



HEALTH WEALTH CAREER

# **ACTIVE FUND SEARCH RECOMMENDATIONS** CITY OF LOS ANGELES DEFERRED COMPENSATION PLAN

SEPTEMBER, 17 2018



**MAKE TOMORROW, TODAY**



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## Introduction

The Investment Policy Statement (IPS) of the City of Los Angeles Deferred Compensation Plan stipulates that investment manager searches/procurements for specific investment categories generally will occur once every 5 years. The current 5-year terms for the Plan's various investment providers will expire between 2019 and 2020. At the July 2018 Board of Deferred Compensation Administration (Board) meeting, the Board approved 2018-2019 investment manager search plan for the Deferred Compensation Plan investment menu and directed the Investments Committee to develop recommendations to the Board with respect to the type of search process (mutual fund and/or institutional manager procurement) to be applied to each investment mandate; proposed investment and evaluation criteria for each mandate; and recommendations for provider selections. As a result, staff have been working with the Board's investment consultant, Mercer Investment Consulting, to develop a timetable for the implementation of searches over the next couple of years. Per this timetable, in 2018 and 2019, we will be conducting searches for all of the Plan's active investment managers. Our recommendations as to which type of investment vehicle search (i.e., mutual fund and/or institutional manager procurement) the Board should conduct in each category based on the specifics of the respective investment mandates will be discussed in this report.

In addition, we outline recommended minimum qualifications for each of the searches which follow the principles outlined in the IPS' Investment Selection and Termination section. These recommended minimum qualification screens are tailored to each specific mandate and are based on our expertise conducting similar searches. These minimum requirements broadly establish that prospective investment strategies are accessible in the recommended investment vehicle type; have a seasoned track record in relation to similar strategies; are managed in alignment with the subject investment mandate; hold a sufficient, yet not too large, amount of assets to effectively implement the investment strategy; and maintain investment expenses that are reasonable.

## Search Evaluation

After the initial screening is completed, Mercer will compile search documents containing the candidates that meet the foregoing minimum qualifications in each category. In the search reports, we will provide detail on the qualitative and quantitative evaluation factors that the Board has outlined in the Investment Policy. Dimensions considered include the following:

### *Qualitative Factors*

- Investment research strength (Idea Generation)
  - Number of investment staff
  - Number of portfolio management staff
  - Tenure of lead portfolio management team
  
- Portfolio construction
  - Number of holdings
  - Portfolio turnover
  - Active share of portfolio
  - Weighted average market capitalization
  - Portfolio statistics (e.g., P/E ratio, growth rate, etc.)
  - Adherence to investment style relative to benchmark
  - Off benchmark exposure
  - Cash holding
  
- Implementation
  - Strategy capacity
  
- Business Management
  - Investment expenses
  - Ownership structure

*Quantitative Factors*

- Long-term performance relative to the index and peer group
- Long-term risk-adjusted performance
- Diversification benefits of a given option in light of complementary investments selected in each Investment Option

*Consultant Ratings*

All investment funds are candidates for letter grades pursuant to ongoing fund monitoring and due diligence that Mercer conducts for all of its clients. These letter grades will be included in the data items reported to the Committee and can be used by the Committee as an additional measure in assessing the relative strength of each fund.

## Timing

Assuming the Board is in agreement with the recommendations herein, we will begin conducting the searches according to the timetable immediately and in alignment with the timeline previously reviewed by the Board at its July 2018 meeting. Our anticipated timing for completion for each asset class category will be eight weeks, and staff will schedule a series of Investment Committee meetings, each covering specific asset classes, to coincide with this anticipated delivery.

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## Proposed Investment Fund Searches

- Active Core Plus Bond
- Active Mid-Cap Growth and Mid-Cap Value Equity
- Active Small-Cap Growth and Small-Cap Value Equity
- Active International Developed Markets Equity
- Active International Small-Cap Equity
- Active Emerging Markets Equity

## Active Core Plus (Opportunistic) Bond

### PROPOSED SEARCH VEHICLE

Estimated Mandate Size: **\$287.0 million**

Recommended Fund Search Type: ***Institutional Manager Procurement and Mutual Fund***

#### Rationale:

- Conducting a pooled investment (commingled and mutual funds) search would provide broad access to high-quality managers
- The universe of available core plus bond funds comprises 20 commingled funds and 407 mutual funds (includes core plus and core investment grade funds)
- The median cost of the commingled fund universe for a mandate size of \$250 million is 27 basis points<sup>1</sup> which is about 40% less than the median cost for like institutional mutual fund vehicles (46 basis points for active core bond mutual funds)
- Using Institutional Products, such as commingled funds, may lead to additional operational costs for custody and unitization. However given this mandate size, “all-in” fees including other operating costs for Institutional Products could still provide cost savings versus using a Mutual Fund vehicle
- Mutual fund search run concurrently would assure that high-quality product at reasonable expense would be secured

