

# Deferred Compensation Plan BOARD REPORT 13-37

Date: November 25, 2013

To: Board of Deferred Compensation Administration

From: Investments Committee and Staff

Subject: Deferred Compensation Plan Investment Manager Searches

*Board of Deferred  
Compensation Administration  
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## Recommendation:

That the Board of Deferred Compensation approve the recommendation of the Investments Committee to (a) consider establishing an option for filling investment manager mandates, where the Board deems appropriate, through a mutual-fund only search process; and (b) direct staff to return to the Board with draft changes to the Plan's Investment Policy Statement incorporating this search option and specific recommendations for moving forward with pending investment fund searches.

## Discussion:

At its July 16, 2013 meeting the Board of Deferred Compensation Administration referred to its Investments Committee a review of Plan investment menu objectives relative to the City's procurement/contracting requirements, the Plan's investment policy, and the Board's administrative responsibilities, and instructed the Committee to return with findings and recommendations. This action was a result of a staff recommendation that the Board consider some broader issues impacting the efficiency and outcomes of its investment procurement processes.

The Committee is recommending that the Board utilize fund search processes that utilize mutual funds rather than institutional funds requiring contracts. Based on information provided by staff and the consultant, the Committee finds that this approach would offer the following benefits:

- (1) **Reduce the costs and other resource burdens** created by administering procurements for institutional funds;
- (2) **Provide competitive fees and services**, given that the largest portions of the City's investment menu are passively managed (and the mutual fund products presently available in this universe already afford institutional-type pricing), and given that those that are actively managed are generally small enough that institutional pricing is unlikely to offer much if any cost advantage over equivalent mutual fund alternatives;
- (3) **Improve the speed and responsiveness** of the Board in being able to make investment menu additions and deletions; and
- (4) By meeting the first three objectives, **better meet the Board's fiduciary obligations** to provide investment menu administration which is in the best interests of Plan participants.

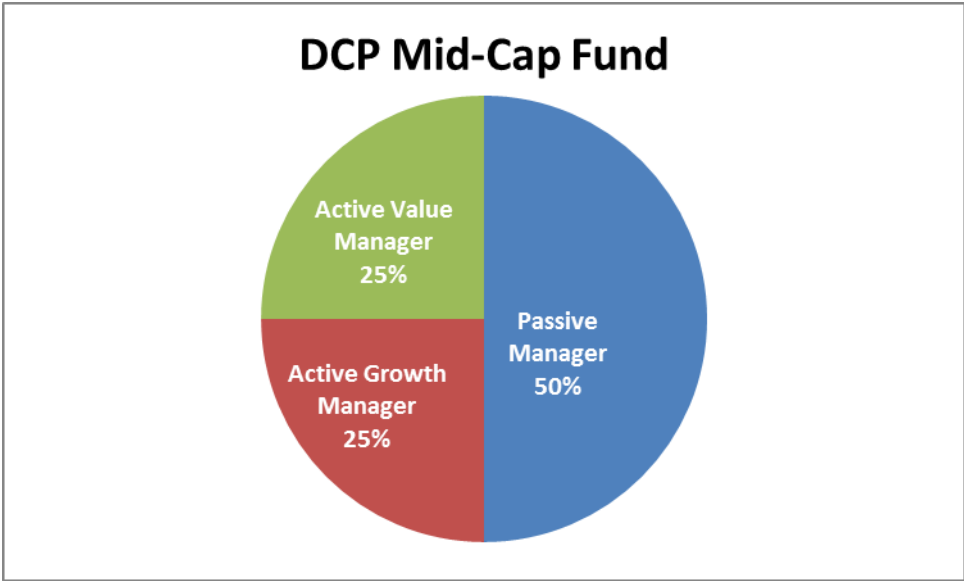
This report provides background on the Plan’s investment menu, the City’s procurement processes relative to fund selection for the Plan, and facts and findings supporting the Committee’s position.

