Deferred Compensation Plan
BOARD REPORT 15-10

Date: February 6, 2015

To: Board of Deferred Compensation Administration

From: Staff, Investments Committee

Subject: Deferred Compensation Plan Passive Manager Searches

Recommendation:
That the Board approve the Investments Committee's recommendations relative to the Board's Passive Funds Search and approve the following funds for the City Plan's core menu:

a) Vanguard Total Bond Market Index Fund Institutional Plus for the underlying passive component of the DCP Bond Fund;
b) Vanguard Institutional Index Fund Institutional Plus for the underlying passive component of the DCP Large-Cap Fund;
c) Vanguard Mid-Cap Index Fund Institutional Plus for the underlying passive component of the DCP Mid-Cap Fund; and
d) Vanguard Small-Cap Index Fund Institutional Plus for the underlying passive component of the DCP Small-Cap Fund.

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 certain investment manager mandates as approved by the Board. The Board further approved recommendations for moving forward with a search schedule for the Plan's various investment options as recommended by staff. At its December 16, 2014 meeting, the Board approved the fund search type and criteria for the Plan's passive equity and bond investment options.

The Investments Committee was convened on January 29, 2015 to review potential passive fund managers.

PASSIVE FUND SEARCH PROCESS

The selection review process for the Plan's passive fund managers differed slightly from the process the Investments Committee (the "Committee") recently conducted for active fund managers, which involved a review of each firm's various methodologies and investment strategies. As passive funds seek to replicate the selections of a benchmark index, the more notable considerations for passive fund selection are how closely each fund seeks to track the selections and performance of its respective benchmark and how much the investment management fees might cost participants.

The Plan's investment consultant, Mercer Investment Consulting (Mercer), conducted an initial search using its proprietary database and other resources and identified passive funds meeting the approved minimum criteria. Mercer prepared a comprehensive review and analysis of the viable funds, which the Investments Committee used in developing its recommendations. Mercer's search document is attached to this report for the Board's review. For each category, the attached Mercer report details:

a) Initial Screening & Identification of Viable Funds
b) Benchmark Descriptions
c) Overview, Characteristics, & Portfolio Information of the Viable Funds
d) Performance Information
e) Information Related to Tracking Error vs. Respective Benchmark

Following are details of each passive mandate and its review process and results:

PASSIVE BOND

The estimated size for the passive bond mandate is $178 million (as of 6/30/2014). Currently, the Plan's DCP Bond Fund is 50% passive and 50% active (Vanguard Total Bond Market Index Fund Institutional Plus and the Loomis Sayles Core Plus Bond N, respectively).

Seven (7) funds met the minimum criteria as approved by the Board:

Fund Name	Fee	Securities Lending
1. BlackRock Bond Index Fund K (WFBIX)	0.12%	Y
2. Dreyfus Bond Market Index Fund Basic (DBIRX)	0.15%	Y
3. Northern Bond Index Fund (NOBOX)	0.10%*	
4. Principal Bond Market Index Fund Institutional (PNIIX)	0.14%*	
5. State Street Aggregate Bond Index Portfolio (SSFEX)	0.09%	Y
6. TIAA-CREF Bond Index Fund Institutional (TBIIX)	0.12%	
7. Vanguard Total Bond Market Index Fund Inst Plus (VBMPX)	0.05%	

** Revenue share component*

After its review, the Investments Committee is recommending that the Vanguard Total Bond Market Index Fund be selected as the passive bond fund option due to its minimal tracking error to its benchmark, low fees, and the strength of its investment process. This is the Plan's incumbent passive bond fund.

PASSIVE LARGE-CAP EQUITY

The estimated size for the passive large-cap equity mandate is $1.64 billion (as of 6/30/2014, 36% of Plan assets). Currently, the Plan's DCP Large-Cap Fund is 100% passive (100% allocation to the Vanguard Institutional Index Inst. Plus fund).

Six (6) funds met the minimum criteria as approved by the Board:

Fund Name	Fee	Securities Lending
1. BlackRock S&P 500 Stock Fund K (WFSPX)	0.05%	Y
2. Northern Stock Index Fund (NOSIX)	0.08%*	
3. Principal LargeCap S&P 500 Index Fund Inst (PLFIX)	0.06%*	
4. Schwab S&P 500 Index Fund (SWPPX)	0.07%*	Y
5. State Street Equity 500 Index II Portfolio (SSSYX)	0.06%	Y
6. Vanguard Institutional Index Fund Inst Plus (VIIIX)	0.02%	Y

** Revenue share component*

The Investments Committee is recommending that the Vanguard Institutional Index Fund be selected as the passive large-cap fund option due to its minimal tracking error to its benchmark, low management fee, strength of its investment process, and conservative approach relative to securities lending. This fund is currently 100% of the DCP Large-Cap Fund.

PASSIVE MID-CAP EQUITY

The estimated size for the passive mid-cap equity mandate is $136 million (as of 6/30/2014). Effective March 20, 2015, the Plan's DCP Mid-Cap Fund will be comprised of the following underlying allocations: 50% passive, 25% active growth, and 25% active value (respectively: the Vanguard MidCap Index Inst. Plus, Voya MidCap Opportunities Fund R6, and RidgeWorth Mid-Cap Value Equity I funds).

