DEFERRED COMPENSATION PLAN
BOARD REPORT 06-01

EMPLOYEE BENEFITS DIVISION

Date: January 9, 2006

To: Board of Deferred Compensation Administration

From: Staff

Subject: Stable Value Fund Consolidation

Recommendation:
That the Board of Deferred Compensation Administration (a) reaffirm a proposed consolidation of the Hartford General Account and Galliard Stable Value Fund into a single stable value investment offering; and (b) direct staff to proceed with taking the necessary next steps in order to effect a tentative target transition date of July 1, 2006; and (c) authorize the Board Chairperson to execute any necessary contract amendments that may be required of Hartford Life Insurance and/or Galliard Capital Management.

Discussion:
Background - In October 2003 the Board adopted a report/recommendation from staff and the consultant to develop a proposal to consolidate the Hartford General Account and Stable Value Fund into a single, "Plan-branded" stable value investment offering. Before that could happen, however, it was necessary to establish a new contract with Hartford, which was expiring. Staff subsequently sought and obtained authority from the City Council for the Board Chairperson to execute a new five-year contract term for the Hartford offerings. With that new contract having only recently been finalized, staff is now returning to the matter of consolidating the two accounts.

Because the composition of the Board has changed substantially since it originally took this action, and because this consolidation would involve a significant change to the Plan's core investment menu, staff is returning this issue to the Board for review. The Board has several options – (a) reaffirming its previous action; (b) requesting further information from staff and the consultant; or (c) referring this matter for more consideration by the Board's Investments Committee.

The City's relationship with Hartford Life Insurance has been in existence since inception of the Deferred Compensation Plan in 1983. Originally Hartford provided a "bundled" service arrangement, including both Plan administrative services (e.g. recordkeeping, communications, etc. – the services presently performed by Great-West) as well as investment products. There was no discrete "administrative fee" charged by Hartford.

Instead, the company derived its revenue from a variety of sources – primarily investment management fees, mortality and expense risk fees, and even surrender charges if funds were transferred outside of the Hartford lineup to another provider. As is typical for general account annuity products, Hartford does not disclose the investment management or other fees on its fixed account.

As the City's Plan matured, program staff and the Board recognized that there were alternative investment products that would have fewer restrictions and would fully disclose its fees to Plan participants. The Galliard/Wells Fargo Total Return Fund was selected through a competitive bid process; however, because of termination penalties, the City did not have the option of simply exiting its relationship with Hartford and transferring the assets to the Galliard/Wells Fargo Total Return Fund.

When the Board ultimately elected to "unbundle" the Plan in 1999 by separating its administrative services contract from its investment provider contracts, Hartford approached the Board with a proposal to substantially reduce its fees in exchange for the Plan retaining the four largest Hartford offerings in the investment menu. This included three variable funds (the Hartford Stock Fund, Hartford Capital Appreciation Fund, and Hartford Advisers Fund) and one fixed account (the Hartford General Account). At the end of the subsequent five-year contract cycle, no surrender charges would apply to any of the four funds; however, the Hartford General Account still includes what is referred to in the industry as a "market value adjustment." This means that, should the City ever liquidate its holdings in the General Account en masse, a financial penalty or transfer restriction could apply.

In addition, since the City's Plan offers a product similar to the General Account (the Galliard/Wells Fargo Total Return Fund), Plan participants are subject to what is called an "equity wash" restriction which prohibits direct exchanges between what the provider defines as like fixed income products. The intent of equity wash is to prevent short-term asset transfers for the purpose of back-and-forth "interest rate shopping." For Hartford, the equity wash includes not only the Galliard Stable Value Fund but also the Washington Mutual Liquid Account, Washington Mutual CDs, and both of the City's Bond funds. For Galliard, the equity wash extends only to the Hartford General Account and Washington Mutual Liquid Account.

