

Deferred Compensation Plan BOARD REPORT 10-09

Date: April 7, 2010
To: Board of Deferred Compensation Administration
From: Staff
Subject: Investment Menu Consolidation

*Board of Deferred
Compensation Administration
Eugene, Canzano, Chairperson
Richard Kraus, Vice- Chairperson
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Recommendation:

That the Board of Deferred Compensation Administration adopt the following recommendations of the Investments Committee:

- (a) Receive and file this review of objectives and accomplishments in restructuring the Deferred Compensation Plan's core investment menu;
- (b) Approve replacement of the Plan's current large-cap investment funds with a new "DCP Large-Cap Stock Fund" which would be 100% comprised of a passively managed S&P 500 Index Fund (using the incumbent Vanguard Institutional Index Fund until the next investment manager search is conducted) and which would include funds mapped over from the elimination of the incumbent actively-managed large-cap funds;
- (c) Approve replacement of the Plan's current bond funds with a new "DCP Bond Fund" which would be comprised 50% of an actively-managed bond fund and 50% passively managed fund (using the incumbent PIMCO Total Return Fund and Vanguard Total Bond Market Fund until the next investment manager search is conducted);
- (d) Consider and take action with respect to three remaining core menu asset classes: Mid-Cap Stocks, Small-Cap Stocks, and International Stocks.

Discussion:

A. INTRODUCTION

This report contains a review of prior Board actions and current recommendations from the Investment Committee for additional actions concerning restructuring the Deferred Compensation Plan core investment menu. This restructuring has unfolded gradually over the past several years. The purpose of restructuring has been to reduce the complexity of the investment menu and thereby create an investment framework more conducive to participants developing effective asset allocation strategies appropriate for their risk tolerance.

B. BACKGROUND: OBJECTIVES AND ACCOMPLISHMENTS

At the Board of Deferred Compensation Administration meeting on May 15, 2007, the Board directed the Plan's Investments Committee to develop a proposal for restructuring the Plan's core investment options. The core elements of the restructuring include:

- (1) Reducing the number of core investment options; and
- (2) Branding funds by the Plan rather than by investment provider.

As part of its consideration, the Board issued a survey to Plan participants in 2008 on the topic of investments. The results of that survey are included within Board Report 08-26 (attached). The Board indicated the following concepts to be included as elements of this proposal:

Objectives:

- *Fund Consolidation/Plan Branded Funds* – Consolidating the Plan's investment menu into fewer core offerings and eliminating vendor-branded funds in the City's investment menu in favor of funds that would be branded by the City's Plan;
- *Plan Directed Fund Composition* – Establishing investment mandates for each asset class (i.e. determining the percentages that would be actively vs. passively managed, growth vs. value, etc.);
- *Asset Allocation Funds* – Expanding the menu of asset allocation funds;
- *Brokerage Window* – Moving to a "fuller-service" brokerage provider and/or expanding the number of investments available in the brokerage window to provide a broad range of choices to active investors outside of the core options;
- *Savings Options* – Determining an optimal structure for the Plan's savings options.

Accomplishments:

In response, the Committee developed a series of proposals, and the Board has taken on these proposals as well as related actions, to accomplish the following:

- Expansion of the Plan's asset allocation funds from 3 to 5 by adding in "Ultra-Conservative" and "Ultra-Aggressive" portfolios (completed March 2008)
- Completing a survey of Plan participants for the purpose of gauging reaction to the potential for streamlining the Plan's investment menu (completed July 2008)

- Transition from prior SDBO provider Fiserv to full service provider Charles Schwab, adding stocks, bonds, ETFs, and an expanded universe of mutual funds to the menu for SDBO participants (completed August 2008);
- Eliminating five funds for performance reasons which also helped consolidate the core investment menu (completed on various dates for the Fidelity Magellan Fund, Capital Guardian U.S. Equity Fund, Lotsoff Small-Cap Equity fund, Hartford Stock Fund and Hartford Advisers Fund)
- Adding a Mid-Cap index component to the Plan’s asset allocation funds (completed July 2009)
- Eliminating Certificates of Deposit from the investment menu (completed July 2009)
- Consolidating the Plan’s fixed account offerings into a single “City of Los Angeles Stable Value Fund” (completed July 2009)
- Restructuring the Plan’s FDIC-Insured Savings option to expand FDIC coverage using multiple providers and branded as a “City of Los Angeles FDIC-Insured Savings Account” (completed 9/30/09)

Remaining Tasks:

- *Core Option Structure* – Designing the final menu of Plan-branded core options and determining their underlying composition;
- *Investment Policy* - Codifying the adopted investment structure within a formal investment policy; and
- *Timetable* - Developing a timetable for implementation.

