Deferred Compensation Plan
BOARD REPORT 15-57

Date: December 10, 2015

To: Board of Deferred Compensation Administration

From: Staff

Subject: Deferred Compensation Plan Stable Value Fund Sub-Advisors

<u>Recommendation:</u>

That the Board of Deferred Compensation Administration:

a) Find that Galliard's changes to managers of the intermediate asset pool and Short-Term Investment Fund (STIF) are justified within the scope of Galliard's discretion as the SVF manager; and
b) Direct staff to proceed with incorporating language in the new contract with Galliard indicating that Galliard is solely responsible for fiduciary management decisions, including the selection of sub-advisors, as well as providing the City's Plan with timely notification of changes to sub-advisors.

<u>Discussion:</u>

A. SUMMARY

Galliard Capital Management ("Galliard") is the investment management services provider for the DCP Stable Value Fund ("SVF"). Galliard oversees the investment strategy for the option as well as the operation of the SVF and its various underlying investments and components. The SVF presently has approximately $1 billion, or 20%, of Plan assets.

Effective July 1, 2015, the Board renewed its contract with Galliard Capital Management ("Galliard") to provide the Stable Value Fund investment option. Staff is currently finalizing the new contract and has set a deadline to conclude this process by January 15th, 2016.

Galliard is responsible for investing SVF assets using a combination of proprietary and externally managed providers/vehicles. Galliard recently approached staff and the Board's consultant, Mercer Investment Consulting ("Mercer"), regarding a proposed change to a sub-advisory relationship regarding replacing the Fund's intermediate core fixed income manager (involving 15% of Fund assets), which under the expired contract would be subject to Board approval. In addition, Galliard further provided notice of a change being made to the Fund's Short-Term Investment Fund (STIF), the liquidity buffer for the Stable Value Fund (currently involving 3.1% of Fund assets), which under the prior contract was not subject to Board approval.

Both Mercer and staff find that these changes are justified within the scope of Galliard's discretion as the SVF manager. For reasons that will be outlined later in this report, staff recommends that the Board concur with staff's and Mercer's findings but not take any action to approve the change in managers.

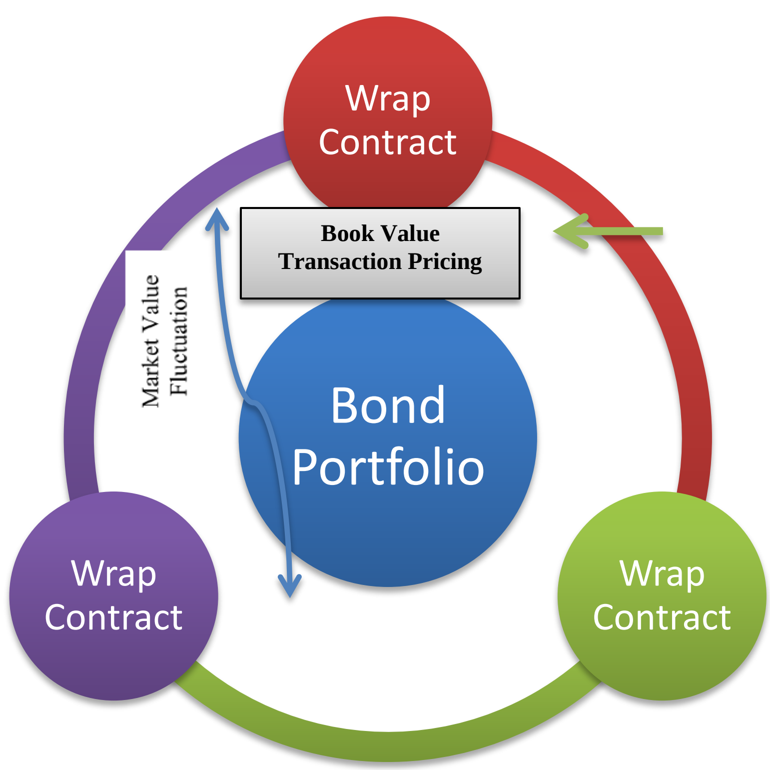
In this report staff will provide:

- Background regarding the structure of the SVF and Galliard's administrative relationships;
- Findings regarding the specific sub-advisor changes; and
- Discussion regarding the roles of the Board and Galliard in future decision-making regarding the SVF, including its sub-advisor, wrap provider, and liquidity buffer service provider relationships.

