

DEFERRED COMPENSATION PLAN BOARD REPORT 10-06

Date: March 2, 2010
To: Board of Deferred Compensation Administration
From: Staff
Subject:: Investment Manager Procurement

Members
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Richard Kraus, Chairperson
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Cliff Cannon, Second Provisional Chair
Maggie Whelan, Third Provisional Chair
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Recommendation:

That the Board of Deferred Compensation Administration direct staff to draft a communication from the Board to the City Attorney requesting a response to the staff positions and questions outlined 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 developed a proposal that it believes is consistent with the City's procurement rules and with the history of the selection of investment providers within the Plan. However, the City Attorney's Office has informally indicated that this proposal is not consistent with the City's procurement rules and that the Plan must continue to issue Requests for Proposal for investment managers using the same process and format that has been utilized from 1999 to the present. Staff is recommending that a more formal response from the City Attorney be solicited. In this report staff will provide background on this issue and fully detail its proposed search process.

BACKGROUND

A. What Types of Provider Searches Does the Plan Conduct?

The City's Deferred Compensation Plan conducts provider searches for three general types of service providers:

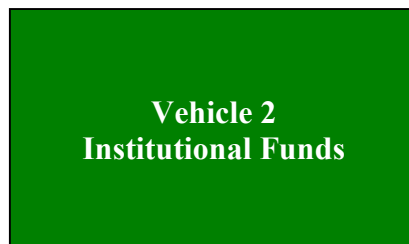
- Investment Managers
- Third Party Administrator
- Consultant

This report addresses **investment manager searches only**.

DRAFT

B. What Categories of Investment Vehicles Can Be Offered in the City’s Plan?

An investment vehicle is a legal structure for how an investment pool is offered to investors. The City’s Plan can offer investments within two general categories of vehicles: mutual funds and “institutional” funds.



Mutual funds are a specific type of investment vehicle with a particular set of governing rules and regulations. Mutual funds are open to retail as well as institutional investors.

Institutional funds come in several different forms. They are generally only available to institutional investors such as a defined contribution plan (like the City’s Plan) with assets sufficiently large enough to attract institutional pricing.

The differences between the two vehicles as they apply to the City’s Plan are outlined in the following table. One key distinction relates to contracting – mutual funds do not require a contract between the City and the provider, while institutional funds do require a contract.

	Mutual Fund	Institutional Fund
<i>Type(s)</i>	<ul style="list-style-type: none"> ▪ Registered Mutual Fund 	<ul style="list-style-type: none"> ▪ Separate Account ▪ Commingled Trust ▪ Annuities (fixed and variable) ▪ Savings Account (FDIC bank product)
<i>Contract</i>	<ul style="list-style-type: none"> ▪ Not Required 	<ul style="list-style-type: none"> ▪ Required
<i>Fees</i>	<ul style="list-style-type: none"> ▪ Retail and institutional pricing 	<ul style="list-style-type: none"> ▪ Institutional pricing
<i>Daily Valued by Investment Manager? (“daily valued” means that the fund provides a unit or share price at the end of each trading day)</i>	<ul style="list-style-type: none"> ▪ Yes 	<ul style="list-style-type: none"> ▪ Separate account typically not, but possible ▪ Commingled fund typically yes ▪ Annuities yes ▪ Savings account no

C. How Have Investment Options Historically Been Chosen in the City's Plan?

1983- 1999

- **Funds Chosen From Provider Platform**
- **No RFP Issued Specific to Fund Category**
- **No consultant used**

The City's Plan was created in 1983. At that time two bundled service contracts were executed: one with Hartford Life Insurance and the other with Great Western Bank. The term "bundled" means that each provider was contracted with to provide both administrative services (of the type currently performed by Great-West Retirement Services) as well as certain investment options chosen by the Plan.

Initially each provider offered only a few options. Over time, the Advisory Committee governing the Plan would periodically add new options. These decisions were not made as a result of a competitive search process, but were rather based on the interests of various Board members in adding new options in concert with recommendations made by Hartford Life and Great Western Bank.

Each provider had a fund platform from which the Advisory Committee could make a choice. With Hartford, this platform was largely confined to the fixed and variable annuities that were offered on Hartford's investment platform. With Great Western Bank, this universe started out being similarly limited but then eventually grew to a platform that included thousands of mutual funds.

**Great-Western Bank
Platform =
Thousands of Funds**

**Hartford
Platform =
Less Than 50
Funds**

There was no requirement at this time that a competitive search process be conducted. The Advisory Committee did not use the services of a consultant in evaluating potential candidates for a given investment category.

1999- Present

- **Funds Chosen Through RFP**
- **RFPs Issued for Specific Fund Categories**
- **Consultant-Facilitated Processed**

In 1995 the City Council moved administration of the City's Plan from the City Treasurer to the Personnel Department. The Advisory Committee was established as a Board and provided contracting authority. Four years later the Board significantly changed the Plan's architecture by unbundling the administrative and investment management services from one another. This meant that investment options could no longer be directly offered by the firm providing Plan administration. Although there was no new requirement to do so, for the first time the Board began issuing Requests for Proposal

for investment management services in the interest of transparency and consistency with other City contracting. This process typically operates as follows.

- (1) The Board's investment consultant proposes specific search criteria and the Board adopts those criteria.
- (2) The RFP is issued.
- (3) If a large enough response is received to create a viable pool of candidates, a selection is made by the Board upon recommendation of staff and the consultant.
- (4) If an insufficient response is received (a situation that has been more the norm in recent years) the Board cancels the RFP and asks its consultant to conduct an investment manager search against its fund database (which includes thousands of funds) using the same criteria previously adopted by the Board for the RFP. The consultant applies the criteria, screens for the top firms, then develops a short list of candidates. A selection is then made by the Board upon recommendation of staff and the consultant.