**C. OVERVIEW OF PROPOSED CORE OPTION STRUCTURE/
MID-CAP, SMALL-CAP, & INTERNATIONAL FUNDS**

The Committee has discussed a proposed investment menu as indicated in Attachment A. The structure of the menu essentially involves three tiers:

TIER 1 - Profile Funds: Risk-based asset allocations providing participants a simple, low-cost means of achieving diversification consistent with individual risk tolerance.

TIER 2 – Asset Class Funds: Core funds branded with the name of the City’s Plan and unique asset class.

TIER 3: Self Directed Brokerage Option: Self-directed option provides small percentage of investors interested in wider choice or active investing with the fullest menu of mutual funds, stocks, bonds, Treasuries, Certificates of Deposit (CDs) Exchange Traded Funds (ETFs), and other choices.

The following table provides a summary of the proposed new Plan investment menu including a recap of those options the Board has already implemented, those for which the Committee is making recommendations, and those for which discussion/resolution is still pending:

PROPOSED DCP INVESTMENT MENU DESIGN		
Investment Option	Structure	Status
Bank-Deposit Account	Blend of 3 Underlying Bank Providers	Implemented
Stable Value Fund	Single vendor with broadly diversified holdings	Implemented
DCP Bond Fund	50% Active/50% Passive	Committee recommends re-branding/blending current bond funds as single option
DCP Ultra-Conservative Asset Allocation Fund	Blend of Stable Value & passive funds; subject to modification once final menu determined	Implemented
DCP Conservative Asset Allocation Fund	Blend of Stable Value & passive funds; subject to modification once final menu determined	Implemented
DCP Moderate Asset Allocation Fund	Blend of Stable Value & passive funds; subject to modification once final menu determined	Implemented
DCP Aggressive Asset Allocation Fund	Blend of Stable Value & passive funds; subject to modification once final menu determined	Implemented
DCP Ultra-Aggressive Asset Allocation Fund	Blend of Stable Value & passive funds; subject to modification once final menu determined	Implemented
DCP Large-Cap Stock Fund	100% Passive Management (S&P 500 Index)	Committee recommends eliminating existing active managed large-cap funds, replacing w/100% S&P 500 fund
DCP Mid-Cap Stock Fund		Committee recommends single mid-cap fund with underlying composition to be resolved
DCP Small-Cap Stock Fund		Committee recommends single small-cap fund with underlying composition to be resolved
DCP Developed Markets/Emerging Markets International Fund(s)		Committee recommends international fund with resolution of whether developed and emerging markets components should be one fund or split into two funds, and underlying composition, to be resolved
Self-Directed Brokerage Option	Broad universe of funds, stocks, bonds, ETFs, CDs, money market funds	Implemented

The Committee is thus making the following specific recommendations relevant to the information included in the preceding table:

- (a) Approve replacement of the Plan’s current large-cap investment funds with a new “DCP Large-Cap Stock Fund” which would be 100% comprised of a passively managed S&P 500 Index Fund (using the incumbent Vanguard Institutional Index Fund until the next investment manager search is conducted) and which would include funds mapped over from the elimination of the incumbent actively-managed large-cap funds;
- (b) Approve replacement of the Plan’s current bond funds with a new “DCP Bond Fund” which would be comprised 50% of an actively-managed bond fund and 50% of an passively managed fund (using the incumbent PIMCO Total Return Fund and Vanguard Total Bond Market Fund until the next investment manager search is conducted);
- (c) Consider and take action with respect to three remaining core menu asset classes:

- **DCP Mid-Cap Stock Fund** – composition of underlying fund structure as discussed in accompanying consultant report.
- **DCP Small-Cap Stock Fund** - composition of underlying fund structure as discussed in accompanying consultant report.
- **DCP Developed Markets/Emerging Markets International Fund(s)** - composition of underlying fund structure as discussed in accompanying consultant report; and question of whether fund should be maintained as a single option or split into two options.