Consolidation Proposal – In developing the proposal previously approved by the Board, staff and Mercer developed several key objectives concerning the Plan's fixed account investment products:

- Simplify the offerings
- Offer funds with fully disclosed fee structures
- Reduce applicability of equity wash restrictions
- Eliminate or reduce applicability of market value adjustments
- Expand discretion of the Board in securing the best products for participants

Presently, based on participant feedback, it appears that many participants are confused by the General Account and Stable Value Fund products and their differing features. For example, some participants believe the Stable Value Fund is a mutual fund because it employs a daily share valuation, unlike the General Account which does not use daily valued shares. Also, many participants do not fully understand that the General Account has a two-tiered rate system, whereby “new money” contributions receive one rate of return and “old money” rates (which apply to existing balances) receive a different rate. By contrast, the Stable Value Fund has a rate which is subject to change daily but which applies across all invested assets. Finally, participants appear confused by the differing applications of equity wash from the two providers.

Further complicating these products is the Hartford “market value adjustment” which subjects participants to the risk of a reduced rate of return if the City’s contract with Hartford is terminated. Although most participants are not aware of, or directly affected by, this provision, from the Plan’s perspective this has always limited the Board’s consideration of making changes. In effect, Hartford has not had to complete with other fixed account providers because of the market value adjustment. In addition, there is a higher level of risk in maintaining such a large amount of funds (presently $348 million) in an investment with a single provider. Ultimately this asset is backed only by the stability of Hartford itself.

As a result, staff continues to recommend blending the Hartford General Account and the Galliard Stable Value Fund into a generic, single Plan-sponsored “DCP Stable Value Fund.” This blending would have two key dimensions. First, the Hartford General Account would be systematically reconstituted over a 2½ year cycle to a stable value separate account. Second, although both Hartford and Galliard/Wells Fargo would continue to manage the assets, from a participant perspective, the “DCP Stable Value Fund” would appear as one investment option. Some of the benefits of this approach include the following:

- The Plan would be provided with unique branding of its own fixed investment option;
- The two investments can be structured to provide a single blended interest rate option, thus reducing participant confusion;
- A single stable value offering would substantially reduce the applicability of equity wash limitations in the City’s Plan (applying now only to transfers from the new option to the Washington Mutual Liquid Account);
- Reconstituting General Account assets as separate account assets would protect the assets from Hartford’s credit risk since assets in an insurance company general account are not the assets of the Plan but of the insurance company and subject to the claims of creditors in the event of bankruptcy or receivership.
- Reconstituting the assets would also end the product’s unique status of not being subject to competitive bid due to termination penalties.

The primary negatives with this approach noted by staff include:

- Some Plan participants may experience this consolidation as an undesirable reduction in the guaranteed investment choices available to them under the Plan;
- Depending on the rates being offered by the two providers, some participants may express concern that “but for” the consolidation they would have realized a higher rate of return had their investment been retained in its discrete non-blended option.

However, in response to these negatives, it should be noted that even were the Plan to retain both the General Account and Stable Value Funds as discrete options, it would not for most practical purposes mean that a participant had a meaningful choice with respect to any existing account balances. Equity wash limitations make the process of transferring funds between the two products sufficiently burdensome that few participants would be likely to move money back and forth between the two products anyway. With respect to rates of return, while any short-term period might form the basis of a "but for" critique, over the long term consolidating the two products will allow the Board to leverage the assets held in the stable value offering to achieve the best return and the lowest fees for the Plan as a whole. For example, it is conceivable that the Board will, over time, elect to add other fixed income managers or products in order to keep the fund diversified and reduce expenses, both of which are primary and legitimate objectives for this offering.

At staff's request, Hartford has done preliminary work on outlining the steps that would need to be taken before initiating the systematic conversion from a general account to a stable value separate account. In addition, to facilitate the administrative operation of a combined stable value fund, Galliard has proposed changes to its current contract that would provide additional support services without increasing its current investment management fee. This is accomplished through the movement of the Plan's current stable value fund assets from a more expensive commingled fund structure (the Total Return Fund) to a separate account. At the initial retention of Galliard the City did not have sufficient assets for a separate account.

Before proceeding further, however, staff is asking that the Board reaffirm its earlier action to create a combined stable value fund, authorize the necessary contract amendments for Hartford and Galliard, and authorize implementation and communication of the new fund to participants. Staff has identified the earliest beginning transition date as being July 1, 2006.

Submitted by: ______________________________

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Approved by: ______________________________

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