Deferred Compensation Plan
BOARD REPORT 11-58

Date: August 30, 2011

To: Board of Deferred Compensation Administration

From: Staff

Subject: Strategic Plan

Recommendation:
That the Board of Deferred Compensation Administration receive and file for discussion the information contained within this report related to allocation of resources in connection with development of a Strategic Plan for the City's Deferred Compensation Plan.

Discussion:
At its June 21, 2011 meeting, the Board directed staff to draft a proposed strategic plan incorporating recommended policy positions concerning the new Great-West contract, pending and structural work projects, the impact of the Great-West fee reduction, communications objectives, a training policy, and other responsibilities of the Board in administering the City's Deferred Compensation Plan.

Staff is crafting the strategic plan as a document whose primary purpose is identifying the Plan's mission, goals and objectives over a five-year period (2012-2016). However, a key threshold for crafting it involves establishing parameters for the allocation of Plan resources.

Goals and objectives, if they are to be realistic, must be established relative to the available resources. Since resources are finite, prioritization of the allocation of resources should be made relative to the degree to which those resources are consistent with the hierarchy of objectives adopted by the Plan.

This report focuses on a review of resources available to the Plan over the next five years. Discussion of the assumptions which should be used and the desired relative allocation of resources will shape the objectives for the strategic plan.

I. ADMINISTRATIVE FEE RESERVE FUNDS

Per the City Administrative Code, all Plan expenses are required to be paid for through participant fees. The Plan collects sufficient revenue from participant accounts to pay both the external administrative costs of the Plan (i.e. those to the third-party-administrator, Great-West Retirement Services) as well as the City's internal administrative costs (e.g. Plan staff, consulting fees, training, etc.).

Mechanically this fee collection and expense reimbursement process utilizes two participant fee reserve funds, detailed as follows:

Fund	03/31/11 Cash Balance
The **Administrative Fee Reserve Fund** is maintained on behalf of the Plan by Great-West and is the repository for all administrative fees paid by Plan participants; most of the Plan's expenditures are made from this Fund.	**$3,117,105**
The **Payroll Fee Trust Fund** is maintained by the City Controller. From 1984 through September 2007 this Fund was used as the repository for a bi-weekly "fifty-cent" fee paid by participants making contributions to their accounts. The fees were used to pay for the City's internal administrative expenses for operating the Plan. The Board eliminated the "fifty-cent" fee in 2007. The Payroll Fee Trust Fund is now used primarily as a pass-through account for certain transactions. For example, in the case of travel, estimated expenditures are first transferred from the Administrative Fee Reserve Fund to the Payroll Fee Trust Fund - travel reimbursements are then processed with checks written from the Payroll Fee Trust Fund.	**$11,813**

The Board adopts an annual budget and approves quarterly reconciliations for these funds. The Board has previously adopted a target surplus balance of $1.5 million to be maintained over a rolling five-year period.

In a fee structure implemented in 2007 by the Board, the Board established that over a five-year period projected expenses would exceed income. The purpose for this was to draw down the net balance closer to the target surplus amount.

The cash balance amount indicated above is an actual dollar amount as of 03/31/11 and does NOT include several staffing reimbursement liabilities; as of 03/31/11, the total net balance for both funds is **$2,668,178** (see Board Report 11-62).

II. FIVE-YEAR RESOURCE ALLOCATION PLAN

The table on the following page provides a summary five-year projection of Plan income/expenses. This projection incorporates a range of variables. At the Board meeting the table will be projected as an Excel spreadsheet via PowerPoint allowing Board members to review the impact of adjusting the variables. The table below should be viewed as one illustration using a particular set of assumptions, although it incorporates staff's best judgments regarding those assumptions.

The adjustment of variables revolves around one key number – the **estimated surplus balance** in the combined reserve funds. In the table that number is highlighted in green.

As indicated above, the Board previously adopted a target surplus balance of $1.5 million over a five-year period. Staff is proposing that this reserve objective be refined and expressed rather as *50%, or six months, of the Plan's annual operating expenses*. Using this refined calculation produces a number relatively close to the Board's previously approved $1.5 million target.

Staff's rationale for expressing the reserve essentially as a unit of time, rather than a dollar amount, is that the reserve provides the Board some lead time to react to unanticipated deviations from its assumptions. The largest deviation risk is a sharp and sustained deterioration in total Plan assets. As assets fall, revenue collected from participant accounts also falls.

