

PASSIVE FUND SEARCH RECOMMENDATIONS

CITY OF LOS ANGELES DEFERRED COMPENSATION PLAN

DECEMBER 2014

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Introduction

At the February 2014 Board meeting, the Board approved a new investment search policy as well as timetable for the implementation of searches over the next several years. Per this timetable, in 2015, we will be conducting searches for all of the Plan's passive investment managers. In line with the newly approved search policy, we provide our recommendations as to which type of investment vehicle search (i.e., Mutual Fund or Institutional Procurement) the Board should conduct in each category based on the specifics of the respective investment mandates.

In addition, we outline recommended minimum qualifications for each of the searches which follow the principles outlined in the Investment Policy Statement's Investment Selection and Termination section. These recommended minimum qualification screens are tailored to each specific mandate and are based on our expertise conducting similar searches. These minimum requirements broadly establish that prospective investment strategies are accessible in the recommended investment vehicle type; they are passively managed, seek to track closely the performance and characteristics of their respective indices; hold a sufficient, yet not too small, amount of assets so that the Plan would not represent a significant percentage (more than 20%) of the particular strategy total assets; and maintain investment expenses that are low to minimize net tracking error.

Search Evaluation

After the initial screening is completed, Mercer will compile search documents containing the candidates that meet the foregoing minimum qualifications in each category. In the search reports, we will provide detail on the qualitative and quantitative evaluation factors that the Board has outlined in the Investment Policy. Dimensions considered include the following:

Qualitative Factors

- Investment team strength (Idea Generation)
 - Number of investment staff
 - Number of portfolio management staff
 - Tenure of lead portfolio management team

- Portfolio construction
 - Indexation strategy (e.g., sampling, full replication, etc.)
 - Number of holdings relative to index
 - Portfolio statistics (P/E ratio, growth rate, yield to maturity, duration, etc.) relative to benchmark
 - Off benchmark exposure
 - Cash holding

- Implementation
 - Transaction cost management

- Business Management
 - Investment expenses
 - Ownership structure

Quantitative Factors

- Long-term performance relative to the index (i.e., tracking error)

Consultant Ratings

All investment funds are candidates for ratings pursuant to ongoing fund monitoring and due diligence that Mercer conducts for all of its clients. These ratings will be included in the data items reported to the Committee and can be used by the Committee as an additional measure in assessing the relative strength of each fund.

Timing

Assuming the Board is in agreement with the recommendations herein, we will begin conducting the searches immediately. Our anticipated timing for completion all searches will be eight weeks, and staff will schedule a series of Investment Committee meetings, covering the specific mandates, to coincide with this anticipated delivery.

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Proposed Investment Fund Searches

- Passive Bond
- Passive Large-Cap Equity
- Passive Mid-Cap Equity
- Passive Small-Cap Equity

Passive Bond

PROPOSED SEARCH VEHICLE

Estimated Mandate Size¹: *\$178 million*

Recommended Fund Search Type: *Mutual Fund*

Rationale:

- Conducting a mutual fund search would provide broad access to high quality index fund managers
- The universe of available passive mutual funds comprises 12 funds
- The average cost of the 5 lowest providers is 11 basis points
- There are possibly lower cost commingled trust vehicles (Institutional Products), but it is debatable whether the time and resources devoted to an Institutional Procurement would yield dramatically better results
- Using Institutional Products may lead to additional operational costs for custody and unitization. The Plan has not procured a custodian, and this would cause additional complexity. Mutual funds eliminate this concern, and at this mandate size, “all-in” fees including other operating costs for Institutional Products could be relatively similar.

PROPOSED MUTUAL FUND SEARCH MINIMUM CRITERIA (SCREENING)

- Availability in mutual fund vehicle
- Vehicle open to new investors
- Vehicle compatible with Great-West platform
- Strategy track record of 5 years or longer (specific vehicle may be shorter)
- Tracks the Barclays US Aggregate Bond Index
- Annualized tracking error² relative to the benchmark should be within +/- 0.30% over the 7- and 10-year periods (or longest available)
- Minimum assets under management in strategy (all share classes) of \$1.5 billion or greater
- Investment expense ratio equal to or less than 0.20%

¹ As of 6/30/2014

² Tracking error for these purposes is defined as the benchmark return less the subject fund return

Passive Large Cap Equity

PROPOSED SEARCH VEHICLE

Estimated Mandate Size¹: *\$1,644 million*
Recommended Fund Search Type: *Mutual Fund*

Rationale:

- Conducting a mutual fund search would provide broad access to high quality index fund managers
- The universe of available passive mutual funds comprises 45 funds
- The average cost of the 5 lowest providers is 4 basis points
- There are possibly lower cost commingled trust vehicles (Institutional Products), but it is debatable whether the time and resources devoted to an Institutional Procurement would yield dramatically better results
- Using Institutional Products may lead to additional operational costs for custody and unitization. The Plan has not procured a custodian, and this would cause additional complexity. Mutual funds eliminate this concern, and at this mandate size, “all-in” fees including other operating costs for Institutional Products could be relatively similar.

