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City of LA 457 Plan Plan Structure Review International Equity

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Contents

- Mercer Introduction
- Current Situation
- International Equity Structure
- Appendix: Assumptions and Supporting Data
- Disclaimers

Mercer Introduction

Mercer Introduction

Devon Muir, CFA

- Principal & Senior Investment Consultant – based in Los Angeles
- 11 years consulting experience, 7 in the industry
- Public DC experience
- Mercer Alternatives Strategic Research Team
- MBA, Carlson School of Management at the University of Minnesota
- BA, University of California, Santa Barbara
- CFA

Eileen Kwei, CFA

- Principal & Senior Investment Consultant – based in San Francisco
- 10 years experience
- Public Fund experience
- DC focus
- Mercer Defined Contribution Committee
- Chair, Mercer Target Date Strategic Research Team
- BA, University of California, Berkeley
- CFA

Current Situation

Current Situation

Overview

- City of LA is considering moving to a fund structure with generically named investment options
 - Investment options will cover major asset classes using a single or multi-manager approach
 - Mutual funds are the primary investment vehicle
 - Goal is to have a streamlined, yet robust, menu of 10-12 options

- Rationale for moving to this structure is to:
 - Reduce the number of Plan options to simplify for participants
 - Promote investor focus on diversification and risk tolerance

- The Investment Committee has approved (and in some cases implemented) new portfolio structures for all of the options except the international equity fund.

Current Situation

Decision Review

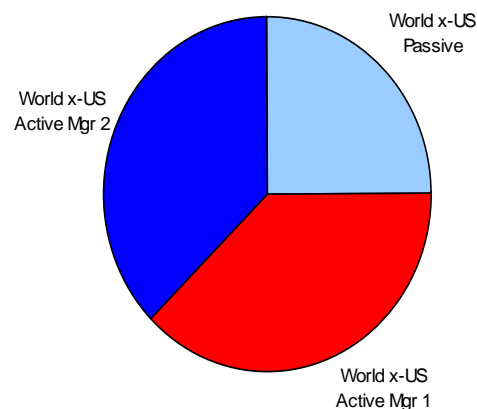
NEW DCP INVESTMENT MENU DESIGN		
Investment Option	Structure	Status
Bank-Deposit Account	Blend of 3 Underlying Bank Providers	Implemented
Stable Value Fund	Single vendor with broadly diversified holdings	Implemented
DCP Bond Fund	50% Active / 50% Passive	Approved
DCP Ultra-Conservative Asset Allocation Fund	Blend of Stable Value & passive funds	Implemented
DCP Conservative Asset Allocation Fund	Blend of Stable Value & passive funds	Implemented
DCP Moderate Asset Allocation Fund	Blend of Stable Value & passive funds	Implemented
DCP Aggressive Asset Allocation Fund	Blend of Stable Value & passive funds	Implemented
DCP Ultra-Aggressive Asset Allocation Fund	Blend of Stable Value & passive funds	Implemented
DCP Large-Cap Stock Fund	100% Passive Management (S&P 500 Index)	Approved
DCP Mid-Cap Stock Fund	50% Passive / 25% Value Active / 25% Growth Active	Approved
DCP Small-Cap Stock Fund	34% Passive / 33% Value Active / 33% Growth Active	Approved
DCP International Fund	TBD	Board Decision Pending
Self-Directed Brokerage Option	Broad universe of funds, stocks and bonds	Implemented

International Equity Structure

International Equity Structure

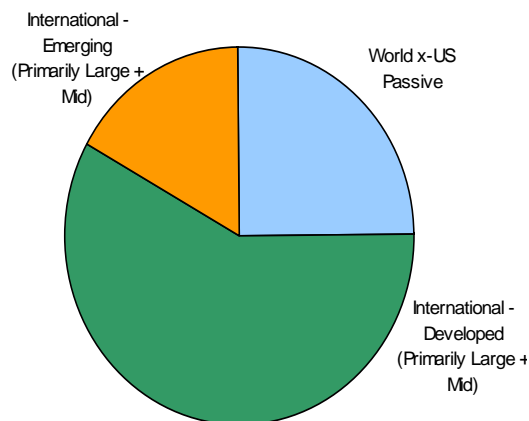
Various Structures

World x-US



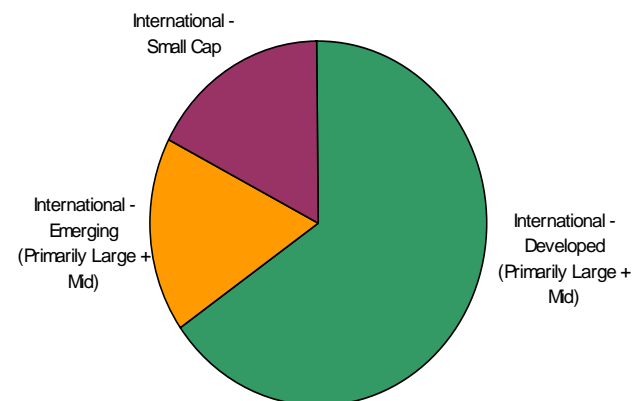
E.g. ACWI x-US (Passive and Active)

Developed + Emerging



E.g. ACWI x-US (Passive only), MSCI EAFE, MSCI EM

Developed + Emerging + Int'l Small Cap ("D+E+S Active")



Objectives and considerations when selecting a structure:

1. Cover broad spectrum of international equities
2. Significant number of potential managers
3. Reasonable expenses
4. Minimize overlapping exposures
5. Reduce complexity of ongoing management

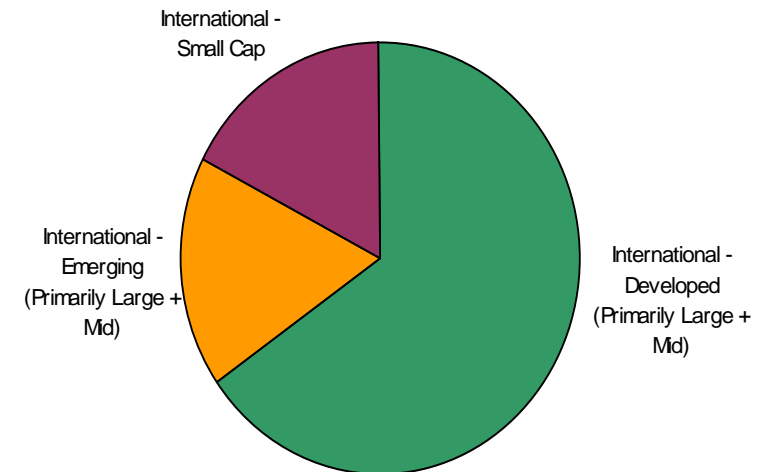
International Equity Structure

Recommended Structure – D+E+S Active

Rationale:

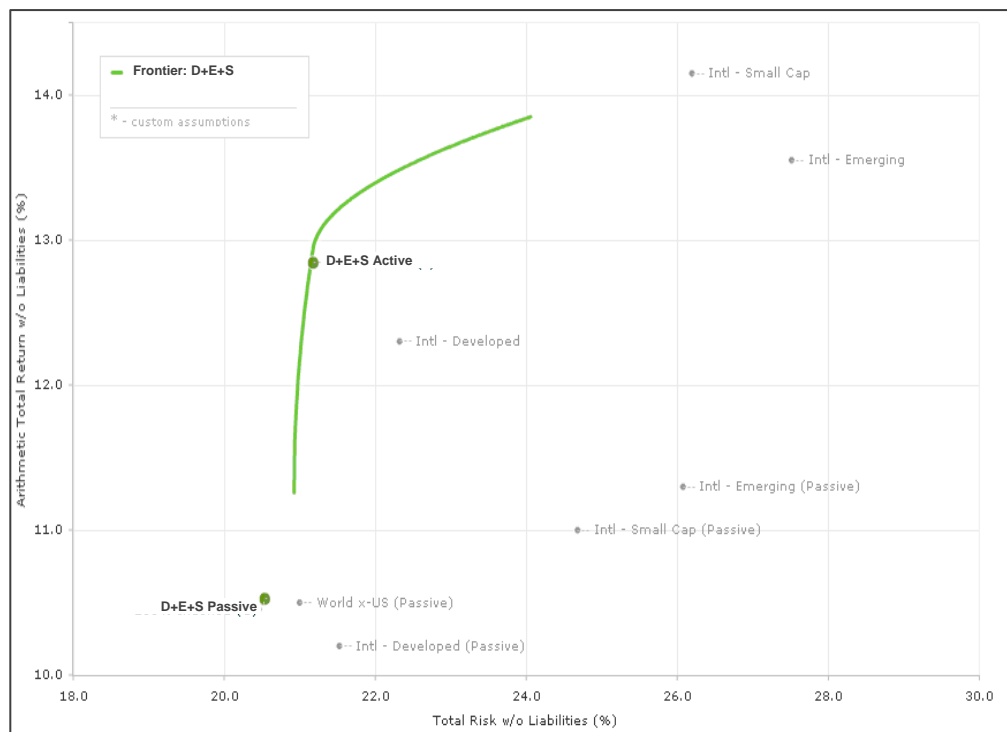
1. Broad international equity exposure
 - Includes int'l small cap and emerging markets
2. Wide selection of managers available within each of these categories
3. Reasonable expenses
 - Institutional share classes would be available to the DCP; however, having no passive component leads to higher fees
4. Minimize overlapping exposures
 - Underlying managers specialize in particular part of the international equity landscape
5. Relatively low complexity of ongoing management

D+E+S Active Structure



International Equity Structure

Efficient Frontier



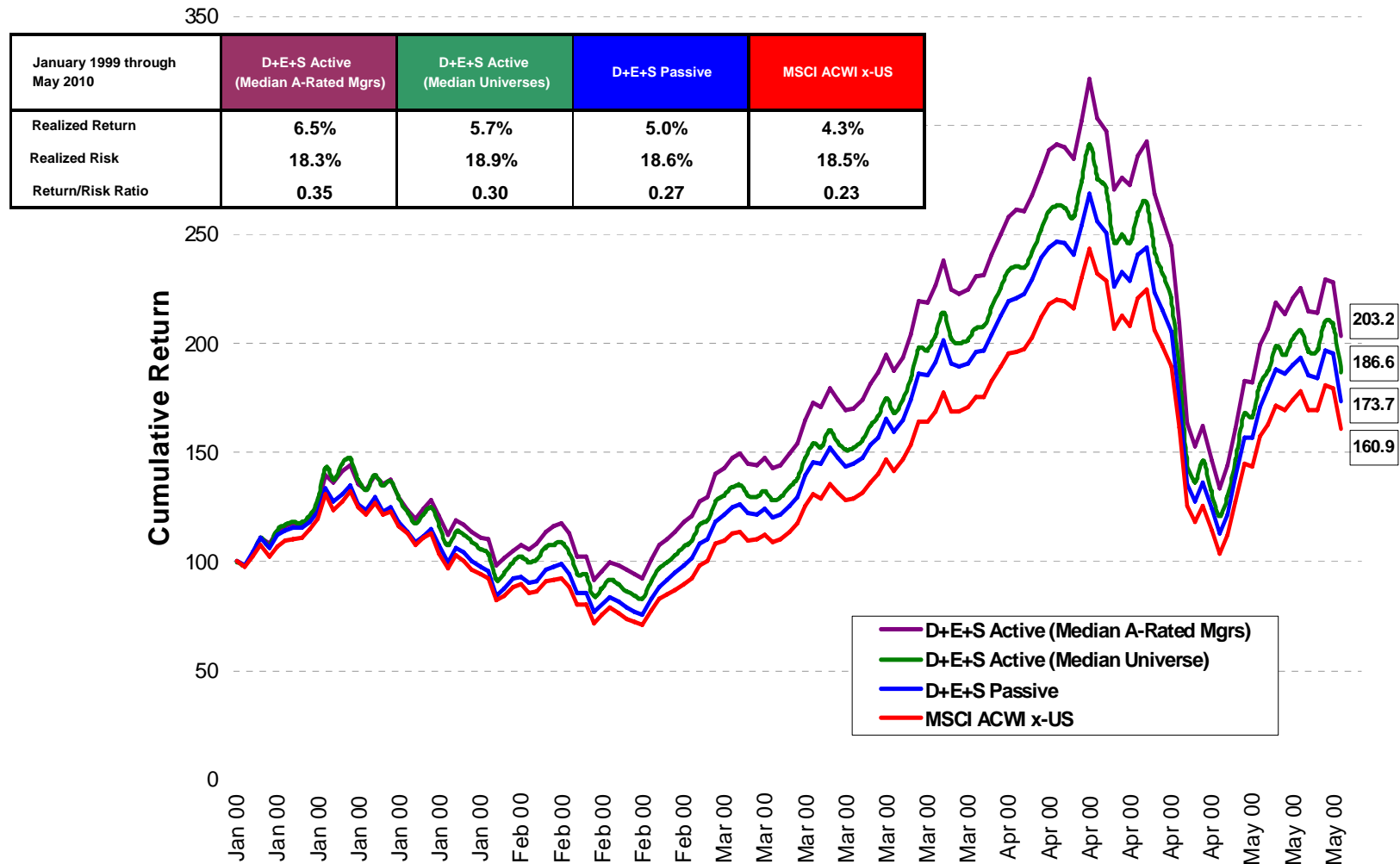
Options	D+E+S Active	D+E+S Passive
<i>Portfolio Allocations</i>		
International - Developed	65.0	65.0
International - Emerging	17.5	17.5
International - Small Cap	17.5	17.5
<i>Expected Risk and Return Characteristics - Net of Fees</i>		
Total Return	9.66	8.67
Total Standard Deviation	21.18	20.54
Reward to Risk Ratio	0.46	0.42
Alpha (Excess Return)	0.95	0.00
Tracking Error	5.25	0.98
Information Ratio	0.18	0.00