Following is staff's five year summary projection

	FIVE YEAR SUMMARY PROJECTION (2012-2016)				
	12/31/2012	12/31/2013	12/31/2014	12/31/2015	12/31/2016
Estimated Starting Balance	$ 2,500,000	$ 2,320,917	$ 2,033,421	$ 1,744,093	$ 1,486,698
Estimated Interest	$ 75,000	$ 69,628	$ 61,003	$ 52,323	$ 44,601
Estimated Revenue	$ 2,387,465	$ 2,442,014	$ 2,495,751	$ 2,551,988	$ 2,611,861
Estimated Expenses	$(2,566,547)	$ (2,729,510)	$ (2,785,079)	$ (2,809,383)	$ (2,834,230)
Revenues Less Expenses	$ (179,083)	$ (287,496)	$ (289,328)	$ (257,395)	$ (222,369)
Estimated Surplus Balance	**$ 2,320,917**	**$ 2,033,421**	**$ 1,744,093**	**$ 1,486,698**	**$ 1,264,329**
Reserve Target (50% Annual Operating Expenses)	**$ 1,283,274**	**$ 1,364,755**	**$ 1,392,540**	**$ 1,404,691**	**$ 1,417,115**
Estimated Balance Over/Under Reserve	**$ 1,037,644**	**$ 668,666**	**$ 351,553**	**$ 82,006**	**$ (152,787)**

The ending estimated surplus balance in this table is consistent with the target. Minor adjustments to the variables used can shift the surplus balance. Staff will now review those variables.

III. VARIABLES AND THEIR ASSUMPTIONS

Staff will now review the key variables that inform the Five Year Projection, and the basis for staff's current assumptions with respect to those variables, listed as follows:

DCP BUDGET VARIABLES							
Required Variables							
Basis Points	**0.100%**	Fee Cap	**$ 125**	Long-Term Asset Growth Assumption (including deposits/earnings)	**5.0%**	Expenses Inflation Adjustment Factor:	**2.0%**
Enrollment Adjusment Factor	**1.0%**	Stable Value Funds Interest Assumption	**3.0%**				
Optional Variables							
Additional Training	**$ 5,000**	Additional Legal Counsel	**$ 5,000**				

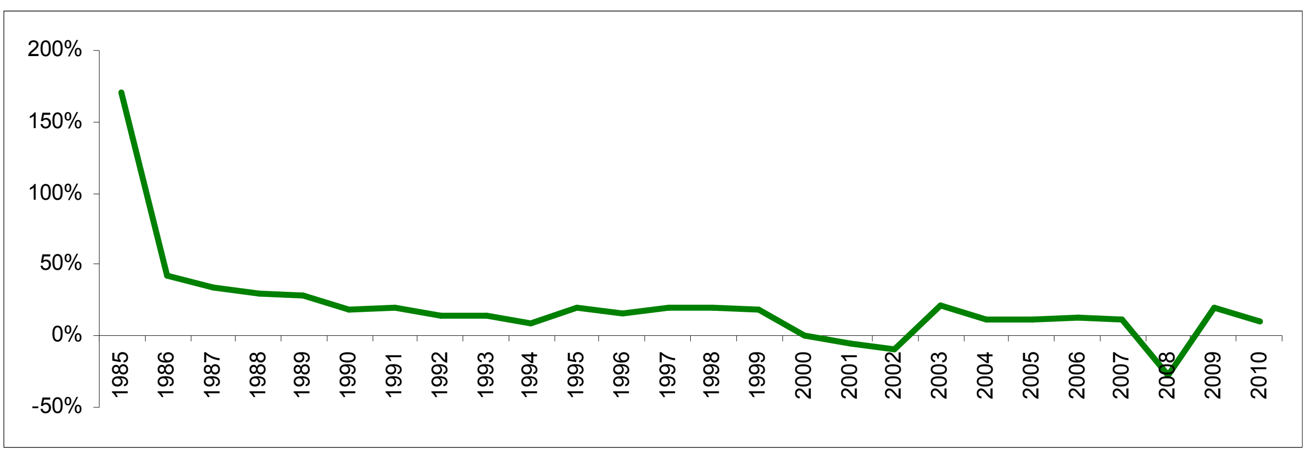
Basis Points/Fee Cap – This variable refers to the manner in which fees are assessed against participant accounts. Contractually the City's Plan is obligated to pay Great-West $36.97 per participant annually (this amount incorporates the 7% fee reduction from Great-West negotiated as part of their contract extension, and which becomes effective 1/1/12). However, the Plan does not charge each participant account $36.97. Fees are collected as an **asset based fee** of 0.10% charged against participant account balances, up to a **fee cap** of $125. A participant with $10,000 pays $10; a participant with $50,000 pays $50; etc. Once a participant's balance reaches $125,000, his/her administrative fee will not increase beyond $125.

