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# DEFERRED COMPENSATION PLAN
# BOARD REPORT 07-23

EMPLOYEE BENEFITS DIVISION

Date: June 7, 2007

To: Board of Deferred Compensation Administration

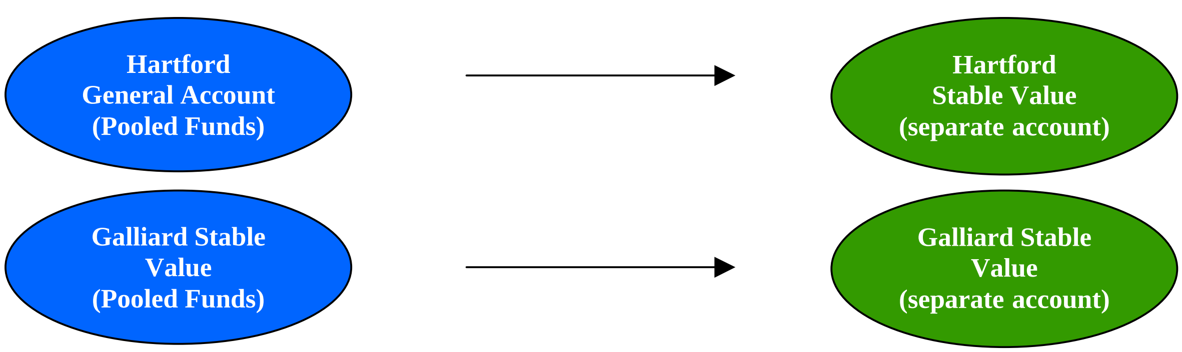
From: Staff

Subject: Consolidation of Stable Value Funds

Recommendation:
That the Board of Deferred Compensation Administration (a) approve staff's proposed modification to the conversion plan for the Hartford and Galliard funds to provide that while both funds will still be migrated to separate accounts, they will maintain their discrete identities as separate investment funds under the Plan until such time as the holdings in both separate accounts can be placed out to competitive bid; and (b) that the Board authorize the immediate release of an RFP for a wrap service provider for the Hartford funds.

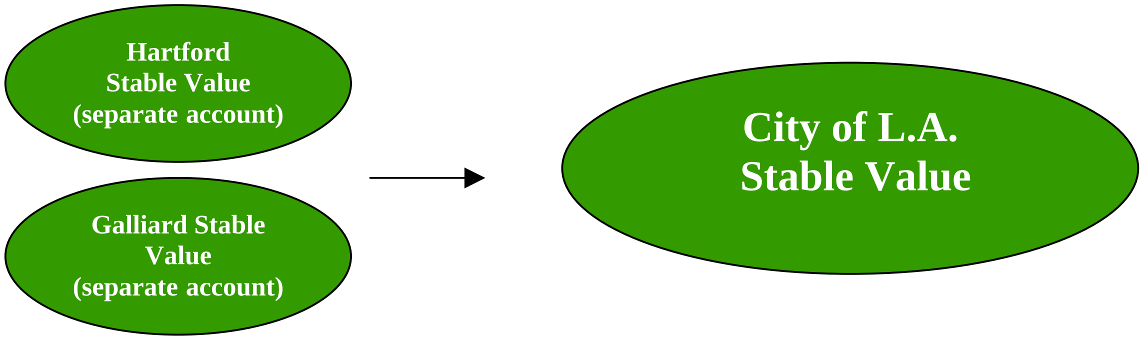
Discussion:
The Board previously approved a restructuring of the Plan's fixed account assets, which include the Hartford General Account and Galliard Stable Value Fund. This restructuring contained three essential elements:

(1) Moving funds in the Hartford General Account and Galliard Stable Value Fund out of their "pooled" accounts (in which the City's assets are mixed in with assets from other plans) and into "separate account" structures where the assets would be held separately from other plans:




(2) The dual migration from the "pooled" to "separate account" structures would take place over 1-3 years (three years for Hartford, one year for Galliard) – however, in the

meantime, the Hartford and Galliard assets would be combined for recordkeeping purposes into a single "City of Los Angeles Stable Value Fund" which would represent a blending of the rates earned in both products and would eliminate the "equity wash"[1] restriction on transfers between the two funds.




