not know whether any Form ADV Part IIs the Fund may have received over time contain the same disclosures as the document we have reviewed. Further, we do not know whether the Fund recently received the filing from CSG that we reviewed. The majority of the disclosure language related to conflicts of interest at CSG appears to have been added recently, in part in response to Securities and Exchange Commission and Department of Labor concerns.

In Part II CSG states that it has arrangements which are material to its advisory business or its clients with a related person who is a broker-dealer; an investment company; another investment adviser; a banking or thrift organization; an insurance company or agency; and an entity that creates or packages limited partnerships. Some of these arrangements are more fully described later in Schedule F of Part II. The firm's 100% ownership of a brokerage firm and 21% ownership interest in another investment adviser is disclosed. There is reference to arrangements with investment companies whereby Trading Services Group ("TSG"), the brokerage affiliate, has selling agreements with such companies that pay fees to TSG; there is disclosure that CSG and/or TSG has relationships with the general partners of several unaffiliated investment partnerships that provide for a sharing of fees. However, arrangements CSG has with any banking and thrift organizations and any insurance company or agency are not elaborated upon.

In Schedule F of Part II Form ADV CSG provides additional detail regarding its business operations. CSG states that investment consulting fees may be fixed dollar amounts or a percentage of assets and may be offset by credits generated on commissions paid to CSG's brokerage affiliate, TSG. In Schedule F, CSG states that both CSG and TSG have relationships with the general partners of several unaffiliated investment partners that provide for the sharing of General Partner fees on any CSG related account. CSG states that "These fees are fully disclosed to any prospective investors at the time of recommendation."

D. TSG

TSG is a subsidiary wholly owned by CSG that according to CSG's Form ADV "was formed to offer brokerage services to clients of CSG and other "related" accounts for a commission." What "related" means in this context is unclear however it would presumably include brokerage from money manager accounts which are not clients of CSG.

Consulting firms generally refer to their affiliated brokerages offering their clients a service, as opposed to providing another source of revenue to the consultant. However, many of the largest consulting firms have or have had brokerage operations with revenues equal to or greater than their revenues from providing pensions objective advice for a fee. Callan, Wilshire, Frank Russell and Mercer all have or had substantial brokerage affiliates. Increasingly consultants have sold (or appeared to have sold) or closed their brokerages in response to growing concerns regarding conflicts of interest. Consultants with affiliated brokerages generally refuse to provide their clients with the audited financial statements of the affiliated brokerage. In order to determine the magnitude of the conflicts of interest related to CSG's brokerage affiliate, we requested disclosure of TSG's revenues and were provided with CSG and TSG's financial statements as described below.

A conflict of interest exists whenever consultants receive brokerage from the very money managers they are responsible for independently evaluating on behalf of pensions, regardless of whether the pension receives any commission recapture or soft dollar credit related to the trading. Consultants who recommend a directed brokerage arrangement with their affiliated brokerage as a means of paying the consulting bill, in our opinion are breaching their fiduciary duty to their clients by proposing an arrangement which is inherently conflict-ridden and undermines the objectivity of the advice critical to investment decision-making, as well as obscures the total compensation the consultant derives from the fund. (The Fund does not pay its consultant through a directed brokerage arrangement.)

In Schedule F of Part II, CSG acknowledges that "Some believe this affiliation creates a conflict of interest whereby CSG has an incentive to recommend managers that generate significant commission flow through TSG." CSG states "Our best defense against this potential is the integrity of our employees." The firm then presents statistics as evidence that this defense works. Of course, these percentages are unverified and do not tell the complete story. That is, exactly how much trading do each of these managers engage in with TSG? What is TSG's total commission revenues related to managers of pension clients?

CSG states in Schedule F that it will recommend that clients and their managers utilize the services of TSG "whenever doing so does not disadvantage the client." This is unusual wording for a pension fiduciary. Fiduciary duty requires that CSG recommend TSG only when it is in the client's best interests. Further, in such cases, CSG should advise its clients that trading through TSG creates a conflict of interest and that the related potential harm can be avoided by using a brokerage not affiliated with CSG for such services. While using a brokerage not affiliated with CSG to pay CSG's consulting fees will not benefit CSG, given the competitive nature of brokerage services, it clearly will always benefit the client by eliminating the potential conflict of interest.

In contrast to the language in the above paragraph CSG later states in Schedule F that "clients are not obligated or encouraged to use TSG if the manager feels that a better or less expensive trade can be executed away.

Despite the statistical evidence to support the contention that the connection between providing independent consulting to pensions and brokerage services to money managers is not problematic, there is additional language in the Schedule F elaborating upon the conflicts of interest involving TSG and CSG. "Using TSG as a transitional broker" could provide an incentive for CSG consultants to recommend terminating a manager. A client can avoid this incentive by using a broker other than TSG…Clients should consider the costs and benefits of using an unaffiliated brokerage firm when considering TSG. Using TSG may create certain conflicts of interest such as encouraging CSG to recommend a manager with higher turnover to generate more commission opportunities or to recommend a manager that executes through TSG rather than one that does not. Thus clients should question CSG about these matters and understand the nature of these services before determining to use TSG for commission recapture or other transaction services." The latter language suggests that it is incumbent upon the client to question his financial adviser, as opposed to acknowledging that CSG, consistent with its fiduciary duty, must fully advise the client as to the risks.

CSG also states that TSG may execute principal transactions in fixed income securities at the discretion of the managers hired by CSG's clients. CSG says these transactions are only executed when in the manager's sole determination, TSG has offered a price on each trade that is competitive with any other price that the manager could obtain from other sources. The general rule is that a fiduciary may not purchase from or sell to a plan. Further, a fiduciary is not permitted a secret profit. In principal trading of bonds, TSG is purchasing or selling from the plan and is earning an undisclosed trading profit. While the investment manager responsible for the account is required to seek best execution and generally should complain whenever the price at which he purchases or sells securities on behalf of clients is not competitive, where the broker is affiliated with the consultant who got him hired, a conflict of interest exists. The manager may choose to simply ignore the problem. Further, given the lack of transparency involved in trading bonds on a principal basis, the manager may not be concerned that the client will discover the uncompetitive trading. The manager's performance may suffer but any consultant participating in such a scheme can be relied upon to be supportive. As a result, a best execution analysis is advisable whenever a consultant is involved in a Fund's trading, especially bond trading.

CSG discloses that its consultants are subject to receive compensation on all such revenues collected by CSG and its affiliates on investments related to a client's account. In other words, CSG consultants' compensation is directly related to trading revenues generated at TSG.

In order to determine total compensation paid by the Fund's managers to CSG related to the Fund's accounts, including commissions paid to TSG, a Manager Questionnaire was sent to all the incumbent managers. One of the Fund's managers, Thomson, Horstman & Bryant, which manages three accounts for the Fund, stated in response to the Questionnaire that "for the five years ended 9/30/06, the firm executed transactions with respect to the Shelby County Small Cap Account that we manage through Neovest that generated commissions of $8,325. Trading Services Group, an affiliate of Consulting Services Group, has an Introducing Broker relationship with Neovest." The firm also disclosed "for the five years ended 9/30/06, THB executed transactions with respect to the Shelby County Financial Sector account through Neovest that generated commissions of $3,933." (The Fund's assets represent only a portion of the total assets of this commingled fund.)

The firm disclosed that "for the five years ended 9/30/06, it executed transactions with respect to the THB MicroCap Common Trust that we manage through Neovest that generated commissions of $27,965." (Again, the Fund's assets represent only a portion of the total assets of this commingled fund.) Finally, the firm disclosed that "SCRS is one of forty two participants in the THB MicroCap Common Trust. With respect to the THB MicroCap Common Trust, THB, for the five years ended 9/30/06 executed no transactions through Rochdale Securities. Trading Services Group has a clearing relationship with Rochdale Securities. Trading Services Group informed THB that it had established a commission recapture program with a number of its clients, but not SCRS."

According to Neovest, TSG receives 50% of all commissions related to all trades executed by Neovest. Neovest has indicated that TSG is the introducing broker at multiple locations. That is, TSG receives commissions from several managers through the Neovest system. We have not questioned Rochdale regarding its commission split with TSG since THB states that no commissions were paid to Rochdale related to the Microcap fund. Since two of the three accounts managed by Thomson, Horstman & Bryant utilize a custodian other than the Fund's master custodian neither the Fund nor Abel/Noser would be aware that Neovest, Rochdale or TSG is participating in the Fund's trading. This same lack of transparency regarding brokerage exists with respect to the five hedge funds of fund managers the Fund utilizes. The Fund simply does not know how much trading TSG receives from the underlying hedge fund managers.

Another manager, Southeastern Asset Management, has indicated that it has used an "electronic trading system called UNX, which is an ECN aggregator and provides direct routing of orders to all major and regional U.S. exchanges, since March, 2003. Southeastern was originally introduced to UNX by CSG via a demonstration by UNX personnel held at CSG's offices. Until December, 2005, when UNX informed SAM that they were terminating their agreement with CSG, SAM was unaware that CSG was being paid by UNX as an introducing party. SAM executed trades through the UNX system on behalf of Shelby County at a rate of two to two and one-half cents per share resulting in a total of $2,392.00 in commissions through 12/01/05. We have attempted to determine the exact amount that UNX has paid CSG as a result of our usage, but UNX has maintained confidentiality since their agreement was with CSG and SAM was not a party thereto."

