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## BOARD REPORT 18-44

Date: October 16, 2018  
To: Board of Deferred Compensation Administration (Board)  
From: Staff  
Subject: 2018-2019 Investment Manager Searches

### **Recommendation:**

That the Board (1) approve Investments Committee recommendations for 2018-2019 Deferred Compensation Plan investment manager searches with respect to (a) type of search process (mutual fund and/or institutional manager procurement) to be applied to each investment mandate and (b) the evaluation criteria for each mandate; and (2) direct staff to return to the Board with a proposed Request for Proposal (RFP) for institutional managers for mandates approved by the Board.

### **Discussion:**

At its July 17, 2018 meeting, the Board considered a report from staff regarding upcoming investment manager searches for the Deferred Compensation Plan investment menu. The Board approved a proposed 2018-2019 investment manager search plan. The Board further directed the Committee to develop recommendations to the Board with respect to:

- The type of search process (mutual fund or institutional manager procurement) to be applied to each investment mandate;
- Proposed investment and evaluation criteria for each mandate; and
- Following the execution of search processes, provider selections.

On September 17, 2018, the Investments Committee held a meeting to consider recommendations from staff and Mercer Investment Consulting (Mercer) with respect to fund search types and search criteria for each investment mandate. This report provides the Committee's recommendations.

### **A. Search Process Type**

The Plan's Investment Policy Statement (IPS) provides that the Board may utilize mutual fund searches and/or institutional manager procurements to fill the various investment mandates comprising the Plan's investment menu. **Mutual fund searches** are defined as a review of the

broad universe of mutual fund investment vehicles available within a specific investment category and for which a contractual relationship between the fund manager and the City's Plan is not available or required. An **institutional manager procurement** is defined as a review of proposals from managers of institutional investment products (e.g., separate accounts, commingled trusts, and bank deposit accounts) within a specific investment category for which a contractual relationship between the fund manager and the City's Plan is required.

The Board has the option of selecting either a mutual fund search or institutional manager procurement, or combination of both, to conduct a search process. The Board makes this decision based on what it finds to be in the best interests of the Plan and its participants. Generally, a mutual fund search provides an opportunity to consider virtually the entire universe of potential mutual fund providers offering fund products within the parameters of a specific mandate. An institutional manager procurement is limited to those firms which are aware of, choose to compete in, and can fulfill the City's procurement prerequisites before their product offerings can be considered.

For the previous search cycle resulting in selections of the Plan's incumbent managers, the Board elected to pursue mutual fund searches exclusively for all investment mandates not requiring a contract with the service provider. The Board made this decision based on its findings that:

- Plan participants would be best served by allowing the Board to consider a much fuller universe of potential providers than would be available within a typical City procurement process;
- A sufficient number of products with institutional fund pricing was available through mutual fund offerings, and the broader universe of products available for consideration created a greater likelihood of finding lower-cost options; and
- The Plan would save the direct consulting costs and Board/staff time and resources associated with institutional manager procurements.

When the Board selects a mutual fund, implementation is relatively simple in that the only additional required step is opening up a Plan account within the mutual fund account on the Third-Party Administrator (TPA) recordkeeping system. When the Board selects a separate account or commingled fund, a contract must be developed and executed, and the service provider must meet all of the City's general contracting requirements. Presently, only the Plan's FDIC-Insured Bank Deposit Account providers (East West Bank and Bank of the West) and Stable Value Fund provider (Galliard Capital Management) are contracted service providers. All of the Plan's other investment vehicles are mutual funds, generally utilizing share classes only available to institutional clients with a significant asset base in the mandate.

The table on page three of this report summarizes the recommended search option types for each active and passive fund category. Justifications for each fund search type are included in the attached reports from Mercer. Unlike the prior search cycle, the Investments Committee is recommending that a number of investment mandates, primarily for the Plan's passive

managers, use a combination of mutual fund searches and institutional manager procurements. Based on staff's and Mercer's recommendations, the Investments Committee's finding is that opportunities for more favorable investment products may be available through a procurement, that a procurement process can be executed efficiently and at a reasonable cost to the Plan, and that therefore engaging in both processes is the most prudent exercise of due diligence for certain mandates.