Notwithstanding the reduction in the Great-West fee, staff's projection does not change the asset based fee and fee cap currently in effect. This is because even slight changes to these variables creates a significant impact on the projected ending surplus. For example, a reduction in the fee cap from $125 to $120 costs approximately $400,000 over five years. A reduction in the asset based fee from 10 to 9 basis points costs approximately $700,000 over five years.

Long-Term Asset Growth Assumption – This variable refers to the estimated rate at which Plan assets will grow over the five-year period. This assumed growth rate incorporates both **contributions** as well as **earnings**. This assumption has the largest impact on the surplus balance.

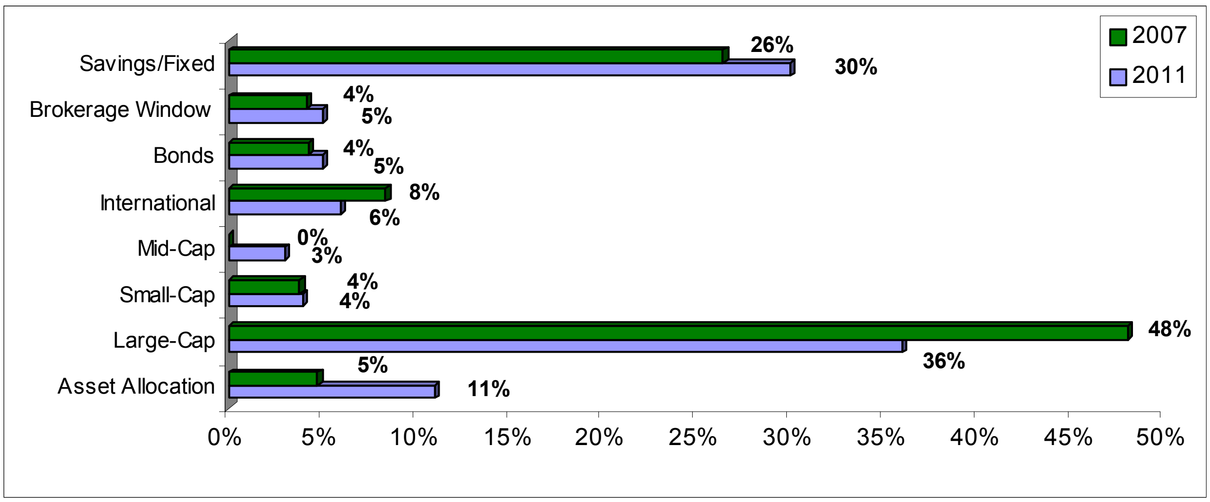
In prior analyses, staff has used assumed growth rates of either 8% or 9%. However, a review of Plan assets over more recent time periods, as well as consideration of Plan investment allocations and demographics, suggests a more conservative assumption is warranted.

The chart below provides a history of annual percent changes in Plan assets from the Plan's inception through December 31, 2010. As the chart indicates, high growth rates in the early years of the Plan have been replaced by lower growth rates in recent years. Excluding the huge first year growth rate of the Plan in 1985 (170%), from 1986 through 1999 the average annual increase was **21.4%**. However, from 2000 through 2010 the Plan's growth rate was **5.3%**, and from 2006 through 2010 it was **5.4%**.