B. BACKGROUND: STABLE VALUE FUND CONSTRUCTION

i. What is a Stable Value Fund?

A stable value fund is an interest-bearing investment vehicle typically only offered within employer-sponsored retirement savings plans. A stable value fund combines a bond portfolio with insurance contracts for the purpose of allowing plan participants to transact at a more stable price than would typically occur in a pure bond portfolio. The purpose of the wrap contracts is to insulate the bond portfolio from interest rate volatility and allow plan participants to transact at the "book value" of the underlying assets rather than the "market value." This structure further allows the stable value fund to invest in intermediate duration fixed income bond securities, providing a return profile that is typically higher than other interest-bearing options such as bank deposit accounts or money market funds.



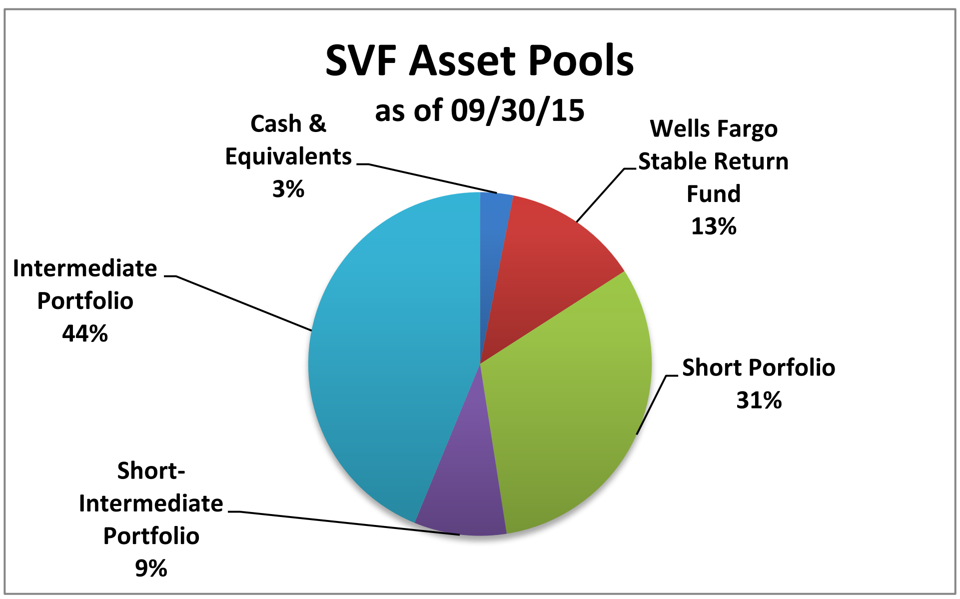
ii. How is the City's Stable Value Fund Administered?

The City's SVF has four primary levels of administration:

(1) Overall Fund Management - Galliard functions as the overall SVF manager, which includes investment management services as well as establishing relationships with various entities to provide external portfolio management, wrap contract, and liquidity buffer services.
(2) Bond Portfolio Management – Galliard provides investment management services for most SVF assets and also sub-contracts a portion of this management to an external provider (presently Prudential).
(3) Wrap Services - Insurance companies or other financial institutions are selected by Galliard to provide the wrap contract services. There are presently five insurance companies that have issued wrap contracts for separate portions of the overall portfolio.
(4) Liquidity Buffer - A "Liquidity Buffer" exists which is divided into two segments: (a) the Wells Fargo Stable Return Fund (SRF) and (b) the Wells Fargo Short-Term Investment Fund (STIF), which is essentially a money market fund. The Liquidity Buffer is used to address shorter-term inflows/outflows that occur as participants move money in and out of the SVF.

iii. What Comprises & Who Makes Investment Management Decisions Within the Bond Portfolio?

