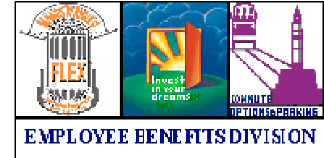
BOARD OF DEFERRED COMPENSATION ADMINISTRATION

MARGARET WHELAN
CHAIRPERSON

BILL STEIN
VICE-CHAIRPERSON
--
EUGENE K. CANZANO
MICHAEL CARTER
JOYA C. DE FOOR
RICHARD KRAUS
RICK ROGERS

DEFERRED COMPENSATION PLAN
BOARD REPORT 07-17



Date: May 2, 2007

To: Board of Deferred Compensation Administration

From: Staff & Mercer Investment Consulting

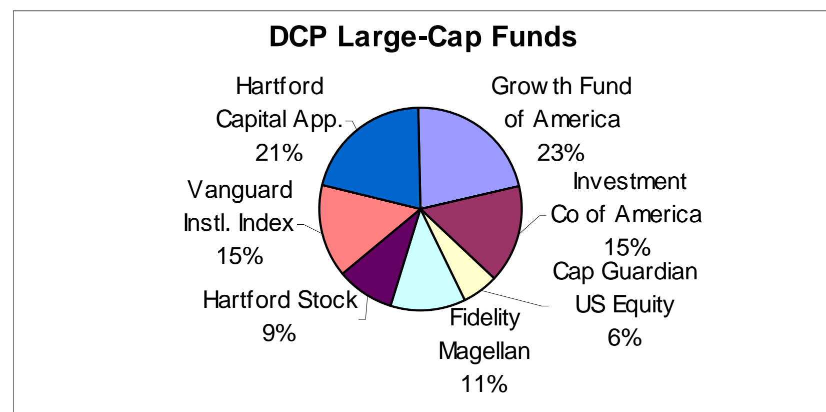
Subject: Fidelity Magellan & Lotsoff Small-Capital Equity Fund

Recommendation:
That the Board of Deferred Compensation Administration consider eliminating the Fidelity Magellan Fund and Lotsoff Small-Cap Equity Funds approximately six months following the date of announcement of this elimination to Plan participants, with any existing assets mapped to the Plan's passively managed large-cap and small-cap funds, respectively.

Discussion:
At the Board's April 17, 2007 meeting, staff and the Board's consultant, Mercer Investment Consulting, were asked to return with a report and recommendation with respect to the two funds on "Watch" status in the City's Plan, the Fidelity Magellan and Lotsoff Small-Capital Equity Funds. Staff and the consultant have reviewed several options and are prepared to make a recommendation. Also per the Board's request, Mercer has also prepared 10-year performance returns for each of these funds (attached).

As noted by the consultant, both funds have been under-performing in key three and five year performance categories and, given the depth of the under-performance, are unlikely to be able to correct that under-performance in the next several quarters. The Board has the latitude within its investment policy regarding fund removal to eliminate a fund if the fund has been on "Watch" for a minimum of two consecutive quarters – that threshold has already been crossed.

Magellan Fund – As indicated in Board Report 07-17, staff supports consolidation of the Plan's investment options to eliminate redundancy and simplify choices for Plan participants. Nowhere is that redundancy more acute than in the Plan's Large-Cap category, where there are presently seven funds that can be grouped in this class. The Magellan Fund represents 11% of the Plan's $1.2 billion in Large-Cap investments, and 5% of overall Plan investments.