It should be noted that the Fund has ongoing procedures aimed at detecting investment consultant participation in its trading, including review of all such trading by Abel Noser as described more fully below. While TSG's participation in trading was not disclosed by the investment consultant and eluded detection by Abel Noser, all such trades apparently were undertaken at a competitive commission rates of 1.5- 2.5 cents per share.

The Fund has A review of the disciplinary records of TSG through the NASD's BrokerCheck Program indicates that the firm has no disclosed criminal or civil judicial actions or arbitrations but has one regulatory action. The firm was censured and fined $7,500 for failing to timely report debt securities transactions.

The recommendation is that, based upon the information already obtained through this review, the Fund should fully investigate all undisclosed brokerage compensation earned by CSG and its affiliates related to the Fund's accounts in order to determine whether CSG's representations to the Fund regarding such compensation have been accurate; whether any harm has resulted to the Fund related to such trading; and whether any brokerage compensation paid to CSG may belong to the Fund.

E. Centennial Partners LLC

According to Schedule F of CSG's Form ADV Part II, Centennial is a fund of funds management company in which CSG has a 21% ownership interest. CSG has indicated to Staff that as of September, 2006, it no longer has any ownership interest in this entity.

F. CSG/TSG Financial Statements

The financial statements of CSG/TSG combined indicate that revenues for 2004 were: trading: $5.4 million; fees: $6.3; and other $2.6. In 2005, revenues were: trading: $4.2 million; fees: $7.9 million and other: $3.6 million. It is unclear from CSG's financial statements the percentage of the firm's revenues that are derived from "pure consulting," i.e., from providing objective advice to pensions, as opposed to selling investment advisory (hedge fund of fund) programs or trading with money managers. (Joe Meals states that all fee revenue consists of retainer consulting fees and that other includes investment advisory fees and special projects such as asset allocation studies.) Selling investment advisory services and trading with money managers both pose conflicts of interest. The financial statements do indicate that the brokerage revenues CSG derives from managers are significant and it is clear that CSG is conflicted in evaluating managers. The audited financials, of course, do not indicate the identity of the managers trading with TSG. We do not know the full extent to which the Fund's managers are trading with TSG and, despite the brokerage review provided by Abel/Noser (discussed more fully in the "Commission Recapture" section), we do not know the full extent to which they are trading with TSG in connection with the Fund's accounts. The financial statements disclose no current litigation related to the company and Joe Meals states that there is no litigation involving the CSG or its affiliates as of October 31, 2006.

Our background investigation of CSG indicates that the firm was sued in 2002 by the Long Island Museum of American Art for exposing the endowment to "excessive risk' in recommending a hedge fund investment. Apparently the case was settled. CSG has been mentioned in several articles recently. A financial arrangement between CSG and a hedge fund, Bayou Partners, was discussed in a New York Times article, "Connect the Dots, Find the Fees" dated September 4, 2005. The article mentioned that representatives of CSG were listed as references in Bayou's marketing materials and CSG acknowledged that Bayou had executed trades with TSG. It is unclear whether CSG disclosed to its clients the trading income it received from Bayou, as well as any referral fee or sharing in the general partner's fee.

An article entitled "Suits Target Fund's Early Pullouts Lawyers Seek to Recoup More Than $41 Million From Bayou Group Investors" in the August 22, 2006 Wall Street Journal states that "Lawyers for Bayou Group LLC, a hedge fund that collapsed last year, have sued to recover money from investors who pulled out in the fund's final two years, saying they "knew or should have known" of its fraud…Some of the defendants are clients of a Memphis investment-advisory firm that had a tie to Bayou that could have given them a window into the events preceding the mid-2005 collapse…The defendants in the current bankruptcy-court lawsuits include about a dozen clients and affiliates of Consulting Services Group, LLC, a Memphis investment adviser which is partly owned by D. Canale & Co., which also owns a local Budweiser beer distributor. Matt Robinson, the son of Canale executive Michael Robinson, another co-owner of CSG, worked at Bayou starting in August 2001, shortly after he graduated from the University of Virginia. Both Mr. Robinson and Canale have ownership stakes in CSG, according to CSG's current filing with the Securities and Exchange Commission…The … lawsuits seek the return of more than $41 million from about 50 investors -- about half of the total from CSG clients including $4.9 million from D. Canale Beverages Inc., and $1.1 million from John D. Canale III, a member of the family that owns the beer distributor…Other Memphis defendants include UT Medical Group Inc., a doctors' group whose pension plan allegedly got out $2 million, and Heritage Hedged Equity Fund LP, a CSG affiliate with $5.7 million." According to Joe Meals, CSG itself is not a defendant in any of these actions. In summary, while CSG's recommendations regarding hedge funds have been controversial and have resulted in recent litigation against affiliates and clients of CSG, the only litigation involving CSG that we uncovered is the Long Island Museum matter mentioned earlier.

In conclusion, it appears that none of the above known controversies involving the investment consultant has adversely impacted the Fund as of this date.

G. DOL/SEC Questionnaire Responses

In late 2003, the Securities and Exchange Commission ("SEC") announced an inquiry into "pay to play" practices of pension consultants as a result of growing dissatisfaction with consultant disclosure of conflicts of interest. "Pay to play" refers to the common practice of consultants requiring investment managers to "pay" to be considered in searches for managers to pensions. When consultants recommend managers based upon their willingness to pay, as opposed to on the merits, they breach their fiduciary duty to place client interests before their own and substantial harm in the form of diminished investment returns may result. The SEC examined the divergent sources of consultant compensation and the related conflicts; whether such amounts were properly disclosed; and whether pensions were being harmed by such practices.

On May 16, 2005 the Office of Compliance Inspections and Examinations issued a Staff Report on Findings From Examinations of Select Investment Consultants. The staff concluded that conflicts of interest were pervasive and disclosure practices abysmal. On June 1, 2005 the SEC and Department of Labor issued a publication entitled "Guidance Addressing Potential Conflicts of Interest Involving Pension Consultants." As a result of these regulatory developments awareness of conflicts of interest involving pension consultants has grown and plan sponsors today acknowledge a duty to investigate. CSG provided the Fund with an undated document responding to some but not all of the questions regarding conflicts of interest included in a questionnaire recommended by Department of Labor and SEC in May 15, 2005. Deficiencies regarding CSG's questionnaire responses are discussed below.

In response to a question regarding whether the firm has relationships with money managers that it recommends, CSG states that "to meet the needs of its clients" it established a brokerage firm in 1990. CSG states that the business of TSG is to capture commissions for the purpose of offsetting client consulting costs that would otherwise have to be paid in cash. (The percentage of TSG's business that is commission recapture related is unknown.) CSG states various unverified statistics, such as that 65% of its clients use TSG for some form of commission recapture and that 5% of CSG's is related to non-client related business. CSG further states that "thus it is not significant enough to create a real conflict." In response to a question regarding payments received from money managers and the extent of these payments in relation to other income, CSG states that it receives 12b-1 fees and hedge fund revenue sharing but noticeably declines to disclose the percentage these payments represent of overall income. While the firm states that it is "independent" in a response to the questionnaire, it has affiliated money management and brokerage operations. Thus, it would not be considered independent by the Securities and Exchange Commission and the Department of Labor.

Most noteworthy of all of CSG's responses to the SEC/DOL questionnaire is the statement that it will acknowledge in writing that it has a fiduciary obligation as an investment adviser when it provides investment consulting services. As mentioned earlier, the contract between the Fund and CSG does not expressly state that CSG is a fiduciary with respect to the Fund.

In conclusion, the Board has been relying upon a consultant subject to myriad conflicts of interest, i.e. affiliated money management and brokerage operations, for objective advice on management of pension assets. These conflicts of interest, as well as the compensation derived by the investment consultant from money managers the consultant is responsible for evaluating for the Fund, have not been adequately disclosed to the Board. As detailed throughout this report, the consultant's advice and recommendations regarding Fund investment policies and decisions has been found to be deficient. The contract between the consultant and the Fund does not stipulate the fiduciary standard of care to which the consultant will be held and does not detail the professional responsibilities or duties of the consultant. The conflicts of interest surrounding the consultant's business is exacerbated by the level of reliance the Board has place upon the consultant. Although the Board makes all final decisions regarding investments, they do so in reliance on the professional advice of CSG.

In addition to the conflicts of interest described above related to the consultant (which are pervasive in the consulting industry nationally), the Fund is subject to certain conflicts as a result of the arrangement with the investment consultant is subject to certain potential conflicts as a result of the extensive financial dealings of the consultant's minority owner in the Shelby County area.

The recommendation is that, based upon the more complete information obtained through this review regarding CSG's diverse and complex business operations and affiliations the Fund should fully investigate all undisclosed compensation earned by CSG and its affiliates (not merely brokerage) in order to determine whether CSG's representations to the Fund regarding such compensation have been accurate; whether any harm resulted to the Fund related to such compensation; and whether any such compensation may belong to the Fund.

VI. Hedge Fund of Funds

Hedge funds, including fund of funds, are generally unregistered private investment partnerships, funds or pools that may invest and trade in many different markets, strategies and instruments (including securities, non-securities and derivatives). Hedge funds may or may not engage in hedging or short-selling. Today the term "hedge" fund generally refers to these funds' lack of registration, high portfolio turnover, use of leverage and fee structure, as opposed to any investment objectives or practices.

