DEFERRED COMPENSATION PLAN
BOARD REPORT 07-16

EMPLOYEE BENEFITS DIVISION

Date: May 2, 2007

To: Board of Deferred Compensation Administration

From: Staff

Subject: Investment Menu Design Discussion: Fund Consolidation & Plan-Branded Investment Options

Recommendation:
That the Board of Deferred Compensation Administration consider information within this report regarding Fund Consolidation & Plan-Branded Investment Options and, should the Board endorse the concept generally, refer the matter back to the Investments Committee to develop a proposal for phased implementation once other investment design issues have been resolved.

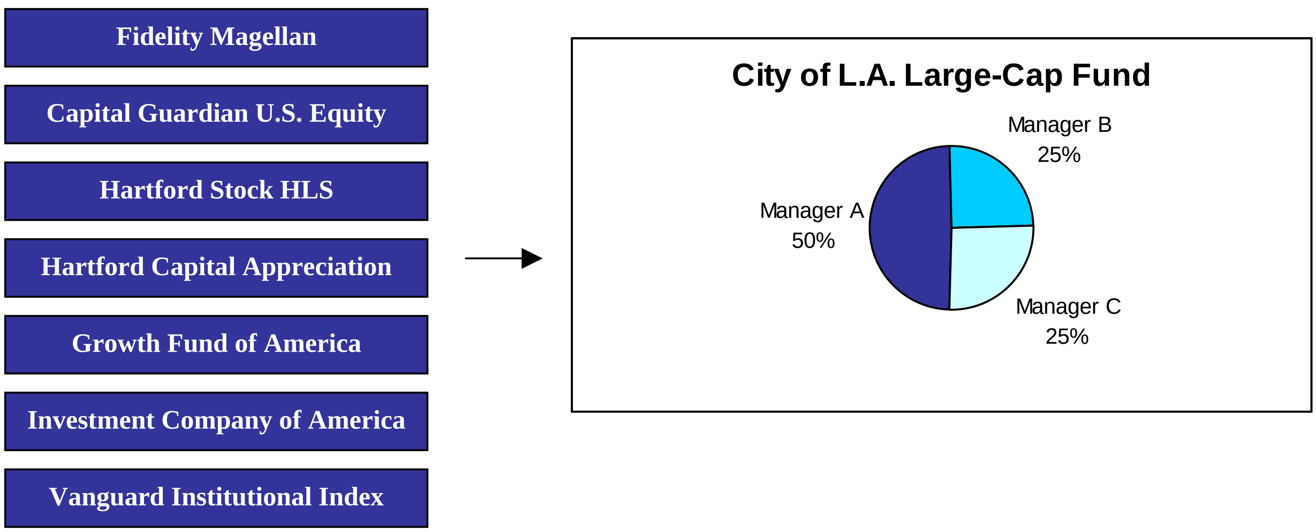
Discussion:
As the Board is aware, the Investments Committee has been studying a number of potential Plan design improvements to the Plan's investment menu. These potential improvements may be summarized as follows:

- *Fund Consolidation/Plan Branded Funds* – Consolidating the Plan's investment menu into fewer core offerings and eliminating the vendor-branded funds in the City's investment menu in favor of funds that would be branded by the City's Plan (e.g. the "City of Los Angeles Large-Cap Fund");
- *Plan Directed Fund Composition* – If the City moved to Plan branded funds, the Board (on the advice of its consultant) would establish investment mandates for each asset class, for example determining the percentages that would be actively vs. passively managed, growth vs. value, etc.;
- *Asset Allocation Funds* – The Plan could either maintain or expand its menu of risk-based asset allocation funds or move to "target date" asset allocation funds;
- *Brokerage Window* – The City could move to a "fuller-service" brokerage provider and/or expand the number of investments available in the brokerage window;
- *Savings Options* – The City could either move to a single stable value offering or maintain both its stable value and cash savings options;
- *Managed Account Service* - The City could provide a service allowing Plan participants to pay a fee in exchange for having their assets externally reviewed, invested and re-balanced over time.

This report will address the first issue: the potential for reducing the number of core Plan offerings and branding all menu options by the Plan rather than by the investment provider. The Investments Committee, in considering independent recommendations from staff, the consultant and Plan Administrator, found unanimous support from all three for both consolidating Plan investment options as well as branding investment choices by Plan and asset class.

What is Fund Consolidation and Plan-Branding? Fund consolidation and Plan branding involve replacing the current array of provider-branded funds with Plan-branded funds comprised of one or more investment managers within each fund. As an example, the City's seven large-cap investment funds could be consolidated to a single "City of L.A. Large-Cap Fund" as illustrated below:

Current Provider-Branded Large-Caps **Potential City-Branded Large-Cap**



Why Consider Fund Consolidation?

