Deferred Compensation Plan
BOARD REPORT 14-08

Date: February 10, 2014

To: Board of Deferred Compensation Administration

From: Staff

Subject: Proposed Change to Stable Value Fund Contract Provision Regarding Investment Guidelines

Recommendation:
That the Board of Deferred Compensation:

(a) Receive and file this report regarding proposed changes to the current contract with Galliard Capital Management to provide the Stable Value Fund investment option; and
(b) Authorize staff to incorporate proposed changes to the contract's "Quality Guidelines" into the draft amendment presently being developed to extend the contract between the City and Galliard Capital Management.

Discussion:
The Board and City Council recently approved a contract extension with Galliard Capital Management ("Galliard") to provide the Stable Value Fund investment option. Staff is currently working on drafting/executing the amendment to extend the contract. In the meantime, Galliard recently approached staff and the Board's consultant, Mercer Investment Consulting ("Mercer"), regarding a proposed change to the investment guidelines contract provisions related to quality guidelines applying to s segments of the portfolio. Due to the complexity of the subject matter, staff will address the proposed change in the form of questions and answers providing background on the Stable Value Fund, relevant concepts, and the proposed changes.

What is a Stable Value Fund? A stable value fund uses an investing strategy combining a bond portfolio with insurance contracts. The addition of the insurance, or "wrap" contracts insulates the bond portfolio from interest rate volatility and allows plan participants to transact at a more stable price than would typically occur in a pure bond portfolio. Utilizing the wrap contracts further allows the stable value fund to invest in intermediate duration fixed income securities, which provide a return profile that is typically higher than other conservative options such as bank deposit accounts or money market funds.

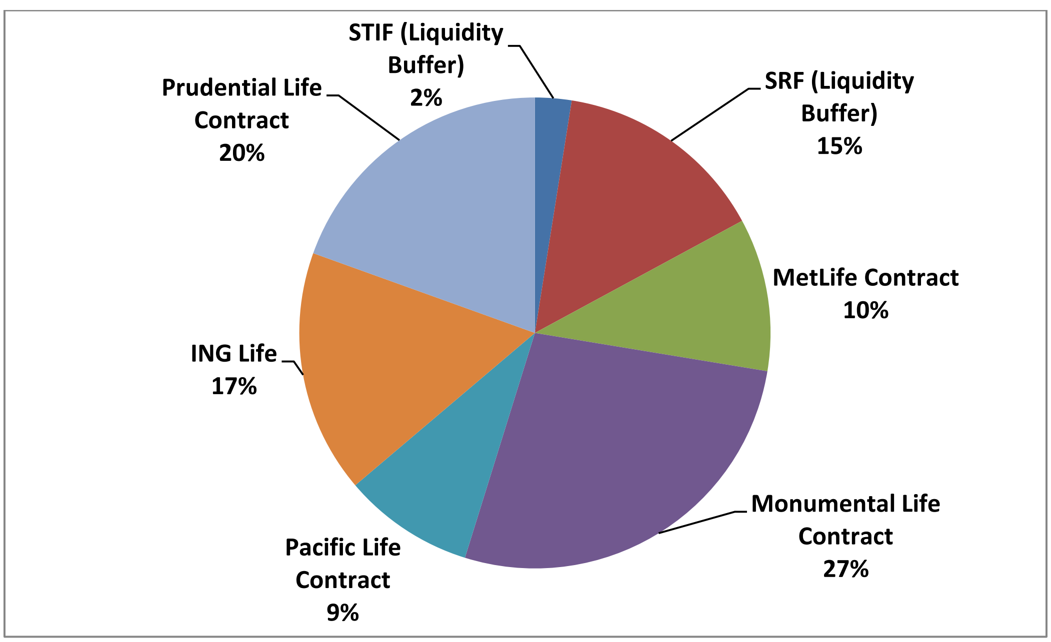
How Are Stable Value Funds Administered? Stable value funds have two levels of administration: (1) the underlying bond portfolio, and (2) the "wrap" investment contracts issued by insurance companies or other financial institutions. In the City's case, Galliard and Prudential manage the underlying bond portfolio and there are five insurance companies that have issued wrap contracts for separate portions of the overall portfolio. In addition, a “Liquidity Buffer” exists which is comprised of the Wells Fargo Stable Return Fund (SRF) managed by Galliard, and 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 will occur in this participant-directed investment option.

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.

What Section of the Contract is Galliard Proposing Be Changed? Galliard is proposing a change to the “Quality Guidelines,” as reflected in the Investment Guidelines contract attachment (see Exhibit #1).

What are the Quality Guidelines in Reference to? The Quality Guidelines refer to the credit quality of (a) the wrap providers and (b) the two components of the Liquidity Buffer: the SRF and the STIF.