Although often described in the press as "lightly regulated," hedge funds are not subject to the same regulatory requirements as mutual funds, including mutual fund requirements to provide certain periodic and standardized pricing and valuation information to investors. Further, hedge funds are not subject to any regulation regarding custody of assets. Assets may be custodied with a bank, trust company or brokerage domestically or abroad which may not be financially sound or adequately regulated. A hedge fund may provide no transparency regarding its underlying investments (including sub-funds in a fund of funds structure) to investors. If this is the case, there may be no way for an investor to monitor the specific investments made by the hedge fund or, in a fund of funds structure, to know whether the sub-fund investments are consistent with the hedge fund's investment strategy or risk levels. Further, investors may be unable to verify the valuation of the specific investments or performance of the managers.

Hedge funds represent speculative investments and involve a high degree of risk. Generally speaking, an investment in a hedge fund should be discretionary capital set aside strictly for speculative purposes. Hedge fund offering documents are not reviewed or approved by federal or state regulators. Hedge funds may be leveraged (including highly leveraged) and a hedge fund's performance may be volatile. An investment in a hedge fund may be illiquid and there may be significant restrictions on transferring interests in a hedge fund. There is no secondary market for an investor's investment in a hedge fund and none is expected to develop. A hedge fund may have little or no operating history or performance and may use hypothetical or pro forma performance which may not reflect actual trading done by the manager or advisor and should be reviewed carefully.

A hedge fund's manager or advisor has total trading authority over the hedge fund. A hedge fund may use a single advisor or employ a single strategy, which could mean a lack of diversification and higher risk. A hedge fund (for example, a fund of funds) and its managers or advisors may rely on the trading expertise and experience of third-party managers or advisors, the identity of which may not be disclosed to investors. Death or impairment of an advisor may result in assets lacking management at a critical moment and for an extended period of time.

Many hedge funds experience substantial portfolio turnover involving significant commission expenses. Hedge funds may execute a substantial portion of trades on foreign exchanges or over-the-counter markets, which could mean higher risk. A hedge fund's fees and expenses-which may be substantial regardless of any positive return- will reduce the hedge fund's trading profits. In a fund of funds or similar structure, fees are generally charged at the fund as well as the sub-fund levels; therefore fees charged investors will be higher that those charged if the investor invested directly in the sub-funds.

Notwithstanding the above list of formidable risks (and additional risks not mentioned above), many pensions today are turning to hedge funds in pursuit of above-market rates of returns or returns that do not correlate with traditional long-only investing. The degree of additional risk related to hedge funds, if any, and the incremental investment return related to such funds, if any, is hotly debated.

For example, according to a new global survey by Mercer Investment Consulting, less than a quarter (23%) of 180 pension funds surveyed that invest in funds of hedge funds are satisfied with their investment returns, while 28% are dissatisfied. The survey also found that just 58% of respondents understand their fund of hedge funds manager's investment approach. Globally, a third of the pension funds surveyed (33%) invest in funds of hedge funds, and despite their apparent lack of satisfaction, 54% intend to increase their allocations to hedge funds within the next two years.

Given the degree of justifiable controversy regarding these investments, it is critical that pensions investing in hedge funds and hedge fund of funds follow a well-conceived strategy. For fiduciaries, investing in unregulated, speculative hedge funds poses enormous risks.

The following is our understanding of the sequence of events that resulted in the Fund investing in five hedge fund of funds involving “over 120 underlying hedge funds and over ten different underlying strategies,” according to CSG. Initially CSG recommended to the Manager of Pension Investments that the Fund consider hedge funds as a means of meeting the Fund’s investment objectives.

Representatives of AIS, then a wholly owned subsidiary of CSG “with expertise in alternative investments,” next met with the Investment Committee to “educate” the Committee regarding hedge funds. AIS described to the Investment Committee the direct and indirect means of approaching an investment in hedge funds. Since it was the Fund’s first investment in hedge funds, an indirect approach was recommended. The indirect approach (fund of funds) would provide the Fund with a sophisticated intermediary (the fund of funds manager) to select and monitor the hedge funds into which the Fund’s assets would be invested. In addition, the fund of funds approach would enable the Fund to invest in 20-30 managers per fund of fund manager, providing greater diversification and risk reduction. Presumably risk reduction through diversification and higher returns through superior manager selection were cited as the rationale for the fund of funds approach. Apparently the issue of exactly how many fund of funds were required to achieve the optimal level of diversification and investment return was not addressed at this time. However, multiple fund of funds were clearly envisioned since CSG serving as manager of the managers of the managers, which CSG apparently did recommend, would not have been necessary if only one or two fund of fund managers were recommended. Finally, CSG recommended that it provide ongoing strategic and due diligence services focusing upon the fund of funds managers. That is, CSG would serve as the manager of the managers of the managers.

The issue of investing in hedge funds was then presented to the Board. The Board approved amending the Fund's contract with CSG effective July 1, 2004 to include that AIS would provide the Fund with additional investment consulting services pertaining to alternative investments and more specifically fund of funds investing in hedge funds. As compensation for this additional service, CSG would earn a fee of .25 on all assets invested in hedge funds. This .25 basis point fee related to a minority portion (15%) of the Fund's assets would be exponentially greater ($337,5000) than the $50,000 fee the Fund was already being paid for consulting services related to the remaining 85% of the assets and in addition to such amount.

Apparently at the December 8, 2004 Investment Committee meeting and the January 4, 2005 Board meeting, AIS/CSG provided the Investment Committee and the Board with an undated summary presentation recommending 5 finalists who were chosen, according to the presentation materials, from a universe of 2000 fund of fund investment products, screened for assets under management, length of track record and minimum return. According to the presentation, duplicates were removed, as well as niche strategies and funds known to utilize high leverage. The remaining 187 funds were ranked in various statistical categories, and the number of funds was further reduced to 48. Following a qualitative review, the list was narrowed to 13, with 4 added back for various reasons. After AIS/CSG conducted due diligence on the list of 17, AIS/CSG selected 5 finalists to present to the Board. The AIS/CSG recommendation was that all 5 finalists be allocated assets.

The AIS/CSG presentation materials raise numerous serious issues. No information regarding manager performance, performance versus a benchmark, peer group ranking, risk analysis or the multiple layers of fees and the amounts of such fees involved in the manager of managers of managers approach is provided in the presentation materials. (Staff indicates that much of this information was provided to the Board in supplemental materials, however we were unable to review such material for purposes of this report.) Finally, no rationale for the manager of managers of managers approach and allocating assets to five fund of funds involving over 120 hedge funds is provided. There is no mention of the potential for duplication among the underlying managers used by the five funds of funds.

A disclaimer is included at the outset of the presentation regarding the risks related to “hypothetical or simulated performance” which, in addition to being poorly worded, suggests that such performance results were either included in other materials or discussed at the meeting with respect to one or more of the finalists. (According to a February 3, 2005 letter from the Bogatin law firm, the “historic track record” of the Niagra Elite Fund was “retroactively projected.” That is, Niagra Elite had no track record and the performance of the fund was borrowed from another fund, Blue Elite, Ltd.) No search criteria are stated in the presentation materials, such as assets under management, length of track record or performance. There is no conflicts of interest disclosure.

AIS/CSG has recently stated that the criteria for the hedge fund of funds search was $100 million, 3 year track record and a 4% annualized return. The minimums included in the search criteria appear extremely low and unreasonable. Further, one of the managers recommended and hired, Niagra Elite, did not even meet these minimum standards. This firm apparently lacked both assets under management and a track record at the time. Nevertheless the AIS/CSG recommendation was to allocate $6 million to the firm. The presentation materials do not indicate the benchmark(s) to be utilized in judging the performance of the fund of fund managers going forward. (AIS/CSG has stated that the Hedge Fund Research Index Fund of Funds, S&P 500 and the Lehman Aggregate indexes are being used.)

At the December 8, 2004 Investment Committee meeting and the January 4, 2005 meeting of the full Board, the proposed investments recommended by AIS/CSG were unanimously approved without modification. Following the Board meeting, in late January and early February 2005, legal counsel to the Fund, Susan Callison, wrote separate letters to Mayor Wharton, Chairman of the Board, indicating that in the firm’s opinion, the procedural requirements of the Trust and Administration Agreement with respect to the approval of the making of each hedge fund investment had been complied with. Further, the firm opined that the Fund was duly authorized, pursuant to the provisions of Section 6.6(m) of the Trust and Administration Agreement, to make the proposed investments and that it was not aware of any governing law that would prevent or invalidate the making of such an investment. Attached to each letter was a summary of the documents related to each hedge fund of fund investment. Each letter noted that the law firm had not performed any due diligence with respect to the underlying merits of the proposed investment and did not purport to advise the Board with respect to such.

Thus, approximately six months after signing of the amendment to the CSG consulting contract related to hedge funds, in late January and early February, 2005, the Fund executed subscription agreements with the five hedge fund of funds managers. The initial five fund of fund managers hired were Archstone Offshore Fund; Blue Elite Fund (name subsequently changed to Niagra Elite); GT Partners; Ironwood and Lazard Diversified Strategies Fund. A total of $70 million was allocated to these managers. Lazard was terminated at the end of 2005 for performance reasons and replaced by Acorn Overseas Limited, at the recommendation of AIS/CSG. The Bogatin Law Firm sent an opinion letter to Mayor Wharton regarding the hiring of Acorn, citing in its opinion a December 6, 2005 Investment Committee approval and Board approval on the same day as the basis for its conclusion that the procedural requirements with respect to the approval of the Acorn investment had been complied with.