- **How can active management in international equities provide incremental return over passive management while not substantially increasing volatility?**
 - **Fundamental research may yield greater advantages internationally**
 - Size, transparency, disclosure
 - **Index construction imperfections**
 - “Bubble” economies can take disproportionate weight
 - **Currency exposure can be managed more effectively**
 - Strong equity market does not mean a strong currency necessarily

International Equity Structure

Backtest Analysis – Cumulative Returns

- We compared 2 D+E+S Active portfolios¹ to the D+E+S Passive portfolio² as well as MSCI All Country World (ACWI) ex-US Index, representing developed and emerging market stocks



¹ One D+E+S Active portfolio used Mercer's A-rated manager median performance in each category and the other used the median manager performance from each category's universe.

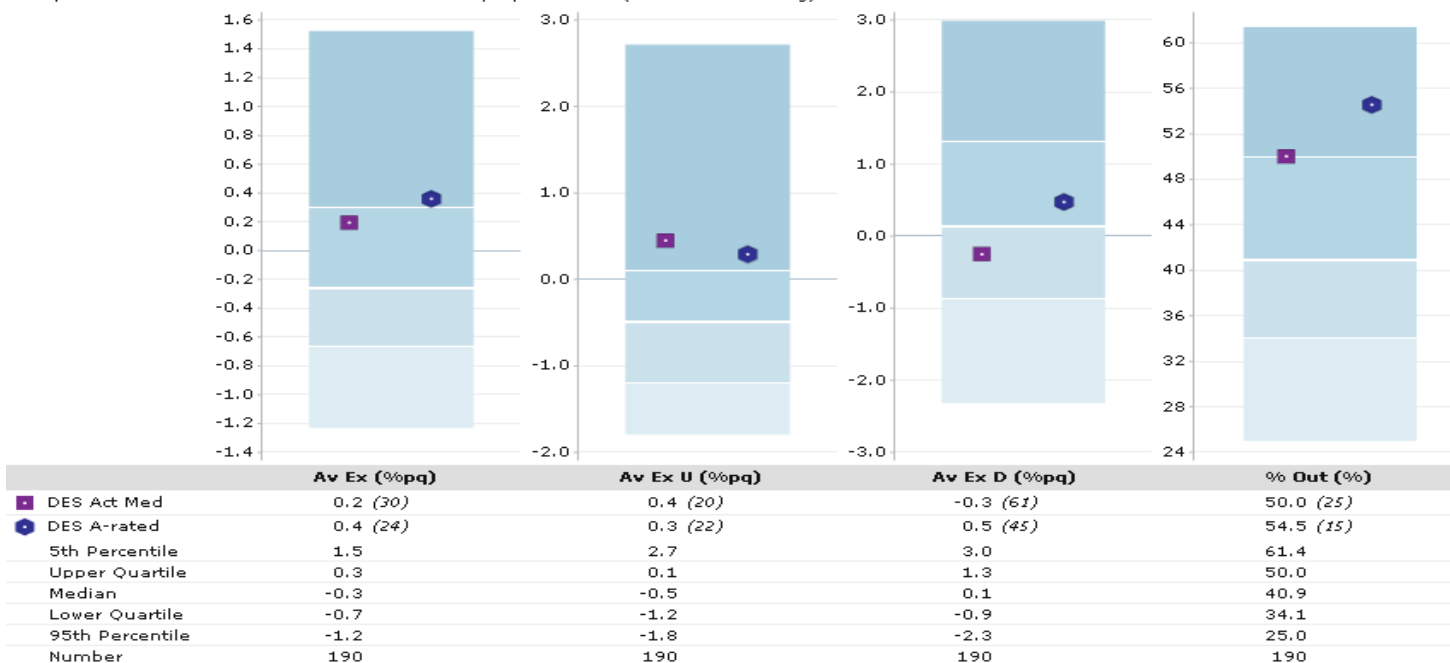
² D+E+S Passive uses the same weights as the D+E+S Active but uses completely passive management

International Equity Structure

Backtest Analysis Summary

- In summary, our findings were that the D+E+S Active portfolio structure:
 - outperformed the alternatives generally
 - provided greater downside protection generally
 - particularly was aided by international small cap active management
 - was enhanced by using Mercer’s highly-rated managers

D+E+S Active (Median Mgr) & D+E+S Active (Mercer A-rated) qrtly excess perf. relative to ACWI ex-US
 Performance characteristics vs. D+E+S Passive in \$US (after fees) over 11 years ending March-10 (quarterly calculations).
 Comparison with the Mutual Fund International Equity universe. (Percentile Ranking).



