

# INVESTMENTS COMMITTEE COMMITTEE REPORT 10-01

Investments Committee Members

Richard Kraus, Chairperson

Sangeeta Bhatia

John Mumma

Michael Perez

Date: October 20, 2010  
To: Investments Committee  
From: Staff  
Subject: Investment Menu Consolidation

Recommendation:

That the Investments Committee:

- (a) Adopt for recommendation to the full Board the Procurement Plan as outlined in this report;
- (b) Adopt for recommendation to the full Board an instruction to staff to draft a contract amendment adding \$175,000 to the consultant contract ceiling amount;
- (c) Develop a recommendation to the full Board resolving whether decision-making related to these selection processes will be vetted through the Committee and then considered by the full Board; delegated to the Committee; or considered by the full Board without being vetted by the Committee;
- (d) Develop a recommendation to the full Board to use the Plan's new core menu components (including the blended Mid-Cap, Small-Cap, and International core funds) to populate the Plan's Asset Allocation Funds, and direct the consultant to review whether adjustments should be made to the sector weightings within any or all of the funds.
- (e) Direct staff to develop a communication plan and related materials to explain the coming investment menu changes;
- (f) Direct staff to draft an Investment Policy document for consideration at its next meeting; and
- (g) Develop a recommendation to the full Board to initiate a search process for a Master Custodian.

Discussion:

At the August 17, 2010 meeting of the Board of Deferred Compensation Administration, the Board referred to the Investments Committee development of an implementation plan for its approved changes to the Plan's core investment menu. In this report staff will address the following primary areas related to implementation: (A) Procurement Plan, (B) Costing, (C) Manager Selection Timeline, (D) Consolidation, (E) Communications, and (F) Investment Policy.

## BACKGROUND

The Board has completed its adoption of a new core investment menu for the primary objective of promoting more effective asset allocation decisions among Plan participants. This objective will be met through two key steps:

- A. Reducing the number of options in the investment menu; and
- B. Branding investment options by asset class rather than investment manager.

Taking these two steps is consistent with the best practices of a number of large comparable plans, including the City of New York, State of California, and County of Los Angeles, which have already adopted investment models largely consistent with the City's.

The Board utilized the analysis of its Investments Committee and consultant in considering, over the course of several years and a series of meetings, each asset class component of an ideal investment menu. The Board has taken various actions to adopt the components of its investment menu, as well as the composition structures for each option.

The following table provides a summary of the investment menu categories, and their composition structures, as adopted by the Board:

Menu Offering	Composition Structure
DCP Deposit Savings Account	3 Providers of FDIC-Insured Deposit Savings Accounts (33% each)
DCP Stable Value Fund	1 Discretionary Stable Value Fund Manager (100%)
DCP Bond Fund	1 Active (50%), 1 Passive Manager (50%)
DCP Large-Cap Stock Fund	1 Passive Manager (100%)
DCP Mid-Cap Stock Fund	1 Passive (50%), 1 Active Value (25%), 1 Active Growth Manager (25%)
DCP Small-Cap Stock Fund	1 Passive (34%), 1 Active Value (33%), 1 Active Growth Manager (33%)
DCP International Fund	1 Developed Markets (65%), 1 Emerging Markets (17.5%), 1 Small-Cap Manager (17.5%)
DCP Ultra-Conservative Asset Allocation Fund	Blend of Core Asset Classes
DCP Conservative Asset Allocation Fund	Blend of Core Asset Classes
DCP Moderate Asset Allocation Fund	Blend of Core Asset Classes
DCP Aggressive Asset Allocation Fund	Blend of Core Asset Classes
DCP Ultra-Aggressive Asset Allocation Fund	Blend of Core Asset Classes
Self-Directed Brokerage Option	Various
<b>Total Options: 13</b>	<b>Total Managers Needed: 16</b>

Having adopted these investment menu components, the Board's task now is to adopt a plan for implementation by transitioning the current investment menu to the new menu.

## A. PROCUREMENT PLAN

Staff and the Board's consultant, Mercer Investment Consulting, have met to review the steps involved in transitioning the existing menu to the new menu. Because of the significant scope of the project, and the considerable time, resources, and costs involved with conducting procurement processes, staff has looked for areas where existing options can be used and procurement deferred. Staff has also attempted to develop a long-range plan for conducting procurement on a regular schedule in which not all options would be competitively searched at the same time.