The following table summarizes the recommended search option types for each active and passive fund category. Justifications for each fund search type are included in the attached report from Mercer (**Attachment A**).

Investment Mandate	Active or Passive	Incumbent Manager	Inception Date	5-Year End Date	Assets	Recommended Search Vehicle
Bank Deposit Account	n/a	East West Bank	10/1/14	9/30/19	\$171 million	Institutional Manager Procurement only (RFP in process)
Bank Deposit Account	n/a	Bank of the West	10/1/14	9/30/19	\$171 million	
Bank Deposit Account	n/a	Vacant	n/a	n/a	n/a	
Investment Mandate	Active or Passive	Incumbent Manager	Inception Date	5-Year End Date	Assets	Recommended Search Vehicle
Stable Value	n/a	Galliard Stable Value	7/1/15	6/30/20	\$1.1 billion	Institutional Manager Procurement only
Core Bond Passive	Passive	Vanguard Total Bond Market Index	6/26/15	6/25/20	\$287 million	Institutional Manager Procurement and Mutual Fund Search
Core Bond Active	Active	Natixis Loomis Sayles Core Plus Bond	10/14/14	10/31/19	\$287 million	Institutional Manager Procurement and Mutual Fund Search
Large-Cap Core Equity	Passive	Vanguard Institutional Index	6/26/15	6/25/20	\$2.3 billion	Institutional Manager Procurement and Mutual Fund Search
Mid-Cap Core Equity	Passive	Vanguard Mid-Cap Index	6/26/15	6/25/20	\$192 million	Institutional Manager Procurement and Mutual Fund Search
Mid-Cap Value Equity	Active	RidgeWorth Mid-Cap Value Equity	3/20/15	3/19/20	\$96 million	Mutual Fund Search only
Mid-Cap Growth Equity	Active	Voya Mid-Cap Opportunities	3/20/15	3/19/20	\$96 million	Mutual Fund Search only
Small-Cap Core Equity	Passive	Vanguard Small-Cap Index	6/26/15	6/25/20	\$130 million	Institutional Manager Procurement and Mutual Fund Search
Small-Cap Value Equity	Active	DFA Small-Cap Value	3/20/15	3/19/20	\$131 million	Mutual Fund Search only
Small-Cap Growth Equity	Active	Hartford Small-Cap Growth HLS	3/20/15	3/19/20	\$131 million	Mutual Fund Search only
International Equity	Active	MFS Institutional International Equity	6/26/15	6/25/20	\$401 million	Institutional Manager Procurement and Mutual Fund Search
International Small-Cap Equity	Active	Brandes International Small-Cap Equity	6/26/15	6/25/20	\$105 million	Mutual Fund Search only
International Emerging Markets Equity	Active	DFA Emerging Markets Core Equity	6/26/15	6/25/20	\$105 million	Mutual Fund Search only

If the Board approves the Committee's recommendations, a single RFP will be developed incorporating all of the investment mandates allowing managers to submit proposals for one or

more mandates. Managers will also be permitted to submit bundled proposals which may provide options for more favorable pricing.

## **B. Fund Search Criteria**

The Mercer report also contains recommended fund search criteria for each investment option. The search criteria utilize and provide further specificity with respect to the existing investment fund construction parameters already included in the Board's Investment Policy Statement. Upon adoption of these criteria by the Board and initiation of the search processes, Mercer will apply these criteria against the applicable mutual fund universe of funds and, for each category, identify those funds which have met the criteria. The criteria will be similarly incorporated into accompanying institutional manager procurements. The results of this screening and viable RFP responses will then be presented to the Investments Committee for further review and for the purpose of developing recommendations for specific fund selection to the full Board. The fund search criteria are included in Attachment A.

The Investments Committee recommends that the Board (1) approve Investments Committee recommendations for 2018-2019 Deferred Compensation Plan investment manager searches with respect to (a) type of search process (mutual fund and/or institutional manager procurement) to be applied to each investment mandate and (b) the evaluation criteria for each mandate; and (2) direct staff to return to the Board with a proposed RFP for institutional managers for mandates approved by the Board. Upon action by the Board, staff and Mercer will proceed with drafting the RFP and further refine the search timeline.

