DEFERRED COMPENSATION PLAN
BOARD REPORT 07-29

EMPLOYEE BENEFITS DIVISION

Date: July 9, 2007

To: Board of Deferred Compensation Administration

From: Staff & Mercer Investment Consulting

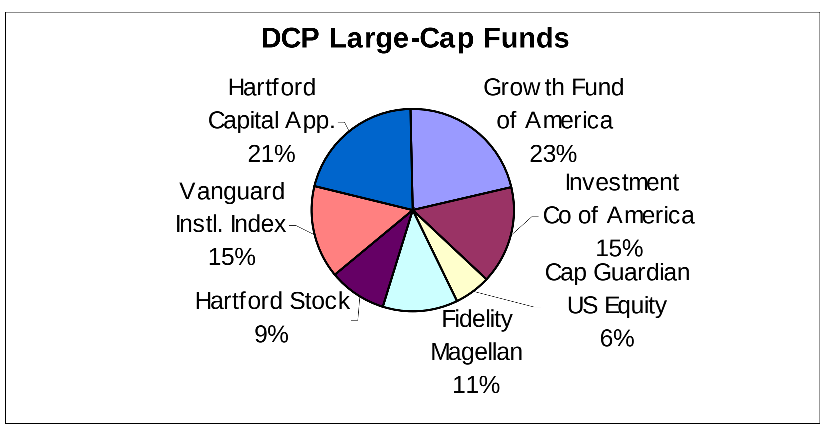
Subject: Fidelity Magellan & Lotsoff Small-Capital Equity Fund

Recommendation:
That the Board of Deferred Compensation Administration terminate 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, while retaining the option to postpone or cancel termination of the Lotsoff Capital Equity Fund based on ongoing monitoring of its performance over this six-month period.

Discussion:
At the Board's May 15, 2007 meeting, staff and the Board's consultant, Mercer Investment Consulting, provided 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. The Board was unable to take any action at that point in time because the Board's counsel, Deputy City Attorney Richard Bobb, advised that potential conflict-of-interest issues involving Board members and the two funds would first need to be investigated and resolved. Mr. Bobb subsequently advised that the Board was free to move forward.

As noted in the consultant's report, 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 prior reports, 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.

Given the Large-Cap redundancy, and given Magellan's severe and long-standing under-performance, staff recommends that the Board act to terminate the Magellan Fund from the Plan. With respect to the timing of this change, staff further 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 provided Plan participants ample time to move their assets on their own initiative if they chose to.

With respect to where these assets 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 – 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 Mercer data indicates that the Fund has exhibited periods of significant out-performance as well as under-performance.

In addition, elimination of this Fund may be considered more problematic because the City's Plan has only one alternative small-cap investment option, and it is passively managed. Also, there are some very recent and tentative indications of Fund out-performance relative to its benchmark. However, given the severity of the prior under-performance, staff believes it is incumbent upon the Board to take action at the present time.

Staff therefore recommends that the Fund be eliminated and its assets mapped into the Plan's passively managed small-cap fund. Fees would be reduced for these participants from 0.95% to 0.20%. However, staff further recommends that the Board maintain the option to reverse its decision if the Fund is able to generate substantial out-performance over the six-month period. Performance will be reported to the Board at each monthly meeting.

This Fund would not be reachable through the Plan's brokerage window because Lotsoff is an institutional money manager, not a retail fund provider.

<u>Conclusion</u>:
Staff believes that elimination of the Magellan Fund is an appropriate response to the Fund's exceptionally long period of under-performance, and is consistent with the principle of consolidating redundant investment offerings within the Plan. Staff believes that its

recommended action for the Lotsoff Fund is a balanced way for the Board to move forward in exercising its investment oversight responsibilities while still retaining some flexibility in the event the Fund can exhibit sustained signs of having turned around its performance.

Submitted by: ____________________________
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