The following table provides a summary of each core menu option and the proposed timing of the procurement:

Menu Offering	Procurement Status	Immediate Procurement Required?	Procurement Schedule
DCP Deposit Savings Account	Utilize existing manager(s)	No	2014
DCP Stable Value Fund	Utilize existing manager(s)	No	2014
DCP Bond Fund	Utilize existing manager(s)	No	2013
DCP Large-Cap Stock Fund	Utilize existing manager(s)	No	2013
DCP Mid-Cap Stock Fund	Utilize existing passive manager, conduction searches for active growth and active value managers	Yes (2)	2013 (Passive), 2011 (Active)
DCP Small-Cap Stock Fund	Utilize existing passive manager, conduct procurement for active growth and value managers	Yes (2)	2014 (Passive), 2011 (Active)
DCP International Fund	Conduct procurement for active developed, emerging, and small-cap managers	Yes (3)	2011
DCP Ultra-Conservative Asset Allocation Fund	Blend of Core Asset Classes	No	n/a
DCP Conservative Asset Allocation Fund	Blend of Core Asset Classes	No	n/a
DCP Moderate Asset Allocation Fund	Blend of Core Asset Classes	No	n/a
DCP Aggressive Asset Allocation Fund	Blend of Core Asset Classes	No	n/a
DCP Ultra-Aggressive Asset Allocation Fund	Blend of Core Asset Classes	No	n/a
Self-Directed Brokerage Option	Various	n/a	n/a
<b>Total Options: 13</b>	<b>Total Managers Needed: 16</b>	<b>7</b>	<b>9</b>

Recommended Procurement Deferrals - Staff and the consultant are recommending that procurement processes be deferred for the:

- (a) **DCP Deposit Savings Account** (since the Board recently conducted procurement for this option in 2009 and existing contracts run through September 2014);
- (b) **DCP Stable Value Fund** (since the Board recently conducted procurement for this option in 2009 and existing contracts run through June 2014);
- (c) **DCP Bond Fund** (since the Board's current providers meet the investment objectives of the new core fund and are strong performers);
- (d) **DCP Large-Cap Stock Fund** (since the Board's current provider meets the investment objectives of the new core fund and is a strong performer);
- (e) **DCP Mid-Cap Fund-Passive Manager Only** (since the Board recently conducted procurement for this option in 2009 – no contract is required on this option because it is a mutual fund); and
- (f) **DCP Small-Cap Fund-Passive Manager Only** (since the Board recently conducted procurement for this option in 2009 and the existing contract runs through September 2014).

Recommended Procurements for 2011 – Staff and the consultant are recommending that procurement processes be initiated for the:

- (a) **DCP Mid-Cap Active Growth and Value Managers Only** (since the current manager does not meet the composition structure mandate and has been an under-performing option);
- (b) **DCP Small-Cap Active Growth and Value Managers Only** (since there are no incumbent managers in these categories); and
- (c) **DCP International Managers** (since the incumbent active developed markets manager may or may not be an optimal choice for meeting the composition structure mandate and because there are no incumbent managers in the remaining categories).

**Action Item: Staff recommends that the Committee adopt for recommendation to the full Board the Procurement Plan as outlined in this report.**

### C. COSTING

Staff asked Mercer to prepare costing estimates for its work on the proposed seven (7) procurements to be conducted in 2011. The figures included in the table below are based on the hourly billing rates provided for in the consulting contract multiplied by the estimated number of hours each review could involve. The results are as follows:

	Total	Cost Per Search			Total Cost		
		Low Estimate	Middle Estimate	High Estimate	Low Estimate	Middle Estimate	High Estimate
Active Manager Searches	7	\$ 16,355	\$ 20,553	\$ 24,750	\$ 114,485	<b>\$ 143,868</b>	\$ 173,250

This table indicates that the total consulting costs for executing these procurement processes could range from approximately \$114,485 to \$173,250, with the middle estimate being \$143,868. The annual budgeted/contract amount for Mercer is \$150,000. As a result, the Board would need to execute a contract amendment in 2011 to pay for these additional services.

**Action Item:** Staff recommends that the Committee adopt for recommendation to the full Board an instruction to staff to draft a contract amendment adding an additional \$175,000 to the annual contract ceiling amount in 2011.

**C. MANAGER SELECTION TIMELINE**

As Committee members are well aware, procurement processes are lengthy and involve a number of steps either required by the City’s procurement rules or built into the Board’s decision-making process. The volume of simultaneous activity that would be required in this particular group of searches will also add to the time involved. In the following table, Mercer has developed a tentative timeline for the initial group of manager searches. This timeline assumes that the Committee and the Board are able to take final action in the next few months, so that staff and Mercer can begin drafting Requests for Proposal (RFPs) with a targeted release date of March 2011.

