

Deferred Compensation Plan BOARD REPORT 14-11

Date: March 6, 2014

To: Board of Deferred Compensation Administration

From: Staff

Subject: Deferred Compensation Plan Active Equity and Bond Investment Manager Searches

*Board of Deferred
Compensation Administration*
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Recommendation:

That the Board of Deferred Compensation approve the recommendations of staff and the investment consultant with respect to fund search types and search criteria for the Deferred Compensation Plan active equity and bond investment options.

Discussion:

At its February 18, 2014 meeting, the Board adopted revisions to the Plan's Investment Policy Statement incorporating the option for a mutual-funds search process for filling investment manager mandates. The Board further approved recommendations for moving forward with a search schedule for the Plan's various investment options as recommended by staff.

The fund search schedule approved by the Board provides for investment manager searches for the Plan's active equity and bond investment options in 2014. Staff has been working with the Board's investment consultant, Mercer Investment Consulting ("Mercer"), to develop recommendations for the fund search type and search criteria. The following table summarizes the recommended search option types for each active fund category. Justifications for each fund search type are included in the attached report from Mercer.

	Investment Menu Option	Fund Sub-Category	Presently Filled?	Incumbent Provider	Incumbent Fund	Assets	Recommended Search Vehicle
Search Year - 2014							
ACTIVE MANAGERS	DCP Small-Cap Fund	Active Small-Cap Growth	No	n/a	n/a	\$99 million	MUTUAL FUND
	DCP Small-Cap Fund	Active Small-Cap Value	No	n/a	n/a	\$99 million	MUTUAL FUND
	DCP Mid-Cap Fund	Active Mid-Cap Growth	No	n/a	n/a	\$58 million	MUTUAL FUND
	DCP Mid-Cap Fund	Active Mid-Cap Value	No	n/a	n/a	\$58 million	MUTUAL FUND
	DCP International Fund	Active Intl Developed Mkts	Yes	Fidelity	n/a	\$214 million	MUTUAL FUND
	DCP International Fund	Active Intl Emerging Mkts	No	n/a	n/a	\$58 million	MUTUAL FUND
	DCP International Fund	Active Intl Small-Cap	No	n/a	n/a	\$58 million	MUTUAL FUND
	DCP Bond Fund	Active Bond	Yes	PIMCO	Mutual Fund	\$78 million	MUTUAL FUND

The Mercer report also contains recommended fund search criteria for each investment option as prepared by staff and the investment consultant. The search criteria utilize and provide further specificity with respect to the existing investment fund parameters already included in the Board's Investment Policy. The Investment Consultant will apply these search criteria against the applicable mutual fund universe of funds and, for each category, identify those funds which have passed the criteria. The results of this screening will then be presented to the Investments Committee for further review and for the purpose of developing recommendations for fund selection to the full Board.

Staff recommends that the Board adopt the search vehicle types and search criteria for each of the active equity and bond fund options identified in this report.

Submitted by: _____
Steven Montagna

Approved by: _____
Alex Basquez

**DEFERRED COMPENSATION PLAN INVESTMENT FUND
SEARCH RECOMMENDATIONS
CITY OF LOS ANGELES DEFERRED COMPENSATION
PLAN**

MARCH 18, 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 2014, we will be conducting searches for all of the Plan's active investment managers. In line with the newly approved search policy, we provide our recommendations as to which type of investment vehicle search 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; have a seasoned track record in relation to similar strategies; are managed in alignment with the subject investment mandate; hold a sufficient, yet not too large, amount of assets to effectively implement the investment strategy; and maintain investment expenses that are reasonable.

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

- Portfolio construction
 - Number of holdings
 - Portfolio turnover
 - Active share of portfolio
 - Weighted average market capitalization
 - Portfolio statistics (P/E ratio, growth rate, etc.)
 - Adherence to investment style relative to benchmark
 - Off benchmark exposure
 - Cash holding

- Implementation
 - Strategy capacity

- Business Management
 - Investment expenses
 - Ownership structure

Quantitative Factors

- Long-term performance relative to the index and peer group
- Long-term risk-adjusted performance
- Diversification benefits of a given option in light of complementary investments selected in each Investment Option

Consultant Ratings

All investment funds are candidates for letter grades pursuant to ongoing fund monitoring and due diligence that Mercer conducts for all of its clients. These letter grades 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 will be eight weeks, and staff will schedule a series of Investment Committee meetings, each covering specific asset classes, to coincide with this anticipated delivery.