Typically the selected vendor has been a mutual fund provider. Less frequently the selected vendor has offered an institutional fund requiring a contract. One recent example of this is the Board's October, 2009 selection of three banking institutions for its new blended FDIC-Insured Savings Option.

The process described above for adding investment options to the City's menu has been in effect from 1999 until the present.

D. How Many Mutual Funds Does the City's Plan Currently Offer? How Many Institutional Funds?

Presently the City's Plan has 11 options in the equity/bond categories. All but two are mutual funds:

Mutual Funds: **9**
 Institutional Funds: **2**

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

E. What are the Limitations of the Current Search Process?

The traditional format for issuing an RFP involves:

- Publishing a written document of the City's requirements;
- Requiring that vendors submit a written response to the RFP;
- Requiring that vendors provide verification of their ability to meet the City's general contracting requirements; and
- Evaluating/scoring responses and identifying the best qualified respondent.

There are several reasons why staff does not believe that the current search process is optimal for the selection of Deferred Compensation Plan investment providers:

1. **Size of Candidate Pool** – The investment provider universe is unlike the universe of potential providers for many City services. 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). Although the numbers for any individual asset class (e.g. large company stocks, small company stocks, etc.) is a subset, each subset is still substantial. It is a challenge under any circumstance to effectively communicate to a universe involving thousands of potential products. In addition, typical response deadlines are so tight that even when vendors are aware a search process is occurring it may be impractical for them to prepare the response in time to meet the deadline.
2. **Applying General Contracting Screens Against Mutual Funds When No Contract Required** – A typical City search process requires that vendors demonstrate compliance with the City's general contracting provisions both through formal attestations as well as submission of certain documents. This has the effect of screening out vendors who are unwilling or unable to comply with those requirements. That screening process, however, is unnecessary in the case of mutual funds because no contract between the City and provider will ultimately be executed. The result is that many otherwise fully viable, excellent products may not be considered for reasons which in the end will not apply to them.
3. **Inefficiency of Requiring Written Responses** – Requiring that prospective vendors submit written responses is a redundant and inefficient means of evaluating the data needing to be considered. The consultant already has the data (e.g. assts under management, operating expenses, manager tenure, etc.) that would be requested through an RFP; and would be applying precisely the same screening process that it would use if the same data were provided in the form of a written proposal from a vendor. That screening, which represents the application of the criteria adopted by the Board, is almost entirely quantitative; the evaluation of qualitative factors would arise with the consideration of top firms, and would be done together with the Board or Investments Committee (as it is under the current process). Requiring a written response thus only acts to unnecessarily limit, generally quite sharply, the number of firms that can be considered, for reasons

previously noted. A more inclusive, practical and efficient approach would be to apply the search criteria against the data already maintained by the consultant.

F. What Should be the Governing Principles for an Investment Manager Search Process?

Staff is recommending that the Board's investment manager search/procurement process be governed by the following core principles/objectives:

- Meet the primary fiduciary obligation of acting in the best interests of Plan participants
- Provide a fair and equitable process for interested vendors
- Consider the broadest pool of potential providers
- Consider providers in the most efficient manner possible
- Ensure that decision-making is fully transparent

G. What is Staff's Proposed Search Process?

Staff is proposing a search process that addresses the unique challenges of selecting providers consistent with the above-noted principles. This process would involve 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 fund**.
8. If the chosen fund is a **mutual fund**, the Plan Administrator is directed to **activate 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. Staff also views it as entirely consistent with the City's RFP requirements.

H. How do City Procurement Requirements Apply to Proposed Process?

Section 10.15 of the City of Los Angeles Administrative Code establishes the rules regarding competitive bids. The first area in which these provisions do not appear to fit neatly with the selection of investment managers within the Deferred Compensation Plan is that they **assume that a contract will be the ultimate outcome of the competitive search process**. However, as indicated previously, in the City's Plan it is possible (even likely) that the selected product will not require a contract.

Second, two provisions of Section 10.15 provide some exceptions to applying their provisions, including the following:

*10.15(2) Contracts, as determined by the contracting authority, for the performance of **professional, scientific, expert, technical, or other special services** of a temporary and occasional character for which the contracting authority finds that competitive bidding is not practicable or advantageous.*

*10.15(9) Subject to the requirements of Charter Section [1022](#), contracts (including without limitation those, as determined by the contracting authority, for the performance of professional, scientific, expert, technical or other special services), **where the contracting authority finds that the use of competitive bidding would be undesirable, impractical or impossible** or where the common law otherwise excuses compliance with competitive bidding requirements. For purposes of this Section, and for construing the same term in Charter Section [371\(e\)\(10\)](#), the term "**undesirable**" shall mean and include only such situations in which **the nature of the subject of the contract is such that competitive bidding would work an incongruity or be unavailing or would not produce an advantage, with sole reference to the public interest and in light of the purposes to be accomplished.***

Staff believes that these exceptions might be applicable to investment manager searches within the Deferred Compensation Plan. However, even if they are determined to be non-applicable, staff's position would continue to be that the procurement process outlined in this report is consistent with City requirements.

Staff recommends that the Board direct staff to draft a communication from the Board to the City Attorney asking requesting a response to the staff positions and questions outlined in this report. No other process would consider as large a number of candidates, provide the Board the opportunity to view the broadest possible universe of candidates and ensure that all potential providers have an equal opportunity to be

considered and evaluated. Staff believes its proposed process creates a far greater likelihood that the end result will produce the best outcomes for Plan participants.

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
Total→	4,332	3,003

Combined Total: 7,335