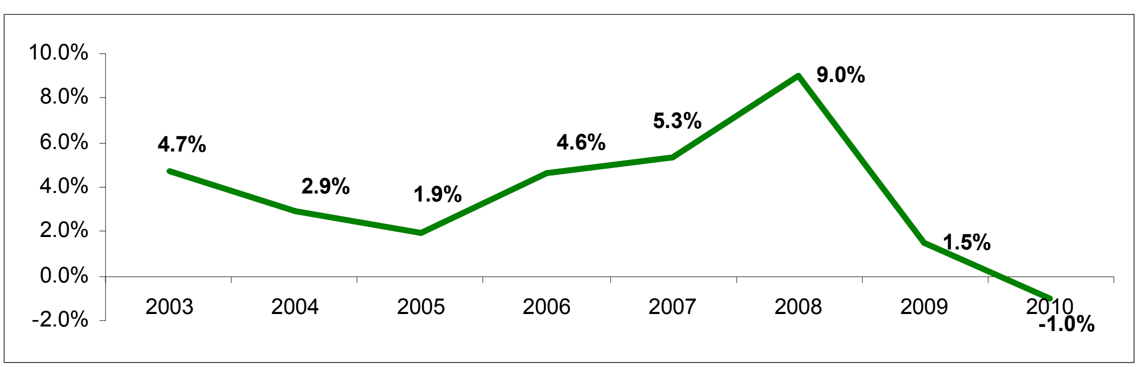
Four other factors come into play in making assumptions about Plan asset growth:

(1) Reduced Hiring - Likely ongoing constraints on City hiring for the foreseeable future mean there will be fewer new employees creating additional inflows.
(2) High Participation - An already above-average participation rate (70%) further limits the ability to grow the total number of Plan participants.
(3) Investment Performance – Some economists are forecasting an extended period of equity returns below long-term historical averages, as well as lower rates of return for interest-bearing investments.
(4) Asset Allocation – Having suffered through two bear markets over the past decade, and given the aging demographics of the City workforce, there is a high probability that Plan participants will trend out of higher-volatility asset classes and into interest-bearing investments. The chart below compares Plan assets for 2011 vs. 2007 (before the 2008-2009 bear market). Total asset levels at both points in time were approximately the same (around $3 billion) but allocations have generally trended towards lower-volatility asset classes.



Expenses Inflation Adjustment Factor – This assumption (2% growth in expenses) remains unchanged from prior projections.

Enrollment Adjustment Factor – Staff is now projecting annual enrollment increases of 1%. This chart indicates percent changes in enrollment from 2003-2010. Comparing this chart against overall City hiring data makes clear that enrollment increases are largely predicted by the rate of City hiring. In 2005 the City began a hiring trend that peaked in 2008, but since then hiring and the participant growth rate have fallen together.



Stable Value Fund Interest Assumption – This is an assumption about the rate of return provided on the Plan's Stable Value Fund, which is the vehicle used for Trust Fund assets. Staff is assuming a 3% rate of return. Over the past five years the annualized rate of return for this Fund has been 4.30%. However, over the last year the return has fallen to 3.44%. Given the current low interest rate environment, an environment which is expected to continue for at least the next two years if recent Federal Reserve guidance is to be believed, staff finds it would be prudent to assume a rate lower than the five-year historical average.

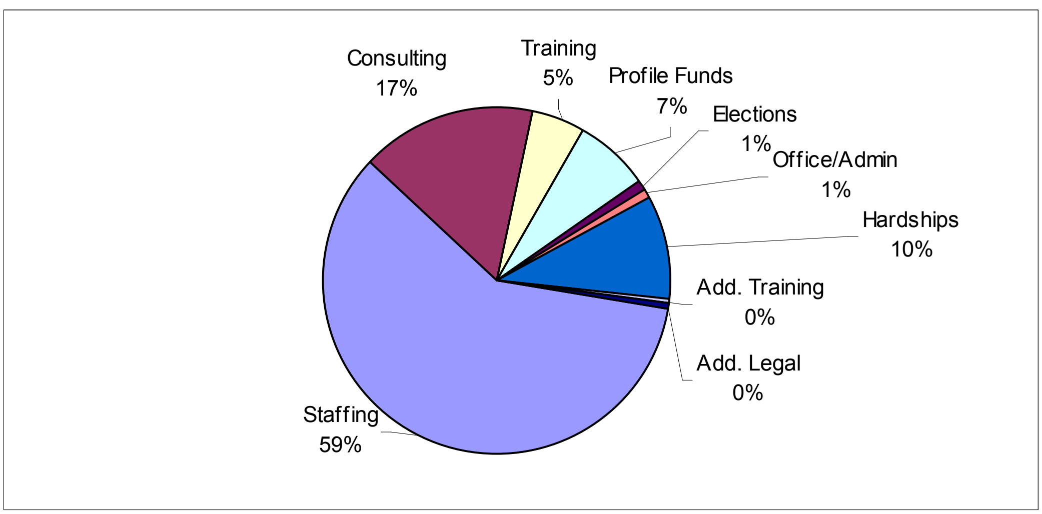
Optional Variables: Additional Training/Additional Legal Counsel - At prior meetings the Board has discussed allocating additional resources for training and outside legal counsel. For the purpose of the illustration contained within this report, staff has inserted nominal amounts of $5,000 for each of these two categories.