Notes:

- Bar charts depict universe quarterly excess performance relative to MSCI ACWI-ex US Index.
- 44 total quarterly periods (28 up markets/16 down markets) in sample
- Av Ex = Average excess performance over all periods; Av Ex U = Average excess performance in up markets; Av Ex D = Average excess performance in down markets; % outperformance = Percentage of total periods that strategy outperformed over all periods

International Equity Structure

Investment Product Availability

- The quantity of active international strategies is large, and Mercer has high ratings on a subset of these
- The number of passive international strategies amounts to only about 10% of active international strategies
- The number of passive international small cap strategies is particularly small
- Many index products are not offered through the convenience of a mutual fund vehicle
 - Some of these commingled trusts would not be eligible for 457 plans
- In practice, Mercer has high conviction in only a handful of index providers

<i>International active strategies</i>	Lipper Mutual Fund Universe	Approx. # of Non-Mutual Fund vehicles*	Mercer Universe (All vehicle types)	<i>International passive strategies</i>	Lipper Mutual Fund Universe	Approx. # of Non-Mutual Fund vehicles*	Mercer Universe (All vehicle types)
Developed International	167	140	305	Developed International	23	20	40
Emerging Markets	123	200	319	Emerging Markets	9	10	22
International Small Cap	17	60	78	International Small Cap	3	0	1
Total	307	400	702	Total	35	30	63

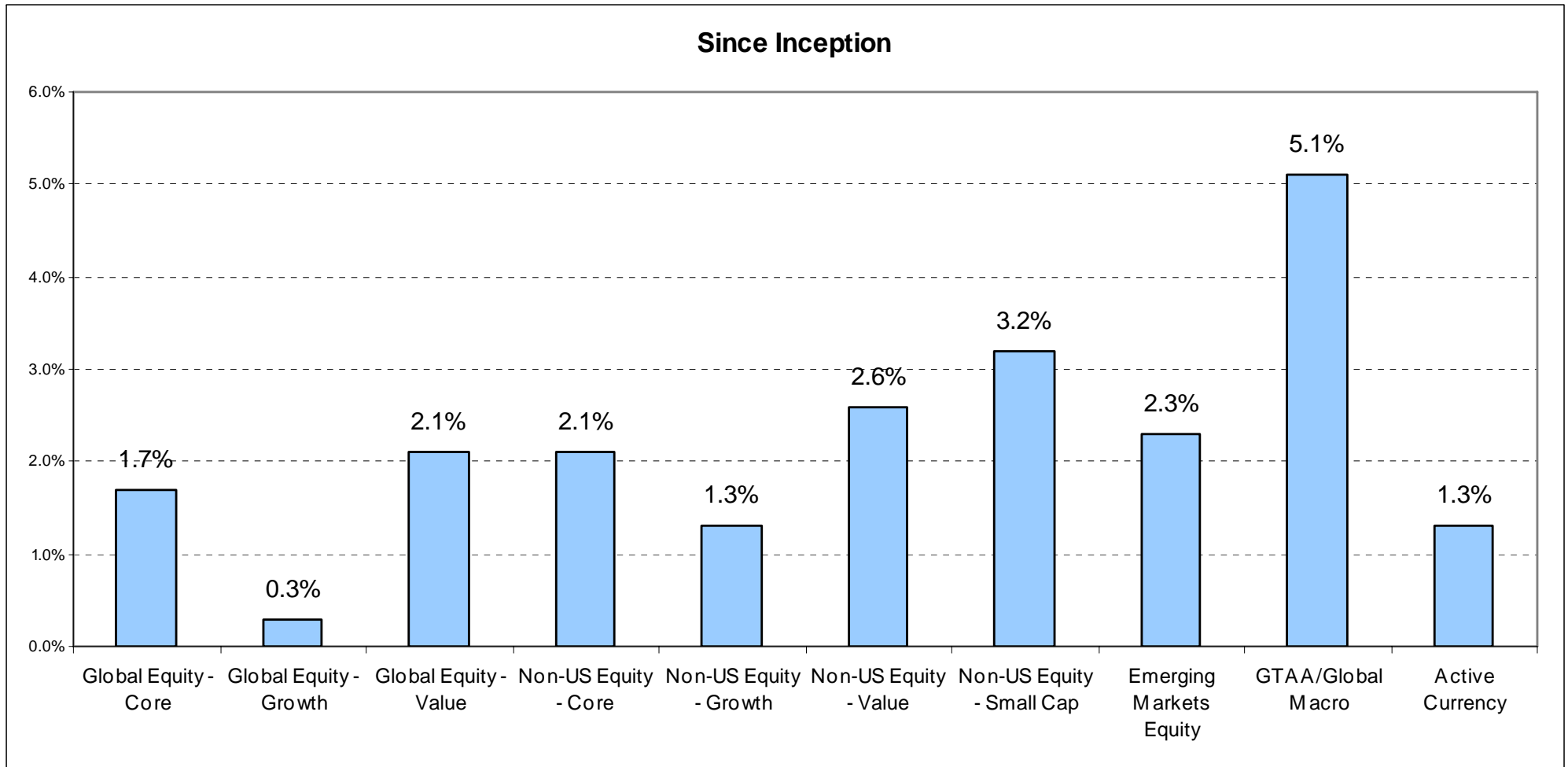
* Approx. non-mutual fund vehicle count approximated from difference of total investment strategies in Mercer Universe and the number of funds in the Lipper Mutual Fund Universe. To the extent that these two databases have unique constituents, actual count may differ.

Appendix: Supporting Data and Assumptions

Supporting Data

Alpha Opportunities Exist Through Manager Research/Selection

Value Added Through Mercer Manager Research Recommendations ending March 31, 2010



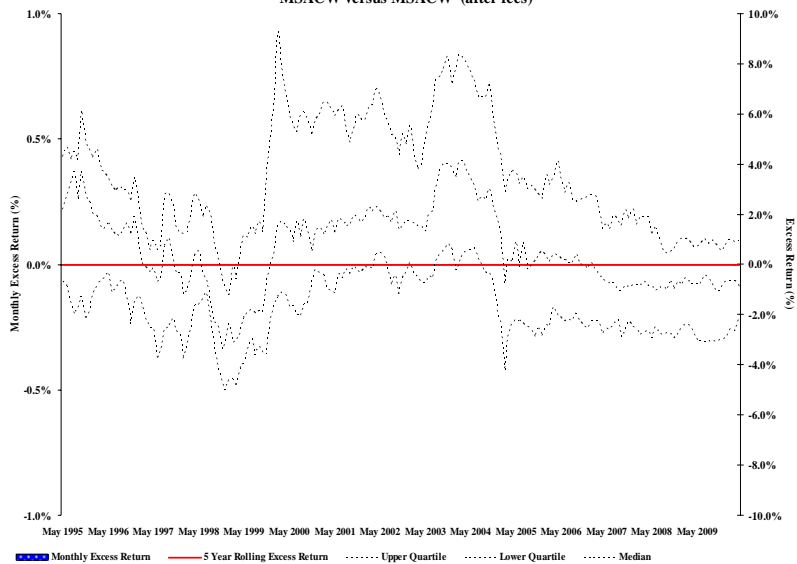
Note: As of March 31, 2010. Value added is calculated as the average return per annum for the A rated strategies since inception less the average return of the style specific benchmark (see Disclaimer).

