CITY OF LOS ANGELES
BOARD OF DEFERRED COMPENSATION ADMINISTRATION

ADOPTED MINUTES
REGULAR MEETING MARCH 19, 2013 – 9:00 A.M.
700 E. TEMPLE STREET, ROOM 350

BOARD MEMBERS:

| **Present:** | **Not Present:** |
|---|---|
| Eugene K. Canzano, Chairperson | Clifford Cannon, First Provisional Chair |
| John R. Mumma, Vice-Chairperson | Michael Amerian |
| Tom Moutes, Second Provisional Chair | Robert Schoonover |
| Sangeeta Bhatia, Third Provisional Chair | |
| William Raggio | |
| Margaret Whelan | |

Staff:

| | | |
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| Personnel: | Steven Montagna | Alejandrina Basquez |
| | Natasha Gameroz | Esther Chang |
| City Attorney: | Curtis Kidder | |

## 1. CALL TO ORDER

The meeting was called to order at 9:10 a.m.

## 2. PUBLIC COMMENTS

There were no public comments.

## 3. MINUTES

Ms. Bhatia indicated there was a minor typographical error on page three, first paragraph of Item 6. **A motion was made by Mr. Mumma, seconded by Ms. Bhatia, to approve the February 19, 2013 minutes, as amended; the motion was unanimously adopted.**

## 4. INVESTMENTS TRAINING: DEFLATION, INFLATION, & REAL ASSETS

Item #6 was taken out of order prior to this item.

Mr. Devon Muir of Mercer Investments Consulting provided a training regarding the impact of deflation and inflation on investment asset classes, protections for participants in inflationary and deflationary environments and trends in other defined contribution plans, and the potential use of real assets as an investment hedge in extreme inflationary environments. Mr. Canzano asked whether real assets would be something that should be offered through the Plan or as part of a custom portfolio. Mr. Muir indicated that it would be a Plan decision, but stated he had seen stand-alone options within the line-up, blended real asset products, options as part of a custom-built portfolio, or TIPS funds added as a conservative option.

Mr. Muir indicated the stimulus for this conversation was due to the current status of global central banks and corporations. He stated central banks were not involved in much lending, while on the corporate side, firms were amassing significant levels of cash on balance sheets but were not using it to hire people to stimulate growth. He indicated that as such, many countries, including the U.S., were effectively encouraging people not to save due to negative real returns (after accounting for inflation from nominal rates). Mr. Muir stated that in an inflationary environment, real assets performed better than bonds, while the converse was true in a deflationary environment. He stated that while the Plan had a bond option available, the line-up did not offer a real asset option at the other end of the spectrum.

Mr. Muir stated deflation was a substantial and continual decrease in general price levels of goods and services due to people not spending or a significant contraction of the money supply. He stated the concern in a deflationary environment was that if prices were falling, consumers were likely to hold onto their money as prices could be even lower in the future. He stated that deflation was generally considered to be worse than an inflationary scenario, and that deflation was usually followed by a depression. He stated Japan was the best example of deflation – since 1995, prices have gone down 2% cumulatively. He stated Japanese banks had held massive amounts of non-performing real estate loans and were not writing them off, allowing bad debt to sit on their balance sheets as an asset. He stated depositors recognized this, and bought government bonds rather than depositing. He stated that it led to less liquid capital available to lend out, which led to a contraction of the money supply, which led to deflation. He stated another example was during the U.S. Great Depression, when the federal government contracted government policy. He stated this led to the hampering of aggregate demand and unemployment rising to 25%, creating a cycle of declining prices. Mr. Muir stated that in periods of deflation, or in an environment with low growth and low inflation, bonds perform best. He stated historically, intermediate and long-term bonds have dominated in deflationary conditions. He indicated the Plan does provide some protection in this adverse circumstance with its bond offering.

Mr. Muir stated inflation was a substantial and continual rise in the general price levels of good and services due to significant expansion in the money supply in relation to the supply of goods available. He indicated the typical types of inflation were: classic inflation, which generally occurred after a period of constrained resources, and debtflation, which occurs with prices increasing due to significant levels of debt issued by central banks. He stated that in the latter scenario, foreign investors do not wish to hold bonds as they question sustainability; bonds are sold, and in turn, currency is weakened. He indicated the effective result of inflation was that purchasing power is eroded; there is an expectation of prices increasing, which leads to demand for higher wages, which leads to employers reacting by increasing prices. Mr. Muir stated that for those going into retirement, inflation can have significant implications. He stated this demographic would normally have a large allocation in bonds, which perform lower in an inflationary period. He stated that since retiree investment horizons were shorter, there was a lower chance of recovery. He stated that healthcare costs should also be considered as these costs were outpacing CPI levels.

