

Deferred Compensation Plan BOARD REPORT 11-51

Date: July 13, 2011
To: Board of Deferred Compensation Administration
From: Staff
Subject: Fund Migration Options

*Board of Deferred
Compensation Administration
Eugene C. Canzano, Chairperson
John R. Mumma, First Provisional Chair
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Recommendation:

That the Board of Deferred Compensation:

- (a) Retain its original schedule for migration of large-cap funds, including Growth Fund of America, to take place in early 2012;
- (b) Accelerate migration of the Lazard Mid-Cap Fund to occur simultaneously with migration of the Plan's actively managed large-cap funds; and
- (c) Retain its original schedule for migration of the Fidelity International fund to take place in the third quarter of 2012.

Background:

At the Board's June 21, 2011 meeting, the Board requested that staff return with an option for potential accelerated migration of three underperforming funds to its new investment menu:

- Growth Fund of America
- Lazard Mid-Cap Fund
- Fidelity Diversified International Fund

Each of these funds has exhibited underperformance over recent evaluation periods (1-year, 3-years, and/or 5-years). Each of these funds has also been placed onto either "Monitor" or "Watch" status. "Monitor" means that areas of concern related to performance, style drift, and/or fund management have been identified by the consultant but typically not to a degree that places the fund in direct danger of elimination. "Watch" means that areas of concern have been identified by the consultant to a more severe degree and warrant placing the fund under danger of elimination.

The Board's previous schedule for transitioning the current investment menu to the Board's recently established new menu is provided as an attachment. In sum, transition of the Plan's large-cap funds was scheduled for the first quarter of 2012, and transition of the Plan's mid-cap, small-cap and international funds was scheduled for the third quarter of 2012.

Staff has reviewed this matter with the Plan administrator and consultant in developing the following recommendations. Both parties are in concurrence with these recommendations. Staff will address each fund and its asset class separately:

Fund: Growth Fund of America
Asset Class: Large-Cap Stocks
Assets: \$245,083,299
Participants in Fund: 9,374
Current Review Status: Monitor
Recommendation: Migrate Fund in early 2012

Growth Fund of America is presently scheduled to be migrated to the Plan's Vanguard Institutional Index Fund in approximately 7-9 months (a precise date yet to be determined that would take place within the January-March quarter of 2012). This migration was occur simultaneously with migration of the Plan's two other actively managed large-cap funds: Investment Company of America and Hartford Capital Appreciation Fund.

Growth Fund of America is presently on Monitor status, but has demonstrated significant underperformance relative to its benchmark index over all recent evaluation periods:

	3 Months	1 Year	3 Year	5 Year
Growth Fund of America	5.4%	13.9%	1.7%	2.7%
Benchmark: Russell 1000 Growth	6.0%	18.3%	5.2%	4.3%

Two options exist for an accelerated migration of Growth Fund of America: either by itself or together with the other two funds noted above. Following discussion with the Plan's third-party-administrator, Great-West Retirement Services, staff determined that an acceptable earlier implementation date for migration of either (1) GFA alone or (2) GFA, ICA and Hartford Capital Appreciation as a group, could take place in approximately late October/early November, 2011. This would accelerate migration by approximately three months. This proposed implementation date takes into account development of the necessary communication materials and the 30-day advance notice requirement to Plan participants required under Federal regulations.

Given the small time gap (three months) between an accelerated migration of Growth Fund of America and the planned migration of the other two actively managed large-cap funds, staff recommends that if the accelerated date is chosen, all three funds should be migrated at the same time.

However, given that the combined asset pool for the three funds is approximately \$703,833,620 and impacts thousands of participants, staff believes that providing more advance notice of the change would be better received by participants. Staff recommends that the Board retain its original schedule for migration of large-cap funds, including Growth Fund of America, to take place in early 2012.