Who are the Wrap Providers and How are Stable Value Fund Assets Presently Distributed? The wrap providers and the portions of fund assets held in the various segments of the portfolio are indicated in the following chart:



How Specifically is Galliard Proposing to Change the Quality Guidelines? Currently the Quality Guidelines essentially provide for two quality standards. First, they set a minimum quality standard for any single wrap provider at a level of "**A-.**" Second, they set an average quality standard of all wrap providers at "**AA-**."

To understand these quality levels and their relative meaning, following is a list of the Standard and Poor's A/B credit quality rankings denoted as investment grade ranked **highest to lowest**:

S&P
AAA
AA+
AA
AA-
A+
A
A-
BBB+
BBB
BBB-

Given this information, it's clear that the current contract language provides for a minimum quality standard for any single wrap provider as being lower than what is required as the average quality standard for all wrap providers.

Galliard is proposing to alter this essentially by eliminating the reference to an average quality of all wrap providers (while also including greater specificity with respect to some of the language applying in the subject paragraph). The result is that the minimum single wrap provider standard of **A-** effectively becomes the contractual minimum average quality. It should be noted that presently the average quality level for the contracts is **A+**, two levels above the individual purchase minimum, which reflects the ability to purchase contracts issued by companies rated higher than the minimum allowed.

Why is the Change Being Proposed? Galliard indicates, and Mercer confirms, that since the 2008 credit crisis there has been an overall reduction in credit quality ratings for the firms that make up the wrap provider universe. When the contract was originally written, Galliard and the City expected that achieving an average quality rating of **AA-** was reasonable, anticipating that notwithstanding the individual minimum floor of **A-**, there would be a number of firms that ranked higher than **AA-** to choose from. Since the universe of available products is now much more restricted, Galliard is proposing to adjust the contract language to reflect current market conditions and to remove any reference to an anticipated average.

What is the Basis of Staff and Mercer's Recommendation to Support the Proposed Change? Mercer advises that maintaining the **AA-** average quality standard could force termination of some of the existing wrap providers and shift greater portions of assets into other providers or the Liquidity buffer (Exhibit #2). This would reduce the diversity of wrap issuers and lower the rate of return on the overall portfolio. Staff's finding is that, given that the existing contract language stipulates that an **A-** rating is acceptable for any individual provider, it's appropriate to remove language requiring an average quality standard above that level. In other words, if an **A-** rating is acceptable for a single provider, it should be acceptable for all providers.

Findings and Recommendation – The Board recently approved extending the Galliard contract through June 2015. The City Council subsequently provided authorization for that contract extension, but the contract has not yet been amended to provide for the extension. Staff recommends that the Board approve, as part of that amendment, also changing the investment guidelines referenced in Attachment B of the contract to read in their entirety as follows:

> ***QUALITY GUIDELINES***
>
> *The minimum quality of GIC/Separate Account/Security Backed contract providers as well as the Liquidity Buffer must be A- or equivalent by at least one Nationally Recognized Statistical Rating Organization ("NRSRO") at the time of initial placement. In the case of a split rating on investment contracts, the higher rating shall apply.*

This additional change would ensure that the contract language is consistent with the current wrap provider environment, while not reducing the minimum quality standard for any single wrap provider.

Submitted by: ______________________________
Steven Montagna

Approved by: ______________________________
Alex Basquez

EXHIBIT 1

ATTACHMENT B

Investment Objectives & Guidelines
For
City of Los Angeles Stable Value Separate Account

INVESTMENT OBJECTIVE

The primary objective of the portfolio is to provide safety of principal. Secondary objectives are consistency of returns with minimal volatility, while maintaining a stable credited rate of interest.

I. ACCOUNT LEVEL (BOOK VALUE) GUIDELINES

A. PERFORMANCE BENCHMARK

The performance objective of the portfolio is to outperform the 3 year Constant Maturity Treasury ("CMT") yield + 0.50% over a full interest/market cycle.

Performance relative to the eVestment Stable Value Universe or other peer universes will also be reviewed.

B. SECTOR GUIDELINES

Expected Fund Level	Minimum Weighting	Maximum Weighting
Liquidity Buffer (STIF or SV Fund)	5%	50%
Guaranteed Investment Contracts	0%	10%
Insurance Separate Account Contracts	0%	50%
Security Backed Contracts	0%	95%

C. ADDITIONAL DIVERSIFICATION GUIDELINES

No more than 2% of the aggregate portfolio will be invested in traditional GICs/BICs from any one contract issuer.

Exposure to any one Insurance company separate account provider shall be limited to not more than 50% of the Fund's Assets.

Exposure to any one single wrap provider shall be limited to not more than 50% of the Fund's Assets. In the event a wrap provider is terminated, it will not be deemed a violation to the guidelines if the provider limit is exceeded. Galliard will replace the terminated provider within 180 days or obtain client approval for an extension.