The Bond Portfolio is broken into sleeves of bond holdings distinguished largely by portfolio "durations." Duration is a measurement of how long, in years, it takes for the price of a bond to be repaid by its internal cash flows. Portfolio duration within a bond or SVF equals the weighted average maturity, in years, of all of the cash flows in the portfolio. For the purposes of the SVF, these weighted average durations are broken into general categories of "short" and "intermediate" and further broken out by whether they are invested in insurance separate accounts or are security backed investment contracts. The chart to the right breaks out these portfolio holdings by broad categories. Galliard manages all of these sleeves, excluding a portion of the intermediate core fixed income segment that is presently managed by Prudential Investment Management.

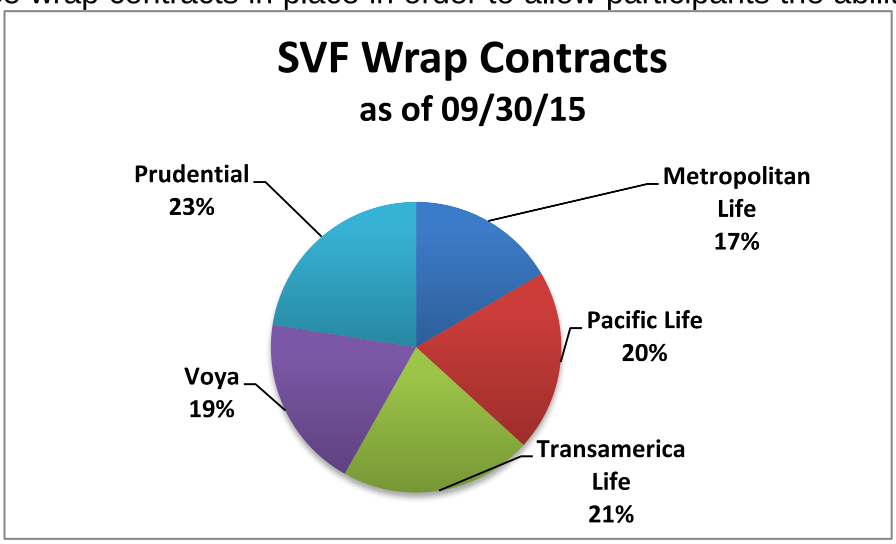


The table below provides the actual dollar amounts attributable to the asset pool management chart as of 09/30/15:

Asset Pool Market Value	Amount
Cash & Equivalents	$ 32,510,661
Wells Fargo Stable Return Fund	$ 133,675,800
Short Portfolio	$ 330,028,226
Short-Intermediate Portfolio	$ 90,989,014
Intermediate Portfolio	$ 457,149,035
	$ 1,044,352,736

iv. How Do Wrap Contracts Work?

Wrap contracts allow participants to transact at a portfolio's "book value." Book value refers to the original purchase cost of portfolio holdings plus their accumulated interest. Book value is different from market value, which is the price at which the portfolio's holdings are valued by the bond market at any given point in time. Wrap providers must manage the risk of participant redemptions occurring when the market value of a portfolio is less than its book value. Stable value funds need to have these wrap contracts in place in order to allow participants the ability to transact at book value. Wrap providers are thus a crucial mechanism for managing the risk of the portfolio. The chart right breaks out SVF wrapped assets by provider.



The table below provides the actual dollar amounts attributable to the wrap provider allocation chart indicated above as of 09/30/15:

Wrap Provider	Amount
Metropolitan Life	$145,583,150
Pacific Life	$177,154,694
Transamerica Life	$188,204,791
Voya	$169,268,404
Prudential	$197,955,235
	$878,166,274

The difference between the total of all asset pools and the wrapped amounts of the SVF Fund ($166 million) represents the amounts that are invested in the Cash & Equivalents and Wells Fargo Stable Return fund categories.

