

INVESTMENTS COMMITTEE COMMITTEE REPORT 11-01

Investments Committee Members

Richard Kraus, Chairperson

Sangeeta Bhatia

John Mumma

Michael Perez

Date: April 11, 2011
To: Investments Committee
From: Staff
Subject: Investment Menu Consolidation

Recommendation:

That the Investments Committee:

- (a) Receive and file staff's proposed Procurement Plan as outlined in this report;
- (b) 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; and
- (c) Review, discuss and provide further direction to staff regarding a draft Investment Policy Statement.

INTRODUCTION

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. The Committee subsequently met on November 1, 2010 to consider recommendations from a report prepared by staff regarding a proposed procurement schedule and other related implementation initiatives.

The Investments Committee took several actions relative to action items identified in that report:

- (1) The Committee agreed to recommending that, with respect to procurement evaluations, the full Board review all matters related to the selection processes and delegate topics to the Investments Committee only when additional review was necessary;
- (2) The Committee directed staff and the consultant to begin work developing an investment policy;
- (3) The Committee approved developing a recommendation to the full Board regarding increasing the contract ceiling amount for the Board's consultant, Mercer Investment Consulting ("Mercer") in order to address additional costs related to investment manager searches; and

- (4) The Committee asked staff to develop a recommendation to the full Board regarding a procurement plan and implementation schedule.

Staff has deferred moving forward on items (3) and (4) until the Committee conducted the present meeting and had further opportunity to discuss the topics addressed in this report.

An additional discussion item at the Committee’s November 1, 2010 meeting involved the potential use of custodial services in the new investment menu. The Committee directed staff to research this issue and prepare a report to the full Board on this issue.

At the Board’s January 18, 2011 meeting staff presented a recommendation, adopted by the Board, to direct staff and the consultant to draft a Request for Proposal for a Fund Custodian. A Fund Custodian as described in the staff report is a firm capable of providing as-needed unitization services for separate account funds that might be included in the Plan’s investment lineup. In this report staff will address the following remaining primary areas related to implementation:

- (a) Recommendations regarding consolidation;
- (b) A proposed procurement schedule; and
- (c) A modified manager selection timeline.

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 consistent with the City’s.

The Board utilized the analysis of its Investments Committee and consultant in developing the components and structure of a new core investment menu. The following table provides a summary of the investment menu categories, and their composition structures, as adopted by the Board:

	Menu Offering	Composition Structure
1	Deposit Savings Account	3 Providers of FDIC-Insured Deposit Savings Accounts (33% each)
2	Stable Value Fund	1 Discretionary Stable Value Fund Manager (100%)
3	Bond Fund	1 Active (50%), 1 Passive Manager (50%)
4	Large-Cap Stock Fund	1 Passive Manager (100%)

5	Mid-Cap Stock Fund	1 Passive (50%), 1 Active Value (25%), 1 Active Growth Manager (25%)
6	Small-Cap Stock Fund	1 Passive (34%), 1 Active Value (33%), 1 Active Growth Manager (33%)
7	International Fund	1 Developed Markets (65%), 1 Emerging Markets (17.5%), 1 Small-Cap Manager (17.5%)
8	Ultra-Conservative Asset Allocation Fund	Blend of Core Asset Classes
9	Conservative Asset Allocation Fund	Blend of Core Asset Classes
10	Moderate Asset Allocation Fund	Blend of Core Asset Classes
11	Aggressive Asset Allocation Fund	Blend of Core Asset Classes
12	Ultra-Aggressive Asset Allocation Fund	Blend of Core Asset Classes
13	Self-Directed Brokerage Option	Various
	Total Options: 13	Total Managers Needed: 16

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. CONSOLIDATION

At its November 1, 2010 meeting, the Committee inquired as to whether it was necessary to wait for proposed procurement processes to be completed for all asset classes before beginning consolidation. The Committee asked staff to develop a recommendation to the full Board regarding an implementation schedule. Staff will now discuss what it is preparing to recommend.

The following table provides a summary of the Plan's new investment menu relative to issues involved in its implementation:

		IMPLEMENTED	FUNDS AVAILABLE FOR IMMEDIATE IMPLEMENTATION	IMPLEMENTATION POSSIBLE W/POST-PROCUREMENT ADJUSTMENTS
1	DCP Deposit Savings Account	✓		
2	DCP Stable Value Fund	✓		
3	DCP Bond Fund		✓	
4	DCP Large-Cap Stock Fund		✓	
5	DCP Mid-Cap Stock Fund			✓

6	DCP Small-Cap Stock Fund			✓
7	DCP International Fund			✓
8	DCP Ultra-Conservative Asset Allocation Fund	✓		
9	DCP Conservative Asset Allocation Fund	✓		
10	DCP Moderate Asset Allocation Fund	✓		
11	DCP Aggressive Asset Allocation Fund	✓		
12	DCP Ultra-Aggressive Asset Allocation Fund	✓		

Two of the Plan’s investment options (the **DCP Deposit Savings Account** and **DCP Stable Value Fund**) have already been established; two others have the underlying investment vehicles in place to proceed with immediate implementation (the **DCP Bond Fund** and the **DCP Large-Cap Stock Fund**); and five others (all of the Plan’s asset allocation funds) have been functionally established (although modest name changes might be considered and some adjustments may be required following procurement).