City of Los Angeles Deferred Compensation Plan Proposed Portfolio Structure Implementation Timeline																						
		2011												2012								
Role	Activity	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
	<b>RFP Development</b>	[Shaded]												[Shaded]								
<i>Mercer</i>	Complete Draft RFP Development	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]
<i>Board</i>	Approval of RFPs by Board	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]
<i>Mercer/Staff</i>	Release RFPs	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]
<i>Investment Managers</i>	Allowance for RFP response time	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]
	<b>RFP Review</b>	[Shaded]												[Shaded]								
<i>Staff</i>	General Contracting Requirements Review	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]
<i>Mercer</i>	Review/score RFP responses	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]
<i>Mercer</i>	Search report: 3-6 candidates per search	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]
<i>Mercer/Staff</i>	Staff review & revision of search reports	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]
	<b>Decision process</b>	[Shaded]												[Shaded]								
<i>Inv. Committee/ Staff/Mercer</i>	1 <sup>st</sup> Investment Committee meetings to review finalists	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]
<i>Inv. Committee/ Staff/Mercer</i>	2nd Investment Committee mtg. to review finalists	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]
<i>Board</i>	Board approval	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]
	<b>Implementation</b>	[Shaded]												[Shaded]								
<i>Staff/Mercer</i>	Begin contract development (if nec.)	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]
<i>Staff/Mercer</i>	Notify Great West re managers/ models	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]
<i>Staff/Great West</i>	Final participant communications	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]
<i>Staff/Mercer/Great West</i>	Transition implemented	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]	[Shaded]

One decision the Committee and Board need to resolve is whether decision-making related to these selection processes will be vetted through the Committee and then considered by the full Board; delegated to the Committee; or considered by the full Board without being vetted by the Committee. The first approach will tend to lengthen the total time devoted to the process; the latter two approaches will tend to shorten it.

**Action Item:** Staff recommends that the Committee develop a recommendation to the full Board resolving whether decision-making related to these selection processes will be vetted through the Committee and then considered by the full Board; delegated to the Committee; or considered by the full Board without being vetted by the Committee.

#### D. CONSOLIDATION

The Board’s actions to create a new investment menu lineup also will eliminate certain options from the Plan. Assuming the Board adopts the Procurement Plan outlined in this report, the migration of the current investment menu to the new menu would be as follows:

Menu Category	Current Provider(s)/Fund(s)	Migration
DCP Deposit Savings Account	Bank of America	Retain
	City National Bank	Retain
	Bank of the West	Retain
DCP Stable Value Fund	Galliard Capital Management	Retain
DCP Bond Fund	Vanguard Institutional Index	Retain (w/rebalance mapping)
	PIMCO Total Return	Retain (w/rebalance mapping)
DCP Large-Cap Stock Fund	Vanguard Institutional Index	Retain
	Growth Fund of America	Map to S&P 500 Index
	Investment Co. of America	Map to S&P 500 Index
	Hartford Cap. Appreciation	Map to S&P 500 Index
DCP Mid-Cap Stock Fund	Vanguard Mid-Cap Index	Retain (w/rebalance mapping)
	Lazard Mid-Cap Institutional	Map to Mid-Cap Blend
DCP Small-Cap Stock Fund	SSgA Russell 2000 Index	Retain
DCP International Fund	DWS EAFE Equity Index	Competitive Search
	Fidelity Diversified Intl.	Competitive Search
DCP Ultra-Conservative Asset Allocation Fund	Blend of Index Funds + SVF	Index Blend or Core Blend?
DCP Conservative Asset Allocation Fund	Blend of Index Funds + SVF	Index Blend or Core Blend?
DCP Moderate Asset Allocation Fund	Blend of Index Funds + SVF	Index Blend or Core Blend?
DCP Aggressive Asset Allocation Fund	Blend of Index Funds + SVF	Index Blend or Core Blend?
DCP Ultra-Aggressive Asset Allocation Fund	Blend of Index Funds + SVF	Index Blend or Core Blend?
Self-Directed Brokerage Option	Charles Schwab	Retain

An issue remaining to be resolved concerns the Plan’s risk-based Asset Allocation Funds. Each of these funds can contain, under the current structure, some mix of the following:

- DCP Stable Value Fund
- Vanguard Institutional Index (Large-Cap)
- Vanguard Mid-Cap Index (Mid-Cap)

- SSgA Russell 2000 Index (Small-Cap)
- DWS EAFE Equity Index (International)

With adoption of the new DCP International Fund structure (which will not include a passive international fund manager), at minimum the Asset Allocation funds will need to substitute the current DWS EAFE Equity Index with the new core DCP International Fund. Also, there will be no change with respect to the Large-Cap component of these funds, since that was and will continue to be the Vanguard Institutional Index Fund.