Fund: Lazard Mid-Cap Stock Fund
Asset Class: Mid-Cap Stocks
Assets: \$35,539,912
Participants in Fund: 2,582
Current Review Status: Watch
Recommendation: Accelerate fund migration

Lazard Mid-Cap Fund is presently scheduled to be migrated into a new blended mid-cap fund that will consist of a passively managed component, an active growth component, and an active

value component. This migration is scheduled to occur in approximately 13-15 months (a date yet to be determined that would take place within the July-August quarter of 2012).

The Lazard Mid-Cap Fund is on Watch status, the most serious classification. Relative to its benchmark, it has underperformed over all recent evaluation periods:

	3 Months	1 Year	3 Year	5 Year
Lazard Mid-Cap	6.3%	21.8%	6.8%	3.8%
Russell Midcap	7.6%	24.3%	7.2%	4.7%

Establishing the Plan's new Mid-Cap Fund cannot occur at an earlier date because of the procurement processes required, but elimination of the Lazard Fund could occur earlier if it was migrated to the Vanguard Mid-Cap Index Fund (this approach would be consistent with the Board's prior elimination of the Lotsoff Small-Cap Equity Fund, which was migrated to the Plan's passively managed Russell 2000 Index Fund, rather than being replaced by a new actively managed small-cap option).

Given the Lazard Fund's Watch status and long-term underperformance, staff recommends that migration be accelerated to occur either in the fourth quarter of 2011 or the first quarter of 2012. The communication notice to participants can be combined with the large-cap migration which is scheduled to occur during this same period.

Fund: **Fidelity Diversified International Fund**
Asset Class: **International Stocks**
Assets: **\$150,049,405**
Participants in Fund: **9,644**
Current Review Status: **Monitor**
Recommendation: **Migrate fund in third quarter 2012**

Fidelity Diversified International Fund is presently scheduled to be migrated into a new blended international fund that will consist of an active developed markets component, an active emerging markets component, and an active small-cap component. This migration is scheduled to occur in approximately 13-15 months (a date yet to be determined that would take place within the July-August quarter of 2012).

The Fidelity Diversified International Fund is on Monitor status, less serious than Watch. Relative to its benchmark, it has underperformed over three and five year periods, but that underperformance has been relatively modest, and it has outperformed over the last one-year period:

	3 Months	1 Year	3 Year	5 Year
Fidelity Diversified	3.2%	12.5%	-3.3%	1.2%
MSCI EAFE Index	3.4%	10.4%	-3.0%	1.3%

Establishing the Plan's new International Fund cannot occur at an earlier date because of the procurement processes required, but elimination of the Fidelity Diversified Fund could occur earlier if it was migrated to the DWS EAFE Equity Index Fund.

In addition to the fact that underperformance has been relatively modest, it should be noted that the Plan's new core International Equity Fund will be 100% actively managed. If the Fidelity Fund was eliminated now, it would eliminate from the Plan any active management in the international space until the new fund structure is established. Staff believes, and Mercer concurs, that this would not represent the most prudent course of action. As a result, staff recommends that the Board retain its original schedule for migration of this fund to take place in the third quarter of 2012.

Submitted by: _____
Steven Montagna

Approved by: _____
Alejandrina Basquez

	IMPLEMENTED	PHASE 1 1 st Quarter 2012	PHASE 2 3 rd Quarter 2012
TIER ONE			
DCP Ultra-Conservative Asset Allocation Fund	✓		
DCP Conservative Asset Allocation Fund	✓		
DCP Moderate Asset Allocation Fund	✓		
DCP Aggressive Asset Allocation Fund	✓		
DCP Ultra-Aggressive Asset Allocation Fund	✓		
	IMPLEMENTED	PHASE 1 1 st Quarter 2012	PHASE 2 3 rd Quarter 2012
TIER TWO			
DCP Deposit Savings Account	✓		
DCP Stable Value Fund	✓		
DCP Bond Fund		✓	
DCP Large-Cap Stock Fund		✓	
DCP International Fund			✓
DCP Mid-Cap Stock Fund			✓
DCP Small-Cap Stock Fund			✓
TIER THREE			
Self Directed Brokerage Option	✓		