Supporting Data

International Equity Excess Return Quartiles

Global

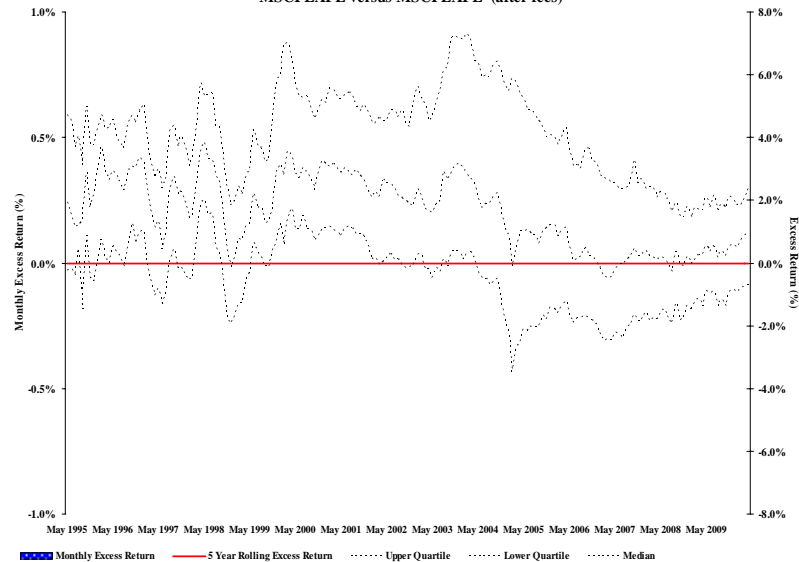
Excess Return in Mutual Fund Global Equity from May 1995 to Apr 2010
MSACW versus MSACW (after fees)



Created on 26 May 2010. Data Source: Lipper, Inc.

International

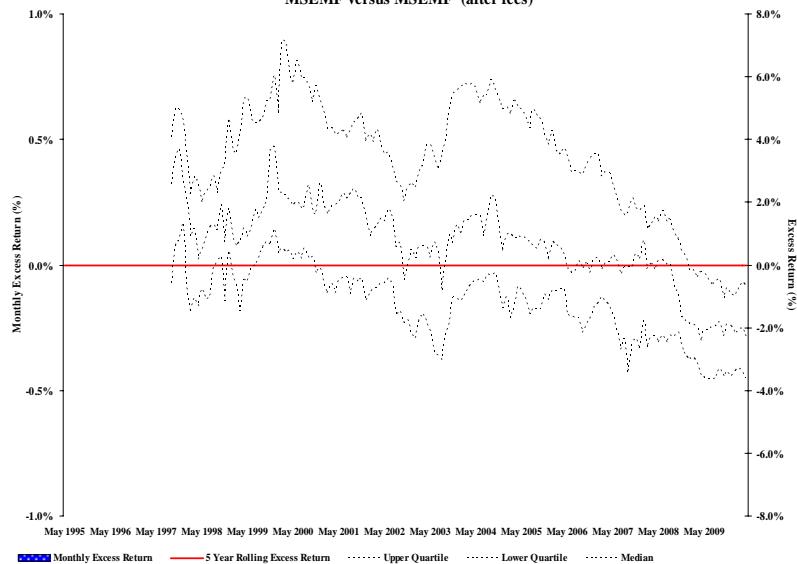
Excess Return in Mutual Fund International Equity from May 1995 to Apr 2010
MSCIEAFE versus MSCIEAFE (after fees)



Created on 26 May 2010. Data Source: Lipper, Inc.

Emerging Markets

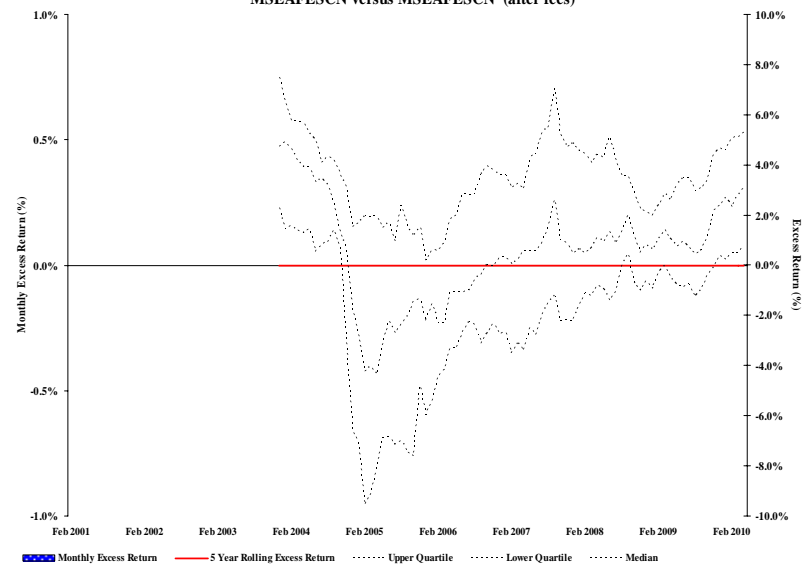
Excess Return in Mutual Fund Emerging Markets Equity from May 1995 to Apr 2010
MSEMF versus MSEMF (after fees)



Created on 26 May 2010. Data Source: Lipper, Inc.