Submitted by:

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Steven Montagna

HEALTH WEALTH CAREER

# ACTIVE FUND SEARCH RECOMMENDATIONS

## CITY OF LOS ANGELES DEFERRED COMPENSATION PLAN

OCTOBER 16, 2018



**MAKE TOMORROW, TODAY**



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Appendix

# 1

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## Introduction

The Investment Policy Statement (IPS) of the City of Los Angeles Deferred Compensation Plan stipulates that investment manager searches/procurements for specific investment categories generally will occur once every 5 years. The current 5-year terms for the Plan's various investment providers will expire between 2019 and 2020. At the July 2018 Board of Deferred Compensation Administration (Board) meeting, the Board approved 2018-2019 investment manager search plan for the Deferred Compensation Plan investment menu and directed the Investments Committee to develop recommendations to the Board with respect to the type of search process (mutual fund and/or institutional manager procurement) to be applied to each investment mandate; proposed investment and evaluation criteria for each mandate; and recommendations for provider selections. As a result, staff have been working with the Board's investment consultant, Mercer Investment Consulting, to develop a timetable for the implementation of searches over the next couple of years. Per this timetable, in 2018 and 2019, we will be conducting searches for all of the Plan's active investment managers. Our recommendations as to which type of investment vehicle search (i.e., mutual fund and/or institutional manager procurement) the Board should conduct in each category based on the specifics of the respective investment mandates will be discussed in this report.

In addition, we outline recommended minimum qualifications for each of the searches which follow the principles outlined in the IPS' 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 (e.g., 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 according to the timeline previously reviewed by the Board at its July 2018 meeting. Our anticipated timing for completion for each asset class category will be eight weeks for mutual funds, with institutional manager procurements taking longer due to the RFP process requirements. Staff will schedule a series of Investment Committee meetings, each covering specific asset classes, to coincide with this anticipated delivery.

# 2

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## Proposed Investment Fund Searches

- Active Core Plus 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 Plus (Opportunistic) Bond

### PROPOSED SEARCH VEHICLE

Estimated Mandate Size: **\$287.0 million**

Recommended Fund Search Type: ***Institutional Manager Procurement and Mutual Fund***

#### Rationale:

- Conducting a pooled investment (commingled and mutual funds) search would provide broad access to high-quality managers
- The universe of available core plus bond funds comprises 20 commingled funds and 407 mutual funds (includes core plus and core investment grade funds)
- The median cost of the commingled fund universe for a mandate size of \$250 million is 27 basis points<sup>1</sup> which is about 40% less than the median cost for like institutional mutual fund vehicles (46 basis points for active core bond mutual funds)
- Using Institutional Products, such as commingled funds, may lead to additional operational costs for custody and unitization. However given this mandate size, “all-in” fees including other operating costs for Institutional Products could still provide cost savings versus using a Mutual Fund vehicle
- Mutual fund search run concurrently would assure that high-quality product at reasonable expense would be secured

### PROPOSED CORE PLUS SEARCH MINIMUM CRITERIA (SCREENING)

- Availability in pooled investment vehicle
- Vehicle open to new investors
- Vehicle compatible with Voya platform
- Strategy track record of 7 years or longer (specific vehicle may be shorter)
- Investment style consistent with an active core plus bond manager investing in intermediate duration bonds and categorized in the database as a core plus bond strategy
- Minimum assets under management in strategy of \$7.5 billion
- Investment expense ratio equal to or less than 0.34% after revenue sharing rebates, if any (approximately 1.25 times the institutional median)

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<sup>1</sup> Source: Mercer Global Asset Manager Fee Survey – February 2018. Median fees provided for asset breakdown of \$25M, \$50M, \$100M, \$250M and \$500M.

## Active Mid-Cap Growth and Mid-Cap Value Equity

### **PROPOSED SEARCH VEHICLE**

**Estimated Mandate Size:** *\$96.0 million each mandate*

**Recommended Fund Search Type:** *Mutual Fund*

#### **Rationale:**

- There are 43 Mid-Cap Value and 87 Mid-Cap Growth mutual funds in the respective Mercer mutual fund universes, though a handful of funds are closed in each group
- The median cost of the Mid-Cap Value Institutional Mutual Fund universe for a mandate size of \$100 million is 79 basis points<sup>2</sup>.
- The median cost of the Mid-Cap Growth Institutional Mutual Fund universe for a mandate size of \$100 million is 93 basis points<sup>2</sup>.
- At this mandate size, we believe mutual fund vehicles offer comparable investment opportunities at similar or better investment expenses. Given the incremental complexity of an Institutional Manager Procurement and the expectation of marginal benefit, if any, of such a search, we recommend a mutual fund search.