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Proposed Investment Fund Searches

- Active Core Bond
- Active Mid-Cap Growth and Mid-Cap Value Equity
- Active Small-Cap Growth and Small-Cap Value Equity
- Active International Developed Markets Equity
- Active International Small-Cap Equity
- Active Emerging Markets Equity

Active Core Bond

PROPOSED SEARCH VEHICLE

Estimated Mandate Size: *\$167 million*

Recommended Fund Search Type: *Mutual Fund*

Rationale:

- Conducting a mutual fund search would provide broad access to high quality managers since the universe of available active mutual funds exceeds 300 funds.
- Actively managed bond funds tend to hold a very large number of holdings (e.g., PIMCO holds nearly 20,000 bonds in its Total Return Fund), and even with a \$167 million investment, it is unlikely that the same level of diversification could be replicated using a separate account or commingled fund (“Institutional Product”).
- In certain cases, we have noted that active bond Institutional Products underperform their mutual fund counterparts due to scale and maturity, they are not able to replicate the flagship mutual fund strategy. This further reinforces our preference for mutual funds in this category.
- Using Institutional Products would lead to additional operational costs for custody and unitization. Mutual funds eliminate this concern, and at this mandate size, “all-in” fees including other operating costs are 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 7 years or longer (specific vehicle may be shorter)
- Investment style consistent with a core bond manager investing in intermediate duration bonds and categorized in the database as a core bond strategy
- Minimum assets under management in strategy of \$7.5 billion
- Investment expense ratio equal to or less than 0.65% (approximately 1.25 times the institutional median)

Active Mid-Cap Growth and Mid-Cap Value Equity

PROPOSED SEARCH VEHICLE

Estimated Mandate Size: *\$59 million each mandate*

Recommended Fund Search Type: *Mutual Fund*

Rationale:

- There are over 50 Mid-Cap Value and 100 Mid-Cap Growth mutual funds in the respective Mercer mutual fund universes, though a handful of funds are closed in each group.
- At this mandate size, we believe mutual fund vehicles offer comparable or better investment expenses given the additional operational costs of Institutional Products.

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)
- Investment style consistent with the respective mid cap styles (growth and value) including appropriate categorization in the database. In addition, stated benchmark of the strategy will be representative of the style.
- Minimum assets under management in strategy of \$600 million
- Maximum assets under management in strategy of \$15 billion
- Investment expense ratio equal to or less than 1.25%

Active Small-Cap Growth and Small-Cap Value Equity

PROPOSED SEARCH VEHICLE

Estimated Mandate Size: *\$100 million each mandate*

Recommended Fund Search Type: *Mutual Fund*

Rationale:

- The number of high quality active small value and growth manager strategies that are accepting new mandates is fairly small; a mutual fund search is nevertheless likely to produce sufficient candidate fund, while an Institutional Product search process at best is likely to yield a fairly limited pool of high quality respondents.
- Despite a capacity constrained universe of funds in these categories, there are still high-quality options available.
- Institutional mutual fund fees are reasonably close to Institutional Product fees in general in these categories.

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)
- Investment style consistent with the respective small cap styles (growth and value) including appropriate categorization in the database. In addition, stated benchmark of the strategy will be representative of the style.
- Minimum assets under management in strategy of \$400 million
- Maximum assets under management in strategy of \$12 billion
- Investment expense ratio equal to or less than 1.35%

Active International Developed Markets Equity

PROPOSED SEARCH VEHICLE

Estimated Mandate Size: *\$214 million*

Recommended Fund Search Type: *Mutual Fund*

Rationale:

- There is an abundance of high quality, low-cost active international developed managers available in mutual fund vehicles
- Implementing separate accounts within the international equity landscape is a cumbersome process involving a custody bank to effect foreign exchange transactions and additional tax consulting is necessary within the major geographies. The result can be substantial operational costs that are prohibitive at this asset level.

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 7 years or longer (specific vehicle may be shorter)
- Investment style consistent with international ex-US investment style including appropriate categorization in the database. In addition, stated benchmark of the strategy will be representative of the style (MSCI EAFE or comparable).
- Minimum assets under management in strategy of \$5 billion
- Investment expense ratio equal to or less than 1.20%

Active International Small-Cap Equity

PROPOSED SEARCH VEHICLE

Estimated Mandate Size: *\$58 million*
Recommended Fund Search Type: *Mutual Fund*

Rationale:

- A mutual funds search will provide access to a focused list of high quality candidates.
- Use of a separate account vehicle would be cost prohibitive (custody, currency, foreign tax, etc.) in this space which favors the use of commingled vehicles like mutual funds.

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)
- Investment style consistent with international ex-US small cap investment style including appropriate categorization in the database. In addition, stated benchmark of the strategy will be representative of the style (MSCI EAFE Small Cap Index or comparable).
- Minimum assets under management in strategy of \$300 million
- Investment expense ratio equal to or less than 1.50%

Active Emerging Markets Equity

PROPOSED SEARCH VEHICLE

Estimated Mandate Size: *\$58 million*
Recommended Fund Search Type: *Mutual Fund*

Rationale:

- There is an abundance of high quality, low-cost mutual fund strategies to choose from in the emerging markets space
- At this mandate size, the viability of Institutional Products is doubtful
- Use of a separate account vehicle is very cumbersome with emerging markets securities. Given this relatively small asset size, we do not recommend exploring this approach.

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 7 years or longer (specific vehicle may be shorter)
- Investment style consistent with emerging markets equity investment style including appropriate categorization in the database. In addition, stated benchmark of the strategy will be representative of the style (MSCI Emerging Markets Index or comparable).
- Minimum assets under management in strategy of \$2 billion
- Maximum assets under management in strategy of \$25 billion
- Investment expense ratio equal to or less than 1.35%



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