Deferred Compensation Plan
BOARD REPORT 11-30

Date: May 6, 2011

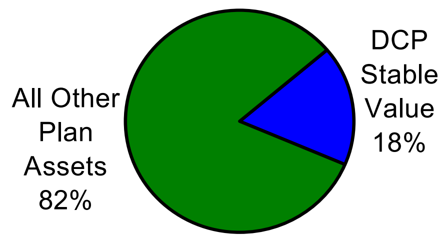
To: Board of Deferred Compensation Administration

From: Staff

Subject: Stable Value Fund

Recommendation:
That the Board of Deferred Compensation Administration approve staff's proposed correspondence from the Board to Galliard Capital Management regarding the application of equity wash provisions to the Plan's Self-Directed Brokerage Option.

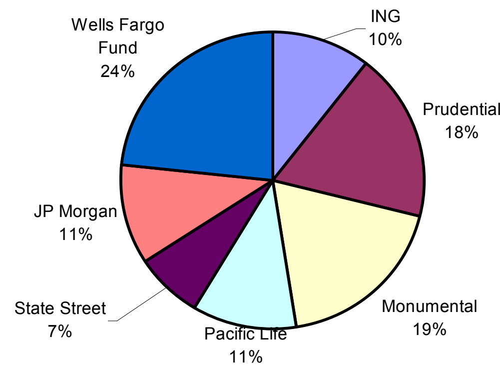
Discussion:
The Deferred Compensation Plan Stable Value Fund is a core investment option in the City's Plan. The Fund has more assets than any single investment option in the City's Plan – almost $700 million out of $3.2 billion. The incumbent manager of this option is Galliard Capital Management ("Galliard").



What is a Stable Value Fund? A stable value portfolio operates essentially as a bond fund with a provision, or "wrap," allowing participants to transact at a stable price. Because stable value funds can hold bonds with a 3-5 year time horizon, they typically offer higher rates of return than bank deposit accounts or money market funds.

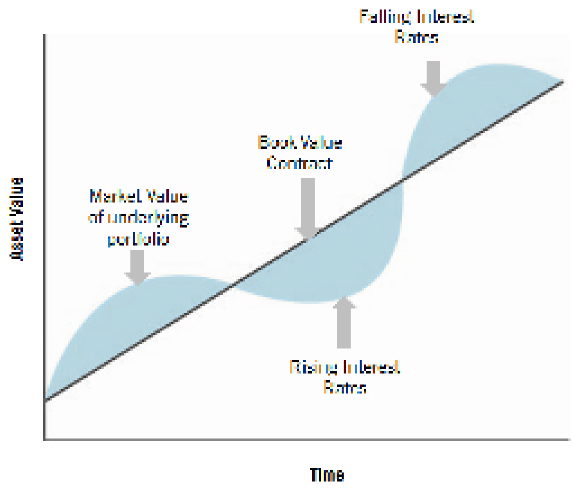
How Are Stable Value Funds Administered? Stable value funds have two levels of administration: (1) a **fund manager** functions as the investment manager and makes investment decisions, while (2) **"wrap providers"** (insurance companies or other financial institutions) issue wrap contracts providing the stable pricing for the fund. In the City's case, Galliard is the investment manager, and there are six insurance companies and banks that have issued wrap contracts for some portion of the overall portfolio.