### A. CURRENT INVESTMENT MENU DESIGN

As detailed in the Plan’s Investment Policy Statement (Attachment A), the Board has adopted an investment menu which is comprised of a range of core options. →

Included among these are the “Tier II” options, which are designed to represent major asset class choices for Plan participants. All of these funds have underlying managers but, when presented to participants, are branded by asset class. One of them (the DCP Large-Cap Fund) has a single underlying manager, but all the others - **Bond, Mid-Cap, Small-Cap, and International** options - are intended to have multiple managers which are blended together by the Plan recordkeeper (Great-West). One example of how this works, for the DCP Mid-Cap Fund, is illustrated below.

Tier I Asset Allocation Risk Profile Funds	Tier II Core Options	Tier III Brokerage Window
	FDIC Insured Option DCP Deposit Savings Account (Multiple FDIC providers)	
DCP Ultra Conservative	Stable Value DCP Stable Value (separate account)	
DCP Conservative	US Core Fixed Income DCP Bond Fund (50% active manager/50% passive manager)	
DCP Moderate	US Large Cap Equity DCP Large Cap Stock Fund (100% passive manager)	Schwab Self-Directed Brokerage Option
DCP Aggressive	US Mid Cap Equity DCP Mid Cap Stock Fund (25% active growth mgr./50% passive mgr./25% active value mgr.)	
DCP Ultra Aggressive	US Small Cap Equity DCP Small Cap Stock Fund (33% active growth mgr./34% passive mgr./33% value mgr.)	
	All Country World ex-US Equity DCP International Fund (65% developed mkt mgr./17.5% emerging mkt mgr./17.5% small cap mgr.)	



## B. FUND VEHICLES & FUND UNIVERSE

The City's Plan can select from two primary vehicle types to fill its investment menu: **Mutual Funds** (a unique legal structure for pooling investor monies, open to both retail as well as institutional investors), **Institutional Funds** (separate accounts, commingled trusts, etc., generally open only to institutional investors), or both.

Mutual funds do not involve contracts between the fund provider and the City. Institutional funds do involve contracts. There are approximately 4,300 funds in the Mutual Fund universe and 3,000 funds in the institutional fund universe. The following illustrations highlight some of the key features of each:

**Vehicle 1**  
**Mutual Funds**  
**4,300**

- Governed by Prospectus
- Pooled Investment
- External Custodian Not Required
- No Contract Required

**Vehicle 2**  
**Institutional Funds**  
**3,000**

- Governed by Contract
- Limited Investment
- External Custodian Generally Required
- Contract Required

## C. PROCUREMENT SCHEDULE

In May 2011 the Board adopted a procurement schedule for the Plan's investment options which provided for rolling procurements for various core option sub-mandates. The concept for this schedule was that procurements would be staggered over five years, and that investment relationships with managers would generally be for five-year periods.

Presently the Large-Cap, Mid-Cap, and Small-Cap menu offerings are 100% passively managed. The Plan has two international funds which have not yet been blended into a single fund. Contracts with State Street Global Advisors (SSgA), Galliard Capital Management, and the Plan's three bank providers all expire between October-December 2014.

The following table details staff/Mercer's initially proposed procurement schedule; which investment manager search applies to which investment menu option; whether the mandate is presently filled by an incumbent manager, and the fund type of the incumbent (where applicable). None of the Year 1 and Year 2 procurements have yet begun.