### **PROPOSED MID-CAP EQUITY (GROWTH AND VALUE) SEARCH MINIMUM CRITERIA (SCREENING)**

- Availability in pooled investment vehicle
- Vehicle open to new investors
- Vehicle compatible with Voya 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 \$25 billion
- Investment expense ratio equal to or less than 1.00 after revenue sharing rebates, if any

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<sup>2</sup> Source: Mercer Global Asset Manager Fee Survey – February 2018. Median fees provided for asset breakdown of \$25M, \$50M, \$100M, \$250M and \$500M.

## Active Small-Cap Growth and Small-Cap Value Equity

### **PROPOSED SEARCH VEHICLE**

**Estimated Mandate Size:** *\$131.0 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 candidates, while an Institutional Manager Procurement search process may fail to solicit sufficient response from high-quality respondents.
- There are 68 small-cap value and 137 small-cap growth mutual funds in the respective Mercer mutual fund universes
- The median cost of the Small-Cap Value Institutional Mutual Fund universe for a mandate size of \$100 million is 105 basis points<sup>3</sup>.
- The median cost of the Small-Cap Growth Institutional Mutual Fund universe for a mandate size of \$100 million is 103 basis points<sup>3</sup>.
- Despite a capacity constrained universe of mutual 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 SMALL-CAP EQUITY (GROWTH AND VALUE) SEARCH MINIMUM CRITERIA (SCREENING)**

- Availability in pooled investment vehicle
- Vehicle open to new investors
- Vehicle compatible with Voya platform
- Strategy track record of 5 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 \$600 million

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<sup>3</sup> Source: Mercer Global Asset Manager Fee Survey – February 2018. Median fees provided for asset breakdown of \$25M, \$50M, \$100M, \$250M and \$500M.

## Active Small-Cap Growth and Small-Cap Value Equity

### **PROPOSED SMALL-CAP EQUITY (GROWTH AND VALUE) SEARCH MINIMUM CRITERIA (SCREENING), continued**

- Maximum assets under management in strategy of \$12 billion
- Investment expense ratio equal to or less than 1.00 after revenue sharing rebates, if any

## Active International Developed Markets Equity

### **PROPOSED SEARCH VEHICLE**

**Estimated Mandate Size:**

*\$401.0 million*

**Recommended Fund Search Type:**

*Institutional Manager Procurement and Mutual Fund*

#### **Rationale:**

- There is an abundance of high-quality, low-cost active international developed managers available in pooled investment vehicles
- There are 91 International Developed Markets Equity mutual funds in the Mercer mutual fund universe and 39 International Developed Markets Equity commingled funds in the universe
- The median cost of the mutual fund universe for a mandate size of \$250 million is 82 basis points and the median cost of commingled fund universe for a mandate size of \$250 million is 53 basis points<sup>4</sup>
- Emphasis would be on pooled investment vehicles for institutional product since implementing separate accounts would be needlessly complex and could result in substantial operational costs.

### **PROPOSED INTERNATIONAL DEVELOPED MARKETS EQUITY SEARCH MINIMUM CRITERIA (SCREENING)**

- Availability in pooled investment vehicle
- Vehicle open to new investors
- Vehicle compatible with Voya platform
- Strategy track record of 7 years or longer (specific vehicle may be shorter)
- Investment style consistent with international ex-US core 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 1.00% after revenue sharing, if any

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<sup>4</sup> Source: Mercer Global Asset Manager Fee Survey – February 2018. Median fees provided for asset breakdown of \$25M, \$50M, \$100M, \$250M and \$500M.