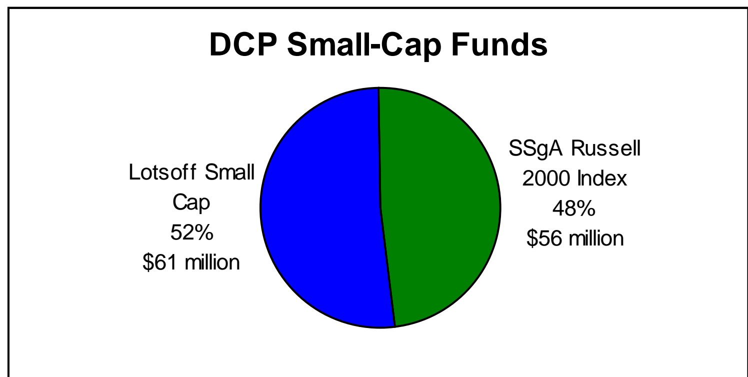
If the Board chose to eliminate the Magellan Fund, staff recommends that the Board utilize the same approach used when it acted in October 2006 to eliminate the MSIF Trust Core Plus Fixed Fund. In that action, the Board voted to leave the Fund in the Plan, open to new investments, for a period of approximately six months following the announcement of its elimination to Plan participants. This would provide Plan participants ample time to move their assets on their own initiative if they chose to.

With respect to where the funds should be mapped upon point of elimination, staff and the consultant recommend that they be moved to the Plan's passively managed large-cap fund (the Vanguard Institutional Index Fund). The index fund represents the benchmark used for all the Plan's large-cap funds and has the further benefit of having the lowest expense ratio, 2.5 basis points, of all the large-cap funds, vs. Magellan's fees of 56 basis points.

In communicating this change to Plan participants, staff proposes that the Board indicate that the action was taken both because of Magellan's under-performance as well as to eliminate redundancy and help simplify investment choices for Plan participants. It is important to note that the Magellan Fund is still closed to new investors, which means that participants unhappy with its elimination would not be able to invest in it through the Plan's brokerage window.

Lotsoff Small Capital Equity Fund – Elimination of this Fund due to under-performance may be considered more problematic because the City's Plan has only one alternative small-cap investment option, and it is passively managed. However, even if there were alternative actively managed small-cap funds in the City's Plan, upon termination staff and the consultant would still recommend that remaining assets be mapped into the Plan's passively managed small-cap fund. Fees would be reduced for these participants from 0.95% to 0.20%. In addition, as indicated by the Board's consultant at the April 17, 2007 meeting, finding replacement actively managed funds in this category might be difficult in any event given that so many small-cap funds have closed themselves to new investors.

Further, per Board Report 07-16, if the Board adopted the recommendation from staff, consultant and Plan administrator for consolidated Plan-branded funds, eventually there would only be a single small-cap offering in the Plan. Within that single small-cap fund the Board, on the advice of its consultant, would establish parameters for the percentages that would be actively vs. passively managed. As a result, eliminating the Lotsoff Fund within approximately six months (in the same time-frame as the Magellan Fund), would be largely consistent with this potential longer-term restructuring of the Plan's investment options.



However, Lotsoff Small Capital Equity is another fund that would not be reachable through the Plan's brokerage window because Lotsoff is an institutional money manager, not a retail fund provider. Given the severity of recent under-performance, it is possible that elimination

of this Fund might engender more resistance from its participants as its recent losses, relative to its benchmark, have been much more severe than Magellan's relative losses. From a participant communications perspective, similar to the approach recommended for the Magellan Fund, staff proposes that the Board indicate that the action was taken due to Lotsoff's severe under-performance.

Broader Considerations – Mercer advises that one of the risks posed in eliminating an under-performing fund is that the fund may out-perform following its elimination. This is a particular risk in a fund such as Lotsoff Small Capital Equity, where the Mercer data indicates that the Fund has exhibited periods of significant out-performance. If this were to happen some former participants in the Fund might be even further distressed.

Participants become attached to specific fund names and their specific performance. However, in an investment menu in which the Plan offered, for example, a single fund in each primary asset class, participants might be distressed by under-performance of the portfolio as a whole, but not by specific manager replacements. For example, if the Board created a "City of L.A. Small-Cap Fund" which had three underlying managers (e.g. a passive manager, an active growth manager, and an active value manager) the replacement of, say, the active growth manager for under-performance would be fairly innocuous to participants in the Fund. As a result, the challenges presented by the under-performance of these two funds provide an opportunity for the Board to consider the merits of an alternative investment menu design discussed in Board Report 07-16.

Submitted by: ___________________________
Steven Montagna

Approved by: ___________________________
Maryanne Keehn