In the first quarter of 2006, an additional $52 million was allocated to the hedge fund managers, at the recommendation of AIS/CSG, for a total of approximately $135 million at this time.

The Fund's involvement in the AIS/CSG recommended manager of managers of managers program is problematic for numerous reasons including, excessive layers and amounts of fees; questionable manager of managers monitoring and selection; massive duplication of underlying managers; and rampant conflicts of interest. Finally, the complexity and lack of transparency related to this multiple fund of funds approach, in our opinion, precludes compliance with applicable fiduciary standards for the reasons stated below.

Total fees related to the manager of manager of managers program range from approximately 2.50 to 3.25% plus 20% of profits. In contrast to the 60 basis points the Fund pays arguably its best performing manager, Southeastern Asset Management, this is a staggering amount of fees. Further, it is unclear why three layers of fees are necessary. For example, if the fund of funds managers perform meaningful due diligence and monitoring services, is it necessary to have AIS/CSG monitoring them? Do fund of funds managers really provide superior manager selection? If so, how many fund of funds are necessary to achieve the optimal level of diversification? If not, a direct investment approach would be preferable as it would eliminate two of the three layers of fees.

According to a report entitled "Hedge Funds: Too Much of a Good Thing" in Bernstein Wealth Management Research, June 2006, there is some merit to investing in as much as 20 hedge funds if an investor's portfolio consists solely of hedge funds; however, if only 20% of an investor's total portfolio is in hedge funds, the advantage of owning 20 hedge funds is much diminished. Since the Fund is investing only 15% of its portfolio in hedge funds, less than 20 underlying hedge fund investments would be advisable. However, the Fund has approximately $135 million invested in over 120 hedge funds. While the fund of funds approach permits diversification into a greater number of funds than the direct approach, five fund of funds appears to be an unnecessary diversification. It is impossible for any one manager to significantly add value and it seems likely the vast number of managers will result in, at best, a market rate of return net of fees, with significantly greater investment and operational risk. In our opinion, at most, one fund of funds would be advisable.

Further, research has shown that on average fund on fund managers fail to deliver additional return. Over the last ten years the compound pre-tax return of a fund of funds composite would have been 1.5 percentage points lower than Bernstein's hedge fund composite. The reason that fund of funds have not fared well, according to Bernstein, is their multiple fee structure. Fund of fund managers need to pick not just better-than-average funds to produce incremental return, but among the best, concludes Bernstein.

A December 18, 2006 Bloomberg News article entitled "Dirty Wall Street Secret: Hedge Funds of Funds Pay T-Bill Rates," (which we have provided to Staff) also questions the investment merits of hedge funds of funds.

AIS/CSG describes its role as reviewing or monitoring the fund of fund managers, as opposed to the underlying managers. AIS/CSG states that all of the Fund's funds of funds managers are investment advisors registered with the Securities and Exchange Commission. The June 30, 2006 Quarterly Review prepared by AIS/CSG states, "…all of the fund of funds currently in the portfolio are currently registered and plan on staying registered." We were unable to locate an SEC registration for Niagra Elite and AIS/CSG was unable to provide a registration number. Niagra Elite confirmed that, contrary to statements by AIS/CSG, it is not SEC registered. (Staff indicates Niagra Elite was registered with the SEC at one time but dropped its registration in June 2006.)

What additional information related to the fund of funds managers does AIS/CSG review? Obviously, AIS/CSG has access to quantitative performance-related information regarding the fund of funds managers; however, AIS/CSG reviews such information regarding all of the Fund's managers for the $50,000 annual retainer it receives. Does AIS/CSG provide any additional qualitative review related to the hedge fund of fund managers? AIS/CSG states that it has confidentiality agreements with the fund of funds managers that allow it to receive information related to the fund of funds that it reviews but is not permitted to share with the Fund. However, as elaborated upon below, we were unable to establish that AIS/CSG receives any meaningful information from the fund of funds managers that it does not provide to the Fund.

AIS/CSG states that with respect to most, but not all of the fund of fund managers, it receives lists of the underlying managers actually handling the Fund's assets. While AIS/CSG acknowledges that it does not perform any due diligence of the underlying managers, a list of the managers each fund of funds manager uses is necessary to establish that, at a minimum, the different fund of funds are not using the same underlying managers. If the different funds of funds managers are using many of the same underlying managers, then the multiple fund of funds managers approach makes no sense.

Since it does not receive a complete list of managers, AIS/CSG acknowledges it is possible that the funds of funds may be investing in some of the same underlying funds. However, AIS/CSG stated, in response to our inquiry, that the potential for duplication of managers or funds existed only to a limited degree. AIS/CSG declined to provide us with the lists of each fund of funds' managers, citing fund of funds confidentiality concerns, but suggested we contact the fund of funds managers themselves. All the fund of funds managers, except Acorn, willingly provided us with lists of the managers they use. AIS/CSG has indicated that Acorn also refuses to provide it with a list of the underlying managers Acorn uses but allows AIS/CSG to view the list at its offices. Acorn claims that its list of managers is proprietary and if it were to disclose the names, other fund of funds managers would see the results of its unique due diligence and seek to duplicate its line-up. As discussed further below, the few managers that Acorn did reveal to us are, in fact, used by the Fund's other fund of funds managers. We found no reason to believe that Acorn's due diligence selection process is particularly unique or rigorous.

Contrary to statements by AIS/CSG, our limited review immediately revealed substantial duplication between the funds of funds underlying managers, involving even their most significant managers. For example, Ironwood indicated that Citadel is its largest underlying manager with 12.8 percent of the assets. Gerber Taylor indicated that Citadel is its second largest underlying manager with 6.8 of the assets. Ironwood and Gerber Taylor also both share D. B Zwim Partners; Magnetar Financial; and Silverpoint Capital as underlying managers. Over 30% of Gerber Taylor's assets are managed by the same managers that the other fund of funds managers use. Approximately 43% of Ironwood's assets are managed by the same managers as the other fund of funds managers. Archstone also utilizes four managers, Raptor, Farallon, Eton Park and Och-Ziff, representing 28% of assets, used by the other fund of funds managers. Niagra Elite uses Perry, Level Global, Prentice, Raptor, Silverpoint, Sandelman and Citadel, representing 35% of its assets, which are used by the other fund of funds managers. The only two managers Acorn disclosed, Och-Ziff and Farallon, are used by other managers.

While there is duplication, the largest allocation the Fund has to any single underlying hedge fund manager, i.e., Citadel, amounts to only 4.5%, according to Staff.

In summary, not only is AIS/CSG not performing any review of the underlying managers, it appears that it is not even monitoring the lists of managers for duplication. Given the degree of duplication, the justification for multiple funds of funds managers seems suspect.

Since the Fund is not provided with the lists of managers each fund of fund utilizes, in addition to not knowing the identity of its managers, it is unable to determine the degree of duplication of managers. Information regarding both of these issues is critical in order for the Board to fulfill its fiduciary duties.

AIS/CSG indicates that each fund of fund manager provides an annual audited financial statement to AIS/CSG, which is passed onto the Fund. We have not reviewed these statements and cannot comment as to their completeness or usefulness. For example, these financial statements may merely repeat questionable portfolio valuations provided by the underlying managers to support their incentive fee payouts. In addition, each of the underlying manager funds in which the Fund invests should produce audited financials. Apparently CSG/AIS does not receive and review these audited financials. AIS/CSG receives only the audited financials of the fund of funds managers. Whether AIS/CSG reviews the audited financials is unclear.

In addition, AIS/CSG states that it is provided with a monthly performance report from each fund of fund manager which is provided to the Fund. AIS/CSG also provides a review of the fund of funds and a market review on a quarterly basis to the Fund. We have reviewed the second quarter 2006 AIS/CSG report only and, as indicated below, have found it to be deficient.

AIS/CSG states that while its role in connection with the Fund's manager of managers program is solely to monitor the fund of fund managers and not the underlying managers, since the firm places certain of its high net worth clients' assets directly in hedge funds, AIS/CSG claims it has performed due diligence reviews of a substantial portion of the hedge managers included in the Fund's fund of funds line-up. AIS/CSG states that it may have client capital with as many as half of these managers, including Bay Resource Partners, Black Bear, Cantillon, Cerberus, Chesapeake, Citadel, DE Shaw, Eagle Global, Elliot Associates, Eton Park, Farallon Capital, Greenlight, GSO, HBK, Highbridge, Highfields Capital, JMG, King Street, Maverick Capital, Millennium, Och-Ziff, Ore Hill, Perry Partners, RAB Capital, SAC Capital, Scoggin Capital, Silver Point, Stark Investments, and Tudor Investments. This may result in a variety of serious conflicts of interest scenarios.

First, according to AIS/CSG, TSG apparently from time-to-time executes trades related to its high net worth client accounts directly invested in hedge funds. Thus, TSG may receive compensation from the underlying managers included within the funds of funds it recommends. Second, CSG may have referral fee arrangements with the underlying managers it uses to manage client assets directly, which may encompass the Fund's assets invested indirectly through the fund of funds managers. The compensation it receives from underlying mangers may influence AIS/CSG's fund of fund manager recommendations, including the number of fund of funds AIS/CSG recommends. (The fund of funds managers may be unaware of any compensation arrangements between AIS/CSG and the underlying managers. In response to our inquiries, the funds of funds managers acknowledge such and state that they are not concerned with any such arrangements.) In response to our inquiry, CSG states that of all the underlying managers utilized by the five fund of funds, TSG only receives trading commissions from Scoggin Capital. We have not verified this representation.