## Active International Small-Cap Equity

### **PROPOSED SEARCH VEHICLE**

**Estimated Mandate Size:** *\$105.0 million*

**Recommended Fund Search Type:** *Mutual Fund*

#### **Rationale:**

- A mutual fund search will provide access to a focused list of high-quality candidates
- There are 14 International Small-Cap Equity mutual funds in the Mercer mutual fund universe
- The median cost of the mutual fund universe for a mandate size of \$100 million is 115 basis points<sup>5</sup>
- Use of a separate account vehicle would be cost prohibitive (custody, currency, foreign tax, etc.) in this space which favors the use of pooled investment vehicles like mutual funds.

### **PROPOSED INTERNATIONAL SMALL-CAP EQUITY SEARCH MINIMUM CRITERIA (SCREENING)**

- Availability in mutual fund vehicle
- Vehicle open to new investors
- Vehicle compatible with Voya platform
- Strategy track record of 5 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 \$600 million
- Maximum assets under management in strategy of \$20 billion
- Investment expense ratio equal to or less than 1.15% after revenue sharing rebates, if any

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<sup>5</sup> Source: Mercer Global Asset Manager Fee Survey – February 2018. Median fees provided for asset breakdown of \$25M, \$50M, \$100M, \$250M and \$500M.



## Active Emerging Markets Equity

### **PROPOSED SEARCH VEHICLE**

**Estimated Mandate Size:** *\$105.0 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
- There are 307 Emerging Markets Equity mutual funds in the Mercer mutual fund universe
- The median cost of the mutual fund universe for a mandate size of \$100 million is 104 basis points<sup>6</sup>
- 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.
- At this mandate size, we believe mutual fund vehicles offer comparable investment opportunities at similar or better investment expenses. Given the incremental complexity of an Institutional Manager Procurement and the expectation of marginal benefit, if any, of such a search, we recommend a mutual fund search.

### **PROPOSED EMERGING MARKETS EQUITY SEARCH MINIMUM CRITERIA (SCREENING)**

- Availability in mutual fund vehicle
- Vehicle open to new investors
- Vehicle compatible with Voya 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 \$5 billion
- Maximum assets under management in strategy of \$35 billion
- Investment expense ratio equal to or less than 1.15% after revenue sharing rebates, if any

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<sup>6</sup> Source: Mercer Global Asset Manager Fee Survey – February 2018. Median fees provided for asset breakdown of \$25M, \$50M, \$100M, \$250M and \$500M.

## Appendix – Disclosures

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HEALTH WEALTH CAREER

**PASSIVE FUND SEARCH RECOMMENDATIONS**  
CITY OF LOS ANGELES DEFERRED COMPENSATION PLAN  
OCTOBER 16, 2018

**MAKE TOMORROW, TODAY**



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Appendix



# 1

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## Introduction

The Investment Policy Statement (IPS) of the City of Los Angeles Deferred Compensation Plan stipulates that investment manager searches/procurements for specific investment categories generally will occur once every 5 years. The current 5-year terms for the Plan's various investment providers will expire between 2019 and 2020. At the July 2018 Board of Deferred Compensation Administration (Board) meeting, the Board approved 2018-2019 investment manager search plan for the Deferred Compensation Plan investment menu and directed the Investments Committee to develop recommendations to the Board with respect to the type of search process (mutual fund and/or institutional manager procurement) to be applied to each investment mandate; proposed investment and evaluation criteria for each mandate; and recommendations for provider selections. As a result, staff have been working with the Board's investment consultant, Mercer Investment Consulting, to develop a timetable for the implementation of searches over the next couple of years. Per this timetable, in 2018, we will be conducting searches for all of the Plan's passive investment managers. Our recommendations as to which type of investment vehicle search (i.e., mutual fund and/or institutional manager procurement) the Board should conduct in each category based on the specifics of the respective investment mandates will be discussed in this report.

In addition, we outline recommended minimum qualifications for each of the searches which follow the principles outlined in the IPS' 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 IPS. 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 (e.g., 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 conduct searches in alignment with the timeline previously reviewed by the Board at its July 2018 meeting. Our anticipated timing for completion of all mutual fund searches will be eight weeks with institutional manager procurements taking longer due to RFP process requirements. Staff will schedule a series of Investment Committee meetings, covering the specific mandates, to coincide with anticipated delivery.