Investment Menu Option	Investment Manager Search	Presently Filled?	Incumbent Provider	Incumbent Fund Vehicle	Current Assets
<b>Rotation Schedule - Year 1</b>					
DCP Mid-Cap Fund	Active Mid-Cap Growth	No	n/a	n/a	n/a
DCP Mid-Cap Fund	Active Mid-Cap Value	No	n/a	n/a	n/a
DCP Small-Cap Fund	Active Small-Cap Growth	No	n/a	n/a	n/a
DCP Small-Cap Fund	Active Small-Cap Value	No	n/a	n/a	n/a
DCP International Fund	Active International Developed Markets	Yes	Fidelity	n/a	\$147 million
DCP International Fund	Active International Emerging Markets	No	n/a	n/a	n/a
DCP International Fund	Active International Small-Cap Markets	No	n/a	n/a	n/a
<b>Rotation Schedule - Year 2</b>					
DCP Bond Fund	Active Bond	Yes	PIMCO	Mutual Fund	\$103 million
DCP Bond Fund	Passive Bond	Yes	Vanguard	Mutual Fund	\$251 million
DCP Large-Cap Fund	Passive Large-Cap	Yes	Vanguard	Mutual Fund	\$1.3 billion
DCP Mid-Cap Fund	Passive Mid-Cap	Yes	Vanguard	Mutual Fund	\$170 million
DCP Small-Cap Fund	Passive Small-Cap	Yes	SSgA	Institutional (commingled fund)	\$223 million
<b>Rotation Schedule - Year 3</b>					
Bank Deposit FDIC Fund	FDIC Insured Savings	Yes	Bank of America, Bank of the West, City National Bank	Bank deposit account	\$302 million
Stable Value Fund	Stable Value Manager	Yes	Galliard	Institutional (separate account)	\$907 million
<b>Rotation Schedule - Year 4</b>					
None	n/a				
<b>Rotation Schedule - Year 5</b>					
None	n/a				

- Note – table does not include DWS Eafe Equity Index, with \$124 million in assets, since passive international is not included within the new International fund structure

## D. PROCUREMENT PROCESS

Prior to 1999 the City's Plan had bundled contracts with two providers: Hartford Life Insurance Company and Great-Western Bank. Hartford offered its own proprietary funds, while Great-Western Bank used a contracted third-party-administrator (similar to the model presently used with Great-West).

The Board (formerly an Advisory Committee) chose specific fund options for the Plan based on the recommendations of the providers. The Plan did not use an investment consultant as part of that determination process. No competitive process (procurement or fund search) was involved in that determination process.

When the City's Plan was unbundled in 1999, it issued separate RFPs for Plan Third-Party-Administration (TPA) and investment providers. Investments RFPs have been issued periodically over the years to search for various mandates. Over time, there was a tendency for the RFP to result in fewer and fewer proposals, and as a result the RFP would be canceled and the Board would conduct a fund manager search instead using the resources of its investment consultant.

To address this situation, the Board, working with staff, developed a proposed procurement process which would meet its objectives of designing a fair and transparent process leading to best-of-class providers, considering the broadest possible pool of investment managers, and meeting the Board's fiduciary obligations to act in the best interests of Plan participants. The Board was specifically interested in being able to consider mutual fund offerings without requiring that fund management companies participate in a procurement process which was not applicable to them since, if selected, a contract would not be executed.

In May 2010, the City Attorney agreed that mutual funds would not have to demonstrate compliance with general contracting requirements given that the Board would not be entering into contracts with mutual fund providers. In addition, the City Attorney agreed that vendors would not need to submit specific fund data to the Plan in the form of a response to an RFP questionnaire, but could provide that directly to the Plan consultant through the consultant's open database. All of this was intended to facilitate the efficiency of the Board's fund selection process.

At the Board's February 19, 2013 meeting, the Board adopted an additional change to its Requests for Proposal (RFPs) to improve the efficiency of its procurement processes. Specifically, the Board took action to allow proposing firms the ability to **defer submission of certain required contracting forms and documents to the contract execution date**, and to be able to **pre-submit where possible other general contracting requirement documents for the purpose of identifying oversights in those documents such that vendors could correct them in advance of an RFP due date**.

The Board made these changes out of concerns that vendor confusion over the City's general contracting requirements could lead to confusion in the submission of bid responses by institutional providers. Staff recommended that the Board apply this new

process on a pilot basis with the pending Custodial Services RFP (with its smaller pool of potential respondents) before applying it to the much larger pending Investment Manager RFP, which could involve dozens or more responses from institutional providers.

These procurements were delayed by approval of the Board’s contract with Mercer Investment Consulting. The Board relies on Mercer to assist in the evaluation of its investment searches. The development and approval process for this contract was lengthy, with the contract being only recently approved.