### PROPOSED CORE PLUS SEARCH MINIMUM CRITERIA (SCREENING)

- Availability in pooled investment vehicle
- Vehicle open to new investors
- Vehicle compatible with Voya platform
- Strategy track record of 7 years or longer (specific vehicle may be shorter)
- Investment style consistent with an active core plus bond manager investing in intermediate duration bonds and categorized in the database as a core plus bond strategy
- Minimum assets under management in strategy of \$7.5 billion
- Investment expense ratio equal to or less than 0.34% after revenue sharing rebates, if any (approximately 1.25 times the institutional median)

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<sup>1</sup> Source: Mercer Global Asset Manager Fee Survey – February 2018. Median fees provided for asset breakdown of \$25M, \$50M, \$100M, \$250M and \$500M.

## Active Mid-Cap Growth and Mid-Cap Value Equity

### PROPOSED SEARCH VEHICLE

**Estimated Mandate Size:** *\$96.0 million each mandate*  
**Recommended Fund Search Type:** *Mutual Fund*

#### **Rationale:**

- There are 43 Mid-Cap Value and 87 Mid-Cap Growth mutual funds in the respective Mercer mutual fund universes, though a handful of funds are closed in each group
- The median cost of the Mid-Cap Value Institutional Mutual Fund universe for a mandate size of \$100 million is 79 basis points<sup>2</sup>.
- The median cost of the Mid-Cap Growth Institutional Mutual Fund universe for a mandate size of \$100 million is 93 basis points<sup>2</sup>.
- At this mandate size, we believe mutual fund vehicles offer comparable investment opportunities at similar or better investment expenses. Given the incremental complexity of an Institutional Manager Procurement and the expectation of marginal benefit, if any, of such a search, we recommend a mutual fund search.

### PROPOSED MID-CAP EQUITY (GROWTH AND VALUE) SEARCH MINIMUM CRITERIA (SCREENING)

- Availability in pooled investment vehicle
- Vehicle open to new investors
- Vehicle compatible with Voya platform
- Strategy track record of 5 years or longer (specific vehicle may be shorter)
- Investment style consistent with the respective mid cap styles (growth and value) including appropriate categorization in the database. In addition, stated benchmark of the strategy will be representative of the style.
- Minimum assets under management in strategy of \$600 million
- Maximum assets under management in strategy of \$25 billion
- Investment expense ratio equal to or less than 1.00 after revenue sharing rebates, if any

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<sup>2</sup> Source: Mercer Global Asset Manager Fee Survey – February 2018. Median fees provided for asset breakdown of \$25M, \$50M, \$100M, \$250M and \$500M.



## Active Small-Cap Growth and Small-Cap Value Equity

### **PROPOSED SEARCH VEHICLE**

**Estimated Mandate Size:** *\$131.0 million each mandate*

**Recommended Fund Search Type:** *Mutual Fund*

#### **Rationale:**

- The number of high-quality active small value and growth manager strategies that are accepting new mandates is fairly small; a mutual fund search is nevertheless likely to produce sufficient candidates, while an Institutional Manager Procurement search process may fail to solicit sufficient response from high-quality respondents.
- There are 68 small-cap value and 137 small-cap growth mutual funds in the respective Mercer mutual fund universes
- The median cost of the Small-Cap Value Institutional Mutual Fund universe for a mandate size of \$100 million is 105 basis points<sup>3</sup>.
- The median cost of the Small-Cap Growth Institutional Mutual Fund universe for a mandate size of \$100 million is 103 basis points<sup>3</sup>.
- Despite a capacity constrained universe of mutual funds in these categories, there are still high-quality options available.
- Institutional mutual fund fees are reasonably close to Institutional Product fees in general in these categories.

### **PROPOSED SMALL-CAP EQUITY (GROWTH AND VALUE) SEARCH MINIMUM CRITERIA (SCREENING)**

- Availability in pooled investment vehicle
- Vehicle open to new investors
- Vehicle compatible with Voya platform
- Strategy track record of 5 years or longer (specific vehicle may be shorter)
- Investment style consistent with the respective small-cap styles (growth and value) including appropriate categorization in the database. In addition, stated benchmark of the strategy will be representative of the style.
- Minimum assets under management in strategy of \$600 million

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<sup>3</sup> Source: Mercer Global Asset Manager Fee Survey – February 2018. Median fees provided for asset breakdown of \$25M, \$50M, \$100M, \$250M and \$500M.