PROPOSED MUTUAL FUND SEARCH MINIMUM CRITERIA (SCREENING)

- Availability in mutual fund vehicle
- Vehicle open to new investors
- Vehicle compatible with Great-West platform
- Strategy track record of 5 years or longer (specific vehicle may be shorter)
- Tracks the S&P 500 Index
- Annualized tracking error² relative to the benchmark should be within +/- 0.30% over the 7- and 10-year periods (or longest available)
- Minimum assets under management in strategy (all share classes) of \$10 billion or greater
- Investment expense ratio equal to or less than 0.10%

¹ As of 6/30/2014

² Tracking error for these purposes is defined as the benchmark return less the subject fund return

Passive Mid-Cap Equity

PROPOSED SEARCH VEHICLE

Estimated Mandate Size¹: *\$136 million*
Recommended Fund Search Type: *Mutual Fund*

Rationale:

- Conducting a mutual fund search would provide broad access to high quality managers
- The universe of available passive mutual funds comprises 15 funds
- The average cost of the 5 lowest providers is 9 basis points
- There are possibly lower cost commingled trust vehicles (Institutional Products), but it is debatable whether the time and resources devoted to an Institutional Procurement would yield dramatically better results
- Using Institutional Products may lead to additional operational costs for custody and unitization. The Plan has not procured a custodian, and this would cause additional complexity. Mutual funds eliminate this concern, and at this mandate size, “all-in” fees including other operating costs for Institutional Products could be relatively similar.

PROPOSED MUTUAL FUND SEARCH MINIMUM CRITERIA (SCREENING)

- Availability in mutual fund vehicle
- Vehicle open to new investors
- Vehicle compatible with Great-West platform
- Strategy track record of 3 years or longer (specific vehicle may be shorter)
- Tracks the Russell Mid-Cap Index or a similar index (e.g., S&P Mid-Cap 400 Index or CRSP US Mid-Cap Index)
- Annualized tracking error² relative to the benchmark should be within +/- 0.30% over the 7- and 10-year periods (or longest available)
- Minimum assets under management in strategy (all share classes) of \$1 billion or greater
- Investment expense ratio equal to or less than 0.20%

¹ As of 6/30/2014

² Tracking error for these purposes is defined as the benchmark return less the subject fund return

Passive Small-Cap Equity

PROPOSED SEARCH VEHICLE

Estimated Mandate Size¹: *\$106 million*
Recommended Fund Search Type: *Mutual Fund*

Rationale:

- Conducting a mutual fund search would provide broad access to high quality managers
- The universe of available passive mutual funds comprised of 26 funds
- The average cost of the 5 lowest providers is 11 basis points
- There are possibly lower cost commingled trust vehicles (Institutional Products), but it is debatable whether the time and resources devoted to an Institutional Procurement would yield dramatically better results
- Using Institutional Products may lead to additional operational costs for custody and unitization. The Plan has not procured a custodian, and this would cause additional complexity. Mutual funds eliminate this concern, and at this mandate size, “all-in” fees including other operating costs for Institutional Products could be relatively similar.

PROPOSED MUTUAL FUND SEARCH MINIMUM CRITERIA (SCREENING)

- Availability in mutual fund vehicle
- Vehicle open to new investors
- Vehicle compatible with Great-West platform
- Strategy track record of 3 years or longer (specific vehicle may be shorter)
- Tracks the Russell 2000 Index or a similar index (e.g., S&P 600 Small-Cap Index or CRSP US Small-Cap Index)
- Annualized tracking error² relative to the benchmark should be within +/- 0.30% over the 7- and 10-year periods (or longest available)
- Minimum assets under management in strategy (all share classes) of \$1 billion or greater
- Investment expense ratio equal to or less than 0.25%

¹ As of 6/30/2014

² Tracking error for these purposes is defined as the benchmark return less the subject fund return

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