

# DEFERRED COMPENSATION PLAN BOARD REPORT 09-47

Date: October 5, 2009  
To: Board of Deferred Compensation Administration  
From: Staff  
Subject: Proposed Investment Manager Procurement Process

*Members*  
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## Recommendation:

That the Board of Deferred Compensation Administration adopt the investment manager procurement process identified in this report.

## Discussion:

At the Board's June 16, 2009, meeting, the Board requested that Personnel Department and City Attorney staff work together to develop a proposal for an investment manager search/procurement process that would provide for the broadest consideration of potential providers consistent with observing those general contracting principles embodied within the City's Standard Provisions and other rules and policies adopted by the City of Los Angeles. Staff reviewed the matter with the City Attorney and developed the proposal contained within this report. The City Attorney's Office indicates that this proposal is acceptable within the City's procurement rules.

**Background** – The City's Deferred Compensation Plan conducts a variety of searches for service providers. These searches include the following general recurring categories:

- Investment Managers
- Third Party Administrator
- Consultant

The proposal contained within this report addresses investment manager searches only.

The City's Plan offers investments within two broad categories of pooled investment vehicles: mutual funds and "institutional" funds. Investment vehicles are the legal structures for how an investment pool is offered to investors. Mutual funds are a specific type of investment vehicle open to retail as well as institutional investors. Institutional funds come in several different forms and are generally only available to institutional investors.

The differences between the two categories are outlined in the following table. However, the key difference for the purpose of this discussion relates to contracting –

mutual funds require a contract between the City and the provider, while institutional funds do not require a contract.

	<b>Mutual Fund</b>	<b>Institutional Fund</b>
<i>Type(s)</i>	<ul style="list-style-type: none"> <li>▪ Registered Mutual Fund</li> </ul>	<ul style="list-style-type: none"> <li>▪ Separate Account</li> <li>▪ Commingled Trust</li> <li>▪ Annuities (fixed and variable)</li> <li>▪ Savings Account (FDIC bank product)</li> </ul>
<i>Contract</i>	<ul style="list-style-type: none"> <li>▪ Not Required</li> </ul>	<ul style="list-style-type: none"> <li>▪ Required</li> </ul>
<i>Fees</i>	<ul style="list-style-type: none"> <li>▪ Retail and institutional pricing</li> </ul>	<ul style="list-style-type: none"> <li>▪ Institutional pricing</li> </ul>
<i>Daily Valued by Investment Manager?</i>	<ul style="list-style-type: none"> <li>▪ Yes</li> </ul>	<ul style="list-style-type: none"> <li>▪ Separate account typically not, but possible</li> <li>▪ Commingled fund typically yes</li> <li>▪ Annuities yes</li> <li>▪ Savings account no</li> </ul>

Presently the City’s Plan has 11 options in the equity/bond categories (excluding the two Hartford funds, which will be eliminated shortly, and the asset allocation funds, which are blends of other funds offered in the Plan). Of these, all but two are mutual funds (as listed on the table below).

<b>Investment Option</b>	<b>Mutual Fund</b>	<b>Institutional Fund</b>
PIMCO Total Return Fund	<b>x</b>	
Vanguard Total Bond Index Fund	<b>x</b>	
Growth Fund of America	<b>x</b>	
Investment Co. of America	<b>x</b>	
Hartford Capital Appreciation		<b>x</b>
Vanguard Instituti. Index Fund	<b>x</b>	
Lazard Mid-Cap Institutional	<b>x</b>	
Vanguard Mid-Cap	<b>x</b>	
State Street Russell 2000 Index		<b>x</b>
Fidelity Diversified International	<b>x</b>	
DWS EAFE Equity Index	<b>x</b>	

The universe of potential products is huge. The Board’s consultant indicates there are approximately 4,300 mutual funds and 3,000 institutional funds, or 7,300 total funds that could potentially be considered (see attachment).

**Search/Procurement Principles** – As outlined in a prior report regarding proposed Board governance policies, staff is recommending that the Board’s investment manager search/procurement process be governed by the following core principles/objectives:

- Safeguard the trust of Plan participants
- Make decision-making transparent

- Meet the Plan's fiduciary obligations
- Provide a fair and equitable process for interested vendors
- Efficiently consider the broadest pool of potential providers
- Promote decisions based strictly on what is in the best interests of the Plan and its participants

**Limitations of RFP Process** – In the past the City's Plan has used Requests for Proposal (RFPs) for its investment manager searches. The Board's investment consultant has proposed specific search criteria and the Board has approved those criteria. If the RFP has yielded a small number of viable respondents (a situation that has occurred frequently in recent years) the Board has canceled the RFP and asked its consultant to conduct an investment manager search using the same criteria previously adopted by the Board for the RFP. The consultant has developed a short list of strong candidates, and those firms have either been reviewed first by the Investments Committee and then the full Board, or by the full Board without prior Committee review. The Board has then made a selection.