C. CHANGES TO ASSET POOL INVESTMENT MANAGERS & WRAP PROVIDERS

Galliard recently approached the City with a proposed change to the manager of a portion of the intermediate asset pool, replacing Prudential Investment Management with Jennison Associates. At the same time, Galliard also provided notice regarding a change to the manager of the Wells Fargo Short-Term Investment Fund (STIF), replacing Wells Capital Management with BlackRock Institutional Trust Company. These changes will result in a slight increase to the DCP Stable Value Fund's overall expense ratio, adding approximately one basis point (0.01%), moving from 0.315% to 0.325%.

Staff reviewed these proposed changes closely with both Galliard and Mercer Investment Consulting ("Mercer"), both relative to the investment-related perspective of the impact of these changes on the SVF portfolio, as well as relative to the broader question of how and by whom the fiduciary discretion of investment manager changes should be made and, relatedly, how that authority should be reflected in the City's contract with Galliard. Staff will address each of these items separately.

i. Intermediate Asset Pool Sub-Advisory Change: Prudential to Jennison

Galliard is recommending a change to the manager of a portion of the intermediate asset pool, replacing Prudential Investment Management with Jennison Associates (see Attachment A). Under the new contract, Prudential is targeted to manage 15% of overall SVF assets.[1]

Galliard is proposing this change because it believes that Jennison's greater actively managed investment approach, focusing on fundamental research and individual security selection, is likely to provide higher levels of performance than the incumbent manager. Mercer has advised that Jennison employs a greater degree of active management than Prudential, emphasizing security selection, yield curve management, and sector rotation as sources of potential added value above the benchmark; and that Prudential, by contrast, utilizes an approach that attempts to enhance index returns by taking modestly different positions than are found in the benchmark (Attachment B).

Galliard advises that the change in providers will result in an increase of 0.0048% to the DCP Stable Value Fund's expense ratio, but that this additional fee amount should be surpassed by excess performance by Jennison compared to Prudential. In addition, Galliard advises that because Galliard is executing this change across all of its relevant client accounts, Galliard is unlikely to retain the same pricing power with Prudential and projects that if the City were to maintain Prudential as its provider, fees would increase by a larger amount (0.0093%). Both Mercer and staff find that these changes are justified within the scope of Galliard's discretion as the SVF manager. For reasons that will be outlined shortly, staff recommends that the Board concur with staff's and Mercer's findings but not take any action to approve the change in managers.

ii. STIF Sub-Advisor Change: Wells Fargo to Black Rock

Galliard also provided a notice from Wells Fargo (the STIF fund's trustee) regarding their change to the manager of the Wells Fargo Short-Term Investment Fund (STIF), replacing

[1] In addition, under the new contract Dodge & Cox will be added as an additional external manager and will be managing 15% of overall SVF assets. This change was previously approved by the Board at the time that Galliard was selected pursuant to the Board's Request for Proposal for Stable Value investment management services.

Wells Capital Management with BlackRock Institutional Trust Company. The STIF holds approximately 3.1% of Plan assets.

The fund's trustee is making this change because it believes BlackRock will provide more competitive investment performance and pricing, more expertise and scale in the STIF money fund space, and the infrastructure to meet changing regulatory requirements for commingled money market pooled offerings. Galliard reviewed the proposed change and concurred with Wells Fargo's findings. Mercer has advised that STIF fees will increase from 0.01% to 0.13%, but because of the relatively small portion of overall Plan assets, the fee impact on the portfolio as a whole is 0.007%. Both Mercer and staff find that these changes are justified within the scope of Galliard's discretion as the SVF manager. For reasons that will be outlined shortly, staff recommends that the Board concur with staff's and Mercer's findings but not take any action to approve the change in managers.

iii. Fiduciary Decision-Making and the SVF

As noted previously, staff considered both of these changes relative to the broader question of how and by whom the fiduciary discretion of investment manager changes should be made and, relatedly, how that authority should be reflected in the City's contract with Galliard.

Under the expired contract, Galliard must seek and obtain City approval before it makes a change to an investment manager sub-advisor. That contract does not, however, require that Galliard seek and obtain City approval for changes to wrap contract providers or STIF sub-advisors.