(3) At the end of the three-year transition process, both accounts would be held entirely in separate account structures, providing the Board with broad flexibility in going out to bid for a stable value manager.

The Board approved initiating this consolidation process in October 2007. Staff and the Board's consultant, Mercer Investment Consulting, have been working with Hartford and Galliard on implementation. As part of that work, Mercer recently prepared some modeling on what the effect of the consolidation would have on the rates of return provided to Plan participants.

Hartford presently has $312 million in Plan assets. The current declared rate on those assets is 4.10%. Under the phased consolidation plan, Hartford would liquidate $100 million each year from its General Account to a new Separate Account. Based on today's rates, Hartford and Mercer expect that the first year's assets could be re-invested at a rate of approximately 5.20%. Galliard has a current rate of 4.86%.

| | Assets | Current Rate |
|---|---|---|
| Hartford: | $312M | 4.10% |
| Galliard: | $120M | 4.86% |
| | | |
| Projected Initial Combined Rate: | | 4.61% |
| | | |
| Initial Loss to Galliard participants: | | 0.25% |

In staff's view this projected initial loss for Galliard participants was too high. While the combined portfolio would provide a higher rate for Hartford participants, it would result in a rate reduction for Galliard participants. Staff requested that Mercer consider the possibility of an alternative approach: (1) continuing with the plan of transitioning both the Galliard and Hartford pooled accounts to separate account structures; while (2) delaying the consolidation

[1] "Equity wash" refers to a 90-day restriction placed on participants from being able to transfer funds out of the underlying fund into what is considered a "like investment." Funds must effectively be held in equities for 90 days. Consolidating the Hartford and Galliard funds would eliminate the equity wash restriction between those two funds, but the combined account would still have an equity wash restriction on transfers to the Washington Mutual Liquid Account and CDs.

of the two accounts until both accounts have been fully transitioned to separate accounts and the entire pool of funds can be placed out to competitive bid.

The benefits of this alternative approach are that it would (a) provide an immediate increase in yield for Hartford General Account participants but (b) not reduce the rate of return for Galliard participants (in fact, Mercer advises that Galliard participants would also likely see an increase in yield based on the current interest rate environment). As a result the conversion of the Hartford and Galliard to their respective separate account portfolios will increase the crediting rates for participants in each of these two funds.

Staff and Mercer are working with Hartford and Galliard to address potential implementation issues. Since in effect the Plan would be having both Hartford and Galliard "wrap" their existing pooled products with their new separate account portfolios and separate accounts together and provide blended rates, certain logistical issues would need to be addressed. Mercer has advised that it would be prudent to secure the services of an outside firm to provide the "wrap" of Hartford's two accounts, rather than having Hartford do it, because Hartford does not have prior experience providing this service. As a result, it would be necessary for the Plan to issue a Request for Proposal (RFP) for these services. This RFP would have to be processed in an expedited fashion in order to begin implementation of the Hartford transition by October 2007, which would be optimal given the length of time it would take for the transition to be completed and the length of time remaining on the Hartford contract.

As a result, staff is requesting two actions from the Board: (a) approve the modification to the conversion plan for the Hartford and Galliard funds to provide that while both funds will still be migrated to separate accounts, they will maintain their discrete identities until such time as the holdings in both separate accounts can be placed out to competitive bid, which will occur in approximately three years; and (b) authorize the immediate release of an RFP for a wrap service provider for the Hartford funds.

Given the current disparity in the rates offered by the Hartford and Galliard products, staff and Mercer believe this approach is optimal because it would provide an immediate increase in yield for both Hartford and Galliard participants but still place these assets on track for ultimate consolidation. At the end of three years these assets would be combined following a competitive bid process. Once combined, the City's Plan will have a single pool of stable value money and equity wash limitations between the existing fixed account offerings will have been eliminated.

Submitted by: ____________________________
Steven Montagna

Approved by: ____________________________
Maryanne Keehn