Finally, as reported in the Wall Street Journal, principals and employees of CSG and affiliates may directly invest in certain hedge funds in which clients of CSG, including the Fund, may invest directly or through fund of funds. As a result of side agreements and other dealings, certain investors in hedge funds (for example, persons related to CGS) may receive preferential treatment from these hedge funds. In summary, CSG and persons affiliated with CSG may benefit and the Fund may suffer when CSG recommends the Fund invest (even through fund of funds) with the very same managers as CSG and affiliated persons. In order to determine whether any such harm has resulted, additional investigation would be required.

With respect to the underlying fund managers, AIS/CSG states it is unaware whether the firms are registered with the SEC or not. Registration of money managers or lack thereof is important information for fiduciaries to consider. The fund of fund managers indicate that 50% or less of the underlying managers are registered with the SEC and that the percentage is declining as a result of reversal of the SEC's new hedge fund registration rule. This trend toward deregistration may be disturbing to fiduciaries. In any case, registration (or lack thereof) of the underlying managers should be considered. In the Second Quarter Review 2006 AIS/CSG prepared for the Fund, there is a limited discussion of the reversal of the SEC hedge fund registration requirement and trend of the underlying managers to deregister. The statement is made that AIS/CSG does not anticipate this reversal to affect the Fund's portfolio negatively. Rather, AIS/CSG says it could be a positive since (1) the fund of fund managers remain registered and (2) underlying liquidity may be enhanced as lock-ups instituted as a defense to registration are eliminated.

With respect to securities holdings, AIS/CSG and the fund of fund managers are unaware of the each underlying manager's securities holdings. As a result, if the investment restrictions in the Trust and Administration Agreement are violated by the underlying managers, the Fund will not know. For example, if any of the over

120 hedge funds were utilizing financial futures contracts for speculative versus hedging purposes, which many hedge funds do, the Fund's investment restrictions may be violated. If, on the other hand, the Fund is of the opinion that for purposes of the investment restrictions in the Trust and Administration Agreement, there is no "look through" to the underlying portfolio securities and the Fund's investments in the fund of funds are merely considered limited partnership interests, then the intent of the investment restrictions seems to be effectively undermined. In the mutual fund context, ownership of shares in an equity mutual fund is generally considered the equivalent of owning equities. Thus, a fund that is prohibited from investing in equities generally cannot invest in equity mutual funds. It is imperative that fiduciaries scrutinize investments in order to determine whether the investments are consistent with the investment objectives of the pension. To waive the investment restrictions with respect to unregulated money managers, while upholding them with respect to regulated managers appears illogical and imprudent.

(As mentioned earlier, the Board did obtain a legal opinion from the Bogatin Law Firm indicating that in the firm's opinion, the procedural requirements of the Trust and Administration Agreement with respect to the approval of the making of each hedge fund investment had been complied with. Further, the firm opined that the Fund was duly authorized, pursuant to the provisions of Section 6.6(m) of the Trust and Administration Agreement, to make the proposed investments and that it was not aware of any governing law that would prevent or invalidate the making of such an investment.)

With respect to use of leverage by the underlying hedge fund managers, AIS/CSG indicated that hedge funds that engage in "high leverage" are excluded from the program. We did not investigate use of leverage within the program generally; however, we did advise Staff that according to a recent Financial Times article costs related to the Fund's largest underlying manager, Citadel, "are high because its managers trade frequently and take on huge leverage…With $13 billion in net assets and $166 billion in gross assets…more than 90 per cent of the investment expenses represent interest on the roughly $150 billion of debt provided by banks."

With respect to securities trading, neither the Fund nor the fund of fund managers is aware of the securities trading practices of the underlying managers. Some of the underlying managers own affiliated brokerages and may be executing trades at commission rates that are not competitive or churning portfolios to generate trading commissions. Fiduciaries are responsible for monitoring trading costs. Indeed the trading costs of the traditional managers of the Fund are reviewed by Abel/Noser. It is illogical that the unregulated, high risk, high portfolio turnover managers' trading is not scrutinized.

Each fund custodies the assets it manages, including the Fund's assets, wherever it chooses. Thus, the Fund's assets invested with the five hedge fund of funds managers are apparently custodied at over 120 entities, such as banks, trust organizations and brokerages, located domestically and abroad, which may or may not be regulated and which may or may not be financially sound. Generally pensions have sought to consolidate custody with one or two financially sound custodians for safety and ease of administration. The fund of funds arrangement the Fund has entered into, putting aside the issue of any possible investment merits, clearly does not enhance safety and reduce the administrative burden. The structure recommended by AIS/CSG is inconsistent with fiduciary duties regarding safekeeping of assets.

The sole conflicts of interest disclosure CSG provided to the Fund related to the five hedge fund of funds investments was a Disclosure Statement furnished to prospective investors in Ironwood Partners L.P. and Ironwood Capital Partners indicating that TSG is a selling agent unaffiliated with Ironwood that receives compensation from Ironwood equal to one fourth of the management fee charged on the closing capital account balance of each limited partner in the Ironwood funds who was sold an interest by TSG. The Fund receives a credit in the same amount from CSG or TSG toward its consulting fee. The numerous additional conflicts of interest described above, including brokerage and other possible compensation derived from underlying managers and direct investments by CSG affiliates with the underlying managers, apparently were not disclosed.

The drawbacks related to the approach recommended by CSG are enormous and can be summarized as follows: The Fund now has $135 million or approximately 15% of its assets invested with over 120 largely unregulated high-risk money managers scattered throughout the world whose identities, securities holdings, trading costs and custodians are unknown.

While the Second Quarter 2006 Review prepared by AIS/CSG curiously fails to indicate year-to-date performance, the year-to-date performance at that time according to AIS/CSG, was 4.97% and through August was 6.24%. Performance through September 30, 2006 should be flat, according to AIS/CSG. These performance figures are gross of the .25 AIS/CSG fee. In conclusion, in our opinion, it is unlikely that the investments that the Fund has made in hedge funds of funds will (or even can) produce competitive returns sufficient to compensate the Fund for the costs and risks involved.

On the other hand, it is certain that AIS/CSG will derive significantly greater compensation from the Fund as a result of this elaborate scheme. The full extent of AIS/CSG's compensation related to the fund of funds managers, including the underlying managers, remains unknown at this time.

The recommendation is that in light of the additional information provided in this review that the Fund consider objectively the merits of the hedge fund of funds program recommended by CSG involving over 120 underlying hedge funds.

VII. CSG Performance Reporting

The contract between the Fund and CSG states that CSG will provide the Fund with quarterly performance evaluations on the client's entire investable assets in a concise and easy to understand format. (In fact, according to Staff, CSG provides the Board with monthly performance reports.) The evaluation will include a comparison of the investment performance of the Fund to that of relevant market indices and, where appropriate, peer group performance. A review of compliance with the client's stated investment guidelines as described in Client's Review of Investments, Policies and Procedures will also be part of the evaluation.

As mentioned earlier, the Fund lacks an Investment Policy Statement and Manager Guidelines. If professionally drafted, these documents should contain provisions related to the reporting of performance. In the absence of such critical documents, the elements involved in the reporting of performance are not adequately defined.

The quarterly performance reports prepared by CSG we have reviewed are deficient in numerous respects. These reports should inform the Board as to the performance of the total fund, as well as an analysis of the underlying asset classes and managers that comprise the total fund. Initially a comparison of returns, both at the total fund and manager level, should be provided against the appropriate benchmark.

Comparison against multiple benchmarks is commonplace, especially where, as here, the Fund uses style specific managers rather than adopting a core approach.

The performance of the total fund is not measured against a static policy benchmark, which is the standard way of measuring a specific fund's performance and monitoring the effect of asset allocation recommendations adopted over time. As discussed in many industry articles, asset allocation decisions account for approximately 90% of a portfolio's rate of return. In a static benchmark, the weights of the indices are set in advance and do not change over time as the portfolio weights change. Without a comparison to a static benchmark, the Board does not have the type of analysis to determine if their asset allocation decisions added value to the plan. In addition, there are no comparisons or analyses to determine the effect of the consultant's asset allocation recommendations from its annual asset allocation study. The Fund should adopt a static benchmark and the total return of the Fund should be compared to the benchmark. The static benchmark should reflect the target asset allocation weights approved by the Board with appropriate indices chosen for each asset class. The weights of each asset class, and the indices within the static policy benchmark should not change unless the Board authorizes a change in the asset allocation targets.

In the performance reports prepared by CSG, the total fund is compared to a Total Fund Composite Index which is "comprised of market index proxies in the same ratio as the investment managers." This means that the index used to measure the total Fund's performance fluctuates with the composition of the Fund's portfolio.

With respect to most asset classes, performance again generally is measured against a fluctuating composite index. Total equity manager performance is measured against a Total Equity Composite Index. Total fixed income manager performance (including international and emerging markets debt) is measured against a Total Fixed Income Composite Index. International strategies (apparently international equities) and venture capital strategies, two separate asset classes in the performance reports, are not measured against any index in the performance reports we have reviewed. However, staff has indicated that the international strategies are benchmarked to an EAFE Index and venture capital strategies are benchmarked to the S&P 500 index. Hedge fund of funds managers are measured against the Hedge Fund Research Fund of Funds Index which is of limited utility, given the multiple layers of fees involved in hedge fund of funds. A more meaningful comparison may involve measuring performance against lower cost indexes, such as the S&P 500 or a hedge fund index.