In staff's analysis, there should be consistency between how each of these three sub-contracted relationships are treated in terms of who has ultimate fiduciary discretion over the selections of the providers. Each of these changes can impact net investment performance and fees. Each, therefore, represents a fiduciary decision.

Given this, the broad question is whether this kind of fiduciary decision-making should be assumed by the Board or is more appropriately delegated to Galliard. In staff's analysis, the decision-making authority is more appropriately delegated to Galliard. Galliard has been hired as an investment manager for the SVF. If the SVF was a mutual fund, these kinds of decisions would not be subject to plan sponsor approval. For example, a mutual fund manager could make changes to sub-advisory relationships for managing portions of total fund assets which could impact both performance and fees. Because a mutual fund represents a pool of funds from multiple investors, these decisions may not (practically or legally) be subject to any individual investor's approval. The exercise of fiduciary discretion, and the fiduciary responsibility, lies with the fund manager.

In the case of the SVF, the decisions Galliard makes regarding its sub-advisor relationships should likewise be considered as properly falling within the scope of duties assigned to Galliard within its role as SVF manager and in accordance with the investment guidelines included within the contract. To the degree the Board becomes involved in the active role of choosing sub-advisors, it takes on a greater fiduciary role. In addition, such actions blur the line between sub-advisor appointments and other Galliard fund management decision-making which may also impact performance and fees. For example, Galliard in its discretion may increase/decrease asset allocations within the SVF's various asset pools, and these changes can impact performance and cost. If the Board were to operate under the theory that it should have final decision-making approval over any change that may impact fund performance or fees, it may without intending to walk into a role where it becomes the de facto manager of the SVF. This is a fiduciary stretch well beyond what is required or what staff views as appropriate.

Mercer and Galliard both advise that most SVF clients delegate all of this decision-making authority to the SVF manager. Staff's recommendations, therefore, is that in order to establish consistency in the decision-making process as well as bright lines around fiduciary decision-making, all of Galliard's changes to sub-advisors and other changes which can impact performance and fees be at the sole discretion of Galliard, and that this principle be incorporated into the final contract presently under negotiation.

Having said this, however, what staff finds is appropriate and required for the Board to maintain proper oversight of the SVF is that Galliard be required to report all such changes to the Board in a timely manner, not for the purpose of advance approval, but such that the Board is aware that the changes are being made, has the opportunity to receive input from its investment consultant and staff, and is in a position to assess on an ongoing basis whether it believes the strategies and decisions made by Galliard are in alignment with the SVF's investment objectives and guidelines[2] for the SVF and the Plan's Investment Policy Statement (IPS).[3] The Board always has the ability to engage in greater discussion or review of SVF management with Galliard as it deems appropriate. In addition, the Board also has the ongoing ability, as it does with any of its investment management relationships, to terminate a contract and/or initiate a new procurement process whenever it wishes. This is the more fundamental and inherent fiduciary role that is always retained by the Board.

Given this, staff recommends that the Board direct staff to proceed accordingly in drafting the new contract language, by making clear that Galliard is solely responsible for fiduciary management decisions, including the selection of sub-advisors, as well as providing the City's Plan with timely notification of changes to sub-advisors.

Submitted by: ______________________________

Steven Montagna

[2] The contract section, "Investment Objectives and Guidelines," outlines the quality of investments allowed within the DCP Stable Value Fund as well as guidelines on the allowed levels of diversification and allocation to any one particular type of underlying investment. Galliard is contractually obligated to maintain these Fund guidelines. Changes to this document would require Board review as well as an amendment to the contract. Previous changes to this document have been reviewed with the Plan's consultant and brought before the Board before any changes to the document were made.

[3] Through the Plan's "Quarterly Investment Performance Reviews," the Plan's investment consultant continuously monitors the performance of this option and all options of the Plan, including relative to the Plan's Investment Policy Statement.

ATTACHMENT A

GALLIARD
Capital Management, Inc.