Four (4) funds met the minimum criteria as approved by the Board:

Fund Name	Fee	Securities Lending
1. Columbia Mid Cap Index Fund R5 (CPXRX)	0.11%*	Y
2. Northern Mid Cap Index Fund (NOMIX)	0.09%*	
3. Principal MidCap S&P 400 Index Fund Inst (MPSIX)	0.12%*	
4. Vanguard Mid-Cap Index Fund Institutional Plus (VMCPX)	0.06%	Y

** Revenue share component*

The Investments Committee is recommending that the Vanguard Mid-Cap Index Fund Institutional Plus be selected as the passive mid-cap fund option due to its minimal tracking error to its benchmark, low management fee, strength of its investment process, and conservative approach relative to securities lending. This fund is currently the Plan's mid-cap option and will be an underlying component of the new allocation of the DCP Mid-Cap Fund on March 20.

PASSIVE SMALL-CAP EQUITY

The estimated size for the passive small-cap equity mandate is $106 million (as of 6/30/2014). Effective March 20, 2015, the Plan's DCP Small-Cap Fund will be comprised of the following underlying allocations: 34% passive, 33% active growth, and 33% active value (respectively: the SSgA Russell 2000 Index, Hartford SmallCompany HLS IA, and DFA US SmallCap Value Portfolio funds).

Six (6) funds met the minimum criteria as approved by the Board:

Fund Name	Fee	Securities Lending
1. BlackRock Small Cap Index Fund Class K (BDBKX)	0.16%	Y
2. Northern Small Cap Index Fund (NSIDX)	0.09%*	
3. TIAA-CREF Small-Cap Blend Index Fund Institutional (TISBX)	0.16%	Y
4. Columbia Small Cap Index Fund R5 (CXXRX)	0.15%*	Y
5. Principal SmallCap S&P 600 Index Fund Inst (PSSIX)	0.16%*	
6. Vanguard Small-Cap Index Fund Inst Plus (VSCPX)	0.06%	Y

** Revenue share component*

The Investments Committee is recommending that the Vanguard Small-Cap Index Fund Institutional Plus be selected as the passive small-cap fund option due to its minimal tracking error to its benchmark, low management fee, strength of its investment process, and conservative approach relative to securities lending. This will be a new selection and will replace the SSgA Russell 2000 Index Fund.

SECURITIES LENDING

As part of the Investments Committee review, Committee member Tom Moutes stated his concern that some of the investment options that passed the initial screening included securities lending. He indicated that, given prior experience involving the Los Angeles City Employees' Retirement Systems (LACERS) and securities lending that included a loss and subsequent litigation, he wished to review what securities lending risks, if any, were present in the funds including, but not limited to, counterparty risks, risks to the value of the holdings based on the reasons the securities might be borrowed, and risks due to reinvestment of the collateral including the types and quality of the instruments in which the funds can permissibly be reinvested.

With respect to index fund providers, there is an inherent tendency towards underperformance relative to the index because index funds incur investment management, transaction, and other operating costs which the benchmark does not. Index fund managers must also manage cash flows into and out of the fund. Passive managers often seek to offset these factors by employing strategies such as sampling (meaning they do not purchase all the holdings of a given index, only that which is sufficient to be representative of the entire index) and securities lending (to generate additional incremental return).

Securities lending is the lending of securities by one party to another, with loan terms negotiated between the parties. In the passive mutual fund universe, a fund manager may lend out some of the securities held in its portfolio as a means of generating additional income and/or achieving additional incremental return. Borrowers of the securities may use them for short sales, to gain voting rights, or for other reasons.

The borrower is required to provide collateral with an additional margin, generally an additional 2-5% beyond the value of the underlying security. The lender reinvests this collateral to generate additional income/return. At the end of the negotiated loan term, the security is returned to the lender and the collateral is returned to the borrower. The borrower and the lender (and often a broker if one is involved in the transaction) will then share the yield from the reinvested collateral.

The theoretical risk in the transaction is that (a) the borrower may not be able to return the lent security or (b) the collateral is reinvested in poor quality or illiquid investments and loses value. Collateral reinvestment risk can be mitigated by maintaining conservative investment guidelines.

Mercer indicates that Vanguard employs such a conservative securities lending program. Mercer informed the Committee that Vanguard did not incur securities lending-related losses during the 2008 financial crisis because of its strict reinvestment guidelines, whereas some managers sustained losses because the reinvested collateral was held in lower-quality holdings.

Vanguard utilizes a value lending methodology, loaning out only high demand stocks and reinvesting collateral in government backed securities and other high-quality, short-term, fixed income instruments. Additionally, Vanguard lends securities to a limited number of preapproved broker-dealers and maintains guidelines on the amount that may be approved for one borrower. Vanguard rebates all net proceeds from the securities lending component back to the funds directly, rather than retaining a share of the proceeds for its own use as some passive managers do. Given the coincidence of these factors, the Committee determined that Vanguard's securities lending practices would not be a deterrent to recommending selection of its funds.

However, the Committee discussed the value of improving transparency within the City's Plan around the securities lending issue. The Committee suggested addressing securities lending within the Plan's Investment Policy Statement (IPS), to include referencing it as a point of consideration in evaluating investment managers, and perhaps also to formalize reporting on securities lending practices at regular intervals by providers utilizing the strategy. Based on this, staff will work with the Plan's consultant to develop recommendations for these and any other desirable updates to the IPS.

Submitted by: ______________________________
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