The performance reports fail to indicate whether the returns of individual managers are presented gross or net of investment advisory fees. CSG states that performance is presented net of investment advisory and custody fees. However, hedge fund of fund performance is not presented net of the 25 basis points fee charged by CSG. (Staff indicated that audited financial statements reflect all performance net of fees.)

Finally, comments in the performance reviews indicating that there have been no policy violations are confusing since there is no policy. (Staff indicates that this language means that the policies relating to each underlying manager have been reviewed and any exceptions noted.)

In conclusion, it appears that the types of performance analyses CSG has provided to the Board are deficient in certain respects. **The recommendation is that, in connection with the development of an Investment Policy Statement, the performance of the total Fund and its managers should be recalculated and reformatted to provide the Board with a more meaningful analysis of the actual performance of the Fund.**

VIII. CSG Annual Asset Allocation Studies

For an additional cost of $10,000 annually, CSG has prepared asset allocation reports for the Board since 1999. We have reviewed the annual asset allocation reports CSG has indicated were presented to the Board from 2001 through 2005. These reports are limited PowerPoint slide presentations which are deficient in numerous respects. Some of the information provided in the reports is misleading and there is not sufficient information provided for the Board to make informed decisions regarding asset allocation, consistent with its fiduciary duties. We have not been provided with any formal reports, beyond what was submitted in the slide presentations. Thus, the comments below address issues regarding the PowerPoint presentations alone; we assume that no further reports were provided to the Board accompanying the slide presentations.

The general quality and content of the asset allocation reports was improved with the 2002-2004 reports; however the quality of the 2001 and 2005 reports was inferior. This inconsistency in the quality of reports is difficult to understand. Throughout all the studies, including the 2002, 2003 and 2004 reports, there are deficiencies which include: (1) Capital Market Assumptions are used without explanation as to how they were derived or from what source they were obtained; (2) Index proxies are unidentified; (3) Questionable inputs are repeatedly used, for example: (a) Derivation of the U.S. non-taxable portfolio on page 4 of the 2001 report; (b) Basis of the material espousing the use of hedge funds as presented on pages 11, 12 and 13 in the 2001 report; (c) Basis for CSG's "forward thinking" projections on pages 25 and 26 in the 2002 report.

Regarding the most recent report reviewed, 2005, the time period for the asset allocation studies is not clearly identified. Generally the last five or ten years is an appropriate period and in the 2002, 2003 and 2004 reports, five year periods appear to have been used. It is unclear whether the data used in the asset allocation reports is actual historic data, or a function of prospective capital market assumptions. The indexes used to define the asset classes should be disclosed. For example are the Russell or BARRA indexes used to define the domestic equity classes?

It is unclear why the asset allocation reports are limited to the asset classes included therein. The spectrum of asset classes included in the reports does not include all classes to which the Fund has allocated assets.

While standard deviation is the only measure of investment risk included in the asset allocation reports, it is not the only, and indeed not necessarily the best, measure of investment risk. Downside risk measures should be used in depicting the appropriate trade-off between return and risk. For example, few investors are concerned with the potential for gains in excess of the average return; rather, investors are generally concerned about potential for underperformance. Relying on standard deviation frames the asset allocation decision with "good" risk treated the same way "bad" risk is viewed.

In conclusion, while the consultant does provide written recommendations in the annual asset allocation reports, a sufficient basis for such recommendations is not consistently provided in the reports to support a decision by the Board. Given the numerous deficiencies in the asset allocation studies, the Board is forced to rely heavily upon the recommendations of the consultant, as opposed to their own informed judgment.

The recommendation is that consideration be given to reformatting the annual asset allocation reports and that the findings of these reports be reflected in an Investment Policy Statement.

IX. Investment Advisory Contracts

The investment advisory contracts between the Fund and its managers differ significantly and are deficient in numerous respects. Addressing these differences and deficiencies through a single form of investment advisory contract for the Fund to utilize with its managers would provide greater protection to the Fund. It is common practice for public pensions to utilize a single form of contract in their dealings with investment managers. Since the contracts are not uniform, the comments below are general and may not apply to all contracts.

We have reviewed 25 contracts executed between the Fund and current and former investment managers utilized by the Fund during the past five years. These contracts were executed at different times; some of the oldest contracts, such as New South, Southeastern and Thomson, Horstman & Bryant, date back to the 1980s. While these oldest contracts were followed by subsequent summary agreements, such as a 1995 document referred to as an Investment Policy Statement executed by the managers and the Fund, unfortunately the provisions in the original contracts were not entirely updated in the subsequent agreements. For example, some of the older contracts with investment managers state that the custodian of the Fund is Union Planter's Bank of Memphis or First Tennessee Bank. The 1995 summary agreements do not contain provisions referring to custody or changing the name of the custodian in the earlier agreements. (Removal of the name of the custodian from any new form of contract, replacing it with a generic reference to the custodian, will eliminate this problem.) Other more important inconsistencies exist with respect to the older contracts that have been updated, as discussed further below.

The contracts generally do not state a term but are terminable by either party upon prior written notice or thirty days notice. Generally investment advisory contracts are uniquely structured in this manner.

Several sections within the investment manager contracts refer specifically to the manager's investment duties. Most of the contracts have an "Appointment of Advisor" provision wherein the adviser represents that it is duly registered under the federal securities laws. The contract with Delaware Investment Advisers is unusual in that the adviser represents that it is a series of an entity that is a registered investment adviser. That is, the entity managing the assets is not a registered investment adviser itself. This is highly unusual and we have asked for additional information.

Each manager's broad asset class, i.e. fixed income or equity, often is stated in this section. Some contracts are more specific, e.g., global technology, or equity, balanced. Some contracts have no such section and the investment mandate is addressed in an exhibit to the contract which may be referred to as an Investment Policy Statement.

The contract with Sector Capital contemplates that the advisor will hire other investment managers as subadvisors to actually manage the Fund's assets. The only justification for this arrangement appears to be a desire on the part of the Board to engage a local firm, even if the local firm performed limited services. While the contract with Sector does not identify subadvisors, in response to our Manager Questionnaire one of the Fund's managers, NewSouth, has disclosed that it is one of Sector's six subadvisors. Since NewSouth already manages assets for the Fund, it is unclear why it has also been allocated assets as a Sector subadvisor. The contract with Commerce Capital Management does not refer to any subadvisors however Morgan Stanley/Miller Anderson Sherrerd is listed in subsequent agreements as the parties actually managing the assets. Again, the justification for this arrangement appears to be a desire to contract with a local firm. Presumably in both cases the cost of the investment advisory services would have been reduced if the intermediary was eliminated.

The "Governing Legislation" section, if present in the contract, refers the manager to Section 6.6. (or Section 5 in the older contracts) of the Administration and Trust Agreement of the Fund. It is the responsibility of the managers to follow these guidelines in the composition of their portfolios. Some contracts, such as Delaware Investment Advisers and Brandywine, contain no Governing Legislation section and the manager, when asked, claimed to have never received a copy of Section 6.6. Such managers were instead provided with an investment objectives and restrictions document as an Exhibit to their contracts. These Exhibits, referred to as Investment Policy Statements are not portions of any Investment Policy Statement of the Fund; as mentioned earlier, the Fund has no Investment Policy Statement. These documents do not include all of the limitations provided in Section 6.6. In the event that these Exhibits conflict with Section 6.6, problems may arise.

The "Investment Objectives" section of the contracts, if present, indicates that the investment objectives are set forth in an exhibit to the contract. In some cases the investment objective in the exhibit briefly states the investment return objective (see Gintel). In other instances (Dresdner RCM) the exhibit is a lengthy document referred to as an Investment Policy Statement. Again, use of the summary Investment Policy Statement is problematic.

Certain contracts include language referring to matters such as brokerage and commission recapture. It is unclear whether differences in the contracts with regard to these matters are intentional or not. For example, Southeastern's contract does not include commission recapture language. While the firm manages domestic equities that could easily be included within the Fund's commission recapture program, Southeastern apparently has indicated to Staff that participation in the Fund's commission recapture program would negatively impact the Fund's performance. Certain contracts include a prohibition on use of an affiliate for brokerage transactions. Some contracts involving managers with affiliated brokerages, which should include such a prohibition, do not. The Eagle Asset Management contract has no affiliated brokerage prohibition and the firm has indicated in response to our inquiry that it has, in fact, executed trades with its brokerage affiliate.

The following provisions, which would benefit the Fund, are either absent in the Fund's contracts with its managers or not consistently present.

Audit: There is no provision indicating that the Board or the Fund shall have the right to audit, or have an independent accountant audit, the investment manager's books and records on an annual basis for the purposes of determining the accuracy of statements provided by the investment manager. The audit provision could be broadened to include the right to audit whenever any issue arises involving the integrity of the investment manager.

Conflict of interest: Some of the Fund's contracts contain a conflict of interest provision. The manager warrants that it has no interest that conflicts in any manner with the performance of its duties. The manager also warrants that no part of the contract amount will be paid to any officer or employee of the county in exchange for services to the manager in connection with the work performed under the contract. This provision should be consistently included in all contracts of the Fund. Further, it could be strengthened to provide that the investment manager represents that no member of the Board or government official has a direct or indirect interest in the agreement and that no donations have been made or promised to any government official in connection with obtaining the contract.