# 2

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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 Size<sup>1</sup>:** *\$285.6 million*

**Recommended Fund Search Type:** *Institutional Manager Procurement and Mutual Fund*

#### **Rationale:**

- Conducting a pooled investment search (commingled and mutual funds) would provide broad access to high-quality index fund managers.
- The universe of available passive bond funds comprises of 15 commingled funds and 196 mutual funds.
- The median cost of the passive commingled fund universe for a mandate size of \$250 million is 5 basis points<sup>2</sup> compared to the median cost of passive mutual fund universe of 15 basis points. Our experience is that very large investors can obtain significantly better pricing via an institutional product in the current environment.
- Using Institutional Products, such as commingled funds, may lead to additional operational costs for custody and unitization. At this mandate size, however, “all-in” fees including other operating costs for Institutional Products could still provide cost savings versus using a Mutual Fund vehicle.
- Mutual fund search run concurrently would assure that high-quality product at reasonable expense would be secured.

### **PROPOSED PASSIVE BOND SEARCH MINIMUM CRITERIA (SCREENING)**

- Availability in pooled investment vehicle
- Vehicle open to new investors
- Vehicle compatible with Voya platform
- Strategy track record of 10 years or longer (specific vehicle may be shorter)
- Tracks the Bloomberg Barclays US Aggregate Bond Index
- Annualized tracking error<sup>3</sup> relative to the benchmark should be within +/- 0.30% over the 7- and 10-year periods (or longest available)

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<sup>1</sup> As of 7/31/2018

<sup>2</sup> Source: Mercer Global Asset Manager Fee Survey – February 2018. Median fees provided for asset breakdown of \$25M, \$50M, \$100M, \$250M and \$500M.

<sup>3</sup> Tracking error for these purposes is defined as the benchmark return less the subject fund return

## Passive Bond

### **PROPOSED PASSIVE BOND SEARCH MINIMUM CRITERIA (SCREENING), continued**

- Minimum assets under management in strategy (all vehicles) of \$20.0 billion or greater
- Investment expense ratio equal to or less than 0.03%

## Passive Large-Cap Equity

### **PROPOSED SEARCH VEHICLE**

**Estimated Mandate Size<sup>1</sup>:**

***\$2,328.3 million***

**Recommended Fund Search Type:**

***Institutional Manager Procurement and Mutual Fund***

#### **Rationale:**

- Conducting a pooled investment search (commingled and mutual funds) would provide broad access to high-quality index fund managers
- The universe of available passive large-cap equity funds comprises 28 commingled funds and 163 mutual funds
- The median cost of the passive commingled fund universe for assets over \$500 million is 4 basis points versus 11 basis points for Institutional Mutual Fund vehicles<sup>2</sup> and our experience is that very large investors can obtain significantly better pricing via an institutional product in the current environment.
- Using Institutional Products, such as commingled funds, may lead to additional operational costs for custody and unitization. At this mandate size, “all-in” fees including other operating costs for Institutional Products could still provide cost savings versus using a Mutual Fund vehicle.
- Mutual fund search run concurrently would assure that high-quality product at reasonable expense would be secured.

### **PROPOSED PASSIVE LARGE-CAP EQUITY SEARCH MINIMUM CRITERIA (SCREENING)**

- Availability in pooled investment vehicle
- Vehicle open to new investors
- Vehicle compatible with Voya platform
- Strategy track record of 10 years or longer (specific vehicle may be shorter)
- Tracks the S&P 500 Index
- Annualized tracking error<sup>3</sup> relative to the benchmark should be within +/- 0.20% over the 7- and 10-year periods (or longest available)

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<sup>1</sup> As of 7/31/2018

<sup>2</sup> Source: Mercer Global Asset Manager Fee Survey – February 2018. Median fees provided for asset breakdown of \$25M, \$50M, \$100M, \$250M and \$500M.