Typically the selected vendor has been a mutual fund provider. Less frequently the selected vendor has offered an institutional fund requiring a contract. This latter situation occurred recently with the Board's selection of three banking institutions for its blended FDIC-Insured Savings Option.

The primary limitation of the RFP process is that it is inconsistent with the principle of efficiently considering the broadest pool of potential providers, as evidenced by the following:

1. It is a challenge under any circumstance to effectively communicate to a universe involving over 7,000 products.
2. RFP deadlines are so tight (with mandatory pre-bid conferences, deadlines imposed by MBE/WBE outreach efforts, and limited time frames to prepare responses and assemble other Standard Provisions documents) that even when vendors are aware a search process is occurring it may be impractical for them to prepare the response in time.
3. If the full universe of providers could be made aware of the process and responded, it would be administratively impossible and prohibitively expensive to consider responses consistent with the size of the universe pool.
4. Over half of the universe would not be required to enter into a contract in any event (because they offer mutual funds), rendering the Standard Provisions exercise (both in the vendor's preparation and the City's review) as wasted resources; and
5. Mutual fund providers might be excluded based on a review of Standard Provisions compliance even though those requirements would not apply if their product might otherwise be determined to be superior.

**Proposed Search Process** – Staff is proposing a search process that more effectively balances out the various search/procurement principles previously discussed. This

process would involve eliminating the use of RFPs in investment manager searches and replacing them with investment manager searches involving the following steps:

1. Consultant drafts proposed selection criteria for a given investment category.
2. Board considers, potentially modifies, and then adopts selection criteria.
3. Staff issues advance public notice of pending investment manager search, advising interested vendors that they may contact the City or City's consultant to ensure that any product they believe is appropriate for the search is considered by the Plan.
4. Consultant conducts an investment manager search of all potential products against its provider database, applying the search criteria as set forth by the Board, and ensuring that all providers within the database or who have otherwise requested consideration are evaluated.
5. Consultant prepares a list of top-scoring firms, the number of which would be determined on a case-by-case basis (as dictated by the Board) taking into consideration factors such as the investment mandate and size of the potential provider pool.
6. The Board either considers the finalists directly or vets them first through the Investments Committee.
7. The Board chooses a provider.
8. If the chosen product is a mutual fund, the Plan Administrator is directed to active this option on its trading platform.
9. If the chosen product is an institutional fund requiring a direct contract between the City and the entity, the entity will be required to execute a contract with the City and meet all of the City's general and specific contracting requirements – if it is not able to do so, the search will be brought back to the Board to make another selection.

Staff believes this approach is optimal because it provides for the most efficient consideration of the broadest pool of potential providers, the fairest and most equitable process for interested vendors, and is the most likely process to produce a result that is in the best interests of Plan participants. No other process would consider as large a number of candidates, giving the Board the opportunity to view the broadest possible universe and ensuring that all potential providers have an equal opportunity to be considered and evaluated and are not unduly excluded from consideration. This creates a far greater likelihood that the end result will produce the most highly qualified candidates. Given this, staff recommends that the Board adopt the investment manager procurement process identified in this report.

Submitted by: \_\_\_\_\_  
Steven Montagna

Approved by: \_\_\_\_\_  
Alejandrina Basquez

## FUND UNIVERSE

Number of constituents as of 1Q09	Mutual Fund Universe	Institutional Universe
Stable Value	na	27
US Fixed Core	303	289
US Fixed Core Index	24	na
Balanced	475	80
Lifecycle	315	30
US Large Cap Equity Index	105	97
US Large Cap Value Equity	357	379
US Large Cap Core Equity	512	467
US Large Cap Growth Equity	458	335
US Mid Cap Equity Index	26	22
US Mid Cap Value Equity	120	109
US Mid Cap Core Equity	145	68
US Mid Cap Growth Equity	269	121
US Small Cap Equity Index	34	25
US Small Cap Value Equity	122	195
US Small Cap Core Equity	185	140
US Small Cap Growth Equity	227	182
International Equity Index	26	16
International Equity	422	359
International Large Cap Value Equity	93	na
International Large Cap Growth Equity	71	na
International Small Cap Equity	43	62
<b>Total→</b>	<b>4,332</b>	<b>3,003</b>

Combined Total: 7,335