DEFERRED COMPENSATION PLAN
BOARD REPORT 08-37

EMPLOYEE BENEFITS DIVISION

Date: October 1, 2008

To: Board of Deferred Compensation Administration

From: Staff

Subject: Vanguard Total Bond Market Index Fund

Recommendation:
That the Board of Deferred Compensation Administration decline offer from Vanguard to transfer assets from our current fund, Vanguard Total Bond Market Index Fund #222 to the Vanguard Institutional Total Bond Market Index Fund #337, and retain Fund #222 until it can be demonstrated that the performance net of fees for Fund #337 outperforms the current fund.

Discussion:
The City of Los Angeles Deferred Compensation Plan currently invests in the Vanguard Total Bond Market Index Fund #222, with an expense ratio of 7 basis points. Once the invested balance reaches $100 million, the Plan is eligible for investment in the Vanguard Institutional Total Bond Market Index Fund #337, with an expense ratio of 5 basis points. Fund #337 is not a share class of Fund #222; it is a separate and distinct mutual fund.

According to an analysis performed by the Plan's consultant, Mercer Investment Consulting, while each fund has tightly tracked the benchmark (less management fees and an allowance for transaction costs), Fund #222 has historically outperformed Fund #337. The primary reason is because they are independent funds with different cash flow patterns, different numbers of holdings, and slightly different characteristics even though they employ a similar sampling methodology.

When comparing the two funds, the net-of-fees performance is consistently higher in Fund #222, despite a fee that is 2 basis points higher. This is due primarily to the smaller size of Fund #337 ($7.6 billion vs. $11.1 billion), which leads to higher trading costs. With an index fund, the larger size enables the manager to buy more bonds in round lots and trade more efficiently. In our current Fund #222, there are 3,410 holdings as opposed to only 2,595 holdings in Fund #337. This greater diversification explains why Fund #222 is tracking the index more closely. In addition, larger cash flow movements in Fund #337 with a smaller asset base is also affecting performance.

With respect to the above information, staff would recommend that the Board of Deferred Compensation retain Fund #222 until it can be demonstrated that Fund #337 outperforms the current fund net of fees. The Plan's consultant, Mercer Investment Consulting will track performance on both Fund #222 and Fund #337 and the matter will be revisited if performance trends change.

Submitted by: ____________________________
Natasha Zuvich

Reviewed by: ____________________________
Steven Montagna

Approved by: ____________________________
Maryanne Keehn