<sup>3</sup> Tracking error for these purposes is defined as the benchmark return less the subject fund return

## Passive Large-Cap Equity

### **PROPOSED PASSIVE LARGE-CAP EQUITY SEARCH MINIMUM CRITERIA (SCREENING), continued**

- Minimum assets under management in strategy (all vehicles) of \$50 billion or greater
- Investment expense ratio equal to or less than 0.03%



## Passive Mid-Cap Equity

### **PROPOSED SEARCH VEHICLE**

**Estimated Mandate Size<sup>1</sup>:**

*\$192.0 million*

**Recommended Fund Search Type:**

*Institutional Manager Procurement and Mutual Fund*

### **Rationale:**

- Conducting a pooled investment search (commingled and mutual funds) would provide broad access to high-quality index fund managers
- The universe of available passive mid-cap equity funds comprises 9 commingled funds and 53 mutual funds
- The median cost of the passive commingled fund universe for a mandate size of \$100 million is 6 basis points<sup>2</sup> compared to the median cost of passive mutual fund universe of 25 basis points. Our experience is that very large investors can obtain significantly better pricing via an institutional product in the current environment.
- Using Institutional Products, such as commingled funds, may lead to additional operational costs for custody and unitization. At this mandate size, “all-in” fees including other operating costs for Institutional Products could still provide cost savings versus using a Mutual Fund vehicle.
- Mutual fund search run concurrently would assure that high-quality product at reasonable expense would be secured.

### **PROPOSED PASSIVE MID-CAP EQUITY SEARCH MINIMUM CRITERIA (SCREENING)**

- Availability in pooled investment vehicle
- Vehicle open to new investors
- Vehicle compatible with Voya platform
- Strategy track record of 7 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 error<sup>3</sup> relative to the benchmark should be within +/- 0.30% over the 7- and 10-year periods (or longest available)

<sup>1</sup> As of 7/31/2018

<sup>2</sup> Source: Mercer Global Asset Manager Fee Survey – February 2018. Median fees provided for asset breakdown of \$25M, \$50M, \$100M, \$250M and \$500M.

<sup>3</sup> Tracking error for these purposes is defined as the benchmark return less the subject fund return

## Passive Mid-Cap Equity

### **PROPOSED PASSIVE MID-CAP EQUITY SEARCH MINIMUM CRITERIA (SCREENING), continued**

- Minimum assets under management in strategy (all vehicles) of \$5 billion or greater
- Investment expense ratio equal to or less than 0.04%

## Passive Small-Cap Equity

### PROPOSED SEARCH VEHICLE

**Estimated Mandate Size<sup>1</sup>:**

*\$129.6 million*

**Recommended Fund Search Type:**

*Institutional Manager Procurement and Mutual Fund*

#### **Rationale:**

- Conducting a pooled investment search (commingled and mutual funds) would provide broad access to high-quality index fund managers
- The universe of available passive small-cap equity funds comprised of 14 commingled funds and 98 mutual funds
- The median cost of the passive commingled fund universe for a mandate size of \$100 million is 7 basis points<sup>2</sup> compared to the median cost of passive mutual fund universe of 29 basis points. Our experience is that very large investors can obtain significantly better pricing via an institutional product in the current environment.
- Using Institutional Products, such as commingled funds, may lead to additional operational costs for custody and unitization. At this mandate size, “all-in” fees including other operating costs for Institutional Products could still provide cost savings versus using a Mutual Fund vehicle.
- Mutual fund search run concurrently would assure that high-quality product at reasonable expense would be secured.

### PROPOSED PASSIVE SMALL-CAP EQUITY SEARCH MINIMUM CRITERIA (SCREENING)

- Availability in pooled investment vehicle
- Vehicle open to new investors
- Vehicle compatible with Voya platform
- Strategy track record of 7 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 error<sup>3</sup> relative to the benchmark should be within +/- 0.30% over the 7- and 10-year periods (or longest available)

<sup>1</sup> As of 7/31/2018

<sup>2</sup> Source: Mercer Global Asset Manager Fee Survey – February 2018. Median fees provided for asset breakdown of \$25M, \$50M, \$100M, \$250M and \$500M.

<sup>3</sup> Tracking error for these purposes is defined as the benchmark return less the subject fund return

## Passive Small-Cap Equity

### **PROPOSED PASSIVE SMALL-CAP EQUITY SEARCH MINIMUM CRITERIA (SCREENING), continued**

- Minimum assets under management in strategy (all vehicles) of \$10.0 billion or greater
- Investment expense ratio equal to or less than 0.04%

## Appendix – Disclosures

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