## Active Small-Cap Growth and Small-Cap Value Equity

### **PROPOSED SMALL-CAP EQUITY (GROWTH AND VALUE) SEARCH MINIMUM CRITERIA (SCREENING), continued**

- Maximum assets under management in strategy of \$12 billion
- Investment expense ratio equal to or less than 1.00 after revenue sharing rebates, if any

## Active International Developed Markets Equity

### **PROPOSED SEARCH VEHICLE**

**Estimated Mandate Size:**

*\$401.0 million*

**Recommended Fund Search Type:**

*Institutional Manager Procurement and Mutual Fund*

#### **Rationale:**

- There is an abundance of high-quality, low-cost active international developed managers available in pooled investment vehicles
- There are 91 International Developed Markets Equity mutual funds in the Mercer mutual fund universe and 39 International Developed Markets Equity commingled funds in the universe
- The median cost of the mutual fund universe for a mandate size of \$250 million is 82 basis points and the median cost of commingled fund universe for a mandate size of \$250 million is 53 basis points<sup>4</sup>
- Emphasis would be on pooled investment vehicles for institutional product since implementing separate accounts would be needlessly complex and could result in substantial operational costs.

### **PROPOSED INTERNATIONAL DEVELOPED MARKETS EQUITY SEARCH MINIMUM CRITERIA (SCREENING)**

- Availability in pooled investment vehicle
- Vehicle open to new investors
- Vehicle compatible with Voya platform
- Strategy track record of 7 years or longer (specific vehicle may be shorter)
- Investment style consistent with international ex-US core investment style including appropriate categorization in the database. In addition, stated benchmark of the strategy will be representative of the style (MSCI EAFE or comparable).
- Minimum assets under management in strategy of \$5 billion
- Investment expense ratio equal to or less than 1.00% after revenue sharing, if any

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<sup>4</sup> Source: Mercer Global Asset Manager Fee Survey – February 2018. Median fees provided for asset breakdown of \$25M, \$50M, \$100M, \$250M and \$500M.

## Active International Small-Cap Equity

### **PROPOSED SEARCH VEHICLE**

**Estimated Mandate Size:** *\$105.0 million*

**Recommended Fund Search Type:** *Mutual Fund*

#### **Rationale:**

- A mutual fund search will provide access to a focused list of high-quality candidates
- There are 14 International Small-Cap Equity mutual funds in the Mercer mutual fund universe
- The median cost of the mutual fund universe for a mandate size of \$100 million is 115 basis points<sup>5</sup>
- Use of a separate account vehicle would be cost prohibitive (custody, currency, foreign tax, etc.) in this space which favors the use of pooled investment vehicles like mutual funds.

### **PROPOSED INTERNATIONAL SMALL-CAP EQUITY SEARCH MINIMUM CRITERIA (SCREENING)**

- Availability in mutual fund vehicle
- Vehicle open to new investors
- Vehicle compatible with Voya platform
- Strategy track record of 3 years or longer (specific vehicle may be shorter)
- Investment style consistent with international ex-US small-cap investment style including appropriate categorization in the database. In addition, stated benchmark of the strategy will be representative of the style (MSCI EAFE Small-Cap Index or comparable).
- Minimum assets under management in strategy of \$500 million
- Maximum assets under management in strategy of \$20 billion
- Investment expense ratio equal to or less than 1.15% after revenue sharing rebates, if any

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<sup>5</sup> Source: Mercer Global Asset Manager Fee Survey – February 2018. Median fees provided for asset breakdown of \$25M, \$50M, \$100M, \$250M and \$500M.

## Active Emerging Markets Equity

### **PROPOSED SEARCH VEHICLE**

**Estimated Mandate Size:** *\$105.0 million*

**Recommended Fund Search Type:** *Mutual Fund*

#### **Rationale:**

- There is an abundance of high-quality, low-cost mutual fund strategies to choose from in the emerging markets space
- There are 307 Emerging Markets Equity mutual funds in the Mercer mutual fund universe
- The median cost of the mutual fund universe for a mandate size of \$100 million is 104 basis points<sup>6</sup>
- Use of a separate account vehicle is very cumbersome with emerging markets securities. Given this relatively small asset size, we do not recommend exploring this approach.
- At this mandate size, we believe mutual fund vehicles offer comparable investment opportunities at similar or better investment expenses. Given the incremental complexity of an Institutional Manager Procurement and the expectation of marginal benefit, if any, of such a search, we recommend a mutual fund search.

### **PROPOSED EMERGING MARKETS EQUITY SEARCH MINIMUM CRITERIA (SCREENING)**

- Availability in mutual fund vehicle
- Vehicle open to new investors
- Vehicle compatible with Voya platform
- Strategy track record of 7 years or longer (specific vehicle may be shorter)
- Investment style consistent with emerging markets equity investment style including appropriate categorization in the database. In addition, stated benchmark of the strategy will be representative of the style (MSCI Emerging Markets Index or comparable).
- Minimum assets under management in strategy of \$5 billion
- Maximum assets under management in strategy of \$35 billion
- Investment expense ratio equal to or less than 1.15% after revenue sharing rebates, if any

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<sup>6</sup> Source: Mercer Global Asset Manager Fee Survey – February 2018. Median fees provided for asset breakdown of \$25M, \$50M, \$100M, \$250M and \$500M.

## Appendix – Disclosures

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