IV. PLAN EXPENSES AND THEIR ASSUMPTIONS

Staff will next review its assumptions regarding Plan expenses. These assumptions also incorporate certain recommendations for how those expenses should be structured over the five-year period.

The following chart and table provide a broad overview of the Plan's internal administrative expenses. This chart does not include the Plan's external administrative costs (to Great-West for participant administrative fees).

As the chart indicates, the largest Plan expense is for staffing, with the second largest being for consulting. It should be noted that most of these expenses should be approached as relatively fixed or required expense amounts.



	FIVE YEAR EXPENSE PROJECTION (2012-2016)				
Annual Expenses	**12/31/2012**	**12/31/2013**	**12/31/2014**	**12/31/2015**	**12/31/2016**
Admin Fees Owed to GWRS	$ 1,512,989	$ 1,528,119	$ 1,543,400	$ 1,558,834	$ 1,574,423
Staffing	$ 622,602	$ 776,956	$ 792,495	$ 808,345	$ 824,512
Consulting	$ 175,000	$ 175,000	$ 175,000	$ 175,000	$ 175,000
Training	$ 54,106	$ 55,188	$ 56,292	$ 57,418	$ 58,566
Profile Funds	$ 72,000	$ 72,000	$ 72,000	$ 72,000	$ 72,000
Elections	$ 10,000	$ -	$ 21,200	$ 10,600	$ -
Office/Admin	$ 7,650	$ 7,803	$ 7,959	$ 8,118	$ 8,281
Hardships	$ 102,000	$ 104,040	$ 106,121	$ 108,243	$ 110,408
Add. Training	$ 5,100	$ 5,202	$ 5,306	$ 5,412	$ 5,520
Add. Legal	$ 5,100	$ 5,202	$ 5,306	$ 5,412	$ 5,520
	$ 2,566,547	**$ 2,729,510**	**$ 2,785,079**	**$ 2,809,383**	**$ 2,834,230**

Administrative Fees – As previously indicated, the administrative fees assumption for Great-West incorporates the 7% fee reduction that was negotiated as part of the five-year contract extension, to $36.97 per participant annually.

Salary/Related Costs – Staff has reviewed staffing for the Deferred Compensation Plan and made some adjustments to what it would recommend as the budgeted expenditures. In July 2011 the City introduced a new "cost accounting" system for capturing how City employees allocate their time to various tasks. The system provides a mechanism for employees to record their time by major category ("work orders"), and then further identify the population served ("tasks" and "sub-tasks"). The intent of this cost accounting system is to better reflect where time is being allocated and the appropriate funding source for that time. For Deferred Compensation staff, this system is creating greater clarity and precision for time allocation. It will also, in future budget reconciliations, provide more accuracy for calculating salary reimbursements.

The table below compares the Board's adopted reimbursement percentages vs. the reimbursement percentages staff anticipates will be reflected under the new cost accounting system. In addition, the anticipated reimbursement percentages also include an assumption for reallocating one of the Management Analyst II positions to a Senior Management Analyst I position, which staff believes would be valuable for staffing stability and succession planning purposes. Any adjustment to staffing is, of course, a discussion item under the Strategic Plan.