International Small Cap

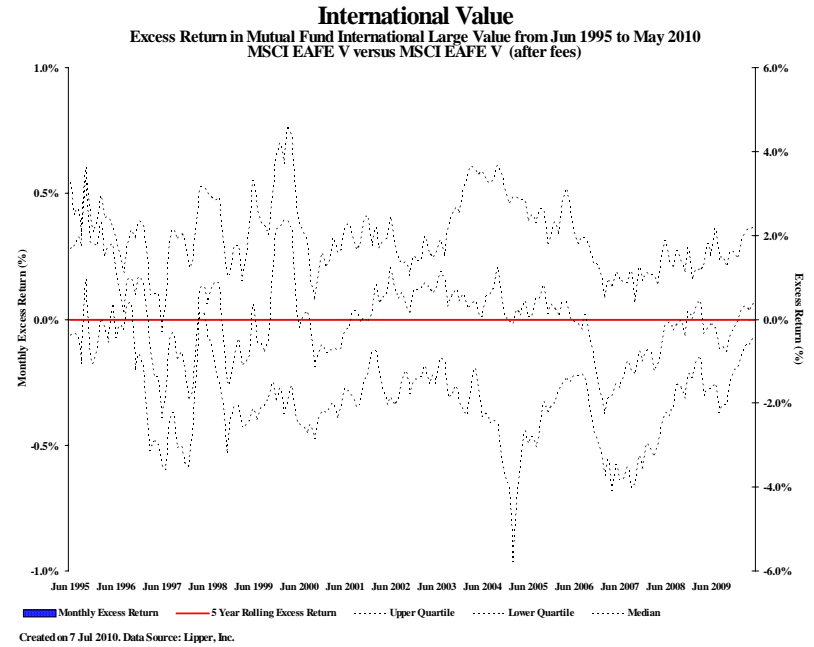
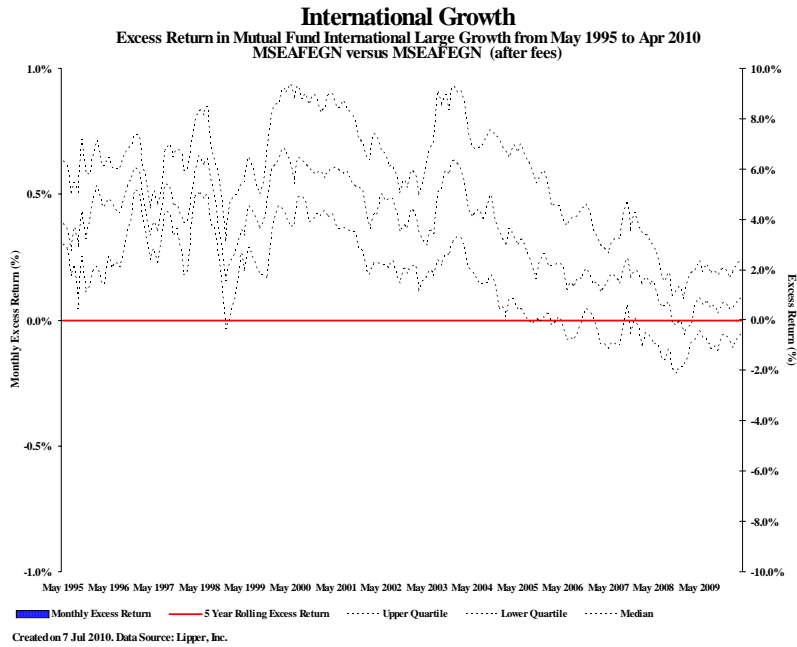
Excess Return in Mutual Fund International Equity Small Cap from Feb 2001 to Apr 2010
MSEAFESC versus MSEAFESC (after fees)



Created on 26 May 2010. Data Source: Lipper, Inc.

Supporting Data

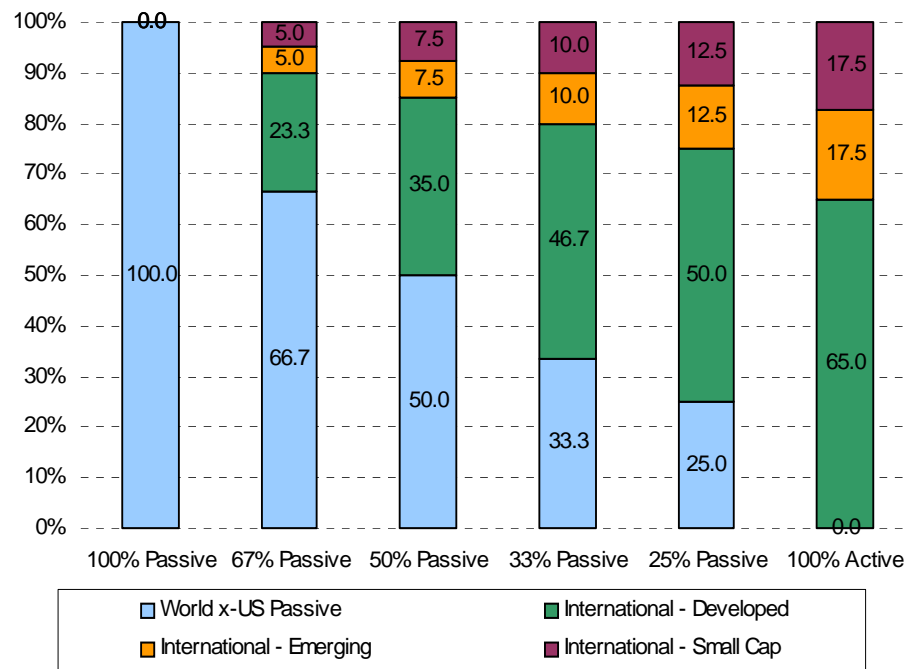
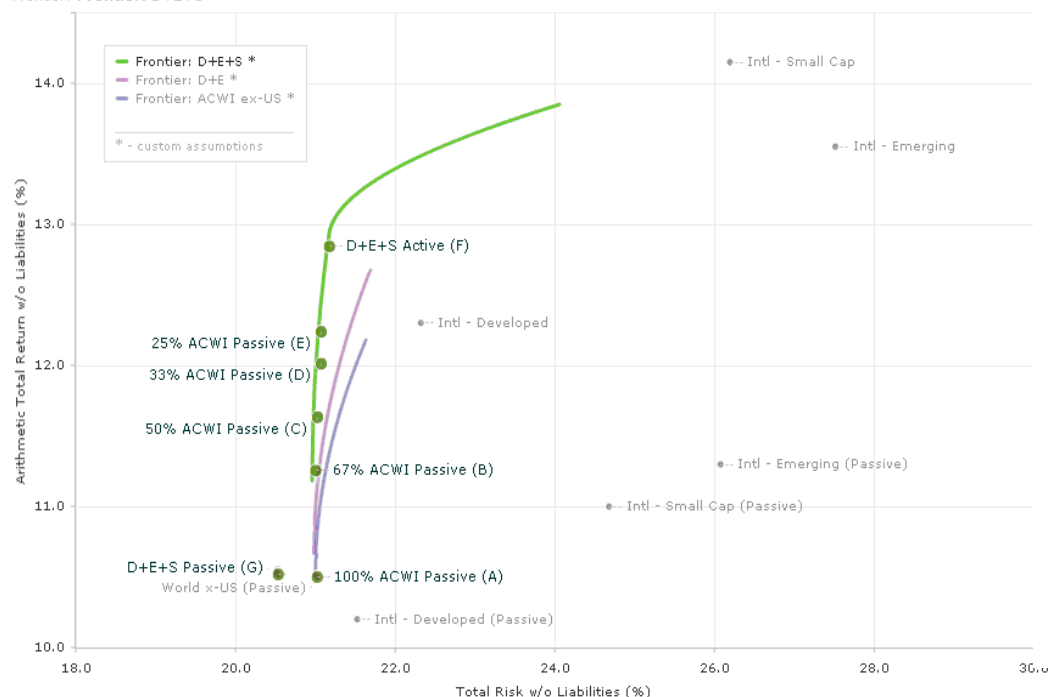
International Equity Excess Return Quartiles