He indicated that real assets, such as Treasury Inflation Protected Securities (TIPS), commodities, or real estate were assets that responded positively to inflation in different economic environments. He stated that real assets tended to have low correlation to stocks and bonds, and ultimately sought to preserve purchasing power. He stated that in a low growth, high inflation environment, TIPS would perform well. He indicated that the market had seen positive performance of TIPS in the last 5-10 years, but the pattern was not expected to persist over the next 10 years. He stated in a high growth, high inflation environment, commodities fared well. He stated commodities would be considered entities involved in oil, gold, or cattle. He stated that the benefit of commodities were that they were pure inputs of price increases - when prices go up significantly, commodities perform well. He stated, however, that commodities were highly volatile. He indicated other types of real assets were real estate, investing in commercial property, or natural resource stock. He indicated testing of hypothetical portfolios showed that real return remained positive with a reasonable exposure to real assets from 1970 to 1981, whereas a traditional allocation without real asset exposure resulted in a negative real return after inflation. He stated that a Mercer study indicated two-thirds of the defined contribution plans surveyed had inflation sensitive products within their investment line-up (or were planning to do so in the near future), generally through a TIPS option or a blended real assets product. He stated that he would have expected this percentage to be significantly lower had the question been asked in 2008.

He stated that of the options for inflation hedging, a blended multi-asset inflation hedge was most correlated with the CPI. He indicated Mercer would recommend a multi-asset inflation hedge that would be a potential mix of TIPS, commodities, real estate, and natural resource equities. He stated a blended multi-asset inflation hedge product would be beneficial to the Plan as either a standalone option and/or as part of a pre-assembled portfolio. Mr. Canzano asked what the fees looked like for this type of product and who was offering them. Mr. Muir indicated the major providers did offer this product; he stated packaged options tended to be high, on the average of 70 to 100 basis points. He indicated fees for TIPS options would tend to be lower. He stated another consideration could be to build a custom option for the Plan to lower expenses.

Mr. Canzano recommended that this issue be reviewed by the Board's Investment Committee to further consider the option of including a real asset option as part of the core investment line-up.

*The Board took a recess at 10:35 a.m. and reconvened at 10:45 a.m.*

## 5. QUARTERLY INVESTMENT REVIEW: MERCER INVESTMENT CONSULTING

Mr. Muir provided a review of Plan performance for the fourth quarter of 2012. He stated that in the fourth quarter, U.S. equity returns were generally directionless as the fiscal cliff neared. He stated that upon resolution found towards the end of the quarter, equities were up 10-12% depending on market cap. He indicated that for 2012, generally risk performed well. He stated that Plan assets were up $40 million quarter over quarter, with about $3.6 billion in total. He stated most of the Plan's assets were invested conservatively, with 24% invested in the Stable Value Fund. He stated that another 31% of participant allocations were to the DCP Large-Cap Fund, which was partially attributed to the consolidation of the large-cap funds due to the investment menu change. Mr. Canzano also noted the increase in allocation to the risk-based portfolios.

Mr. Muir stated that the Plan's net fund expense ratio continued to be well below universe medians, albeit most of the Plan's options were passively managed. He indicated the weighted average net fund expense ratio was 19 basis points. Mr. Canzano asked about the Stable Value Fund's 28 basis points comparative to the expense ratio of the ultra-conservative profile portfolio, which was lower. Mr. Muir indicated he would return with additional information.

Mr. Muir reviewed the performance of the core investment options. He stated that the FDIC savings account was yielding .45%, with a slight increase due to Bank of America's offering of two extra basis points. He stated the Stable Value Fund also performed well and offered a higher return than the FDIC conservative option. He stated PIMCO, which managed the active component of the DCP Bond Fund, had been the prominent driver of the DCP Bond Fund. He stated that for the risk-based portfolios, returns were higher the more aggressive the investment strategy. He stated Fidelity had positive performance for the year, but had lagged in the recent quarter due to significant exposure to U.S. equities and an overweight in IT stocks. He stated Fidelity would be reviewed and compared to other respondents in the upcoming RFP process and may or may not be retained.

Mr. Mumma asked about the next phase of the investment menu change and timeline for completion. Mr. Muir stated that there had been some procedural protocols to overcome, but the City and Mercer were in the process of drafting the RFP. Ms. Gameroz indicated that the RFP would be seeking managers for the international, small cap, and mid cap funds. She indicated it was the final phase of the investment menu change and should be completed by this calendar year.

## 6. BOARD REPORT 13-11: TAX COUNSEL

This item was taken out of order, after Item #3.

Mr. Kidder introduced Don Wellington and Yvonne Park from the firm of Steptoe & Johnson LLC, recommended counsel for the Plan, and Assistant City Attorney Anne Haley, manager of outside counsel for the City Attorney's Office.