November 25, 2015

City of Los Angeles Board of Deferred Compensation Administration
Deferred Compensation Plan
Attn: Steven Montagna, Executive Director
200 N. Spring Street, Room 867
Los Angeles, CA 90012

RE: Stable Value Fund – External Manager Changes

This is in regard to two changes to external managers for the City of Los Angeles Stable Value Fund. The first involves our proposal to change our external sub-advised portfolio from Prudential Investment Management to Jennison Associates. The second involves our recent notice regarding the change in the Wells Fargo Short Term Investment Fund (STIF) subadvisor from Wells Capital Management to BlackRock Institutional Trust Company ("BlackRock"), effective December 1, 2015. More details on both topics are provided below.

(1) Change to External Sub-Advised Portfolio: Prudential Investment Management to Jennison Associates

We currently utilize a collective fund managed by Prudential Investment Management for one component of your underlying fixed income portfolio within your Stable Value Fund. As part of our on-going services, we have a dedicated team that is continually looking at our external partners to assure we have the right strategies in place for our clients. Galliard's external manager team believes there are now better value propositions available than the Prudential strategy within which the City's Stable Value Fund is currently invested. In particular, we believe the active management employed by Jennison has the potential to outpace the current investment strategy employed by Prudential. Jennison's bottom-up approach that focuses on fundamental research and individual security selection has led to a net of fees annual excess return of 21 basis points since inception of our collective fund relationship in 2010. Security selection and yield curve management have been the primary drivers of relative outperformance. Furthermore, their focus on sector rotation, and to a lesser extent, yield curve management, provide a complementary addition to Galliard's fixed income management style.

Additionally, as we have had similar discussions with other clients that utilize the Prudential fund, we are aware of a number of other Galliard clients that we will be transitioning out of that fund in the coming months. The end result from those transitions is that we will see an increase in Prudential's management fee as assets in the collective fund decline, further reducing their value proposition and outperformance potential. These factors lead us to believe it is better to transition the portfolio away from Prudential to Jennison in order to provide the best value to your plan participants.

This transition will result in a nominal fee increase to your overall portfolio of 0.004% (0.4 bps). Our expectation is that Jennison will more than make up for this slight fee increase through their portfolio performance.

(2) Wells Fargo STIF Sub-Advisor Change

We recently sent a notice to you regarding an upcoming change to the manager of the Wells Fargo Short Term Investment Fund (STIF) effective December 1st, 2015. Galliard uses the STIF fund as a component of your liquidity buffer as well as for a daily sweep vehicle within the underlying fixed income collective funds that are used in the portfolio. This manager change does not require any action from the City but it will have a marginal impact to the overall expense ratio of your stable value fund.

Wells Fargo, as trustee for the Wells Fargo collective funds, recently selected BlackRock Institutional Trust Company ("BlackRock") as the new subadvisor of the STIF, effective December 1, 2015. BlackRock will replace the current subadvisor, Wells Capital Management, and the STIF will be renamed to Wells Fargo/BlackRock Short-Term Investment Fund S.

Wells Fargo believes transitioning to BlackRock will deliver a number of key benefits including a) competitive investment performance and pricing; b) substantial management expertise and scale in the STIF/money fund space (BlackRock manages more than $83 billion in STIF assets); and c) the infrastructure to meet the changing regulatory requirements for commingled money market pooled offerings.

In light of this change, our responsibility to you as your investment advisor requires that we act promptly to assess this change and take any action necessary to pursue your best interests. In this regard, we analyzed the population of cash funds/short-term investment vehicles available on the Wells Fargo custody system that meet the timing needs of our daily trading cutoffs.

Our review of performance (based on historical similarly managed BlackRock vehicles), current yield, fees, guidelines, and management expertise supports the view that the STIF under BlackRock management should continue to offer a competitive yield with a fee that is comparable to other available options.