The primary area of debate at the Committee level concerned the question regarding to what degree the underlying composition of a fund should be actively or passively managed. Given that the Committee members had a wide range of views on this topic, the Committee believed that for the remaining asset classes it was more appropriate to have the discussion at the full Board level so that all Board members could participate. Discussion at the Board meeting of these issues will be led by staff and the consultant.

D. ASSET ALLOCATION FUNDS

The Plan's Asset Allocation, or "Profile" Funds, use the Plan's underlying passively managed options. Once the Board has determined the final structure and components of the core offerings, the issue of whether the Profile Funds will continue to use the passively managed options exclusively or will use the new blended core options should be revisited. This is an issue that can be brought back to the Board at a subsequent meeting.

E. FUND AVAILABILITY IN SELF-DIRECTED BROKERAGE OPTION

Consolidating the Plan's investment menu will result in eliminating certain funds from the Plan, or in some cases eliminating them as discrete options even if they are retained as underlying components of Plan-branded funds. Whether a fund will be eliminated depends on final decisions of the Board.

The following table provides a summary of all the Plan's current funds, whether each fund (or in the case of index funds, an equivalent fund) is available in the SDBO, and what the difference is with respect to expense ratios. Generally, it appears that all of the City's core funds, or their equivalents, can be found in the SDBO.

The most significant issue concerns the American Funds, which are available but only with a sales load. Staff is presently exploring the feasibility of an in-kind transfer of holdings in Growth Fund of America and Investment Company of America from the core menu to the SDBO, but did not have this information available at the time of finalizing this report.

Following is the table summary:

ACTIVE FUNDS	Ticker	Current Fees	Offered in SDBO?	Ticker	Fee in SDBO	12B-1 (marketing fee)	Sales Load in SDBO	Other Notes	Transaction Fee Y/N
PIMCO Total Return Fund	PTTRX	0.64%	Yes	PTTDX	0.75%	0.25%	N	n/a	N
Investment Co. of America	AIVSX	0.59%	Yes	AIVSX	0.59%	0.23%	5.75%	Must trade thru Rep	N
Growth Fund of America	AGTHX	0.59%	Yes	AGTHX	0.76%	0.25%	5.75%	Must trade thru Rep	N
Hartford Capital Appreciation	HIACX	0.67%	No	ITHAX	1.11%	0.25%	N	n/a	N
Lazard Mid-Cap Institutional	LZMIX	0.89%	Yes	LZMOX	1.15%	0.25%	N	n/a	N
Fidelity Diversified Intl	FDIVX	1.01%	Yes	FDIVX	1.01%	n/a	N	n/a	Y

INDEX FUNDS		Current Fees	Available in SDBO?	Ticker	Fee in SDBO	12B-1 (marketing fee)	Sales Load in SDBO	Other Notes	Transaction Fee Y/N
Vanguard Total Bond Index	VBPIX	0.08%	Yes	VBMFX	0.22%	N	N	n/a	N
Vanguard Institutional Index	VIIIX	0.025%	Yes	VFINX	0.18%	N	N	n/a	N
State Street Russell 2000	N/A	0.06%	No	Various	n/a	n/a	n/a	n/a	n/a
Vanguard Mid-Cap Index Instl	VMCIX	0.09%	Yes	VIMSX	0.27%	N	N	n/a	N
DWS EAFE Equity Index	BTAEX	0.52%	No*	Various	n/a	n/a	n/a	n/a	n/a

* \$1 million balance requirement

F. IMPLEMENTATION

Once final decisions are rendered regarding all core menu classes, and questions resolved regarding how procurement processes will be conducted in the future, staff can proceed to develop a timetable for implementing the changes. The timetable would include the timing of investment manager searches, communications to Plan participants, and fund consolidation.

G. COMMUNICATION

One of the cornerstones of the Board's redesign process has been ongoing communication with Plan participants as it has both considered and implemented changes. The elimination and/or consolidation of investment options has been extremely successful with respect to participant reaction to these changes, and staff believes it is important to maintain this commitment going forward. This will help not only with making the adjustment to these changes, but more importantly in understanding how to effectively use a redesigned investment menu to achieve better asset allocation outcomes.

Submitted by: _____
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