## E. INVESTMENTS COMMITTEE REVIEW OF FACTORS INFLUENCING PROCUREMENTS

At the Investments Committee meeting staff identified the following considerations related to the City’s current rules/processes involving procurements and contract development and specifically as these impact investment manager searches:

- **Resources** – The consulting costs involved in developing procurements and executing contracts are considerable. Mercer indicated that the cost of conducting an institutional manager search can range from 19-100% higher than a mutual fund search below, as indicated in the following table:

	Mutual Fund Search		Institutional Fund Search	
	<i>Low</i>	<i>High</i>	<i>Low</i>	<i>High</i>
Passive Manager	\$ 3,820	\$ 7,140	\$ 7,640	\$ 12,460
Active Manager	\$ 6,640	\$ 12,370	\$ 10,460	\$ 14,780

- **Time** – The time involved in developing and issuing a procurement, and negotiating contracts as well as moving them through the City’s approval process is lengthy. The uncertainties as to the timing of various stages of that process have grown in recent years. This is a particular concern when considering investment contracts because unlike many other types of personal services contracts, an investment manager will not accept funds without an executed contract in place.
- **Gap Between Procurements and Investment Policy** – Lengthy procurement-related delays in filling investment manager slots in the Plan’s investment menu create gaps between the adopted Investment Policy Statement and the actual menu being offered to Plan participants.
- **Institutional Fund Not Offering Significant Cost Advantages at Current Asset Levels** – The investment manager procurements for the actively-managed portions of the mid-cap, small-cap and international fund options involve asset pools which, once broken out by the various sub-categories (e.g. active growth and active value), reduce the likelihood that significant cost advantages can be realized by using

institutional products. In the passive space, the institutional fund cost advantage is smaller regardless of the size of the asset pool (as one example, the Vanguard Institutional Index Fund, which is a mutual fund, has an investment management fee of 0.02%, a cost that is fully competitive with institutional pricing). Thus, there may not be a significant or any real cost advantage for using institutional products, especially when adding in procurement and custodial costs.

- **Lack of Institutional Interest** – Related to the asset size issue, Mercer indicates that some highly rated managers may choose not to participate in the process as they evaluate what's required in responding to an RFP vs. the amount of assets they could potentially manage. This means that the mere act of conducting an institutional manager search does not guarantee that highly-rated institutional managers will actually compete.

Staff and the consultant indicated that establishing an option for filling investment mandates using a mutual fund search exclusively would meet the Plan's investment objectives in a more efficient and expeditious manner while still retaining the Board's ability to consider a wide universe of managers. The mutual fund search process would involve the following steps:

- (1) Board establishes search criteria for the investment mandate
- (2) Consultant executes search of mutual fund managers based on the criteria adopted by the Board
- (3) Staff and consultant review responses
- (4) Highest-ranked fund offerings are submitted to the Board (directly or after an initial review and consideration by the Investments Committee) with a recommendation from staff and/or the Investments Committee for selection of a firm
- (5) Great-West is directed to activate the selected mutual fund on its recordkeeping platform

Mercer and staff indicated that this process could be executed in a matter of several months, if not less. In essence, this process is not unlike the fund selection process which the Plan used from 1983 to 1999, except that during that period of time the Board did not have the services of a consultant to conduct investment reviews, and instead relied on the guidance of its third-party-administrators.

## **F. Investment Committee Recommendations**

Following its deliberation, the Investments Committee directed staff to draft a report recommending that the Board (a) consider establishing an option for filling investment manager mandates, where the Board deems appropriate, through a mutual-fund only search process; and (b) direct staff to return to the Board with draft changes to the Plan's Investment Policy Statement incorporating this search option and specific recommendations for moving forward with pending investment fund searches. If the Board adopts those recommendations, staff will return at the January meeting with the items included under (b).

Submitted by: \_\_\_\_\_  
Steven Montagna

Reviewed by: \_\_\_\_\_  
Alex Basquez

Approved by: \_\_\_\_\_  
John Mumma, Chair  
Investments Committee