EXHIBIT 1

D. QUALITY GUIDELINES

The minimum quality of GIC/Separate Account/Security Backed~~BIC~~ contract providers as well as the Liquidity Buffer ~~issuers and wrap credit providers~~ must be A- or equivalent by at least one Nationally Recognized Statistical Rating Organization ("NRSRO") ~~on a composite level~~ at the time of initial placement~~purchase~~. In the case of a split rating on investment contracts, the higher rating shall apply. ~~The average quality of all wrap credit providers must be AA-.~~

E. DURATION/MATURITY GUIDELINES

The overall duration of the underlying securities in the Fund shall be maintained between 2.0 and 3.5 years with a target of 3.0 years.

F. PERMITTED INVESTMENTS

Security backed contracts, guaranteed investment contracts, bank investment contracts, insurance separate account contracts, stable value collective funds, cash equivalents and/or money market funds.

G. COMPETING INVESTMENT OPTION

If the Plan offers the Fund as an investment option and also offers a "competing fund" option, participants in the Plan will invest in a "non-competing fund" for at least 90 days before transferring into the "competing fund" option. A competing fund is defined as (i) a fixed income fund with a duration of less than 3 years, or (ii) a balanced, life style, target-date and other similar types of asset allocation fund investment options if the option contains a competing fund that exceeds 70% of that fund.

II. UNDERLYING SECURITY PORTFOLIO GUIDELINES

A. PERFORMANCE BENCHMARK

Actively managed portfolio performance is expected to exceed established benchmarks over a market cycle.

B. SECTOR GUIDELINES

Underlying Asset Level	Maximum Weighting
U.S. Government/Agency	100%
Corporates	30%
Asset Backed	25%
Mortgage Backed	65%

Non-U.S. Issuers (Yankee only)	10%

C. ADDITIONAL DIVERSIFICATION GUIDELINES

No more than 15% may be invested in any single asset backed or non-government mortgage backed issuer.

No more than 2% may be invested in any single corporate issue.

D. QUALITY GUIDELINES

All securities will be rated investment grade (BBB-/Baa- or better) at time of purchase. The minimum weighted average quality of the underlying assets will be maintained at AA/Aa2.

Composite Long-Term Rating	Minimum Weighting	Maximum Weighting
AA-/Aa3 or better	55%	100%
A-/A3 to A+/A1	0%	30%
BBB-/Baa3 to BBB+/Baa1	0%	15%

Minimum rating on money market instruments will be A1/P1 at time of purchase.

For securities downgraded below investment grade, or A1/P1 for short term securities, the manager may retain the security, if in the judgment of the manager, it is appropriate to do so subject to a maximum of no more than 3% of the portfolio's assets in issues below BBB- measured on a par or cost basis.

E. ADDITIONAL CONSTRAINTS

Where collective funds, external manager separate accounts, or insurance company separate accounts are utilized, those guidelines are incorporated and made part of these overall guidelines. The guidelines shall conform to these overall guidelines. If additional restrictions are required by wrapper contract issuers, those restrictions shall be incorporated and made part of these overall guidelines.

MERCER

EXHIBIT 2

777 South Figueroa Street, Suite 2400
Los Angeles, CA 90017
devon.muir@mercer.com
www.mercer.com

MEMO

TO: City of LA Board of Deferred Compensation Administration

DATE: February 5, 2014

FROM: Devon Muir

SUBJECT: Galliard's request for investment guideline amendment

COPY: Staff

Galliard recently advised us that the investment guidelines contained in the investment management agreement with the Deferred Compensation Plan are outdated relative to its current template guidelines. Currently, the guidelines call for the average credit quality of wrap providers that Galliard selects to underwrite the wrapped portion of the Portfolio to be rated AA- (the fourth highest credit rating assigned by a major credit rating agency). The Plan's present average wrap rating, meanwhile, falls slightly below this with an average wrap credit quality of A+ (the fifth highest credit rating assigned by ratings agencies). Galliard is requesting that this threshold be changed to A- (the lowest level of "Upper Medium Grade" ratings) upon purchase.

In addition, the current quality guidelines solely contemplate the wrapped ("security backed") portion of the Portfolio, omitting other allowable investments in guaranteed investment contracts and insurance separate accounts. To remedy this, Galliard is recommending these other types of investments be included in this section. Galliard's proposed guideline amendments in redline are attached.

Mercer is supportive of Galliard's requests, as we believe they are consistent with current market conditions and in the interest of Plan participants. Since the financial crisis, the number of insurance carriers rated above A+ has declined dramatically, making the current guideline difficult to meet. If Galliard were to manage to this threshold, it would have to eliminate existing wrap providers that serve to diversify wrap exposure. If the existing high credit quality wrap providers were unwilling to absorb that lost wrap coverage and no new providers could be found, Galliard may need to invest a greater portion of the Portfolio in cash equivalents. This would lead to a significant decline in the Fund's crediting rate. Given the possibility of this detrimental outcome, **we recommend the Board approve Galliard's amended investment guidelines.**