- Reduce Participant Confusion – There is ample research in the investment community indicating that providing defined contribution participants a longer list of investment options results in them making poorer asset allocation decisions. Part of the reason for this is that participants often have difficulty in conceptualizing investment choices in terms of asset class. When funds are branded by investment providers, participants tend to be drawn to recognized names and/or recent performance returns. As a result, a participant might choose four different large-cap funds based on name recognition and recent performance, thinking that by choosing multiple funds he or she has spread out the investment risk. In fact, however, investment risk has been concentrated in a single market sector. The City's Plan has the largest potential for this in its Large-Cap asset class, which presently contains seven investment options fitting into this class, six of them actively managed. (It is worth noting that depending on the time frame being reviewed, the six actively managed funds are roughly split between under-performing or out-performing the S&P 500, the benchmark index used for most of them.)

Why Consider Plan-Branding?

- Encourage Diversification - As mentioned above, there is a tendency for Plan participants to make investment decisions based on name recognition rather than as part of a well-considered asset allocation strategy. Consolidation can help relieve this problem, but it cannot eliminate it completely. If a plan offers 10 core investment options branded by provider, participants may still choose, for example, the large-cap provider whose name is familiar, rather than diversifying into other asset classes if those provider names are not recognized. To address this issue, some other larger 457 plans (e.g. City of New York and County of L.A.) have moved or are moving towards branding by their own Plan name and the applicable asset class. This encourages investment diversification because investors, quite simply, will no longer be able to conceptualize their choices in terms other than asset class.
- Create Fee Efficiency - Another important advantage of Plan branding is that it promotes the Board's use of "institutional" investment offerings (separate accounts and commingled funds) which tend to have lower investment management expenses than traditional retail mutual funds. Brand-name mutual funds, once established in a Plan, are difficult to eliminate because participants become attached to the brand names. However, if the Plan offers single funds in each asset class, the underlying managers will be retained based on, among other factors, the competitiveness of their fees. As an example, the table below compares the average costs of the City's funds vs. the cost of New York City's funds in the major core stock/bond categories. Keep in mind that the City's fees represent the average fees of its multiple funds, while New York City only offers one fund per category (although it has multiple managers within each fund). The cost differentials on all but one category are substantial:

FEE COMPARISON			
Asset Class	**City of L.A.**	**New York City**	**Difference**
Bond	0.25	0.29	$ 0.04
Large-Cap	0.46	0.04	$ (0.42)
Mid-Cap	0.93	0.57	$ (0.36)
Small-Cap	0.58	0.42	$ (0.16)
International	0.74	0.38	$ (0.36)

- Improve Mobility – The Board will likely have greater mobility to change investment managers in a Plan-branded environment, because the communications challenges associated with a provider-branded environment will have been eliminated. Participant reaction to fund changes may prolong or delay the decision-making process because participant reaction ends up being a factor in making that decision. This factor is eliminated in a Plan-branded environment. Although changes to managers within, for example, a hypothetical "City of L.A. Large-Cap Fund" would certainly be communicated to participants, participants would almost certainly not have formed attachments to those managers and thus replacements would provoke little reaction.

Downside to Consolidation/Plan-Branded Funds – The downside to restructuring the Plan's investment menu in the manner suggested in this report is that there will be negative reaction from many participants in eliminating existing favorite funds. To some extent this could be mitigated if some of the eliminated funds could be offered through the Plan's brokerage window. However, the brokerage window is not a complete safety valve because some of the funds offered by the City are institutional products that would not be available on a retail basis (e.g. the Capital Guardian U.S. Equity Fund) or are funds with front-end loads associated with their retail versions (e.g. the two American Funds).

However, in speaking with the City of New York Plan Manager, Beth Kushner, Ms. Kushner indicated that participant reaction to their consolidation was not unmanageable. She indicated that although there were some participants who reacted negatively, over a relatively brief period of time participants were able to work through the changes and adjust to the new environment. Ms. Kushner indicated that from her perspective the short-term negatives experienced by Plan participants were more than outweighed by the long-term positives produced by creating an investment menu that was less expensive and easier for participants to understand.

Next Steps – Should the Board endorse the concept of consolidation and Plan-branded funds, staff recommends that the matter be referred back to the Investments Committee for development of a proposal to implement the changes. However, staff recommends that the Investment Committee not begin working on the implementation plan until the Board has addressed the other key issues previously identified for Board review by the Investments Committee. In staff's view it is particularly important when contemplating implementation strategies to address all of these issues from a global perspective.

Submitted by: ____________________________
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