International Equity Structure

International: Developed, Emerging & Small Cap

Frontier: Frontier: D+E+S



Options	100% ACWI Passive	67% ACWI Passive	50% ACWI Passive	33% ACWI Passive	25% ACWI Passive	D+E+S Active	D+E+S Passive
<i>Portfolio Allocations</i>							
World x-US Passive	100.0	66.7	50.0	33.3	25.0	0.0	0.0
International - Developed	0.0	23.3	35.0	45.7	50.0	65.0	65.0
International - Emerging	0.0	5.0	7.5	10.0	12.5	17.5	17.5
International - Small Cap	0.0	5.0	7.5	10.0	12.5	17.5	17.5
<i>Expected Risk and Return Characteristics - Net of Fees</i>							
Total Return	8.55	8.91	9.08	9.25	9.37	9.66	8.67
Total Standard Deviation	21.02	21.01	21.03	21.07	21.08	21.18	20.54
Reward to Risk Ratio	0.41	0.42	0.43	0.44	0.44	0.46	0.42
Alpha (Excess Return)	0.00	0.33	0.49	0.64	0.72	0.95	0.00
Tracking Error	1.00	2.18	2.93	3.71	4.08	5.25	0.98
Information Ratio	0.00	0.15	0.17	0.17	0.18	0.18	0.00

Assumptions

Portfolio Modeling Inputs

Asset Class	Mean-Variance Assumptions									Factor Scores					
	20-Yr Assumptions			Shorter Geometric Returns					Equil Return	Equity				T-Costs	Infl Hedg
	GRR	ARR	STD	1-Yr	2-Yr	3-Yr	5-Yr	10Yr		Beta	Dur	Liq	Inc		
Domestic Equity															
All Cap	8.3%	10.2%	20.5%	8.3%	8.3%	8.3%	8.3%	8.3%	8.3%	1	0	93	2	30	50
Large Cap	8.1%	9.9%	20.0%	8.1%	8.1%	8.1%	8.1%	8.1%	8.1%	0.97	0	95	2.2	25	50
Mid Cap	8.2%	10.6%	23.2%	8.2%	8.2%	8.2%	8.2%	8.2%	8.2%	1.06	0	92	1.4	30	50
Small Cap	8.4%	11.1%	25.1%	8.4%	8.4%	8.4%	8.4%	8.4%	8.4%	1.1	0	90	1.1	50	50
Micro Cap	8.6%	12.8%	31.8%	8.6%	8.6%	8.6%	8.6%	8.6%	8.6%	1.27	0	85	0.5	70	50
Smid Cap	8.4%	10.8%	23.4%	8.4%	8.4%	8.4%	8.4%	8.4%	8.4%	1.08	0	91	1.3	40	50
International Equity															
Developed All Cap Unhedged	8.3%	10.3%	21.5%	8.3%	8.3%	8.3%	8.3%	8.3%	8.3%	1.00	0	89	2.3	55	50
Developed All Cap Hedged	8.2%	10.0%	20.5%	8.1%	8.1%	8.1%	8.1%	8.1%	8.1%	1.00	0	89	2.3	57	50
Developed Large Cap Unhedged	8.2%	10.2%	21.5%	8.2%	8.2%	8.2%	8.2%	8.2%	8.2%	0.99	0	90	2.6	50	50
Developed Large Cap Hedged	8.0%	9.9%	20.5%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	0.99	0	90	2.6	50	50
Developed Small Cap Unhedged	8.4%	11.0%	24.6%	8.4%	8.4%	8.4%	8.4%	8.4%	8.4%	1.15	0	87	1.4	60	50
Developed Small Cap Hedged	8.4%	10.8%	23.5%	8.4%	8.4%	8.4%	8.4%	8.4%	8.4%	1.15	0	87	1.4	62	50
Emerging Mkts Unhedged	8.4%	11.3%	26.0%	8.4%	8.4%	8.4%	8.4%	8.4%	8.4%	1.27	0	83	2	75	50
World x-U.S. All Cap Unhedged	8.6%	10.5%	21.0%	8.6%	8.6%	8.6%	8.6%	8.6%	8.6%	1.00	0	88	2.6	63	50
World x-U.S. All Cap Hedged	8.5%	10.3%	20.3%	8.5%	8.5%	8.5%	8.5%	8.5%	8.5%	1.00	0	88	2.6	64	50
World x-U.S. Large Unhedged	8.5%	10.5%	20.9%	8.6%	8.6%	8.6%	8.6%	8.6%	8.6%	0.99	0	89	2.4	55	50
World x-U.S. Large Hedged	8.4%	10.2%	20.2%	8.4%	8.4%	8.4%	8.4%	8.4%	8.4%	0.99	0	89	2.4	57	50
Global All Cap Unhedged	8.7%	10.3%	19.5%	8.6%	8.6%	8.6%	8.6%	8.6%	8.6%	1.00	0	90	2.2	62	50
Global All Cap Hedged	8.6%	10.2%	19.2%	8.6%	8.6%	8.6%	8.6%	8.6%	8.6%	1.00	0	90	2.2	64	50
Global Large Cap Unhedged	8.6%	10.2%	19.3%	8.5%	8.5%	8.5%	8.5%	8.5%	8.5%	0.99	0	91	2.2	55	50
Global Large Cap Hedged	8.5%	10.1%	19.1%	8.5%	8.5%	8.5%	8.5%	8.5%	8.5%	0.99	0	91	2.3	56	50
Global Small Cap Unhedged	8.8%	11.1%	22.6%	8.9%	8.9%	8.9%	8.9%	8.9%	8.9%	1.08	0	83	1.2	75	50
Global Small Cap Hedged	8.8%	11.0%	22.2%	8.8%	8.8%	8.8%	8.8%	8.8%	8.8%	1.08	0	83	1.2	77	50
Domestic Fixed Income															
Gov/Corp	4.8%	5.0%	6.5%	0.9%	1.2%	1.5%	3.0%	4.2%	5.3%	0.1	5.3	94	4.1	30	20
Aggregate	4.9%	5.1%	6.0%	1.0%	1.3%	1.6%	3.1%	4.3%	5.4%	0.1	4.4	93	4.5	35	20
Short G/C	4.3%	4.4%	3.5%	0.2%	0.3%	0.7%	2.4%	3.6%	4.4%	0	1.9	95	3	20	55
Intermediate G/C	4.7%	4.8%	5.0%	0.5%	0.9%	1.2%	2.8%	4.7%	5.0%	0	3.9	94	3.8	30	40
Long G/C	5.3%	6.0%	12.0%	2.4%	2.5%	2.7%	4.0%	4.9%	5.9%	0.1	12.2	95	5.8	25	20
Very Long Bonds	4.5%	6.2%	19.0%	1.4%	1.5%	1.5%	3.0%	4.1%	5.1%	0	20	96	4.9	20	10
Government	4.3%	4.5%	7.0%	0.4%	0.6%	0.8%	1.8%	3.7%	4.6%	0	4.7	99	3.2	10	20
Corporate/Credit	5.5%	5.7%	7.0%	1.9%	2.2%	2.5%	3.9%	5.5%	6.0%	0.2	6.3	90	5.5	50	30
Intrmd Gov	4.1%	4.2%	5.5%	-0.1%	0.3%	0.6%	2.3%	3.5%	4.2%	0	3	99	3	10	40
Long Government	4.7%	5.4%	12.0%	1.3%	1.5%	1.7%	3.1%	4.1%	5.1%	0	12.4	99	5.1	10	10
Intrmd Credit	5.3%	5.4%	5.5%	1.3%	1.6%	1.9%	3.5%	4.7%	5.4%	0.2	4.4	89	5.2	50	40
Long Credit	6.0%	6.7%	12.0%	3.3%	3.4%	3.5%	4.7%	5.6%	6.5%	0.2	12	89	6.3	60	30
Mortgage-Backed	5.0%	5.2%	6.3%	3.7%	3.7%	3.8%	4.8%	4.9%	6.0%	0	3.1	88	5.1	60	30
High Yield	6.3%	6.8%	10.5%	6.3%	6.3%	6.3%	6.3%	6.3%	6.3%	0.5	4.3	70	8.7	120	60
Muni Bonds	4.3%	4.6%	8.3%	4.3%	4.3%	4.3%	4.3%	4.3%	4.3%	0	5.7	70	5	120	30
Infl Indexed Bonds	4.6%	4.7%	4.5%	4.5%	4.5%	4.5%	4.5%	4.7%	4.8%	0	2.4	96	3.7	20	85
Intermediate IIBs	4.2%	4.2%	3.0%	4.2%	4.2%	4.2%	4.2%	4.2%	4.6%	0	1.8	95	3.5	25	85
Long IIBs	4.9%	5.1%	7.0%	4.9%	4.9%	4.9%	4.9%	4.9%	5.0%	0	4.8	95	4.1	25	85
Cash	3.4%	3.4%	1.3%	0.5%	1.2%	1.8%	2.6%	3.1%	3.8%	0	0.1	100	0.3	4	85