GALLIARD MANAGES ASSETS
INSURANCE COMPANIES/BANKS ISSUE WRAP CONTRACTS



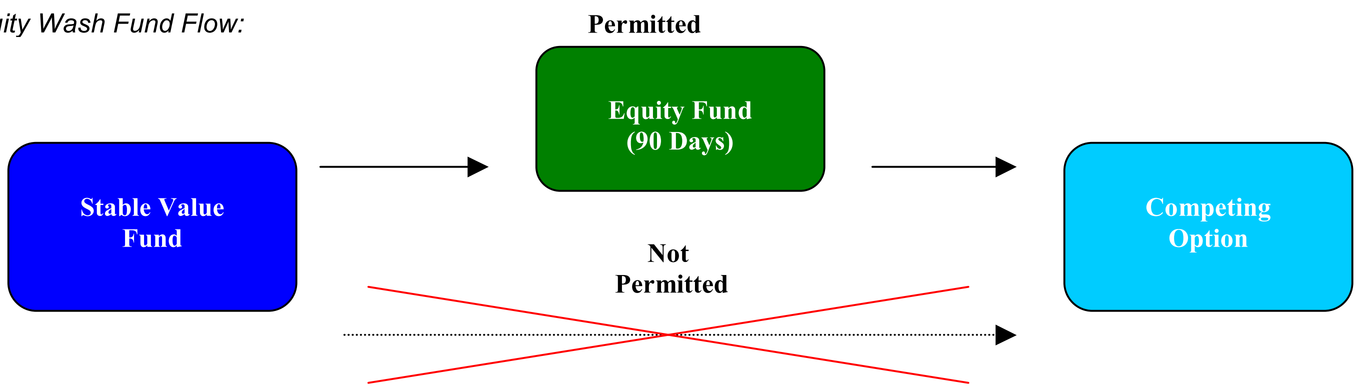
How Do Wrap Contracts Work? Stable value funds provide stable pricing through wrap contracts. Wrap contracts allow participants to transact at a portfolio's "book value." **Book value** refers to the original purchase cost of portfolio holdings plus their accumulated interest. Book value is different from **market value**, which is the price at which the portfolio's holdings are valued by the bond market at any given point in time.

Wrap providers must manage the risk of participant redemptions occurring when the market value of a portfolio is less than its book value. In periods of low or stable interest rates, where market value is equal to or greater than book value, there is little risk of loss from excessive redemptions. However, in periods of rising interest rates and falling bond prices, the risk of loss rises. To manage their risk in guaranteeing book value pricing, wrap providers impose a restriction on the ability of participants to exit the fund. This restriction is called "equity wash."



What is Equity Wash? "Equity wash" is a trading restriction. An equity wash prevents investors from moving directly from a stable value fund to any plan investment options deemed to be "competing" options. Competing options are generally short-term investments including bank deposit accounts, money market funds, or short duration bond funds. Equity wash provisions typically require that funds be transferred into a non-competing stock or intermediate or longer duration bond option and maintained there for 90 days before they can be invested in the competing option.

Equity Wash Fund Flow:



The purpose of the equity wash is to discourage participants from chasing higher interest rates in competing options and therefore creating substantial asset outflows from the stable value fund in a very short period of time. Such outflows can be detrimental to the remaining fund shareholders since those shareholders must absorb losses through a reduced rate of return. As previously indicated, stable value participants are allowed to redeem their investment at book value. When a fund manager is forced to liquidate a large amount of holdings at prices lower than book value, the book value accounting treatment for the fund allows for those market value losses to be amortized over time through a reduction in the rate of return credited to fund participants.

How is Equity Wash Applied in the City's Stable Value Fund? For the City's Stable Value Fund, the only competing fund presently subject to equity wash is the FDIC-Insured Bank Deposit Account. However, staff has been made aware by Galliard that the City account's wrap providers have indicated they may expand this to include the Plan's Self-Directed Brokerage Option (SDBO).

Why are the City Fund's Wrap Providers Considering Extending Equity Wash to the SDBO? After the 2008 financial crisis occurred the number of insurance companies willing to write wrap contracts began shrinking, as there was a general interest in reducing risk exposure. Fewer providers meant less competition, and less competition has made it easier for wrap providers to raise fees and press for more conditions/restrictions in exchange for writing wrap contracts. One of the more recent trends among these conditions is extending equity wash restrictions to SDBOs since they include virtually limitless competing options in the form of short-term fixed income, money market, and other interest-bearing options (e.g. certificates of deposit).

Should Equity Wash Be Applied to the SDBO? As outlined in the attached draft correspondence, staff's research indicates that there is a questionable basis for applying an equity wash to the City's SDBO. Equity washes are designed to prevent *en masse* fund transfers, not occasional ones. Although the theoretical risk for en masse transfers to the SDBO exists, staff's review indicates that in fact these types of transfers have not occurred in the City's Plan across a broad range of market conditions. The data to support this comes from the history of asset flows in the Plan's stable value fund, SDBO, and FDIC-Insured Bank Deposit Account.

Staff has reviewed this issue with the Board's investment consultant, Mercer Investment Consulting. Mercer confirms they are seeing similar restrictions being imposed upon other plans. Nevertheless, they concur it is worthwhile for the Plan to question the basis for applying an equity wash provision to the City's SDBO, as it would be in the best interest of participants to avoid such a constraint. Staff recommends that the Board, on behalf of Plan participants, send the proposed correspondence to Galliard so that Galliard can in turn communicate the City's position to the City's wrap providers.

Submitted by: ____________________________

Steven Montagna

Reviewed by: ____________________________

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