Mr. Kidder stated the Board had requested late last year that tax counsel be recruited for the Board. He indicated the Plan was provided access to the list of tax counsel approved for the City's pension systems, many of which had expertise in providing counsel to deferred compensation plans. He stated letters were sent to eight qualified law firms to inquire about interest in providing services to the Plan and responses were received from five firms. He indicated that of the responses received, three firms were deemed best qualified. He stated these three firms were contacted for interviews: Steptoe & Johnson; Best, Best & Krieger; and Ice Miller. He indicated interviews were conducted on February 20, 2013 by himself, Ms. Haley, and Mr. Montagna. He stated Steptoe & Johnson was then considered the most qualified to provide counsel to the Plan. Mr. Kidder indicated Mr. Wellington had been providing employee benefit advice to municipalities for 20 years, in addition to having worked for the U.S. Department of Treasury for four years, with experience specifically regarding 457 plans. Mr. Kidder indicated Steptoe & Johnson also provided counsel to other public retirement plans, including CalPERS.

Mr. Kidder stated that should the Board provide approval, the recommendation would move to the City Council for its approval, and Ms. Haley would finalize the agreement with the firm. Mr. Kidder stated future tax-related questions from staff would be routed through his office and then to the outside counsel. He stated issues of a complicated nature would be brought before the Board for its review. He indicated Steptoe & Johnson offered a blended, or average, hourly rate of $450.

Mr. Wellington stated he was excited to work with the City of Los Angeles and with the Plan. He indicated his four years of work with the U.S. Treasury Department included work on the preliminary guidelines for 457 plans. He stated Ms. Park had also spent much time with the U.S. Department of Labor, where she acquired knowledge and skills working with fiduciaries for ERISA covered plans. He indicated they have worked together for 12 years and their combined experience has helped assist many public plans. He stated Steptoe & Johnson also provided counsel for LACERS, DWP, and Fire and Police Pensions. Ms. Park stated that while with the Department of Labor, she had helped to enforce the fiduciary provisions of ERISA, and stated she had also investigated many plans to verify breaches of fiduciary responsibility and additionally specialized in government filings and assisting clients with drafting plan provisions.

Ms. Haley stated that the City Attorney's Office had previously worked with this firm and that they would be highly recommended for counsel. She indicated to the Board that her office would manage the finalization of the services agreement and oversee all invoices for accuracy and payment.

Mr. Mumma asked how long Steptoe & Johnson have been providing counsel for LACERS. Mr. Wellington indicated a little over two years. Mr. Moutes stated that Steptoe & Johnson had provided counsel for non-tax issues, though LACERS was currently in the process of obtaining them for counsel on tax issues as well. He highly recommended their services.

Mr. Mumma asked how long it would take for City Council to approve the agreement. Ms. Haley indicated as there was no objection expected due to the use of special funds, she hoped to have it approved by next month, prior to the budget's approval. Mr. Mumma asked whether Plan funds had been obligated. Ms. Gameroz indicated $10,000 had been put aside for tax counsel. Ms. Haley stated at some point it may be necessary to allocate additional funds. Ms. Gameroz indicated adjustments could be made if so. Mr. Kidder indicated if any issues arose that would require a significant number of hours and funds, staff would return to the Board for approval. Ms. Haley stated she would include language in the Council Report that would indicate funding was not capped and that additional expenditures would not require Council approval.

**A motion was made by Mr. Moutes, seconded by Mr. Mumma, to approve Board counsel's recommendation to approve Steptoe & Johnson LLP as tax counsel to the Board of Deferred Compensation Administration; the motion was unanimously adopted.**

7. BOARD REPORT 13-12: STAFF REPORT

Ms. Chang stated Plan statistics for February remained fairly consistent with previous months. Mr. Canzano asked for details on the loan conversion process. Ms. Chang indicated that active loans were reamortized from a biweekly payment loan to a monthly payment loan; participants would then receive a coupon book for their new monthly payments. Ms. Gameroz indicated the form was also simple to complete. Mr. Canzano asked if automatic payment was available. Ms. Chang indicated that if a new retiree loan was requested, automatic deductions could be requested, however, it was not yet an option for those converting from active to retiree loans. Mr. Mumma asked about the status and timeline for the option of converting pre-tax funds to Roth funds. Ms. Gameroz indicated staff and Great-West were still researching the matter and there was no current timeline. Ms. Usha Archer, of Great-West, stated that Great-West was waiting on answers from the IRS on certain technical questions before the process for conversion could be finalized.

**A motion was made by Mr. Mumma, seconded by Ms. Whelan, to receive and file staff's report; the motion was unanimously adopted.**

## 8. REQUESTS FOR FUTURE AGENDA ITEMS

None.

## 9. NEXT MEETING DATE – APRIL 16, 2013

## 10. ADJOURNMENT

**A motion was made by Ms. Whelan, seconded by Mr. Mumma, to adjourn the meeting; the motion was unanimously adopted.** *The meeting adjourned at 11:10 a.m.*

*Minutes prepared by staff member Esther Chang.*