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## City of LA 457 Plan Separate Account and Master Custodian Discussion

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## Overview

- In implementing the recently approved portfolio structures, the Board will need to determine whether it will consider separate account investment strategies in the manager search process
- Using separate accounts to any significant degree in the Plan would require hiring a custody bank to hold individual securities
- Potential benefits of using separate accounts include:
  - Access to a greater number of investment strategies
    - More strategies available in separate account format than through mutual funds or commingled trusts
  - Reduced investment option expenses
    - Separate account fees tend to be lower and are negotiable
  - Customization of investment management to best suit the interest of the Plan's participants

<sup>1</sup> Great-West Bank could facilitate unitization of mutual funds and commingled trusts if separate accounts are not used

## Separate account background

- Characteristics of a separate account
  - Governed by an investment management agreement (IMA) with an investment manager, and the Plan defines investment guidelines for that manager
  - Requires the Plan to monitor compliance with guidelines<sup>2</sup>
  - Lesser (and negotiable) fees typically for large investors compared to mutual fund or commingled trusts
  - The account needs to be divided into smaller units or “unitized” by a custodian to be viable within a defined contribution plan
  - Certain strategies (e.g., emerging market debt or equities) are harder to implement in a separate account because of legal, tax, or other international restrictions
  - Separate account investment managers are Plan fiduciaries and are responsible for adhering to the guidelines to which they commit

<sup>2</sup> Plan can contract with custodian to provide compliance monitoring

# Investment Vehicle Pros and Cons

| Characteristic  | Mutual Fund   | Collective Trust  | Separate Account  |
|---|---|---|---|
| <b>Ease of administration</b>                               | Very easy   | Moderately easy   | More complex  |
| <b>Expenses</b>   | Generally higher for large plan   | Generally lower than mutual funds for large plan and scale down as assets grow typically  | Generally lowest cost for large plan and scale down as assets grow typically  |
| <b>Fee flexibility</b>                                      | Inflexible  | Flexible (negotiable)   | Flexible (negotiable)   |
| <b>Product availability</b>                                 | Large amount  | Somewhat limited  | Greatest amount   |
| <b>Custody</b>  | Mutual fund's custodian   | Trust's custodian   | Plan's custodian  |
| <b>Contracting necessary</b>                                | No  | Yes   | Yes   |
| <b>Portfolio transparency to plan sponsor</b>               | Transparent though subject to delay (publicly filings are not real-time)  | Greater real-time transparency than MFs   | Highly transparent and real-time portfolio data available daily   |
| <b>Plan control over investment guidelines</b>              | No  | No  | Yes   |
| <b>Transaction costs</b>                                    | Borne by pool <ul style="list-style-type: none"> <li>• May be a negative if other investors have shorter horizon than the Plan</li> </ul> | Borne by pool <ul style="list-style-type: none"> <li>• May be a negative if other investors have shorter horizon than the Plan</li> </ul>   | Borne by separate account <ul style="list-style-type: none"> <li>• May be a positive assuming the Plan's participants are long-term investors</li> </ul>                                    |
| <b>Liquidity</b>  | High  | High  | Generally High  |
| <b>Cash levels</b>  | Mutual funds may hold significant cash level to meet redemptions causing cash drag  | May hold significant cash level to meet redemptions   | Cash levels can be tailored to the individual plan  |
| <b>Regulation</b>   | SEC-regulated; Subject to the Investment Company Act of 1940 and Investment Advisers Act of 1940  | Regulated by the Office of the Comptroller of the Currency; may also be subject to ERISA  | Investment adviser regulated by the SEC; subject to the Investment Advisers Act of 1940; adviser may be subject to ERISA  |
| <b>Portfolio transparency to participants*</b>              | Highly transparent: <ul style="list-style-type: none"> <li>•Can be tracked via media outlets</li> <li>•SEC filings</li> </ul>             | Less transparent: <ul style="list-style-type: none"> <li>•Not trackable via media outlets</li> <li>•No public filings</li> <li>•Sponsor can provide transparency to participants</li> </ul> | Less transparent: <ul style="list-style-type: none"> <li>•Not trackable via media outlets</li> <li>•No public filings</li> <li>•Sponsor can provide transparency to participants</li> </ul> |
| <b>Participant Communications (e.g., fund fact sheets)*</b> | Provided by mutual fund   | May be provided by manager or plan sponsor  | Plan sponsor responsibility   |

\* Given the Fund of Funds structure that will be used in the City of LA Deferred Compensation Plan, participant transparency and communications may be of lesser importance since City of LA options will not be trackable via media outlets regardless of vehicle chosen

## Investment vehicle fee comparison

### Illustration of various vehicle costs

| Category                             | Commingled<br>Median/Upper Quartile <sup>3</sup> |       | Separate Account<br>Median/Upper Quartile <sup>3</sup> |       | Institutional<br>Mutual Funds <sup>4</sup> |
|--------------------------------------|--|-------|--|-------|--|
| US Fixed –Intermediate (active)      | 0.24%  | 0.42% | 0.23%  | 0.26% | 0.59%                                      |
| Large Cap Core (active)              | 0.35%  | 0.50% | 0.44%  | 0.54% | 0.68%                                      |
| Mid Cap Core (active)                | 0.48%  | 0.62% | 0.58%  | 0.66% | 0.93%                                      |
| Small Cap Core (active)              | 0.71%  | 0.79% | 0.73%  | 0.83% | 0.95%                                      |
| International – World ex US (active) | 0.59%  | 0.68% | 0.56%  | 0.63% | 1.08%                                      |
| US Fixed Income (index)              | 0.05%  | 0.06% | 0.06%  | 0.08% | 0.15%                                      |
| Large Cap Core (index)               | 0.05%  | 0.06% | 0.10%  | 0.23% | 0.27%                                      |

<sup>3</sup> Source: Mercer's Asset Management Fee Survey 2008 (values are for \$200 million or greater in assets per mandate)

<sup>4</sup> Source: Morningstar and Lipper

## Custody considerations

- Custody bank background
  - A custody bank (custodian) is a financial institution that provides safekeeping of an assets. The custodian will also provide other services such as transaction settlement, periodic statements, and compliance monitoring among other functions.
- Advantages of hiring a custodian
  - Greater flexibility to provide innovative investment options to Plan participants
  - Assets held exclusively in the name of the Trust
  - Unitization of fund of funds structures into a single fund for participants
  - Enhanced accounting/reporting capabilities
- Additional considerations of hiring a custodian
  - Would be unnecessary if the Plan doesn't end up using separate accounts
  - Creates additional RFP process and associated costs
  - Additional costs for custody (rough estimate of 0.02% to 0.05% for domestic separate accounts, and international accounts incur greater fees)
  - Great-West would no longer custody any Plan assets, as newly hired custodian would now assume this role, but this may not be material
  - May be difficult to recover revenue sharing embedded in some options, but it's possible to eliminate use of revenue sharing funds



## Recommendation and Next steps

- Mercer recommendation
  - If the Board is comfortable with the greater administrative complexity associated with separate accounts, Mercer recommends using them, as they can provide greater investment selection, more flexibility, and lower fees, all of which we think will directly benefit participants.
  
- Next steps
  - Decide whether separate accounts should be used in the Plan
  - Direct Staff and Mercer to prepare RFP for custody services
  - Mercer will prepare timeline for the search process



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