Covenant against contingency fees: Certain of the Fund's contracts with managers include such a provision whereby the manager warrants that it has not employed any third party to secure the contract and has not agreed to pay any third party any fee related to the contract. This provision should be included in all of the Fund's contracts.

Most favored nation's clause: The purpose of "most favored nation's" clauses in investment advisory contracts generally is to ensure that a fund receives the lowest rate a manager offers similarly situated clients or accounts. These clauses are commonly used by public funds and, while not completely effective, can be beneficial by reducing the investment advisory fees funds pay. There are no such clauses in the Fund's contracts.

Governing law: The contracts with the managers refer to the laws of various states as governing the agreements or make no reference to governing law. The Brandywine contract refers to Delaware law; Peregrine contract does not include a governing law provision. For added protection and convenience reference to the law of the home state is preferable.

Hold harmless: The investment manager should be required to indemnify and hold the Board harmless from and against any loss or claim, including attorney fees associated, resulting from the investment manager's breach of the agreement, negligence, fraud or willful misconduct in the performance of its duties under the agreement.

The recommendation is that the Fund develop a new single form of contract that all of the current managers be required to sign. The new contract should be drafted to eliminate confusion regarding the investment objectives and restrictions applicable to each manager, as well as to include provisions (such as those recommended above) that would provide greater protection to the Fund.

X. Manager Questionnaire

A Manager Questionnaire was sent via e-mail to all the incumbent managers which included the following inquiries: (1) Please disclose all compensation paid by your firm or any affiliate thereof directly or indirectly to Consulting Services Group, or any affiliate thereof, including but not limited to, brokerage, finder's fees, revenue sharing, and marketing allowances. Please indicate the sources and amounts of compensation. (2) Please indicate whether your firm has engaged in brokerage transactions with Neovest or any other brokerage intermediary where Trading Services Group serves as an introducing broker. Please include the amount of any such commissions in your answer to item 1. (3) Please describe any conflicts of interest related to any arrangements, whether formal or informal, between your firm and Consulting Services Group and any affiliate thereof. (4) Please indicate your firm's published investment advisory fee rate for an account the size of the Shelby County account(s) your firm manages. Is the investment advisory fee rate paid by Shelby County to your firm the lowest your firm offers similar situated accounts? What is your "most favored nation" rate for this account? Please be aware that we may independently verify your answers to these investment advisory fee questions by contacting other clients of your firm.

We received responses from all of the incumbent managers except Ashmore; Brandywine; Morgan Asset; NCM; OFI and Southern Capital. The e-mail delivery of the Questionnaire to these managers was not successful.

In summary, certain managers disclosed in their Questionnaire responses that they had compensation arrangements with CSG or TSG that had not been disclosed to the Fund. In addition, certain managers indicated or suggested in their responses that the investment advisory fees they charge the Fund are not the lowest fees they charge similarly situated clients. The answers received from the managers are incorporated into discussions of the relevant issues throughout this report.

XI. Investment Advisory Fees

Fiduciaries to pensions have an obligation to scrutinize the investment advisory fees plans pay. Most public funds rely heavily or exclusively upon their investment consultants to provide guidance regarding fees, as well as to negotiate fees with managers. Unfortunately, as a result of investment consultant conflicts of interest, lack of intelligent negotiation procedures and manager non-compliance with "most favored nation" clauses, many pensions are paying excessive investment advisory fees.

Certain of the investment advisory fee schedules included in the contracts between the Fund and its managers are both unusually structured and higher than average. For example, the use of flat fee arrangements may cause the plan to pay higher fees than necessary. Generally it is preferable to pay a manager on a graduated scale arrangement, where the fees paid to the manager decrease in basis points as the market value of the account increases. The contract with Southeastern Asset Management provides for a "flat" fee, i.e., a fee without breakpoints, of 60 basis points. According to published surveys of "actual" investment advisory fees, including our own, the Southeastern fee is exceeding high for large cap management and average for mid cap. Staff has attempted unsuccessfully to negotiate this fee downward and has concluded that given the outstanding performance of the firm, it is acceptable.

A "most favored nation" clause may offer some protection against excessive fees. For example, after CSG advised Thornburg that the fee Thornburg was charging the Fund was higher than the fee Thornburg charged a similar account known to CSG, Thornburg agreed to a fee reduction. Thornburg agreed to replace the Fund's flat fee of .75 on an $80 million account with a more appropriate fee including breakpoints reducing the fee to .75 on first $25 million; .65 on amounts between $25 million and $75 million and .50 thereafter. Thus, according to Thornburg the effective fee on the account currently is approximately .66. Thornburg indicated in response to our Manager Questionnaire that their "most favored nation" rate is .60. In response to our Manager Questionnaire Delaware Investments and Eagle Asset Management, indicated that the Fund is paying these firms' "published" rates and suggested that a lower rate may be available if a "most favored nation" clause is inserted into their contracts with the Fund. It is well known that the "actual" fees pensions pay generally are 10% or more below managers' published fees.

The investment consultant to the Fund should educate the Board regarding the difference between "actual" and "published" fees. A "most favored nation" clause does impose an obligation upon a manager to reduce the fee the Fund pays in the event that the manager offers a similarly situated client a lower fee than the Fund is currently paying. However, the Fund should not be dependent upon managers coming forward with notice of entitlement to a fee reduction. The investment consultant to the Fund or the Fund itself should regularly scrutinize the fees the Fund pays. Where a Fund has a investment consultant subject to conflicts of interest, it is possible that conflicts related to the consultant's business, such as brokerage arrangements with money managers, may cause the consultant to negotiate less vigorously with the managers.

The recommendation is that the Fund include a "most favored nation" clause in its contracts with managers and, in connection with executing new investment advisory contracts with managers seek to reduce fees. As mentioned below, passive investment, where appropriate, will reduce investment advisory fees dramatically.

XII. Manager Turnover

In the past 6 years, the consultant has recommended that the Board hire 21investment managers and terminate numerous investment managers for poor performance. This turnover is excessive and, in our opinion, raises questions regarding CSG's manager selection capabilities. Further, as discussed in the hedge fund of funds and venture capital managers sections, CSG's manager due diligence capabilities have been found to be lacking. As a result, it is likely that additional terminations of managers who were recommended by CSG will be inevitable in the near future. In our opinion it appears that 10 or more of the new managers CSG recommended are vulnerable. Staff is of the opinion that only 4 of the new managers are vulnerable.

Since the costs related to CSG's poor manager selection are significant and will continue to detrimentally impact the Fund's investment returns, the recommendation is that the Board review CSG's recommendations regarding new manager hires, as well as previous recommendations that have resulted in terminations, in order to determine whether CSG's advice and due diligence has met with professional standards and been free of conflicts.

XIII. Minority-Owned Business Participation

The Fund has sought to contract with firms that are 51% or more owned by racial minorities. It appears that all of the minority owned firms hired by the Fund, including Chapman; Smith Graham; NCM; Buford, Dickson; Niagra Elite and Pharos have been African American majority owned. The due diligence, as well as the performance results related to many of these investments is questionable. As mentioned elsewhere, the Fund has no Manager Guidelines establishing minimum criteria for any managers hired. Generally pensions that have established programs to increase minority participation in management of plan assets, have to some degree reduced the minimum qualifications applicable to minority managers, in recognition of the limited number of minority firms in existence, as well as the limited performance records related to such firms.

Minority participation programs are highly controversial, especially where performance suffers. Thus, it is critical that when the Fund departs from generally accepted guidelines related to hiring investment managers in order to hire minority managers, such as minimum assets under management and track record, the justification for such departure is clearly articulated and greater due diligence is applied. The due diligence the consultant has provided to the Fund over the years regarding minority firms has not been adequate.

The recommendation is that the Fund either eliminate any informal minority preference or establish guidelines to reduce the potential risks such a preference creates.

XIV. Local Investing

The Board's preference to invest with local traditional asset managers and venture capital managers is problematic. Again, the due diligence the consultant has provided to the Fund over the years regarding local firms has not been adequate. In several instances it appears that the Fund has contracted with local entities for traditional asset management services where the local entity has provided minimal services and has retained a subadviser to actually manage the assets. In these cases there appears to be little rationale for the intermediary, other than for the Fund to contract with and pay fees to a local entity. With respect to venture capital, the Board has invested with several local firms lacking any meaningful track record. A local firm preference increases the risk that local managers will be hired based upon relationships with Board members, as opposed to on the merits. A local preference increases the potential for conflicts of interest exponentially. For example, with respect to the Delta Capital investments, according to Staff an issue was raised regarding the former Mayor's relationship with the General Partner. Another issue related to local investing that could be problematic is whether the minority investor in CSG or persons affiliated with that company have any economic interest in any local firm CSG has recommended to the Fund, even if CSG were unaware of the relationship. For these reasons, many pensions, such as the Metropolitan Government of Nashville and Davidson County plan, have chosen to eliminate any local investment preference or abstain from investing locally.

The recommendation is that the Fund either eliminate any informal local preference or establish guidelines to reduce the potential risks such a preference creates.