With the change in sub-advisor, BlackRock will begin charging a management fee of 12 basis points on the STIF, resulting in a total expense ratio of just under 13 basis points for the STIF. Neither Galliard nor Wells Fargo will receive any additional revenue from this fee. Based on your portfolio allocations as of 8/31/15, we anticipate the BlackRock STIF management fee impact to be 0.007% (0.7 basis points) to your overall expense ratio.

Thank you for your attention to both topics. Please advise if we can supply any additional information regarding the Jennison manager recommendation or the STIF manager change.

Sincerely,

Mike Norman
Partner

Matt Kline
Director

cc: Devon Muir, Mercer

MERCER
MAKE TOMORROW, TODAY

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MEMO

TO:	Board of Deferred Compensation Administration, City of Los Angeles Deferred Compensation Plan
DATE:	November 30, 2015
FROM:	Devon Muir, CFA and Michael Molino
SUBJECT:	DCP Stable Value Fund changes and subadvisory delegation
COPY:	Staff

As the Board is aware, Galliard Capital Management, Inc. serves as the advisor to the DCP Stable Value Fund ("Fund"). Among its investment management duties are investing plan assets in proprietary and externally managed investment strategies and selecting "wrap" insurance providers which guarantee book value treatment of the Fund. Recently, Galliard has advised Mercer and staff of two Fund changes.

STIF management change: The first involves a change in subadvisor to the Wells Fargo short-term investment fund (STIF) which is employed in the DCP Stable Value Fund as the Fund's cash allocation. To this point, the STIF has been subadvised by Wells Capital Management, but Wells Fargo Bank N.A., the trustee of the STIF, recently announced its intention to replace Wells Capital with BlackRock Institutional Trust Company effective November 30, 2015.[1] As a result of the change, STIF fees will increase from 0.01% to 0.13%, but given the DCP Stable Value Fund's small STIF allocation, this will amount to only a 0.007% effective increase in overall Fund fees. Galliard has reviewed BlackRock's cash management capabilities relative to other STIF alternatives available, and it believes retaining the STIF (now managed by BlackRock) is the best course of action. **Mercer concurs with Galliard's assessment of BlackRock's cash management capabilities.**

Recommended change to intermediate bond portfolio: The second change involves replacing the Fund's intermediate core fixed income investment managed by Prudential with a different intermediate bond strategy managed by Jennison, a subsidiary of Prudential. Jennison employs a greater degree of active management than Prudential, emphasizing security selection, yield curve management, and sector rotation as sources of potential value-added above the benchmark. Prudential, meanwhile, implements an investment process that aims to enhance index returns by taking modestly different positions than the benchmark, an approach that Galliard believes will underperform relative to that of Jennison on a net-of-fee basis. Based on an anticipated 15%

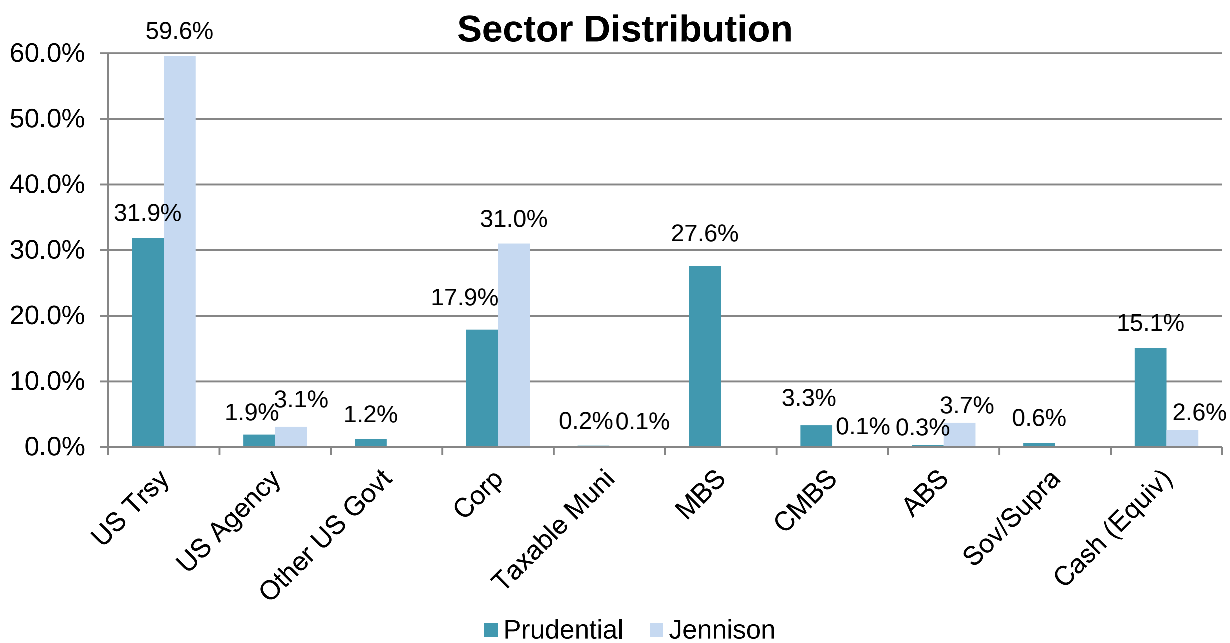
[1] Wells Fargo Bank N.A. states its rationale for the change is that it has a relatively small focus on cash management, while BlackRock manages $83 billion in STIF assets, providing "more than adequate scale and has a liquidity asset management product infrastructure that is well equipped to provide our current and future STIF unit holders with a strong stable net asset value product in this changing regulatory environment."