Position Authority	Current Class	Pre-Cost Accounting Percent Allocated to DCP	Illustration Class	Post-Cost Accounting Percent Estimated Allocated to DCP
Personnel				
Chief Personnel Analyst	Chief Personnel Analyst	25%	Chief Personnel Analyst	20%
Senior Personnel Analyst II	Senior Personnel Analyst II	80%	Senior Personnel Analyst II	60%
Management Analyst II	Management Analyst II	100%	Senior Management Analyst I	90%
Management Analyst II	Management Assistant	100%	Management Analyst II	90%
Benefits Specialist	Clerk Typist	100%	Benefits Specialist	90%
City Attorney				
Assistant City Attorney	Assistant City Attorney	25%	Assistant City Attorney	25%
Legal Assistant	Legal Assistant	40%	Legal Assistant	40%

Presently several of the incumbents in these positions are in job classifications below the allocated or suggested class level. Given that any potential transition to higher classes and salary levels would not occur instantaneously, *staff's salary assumption for calendar year 2012 is based on existing salary costs for current staff*.

Consulting Costs – The 2009-2011 three-year contract has a ceiling amount of $450,000, or $150,000 per year. Staff has increased this assumption by $25,000 to $475,000 for the purpose of the Five Year Projection, anticipating additional costs for procurements.

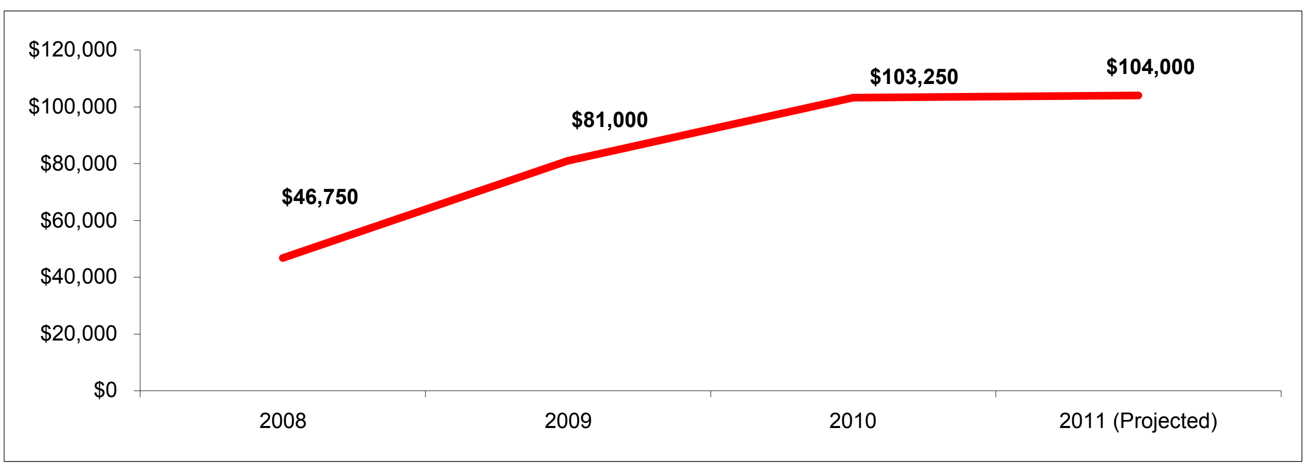
Training/Education – In 2008 the Board adopted an annual budget amount for training/education of $50,000, with the amount to be indexed upward by 2% annually. Staff has maintained the current adjusted amount for the purpose of this illustration. The question of whether the Plan should allocate additional resources for training/education (e.g. for communications) is an item for discussion in shaping priorities for the Strategic Plan.

Quarterly Fee for Asset Allocation Funds – These expenses are a cost fixed within the contract with Great-West and represent the fees for Great-West's administration of the existing and additional blended fund options which will comprise the core investment menu.

Election Administration – These are estimates of ongoing costs to administer Plan elections. Estimates are based on actual expenditures for prior elections.

Office & Administrative Expenses – These are estimates of equipment costs (e.g. for computer upgrades).

Hardship Administration – This amount represents an estimate of costs paid to Great-West to administer hardship withdrawals. The contract provides for a fee of $250 per hardship case. Staff is projecting annual costs of $100,000. The cost of hardship processing from 2008 through the present is provided as follows:



V. SUMMARY

At the Board meeting the discussion of the projections, variables and assumptions included within this report will be helpful in assisting staff with finalizing a draft Strategic Plan. As stated previously, the goals and objectives outlined in the Strategic Plan will need to be realistic and achievable, and the most important considering in making them such will be ensuring that the allocated resources are commensurate with the objectives.

Submitted by: ______________________________
Steven Montagna