XV. Active Versus Passive Management

As mentioned earlier, all of the Fund's managers are considered active managers. According to Staff the Board has made a conscious decision to hire only active managers. It is unclear what, if any, educational materials the consultant has provided to the Board over time regarding the merits of passive management. Many pensions invest some portion of their assets, particularly their domestic large cap equities, with passive managers. The large cap segment of the market is very efficient and outperforming an index is very difficult. Some larger funds with significant small cap allocations index a portion of these assets assets, due to capacity constraints related to many small cap managers. Core international assets may be indexed. With respect to any segment of the market where the Fund's active managers have consistently underperformed passive management, if available, should be considered. In addition to potentially improving performance, passive management involves the certainty of exponentially lower investment advisory fees and brokerage commissions. Consultants with affiliated brokerages are subject to conflicts of interest and may not recommend indexing. Since active managers may generate significantly more trading commissions, consultants with affiliated brokerages may benefit financially from recommending active management.

The recommendation is that the Fund should consider passive management of all asset classes objectively, with additional information provided by a conflict-free advisor, and seek to quantify any underperformance of the Fund related to the decision to remain with active managers.

XVI. Venture Capital Investments

Over the years the Fund has made several venture capital investments without adequate due diligence. While the Fund lacks an Investment Policy Statement and Manager Guidelines generally, such guidelines are critical given the lack of regulation and level of complexity of venture capital investments. Additionally, the Board's policy of preferring to invest in local venture capital creates a potential for conflicts of interest and has resulted in controversy. For example, according to Staff the Board's decisions to invest in Delta Partners I and II have been criticized regarding conflicts of interest involving the former Mayor. The investments in local ventures, Delta Partners I and II and Memphis Biomed Ventures I and II also appear suspect since none of these entities had substantial track records at the time of investment by the Fund and the Fund's percentage ownership in these entities at the time of investment was substantial, in excess of 50%. For this reason, other pensions, such as the Metropolitan Government of Nashville and Davidson County, have established policies of not investing in local venture capital partnerships.

According to Staff the Fund's investment consultant has been responsible for due diligence review of these investments and has recommended each of them (although with respect to the Fund's investment in Delta II, the consultant (according to Staff and CSG) recommended a lesser investment). Given the lack of assets under management and track record of the managers recommended, as well as the vagaries and complexities of venture capital investments, it is difficult to conceive of the due diligence methodology employed by the consultant with respect to these investments.

Furthermore, there is a lack of proper monitoring of the investment performance of the venture capital investments. While venture capital investment returns are included in the quarterly performance reports, there is no benchmark to measure performance against. According to the August 2006 report, performance since inception only is indicated for Delta I and II, Memphis Biomed I and Pharos. All these managers indicate negative performance; no performance is reported for Memphis

Biomed II. Each venture fund's calculated estimated rate of return has to be obtained directly from the managers and, due to the lack of readily ascertainable market values and the illiquidity of the securities held in the venture capital fund portfolios, it is difficult verify performance claims and compare the venture fund returns to a market rate of return. Since the venture capital managers generally are responsible for valuing the illiquid portfolio securities, it is possible that the valuations and performance claims are inflated. The reported negative returns are significantly lower than the returns that could have been earned if the Fund's assets had been invested in publicly traded equities at substantially less risk.

While to date these highly speculative, risky investments that were not properly analyzed prior to committing capital and have not been adequately monitored since they were funded, have produced losses, is too early to determine what losses, if any, will result to the Fund ultimately.

It is especially difficult to conceive how the consultant's due diligence of Pharos Capital Partners II-A could have resulted in a favorable recommendation. As reported in forbes magazine, "Hedge Hell," July 5, 2004, two of the principals of Pharos, D. Robert Crants and Michael Devlin, are among the defendants in a $500 million lawsuit related to two exchange funds they managed. "Among their alleged misdeeds: that the two men put $7.5 million into a money losing real estate firm they controlled and that they invested $5 million in a venture capital fund run by a fund board member. Crants and Devlin have been hit with still other allegations. They ran a side business buying prisons that was named in now-settled securities class actions. They also managed two private equity funds that received $15 million from Nashville's pension fund; an auditor's report said the deal involved conflicts of interest and almost no due diligence. Crants and Devlin were not named in any suit, but the city sued UBS PaineWebber, whose brokers had advised it on funds. In 2002 it paid $10 million to settle."

The Fund's lack of Manager Guidelines and the consultant's subjective method of evaluating venture capital investments subject that portion of the investment portfolio, with a market value of $18.5 million at August 31, 2006, to unnecessary risk. Total capital committed by the Fund to venture capital amounts to $45 million. Given the lack of readily ascertainable market values and illiquidity generally related to securities held in venture capital portfolios, as well as the conflicts of interest related to valuation of such portfolios, it is possible that the true value of the Fund's venture capital investments may be substantially less than indicated in the investment consultant's performance reports. That is, the venture capital losses may exceed those already reported.

The recommendation is that the Fund re-evaluate these investments, including whether to withhold the additional capital it has committed to them. These investments amount to approximately 4% of fund.

XVII. Commission Recapture and Transaction Cost Analysis

The Fund has commission recapture agreements with four brokerages, Lynch, Jones & Ryan, Inc.; Morgan Keegan & Company, Inc., Harvestons Securities, Inc. and Abel/Noser Corp. All of these contracts provide that the Fund agrees to direct its investment managers to effect certain trades through these brokerages consistent with "best execution" at the managers' normal negotiated commission rates. Pursuant to the agreements, the brokerages agree to refund to the Fund a percentage of the commissions paid directly to the brokerages, in accordance with attached schedules. The recapture rate in all contracts is 70% for domestic equity trades. However, the recapture brokers are not rebating 70% to the Fund; rather, each broker has its own understanding of the percentage it is required to rebate. These adjustments (downward) to the recapture rates are not in writing. Abel/Noser says it rebates 70% of the commission, subject to a minimum 1.5 cents per share. Lynch, Jones & Ryan says it rebates 70%, subject to a 2 cent minimum. Thus, since the Fund's managers are paying an average commission of 4.46 (according to Abel/Noser), 70% of the average commission would be 3.12 and the recapture brokers would keep 1.34. Neither firm is rebating such a substantial amount to the Fund. (We did not contact Morgan Keegan or Harvestons.)

Consistent with industry norms, it appears that none of the firms are paying interest on recapture monies. Since Lynch, Jones and Harvestons send refunds to the Fund quarterly by check, interest on Fund monies at the brokerages is more of an issue. Abel/Noser sends refunds monthly by check.

Not all domestic equity trades are subject to recapture. Domestic equity trades related to commingled trusts funds not custodied at Northern, as well as trades related to hedge fund-of-funds (and presumably other alternative investments) are excluded from the commission recapture program. Given the high portfolio turnover generally characteristic of hedge funds, commissions related to these accounts may be substantial. Staff understands that hedge fund commission rates are highly competitive; we have no information on this matter.

The Lynch, Jones & Ryan and Harvestons commission recapture schedules include a 70% refund to the Fund of the available credits generated from domestic fixed income transactions and research credits on new issues. The Lynch, Jones agreement further provides for recapture of international equity trade commissions executed through Instinet or firms with which Lynch, Jones has a correspondent relationship. The schedule states the Fund receives a credit of 45% of gross commissions and that the rate is based upon the gross agency commission paid, less local charges, taxes, etc. According to the schedule, the rebate amounts to approximately 66% of the net commissions retained by Lynch, Jones. (Abel/Noser provides fixed income and international recapture with an 80% rebate however the current agreement between the firm and the Fund does not include such assets.)

Morgan Keegan provides the Fund with an onsite Bloomberg terminal, which is billed to and paid by the firm. All charges for this service are applied against the Fund’s commission recapture amount.

Abel/Noser provides the Fund with its Trade Cost Measurement Report for no additional charge. The Trade Cost Measurement Report provides commission and “best execution” analysis; however, if provided with additional data from the managers, such as time-stamps, Abel/Noser could provide more thorough trade cost analysis. There is a cost to the Fund related to this enhanced service (approximately $15,000 annually), which is referred to as Trade Zoom. The Trade Cost Measurement Report includes only domestic equity trades and excludes international and fixed income trading.

Recently Abel/Noser provided the Fund with its first report regarding fixed income trading, which included a transaction cost analysis. Unfortunately, apparently the initial report was incorrect and is being rerun at this time.

Abel/Noser indicates that the only issue relating to transaction costs that has arisen over the past few years is Southeastern Asset Management paying a five cents commission rate per share, versus the Abel/Noser Universe average of 3.5 cents. According to Abel/Noser, in light of Southeastern’s superior performance, the Fund understandably has not been concerned regarding this issue.

Abel/Noser was not aware that the Fund's consultant had an affiliated brokerage and has not been monitoring whether TSG has received any trades from the Fund's managers. Upon our inquiry, Abel/Noser stated that a review of the Fund's trading records indicates that TSG does not appear to be participating in the Fund's domestic equity trading. However, since TSG has arrangements with numerous other brokers for execution and clearing services, trades with respect to which TSG may receive a commission credit may not indicate TSG on the records Abel Noser reviews. As mentioned earlier, we have identified instances where TSG has received commissions from Fund managers with respect to Fund trades executed by other brokers.

Since the Abel/Noser Trade Cost Measurement Report does not include international or fixed income, any TSG participation in such trading may not be detected.

The recommendation is that the Fund re-negotiate all commission recapture agreements to provide that all commissions above 1.5 cents are rebated. International, fixed income and new issue credits should all be renegotiated to provide an 80% rebate. All refunds should be paid monthly. Consideration should be given to the issue of trading commissions received by TSG from the Fund's managers related to the Fund's accounts that were not authorized by the Fund.