allocation to Jennison, the change would increase overall Fund fees by 0.0048%,[2] an amount that Galliard believes will be surpassed by excess performance provided by Jennison. It is important to note that Galliard is implementing or recommending this change across all of its relevant client accounts. Should these client accounts move, Galliard will no longer have the same purchasing power with Prudential as it did prior to the transition. If the City were to retain the current Prudential investment under these less attractive terms, Galliard expects overall Fund fees to increase 0.0093% (i.e., nearly twice as much as the increase from moving to Jennison). **We are supportive of Galliard's recommendation given our favorable opinion of Jennison's fixed income capabilities and the possibility that taking no action will result in higher fees.** In the appendix of this memo, we provide further details on the Prudential and Jennison Intermediate Fixed Income strategies including portfolio composition, characteristics, fees, and performance.

[2] The advisory fee for Jennison is 0.09% versus the current fee of 0.058% for Prudential. Galliard expects Prudential's fees to go up to 0.12% if most of its clients move out of the Prudential strategy since the most cost-effective breakpoints in the fee schedule will no longer be met.

Appendix

Portfolio Composition ***(data as of 6/30/15 provided by Galliard)***



Portfolio Characteristics

	Prudential	**Jennison**
Weighted Avg Quality	AA+	AA+
Effective Duration (Years)	3.34	4.01
Yield to Maturity	1.76%	1.65%

Investment Expenses

	Prudential	**Jennison**	**Difference**
Fee	0.0580%	0.0900%	+0.0320%
Fee impact on total SV fund (weighted by 15% allocation)	0.0087%	0.0135%	+0.0048%
Fee expected assuming most Galliard clients transition out of fund	0.1200%	N/A	+0.0093%

Performance

	2Q 2015	YTD	1 Year	3 Year	Since Inception	Inception Date
Prudential (Net)	-0.70	0.66	1.86	1.74	2.76	8/2/2010
Barclays US Intm Aggregate Index	*-0.67*	*0.64*	*1.89*	*1.74*	*2.72*	*8/2/2010*
Excess	**-0.03**	**0.02**	**-0.03**	**0.00**	**0.04**	
Jennison (Net)	-1.08	0.59	1.96	1.51	2.82	*8/2/2010*
Barclays US Intm Gov/Cred Index	*-0.62*	*0.82*	*1.68*	*1.6*	*2.61*	*8/2/2010*
Excess	**-0.46**	**-0.23**	**0.28**	**-0.09**	**0.21**	

Important notices

References to Mercer shall be construed to include Mercer LLC and/or its associated companies.

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Returns for periods greater than one year are annualized.