Source: Mercer Capital Market Outlook Summary, April 2010

Disclaimers

Disclaimers

Measurement of Value Added Through Manager Research

Mercer's investment consulting group has developed and implemented a methodology for measuring the value added through their manager research recommendations. An explanation of this methodology is presented below.

Measurement methodology

For each investment product that we research, we arrive at a rating on a four tier scale in which the possible ratings are A, B+, B, and C. When we formulate short lists of candidates for clients to consider in manager searches, these are generally drawn from the list of products rated A within the relevant product category. We first started maintaining formal ratings on this basis in 1995, replacing less formal methods in place before then, and have extended this to cover all product categories that we actively research over the period since.

Our methodology for measuring the performance of our ratings entails calculating the average performance of the strategies that we rated A within each product category each quarter, based on the ratings as they stood at the end of the previous quarter. Therefore there is no element of hindsight in the analysis. We then compound these quarterly results together to calculate performance over longer periods. Finally, we subtract the return for an appropriate and widely accepted benchmark index for the product category concerned to calculate value added. We also calculate a risk-adjusted measure of the value added called the information ratio.

In essence, this methodology tracks the performance of a hypothetical Mercer client that is assumed to split its money evenly between all of the strategies rated A by Mercer within the product category concerned. This hypothetical Mercer client is assumed to have reviewed its manager line-up at the end of each quarter, based on the Mercer ratings as they stood at that point in time. A typical client would not invest in all strategies in all of the categories, as some may not be relevant to a client for a variety of reasons. Therefore the actual added value of strategies selected by a client would vary from the results depicted here. The average added value for each product category is described in the attachments.

Three types of strategy are excluded from the analysis. Firstly, we exclude strategies that are sub-advised by other investment managers, to avoid double-counting. Secondly, where a manager offers two variants of what is essentially just one strategy, we only include one of these in the analysis (the one with the longer track record), once again to avoid double counting. Thirdly, if a strategy's track record relates to a non-standard benchmark index that is materially different than the benchmark index used in the analysis for the product category concerned, it will be excluded from the analysis to avoid distortions that could arise solely as a result of the non-standard benchmark index.

For some product categories where the use of custom benchmarks is prevalent there is no single widely accepted benchmark index that can be used as a basis for this analysis. We have used a slightly different methodology for these categories. In these cases we have carried out the analysis by firstly calculating value added separately each quarter for each track record relative to its custom benchmark, then calculating the average of these value added numbers each quarter, and then compounding the quarterly value added numbers together to calculate value added over longer periods.

We have carried out these calculations for all of the product categories that we both maintain ratings for and for which we have reliable investment performance data (currently 72 categories), going back in each case to when we first started maintaining ratings for the product category concerned.

Disclaimers

Measurement of Value Added Through Manager Research

Some important caveats

All of the added value figures have been calculated by Mercer, but are based upon performance data provided to Mercer by the investment managers concerned. Mercer generally does not independently verify the performance information provided by investment managers.

The methodology described above does not allow for the transaction costs that an investor would have incurred if it had actually changed its panel of investment managers every quarter in line with changes to the list of products rated A by Mercer within the product category concerned. In practice, the turnover of managers incurred by such an investor would have averaged out at about 16% per annum (the actual averages since inception for each product category are shown in the final section of the results). We have not attempted to estimate the transaction costs that would actually have been incurred as this would require assumptions about a number of factors, including the investor's cash flow position and how well the changes had been implemented.

All investment performance data used to create this analysis was reported gross of investment management fees and certain other expenses, such as custody and administration. All of the value added figures likewise are quoted before deduction of these fees. The figures are however net of all transaction costs that the managers concerned have incurred within their investment portfolios.

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