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DEFERRED COMPENSATION PLAN BOARD REPORT 06-31



Date: October 4, 2006
To: Board of Deferred Compensation Administration
From: Staff/Consultant
Subject: Quarterly Investment Review

Recommendation:

That the Board of Deferred Compensation Administration:

(a) Adopt the policies recommended within this report for:

- Establishing Deferred Compensation Plan investment fund performance expectations and/or identifying investment process concerns;
- Placing Plan funds on "Monitor" or "Watch" status; and
- Removing any fund which fails to correct its under-performance or investment process concern; and

(b) Assuming adoption of the first recommendation, place the **Hartford Advisers HLS**, **Hartford Stock HLS**, and **American Funds Investment Company of America** funds on "Monitor" status and the **Fidelity Magellan** and **Lotsoff Small Cap Equity** funds on "Watch" status for a period of four quarters or until performance/other investment concerns improve, or unanticipated negative developments result in a recommendation for termination prior to completion of the four quarters.

Discussion:

Mercer Investment Consulting has completed its quarterly investment performance review for periods ending June 30, 2006 (attached). As part of this review, staff worked with Mercer to develop recommended criteria for establishing fund under-performance, placing funds on "Monitor" or "Watch" status, and removing a fund or adding a more viable option if the fund fails to correct its under-performance or investment process return.

The specific criteria recommended by staff/Mercer include the following:

- (A) All variable investment funds will be monitored quarterly. The consultant will evaluate the relative performance of each fund against its peers and benchmark for the following time periods:
1. Quarter
 2. Year-to-Date

3. One Year
4. Three Years
5. Five Years

- (B) The consultant will focus primarily on the evaluation of three-year and five-year performance for the purpose of assigning a performance designation of “*Satisfactory*” or “*Unsatisfactory*.”
- (C) A “*Satisfactory*” designation will be given to those funds which have met or exceeded their respective mandates. An actively managed fund will generally be found to have exhibited satisfactory performance if it meets or exceeds the return of its benchmark index and universe median over three-year and five-year periods. A passively managed index fund will generally be found to have exhibited satisfactory performance if it substantially replicates the performance of the underlying index and does not exhibit significant tracking error as established by the consultant.
- (D) An “*Unsatisfactory*” designation will be given to those funds which under-perform their respective mandates and/or have significant qualitative concerns. An actively managed fund will generally be found to have exhibited unsatisfactory performance if its returns are below the return of its benchmark index and universe median over three-year and five-year periods. A passively managed index fund will generally be found to have exhibited unsatisfactory performance if its returns do not substantially replicate the performance of the underlying index and exhibit significant tracking error as established by the consultant.
- (E) If a fund is determined to be “*Unsatisfactory*,” the consultant will recommend that it be placed onto either “*Monitor*” or “*Watch*” status. The assignment of the category will be based upon the severity of deviance found in one or more of the following evaluative factors:
1. Performance against the benchmark, peer group or contracted performance targets falling below the applicable targeted range;
 2. Style drift or investment guideline violations;
 3. Organizational changes in ownership or portfolio management personnel that, in the judgment of the consultant, could adversely affect performance.
- (F) “*Monitor*” status means that areas of concern have been identified for one or more of the factors identified under (E), but not to a degree that places the fund in direct danger of elimination. “*Watch*” status means that areas of significant concern have been identified in one or more of the factors identified under (E), to a degree that places the fund under close scrutiny.
- (G) A fund placed on “*Watch*” status will have a minimum of two and not more than six quarters in which to correct its noted deviance, based upon the recommendation by the consultant and adoption of that recommendation by the Board. The specific timeframe for resolution of an issue or issues will be established by the Board and communicated in writing to the investment manager. Based on its ongoing performance the consultant may, in subsequent reviews, recommend elimination of the fund at the conclusion of the adopted timeframe.

(H) Removal from “Watch” status will occur in one of two ways: (1) by action of the Board and notice to the investment manager that the Board is satisfied with improved performance or corrective measures taken; or (2) by action of the Board and notice of termination given to the investment manager.

Based on Mercer’s review, several funds have been identified as having demonstrated unsatisfactory performance for the periods presently under review. As a result, staff and Mercer are recommending that the Board, pursuant to the recommended guidelines proposed within this report, place the following fund(s) on “Monitor” or “Watch” status:

Monitor:

- Hartford Advisers HLS
- Hartford Stock HLS
- American Funds Investment Company of America

Watch

- Fidelity Magellan
- Lotsoff Small Cap Equity

The consultant’s report reviews in depth its findings and basis for recommendations. Should the Board adopt the recommendations provided in this report, appropriate communications will be given to the affected funds.

Submitted by: _____
Steven Montagna

Approved by: _____
Maryanne Keehn