The Committee must now develop a recommendation regarding whether the Asset Allocation funds will continue to use passive managers to populate the remaining components (Small-Cap and Mid-Cap) vs. using the new blended core Small-Cap and Mid-Cap funds. Staff's view is that, in light of the considerable amount of process used in developing these core offerings, and in particular in arriving at conclusions that active managers represent a superior model to creating all-passive funds, it would be logical to switch to using the new blended core Small-Cap and Mid-Cap funds for the Asset Allocation Funds. If this change is made, however, the consultant should review whether any adjustments should be made to the sector weightings within any or all of the funds.

**Action Item: Staff recommends that the Committee develop a recommendation to the full Board to use the Plan's new core menu components (including the blended Mid-Cap, Small-Cap, and International core funds) to populate the Plan's Asset Allocation Funds, and direct the consultant to review whether adjustments should be made to the sector weightings within any or all of the funds.**

## **E. COMMUNICATIONS**

Staff believes that communicating these changes to Plan participants is a process that should, once certain key decisions have been resolved, begin immediately. Staff believes that the Communication Plan should involve the following objectives:

- (1) Communicate the reasons for and objectives of changes to the investment menu;
- (2) Utilize a variety of media and communication tools (including published literature, the website, audio-visual, and group meetings); and
- (3) Communicate repetitively beginning well in advance of, and continuing through, implementation.

With the direction of the Committee, staff can begin developing a more definitive plan and related materials. Staff envisions a cornerstone of the communication effort involving a brief (several pages), highly visual booklet detailing the reasons for, and explaining the substance of, the changes. Work on this document should begin immediately because once finalized it will help guide all other communications media, including web postings, PowerPoint presentations, and audio-visual materials.

Generally, the communication plan would include a stream of messaging that would intensify as implementation draws closer. Staff would look for guidance from strategies used by other entities which have successfully implemented this kind of investment menu design structure.



**Action Item: Staff recommends that the Committee direct staff to develop a communication plan and related materials to explain the coming investment menu changes.**

## **F. INVESTMENT POLICY**

Concurrent with the implementation process the Board is now in a position to pull together the various elements of its investment design and review process within a formal investment policy. The policy will formalize in a single document the following:

- The objectives for the design and ongoing maintenance of the menu
- Components of the core menu
- The investment objectives and evaluation criteria for each of the core offerings
- Roles and responsibilities of the Board, Investments Committee, staff and consultant
- Procurement schedule
- Policies for evaluating/reviewing funds
- Policies for removing/replacing funds

Development of the policy can begin, and in staff's view finalized, relatively quickly. Through the considerable amount of policy work performed in arriving at this new menu, the Board has already defined its core menu objectives and components. The investment objectives and evaluation criteria will need to be developed/refined in connection with developing RFPs for any new offerings, and already exist for any current offerings. Roles and responsibilities are largely described within other documents, and review policies are already contained within the consultant's quarterly evaluations. The one area that may require more substantive discussion is the policies for removing/replacing funds, since the Board has had recent discussion regarding options for streamlining this process and making it more responsive to changes with the underlying managers.

**Action Item: Staff recommends that the Committee direct staff to draft an Investment Policy document for consideration at its next meeting.**

## **G. SEPARATE ACCOUNTS & MASTER CUSTODIAN**

Attached is a report/presentation from the Plan consultant regarding the use of separate account vehicles as candidates for the Plan's underlying investment vehicles; and a master custodian to enable the use of separate accounts. The issues surrounding this issue will be reviewed at length in that report/discussion. However, staff supports the use of separate account vehicles as candidates for the Plan's underlying investment vehicles, and further supports the concept of hiring a master custodian.

**Action Item: Staff recommends that the Committee develop a recommendation to the full Board to initiate a search process for a Master Custodian.**

## **CONCLUSION**

Implementation of the new investment menu will be a considerable effort but represents the culmination of a lengthy and exhaustive process to improve investment choices for Plan



participants. Once implemented, this new menu will create more clearly understood choices, promote investment diversification, and encourage the appropriate match of investment objectives and risk tolerance for each individual.

Submitted by: \_\_\_\_\_  
Steven Montagna

Approved by: \_\_\_\_\_  
Alejandrina Basquez