This leaves only three options for which the fund vehicles do not presently exist to be structured in accordance with the Board’s adopted restructuring. Staff will address each of these separately:

Mid-Cap – The Board’s adopted composition structure for the DCP Mid-Cap Fund is one Passive manager (50%), one Active Value manager (25%), and one Active Growth Manager (25%). The Plan currently has an incumbent passive manager and incumbent active value manager. A single blended option which would be comprised of 50% Passive manager and 50% Value manager could be created immediately, with the non-Passive component adjusted post-procurement. However, given the recent consultant recommendation to terminate the incumbent active manager (Lazard), staff will recommend that the new Plan-branded Mid-Cap Fund be established initially as 100% passively managed, with the Lazard holdings mapped to the current passive manager (Vanguard) and the non-Passive component adjusted post-procurement.

Small-Cap – The Board’s adopted composition structure for the DCP Small-Cap Fund is one Passive manager (34%), one Active Value manager (33%), and one Active Growth Manager (33%). The Plan currently has an incumbent passive manager and no active managers. Staff will recommend that a single blended option which would be comprised of 100% Passive manager be created immediately, with the non-Passive component adjusted post-procurement.

International – The Board’s adopted composition structure for the DCP International Fund is one Developed Markets manager (65%), one Emerging Markets manager (17.5%), and one Small-Cap Manager (17.5%). The Plan currently has an incumbent passive manager and

incumbent active manager. A single blended option which would be comprised of 50% Passive and 50% Active management could be created immediately, with the entire fund being adjusted post-procurement. However, given the current unsatisfactory performance of the incumbent active manager (Fidelity), staff will recommend that the new Plan-branded International Fund be established initially as 100% passively managed, with the Fidelity holdings mapped to the current passive manager (DWS) and the Passive and non-Passive component adjusted post-procurement.

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	Eliminate and Map to Vanguard
	Investment Co. of America	Eliminate and Map to Vanguard
	Hartford Cap. Appreciation	Eliminate and Map to Vanguard
DCP Mid-Cap Stock Fund	Vanguard Mid-Cap Index	Retain (w/rebalance mapping)
	Lazard Mid-Cap Institutional	Eliminate and Map to Vanguard
DCP Small-Cap Stock Fund	SSgA Russell 2000 Index	Retain
DCP International Fund	DWS EAFE Equity Index	Retain until procurement
	Fidelity Diversified Intl.	Map to DWS EAFE Index initially, followed by 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 including some active management 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.

B. 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. Following an initial procurement, staff recommends that subsequent procurements be conducted in five years on a regular basis (this would be codified within the Investment Policy). The following table provides a summary of each core menu option and the proposed timing of the procurement:

	Menu Offering	Procurement Status	Initial Procurement	Follow-up Procurement
1	DCP Deposit Savings Account	Utilize existing manager(s) – 3	2014	2019
2	DCP Stable Value Fund	Utilize existing manager(s) – 1	2014	2019
3	DCP Bond Fund	Utilize existing manager(s) – 2	2013	2018
4	DCP Large-Cap Stock Fund	Utilize existing manager(s) – 1	2013	2018
5	DCP Mid-Cap Stock Fund	Utilize existing passive manager, conduct searches for active growth and active value managers – 3	2013 (Passive-1), 2011/12 (Active-2)	2018 (Passive) 2017 (Active)

6	DCP Small-Cap Stock Fund	Utilize existing passive manager, conduct procurement for active growth and value managers – 3	2014 (Passive-1), 2013 (Active- 2)	2019 (Passive) 2017 (Active)
7	DCP International Fund	Conduct procurement for active developed, emerging, and small-cap managers – 3	2011/12-3	2017
8	DCP Ultra-Conservative Asset Allocation Fund	Blend of Core Asset Classes	n/a	n/a
9	DCP Conservative Asset Allocation Fund	Blend of Core Asset Classes	n/a	n/a
10	DCP Moderate Asset Allocation Fund	Blend of Core Asset Classes	n/a	n/a
11	DCP Aggressive Asset Allocation Fund	Blend of Core Asset Classes	n/a	n/a
12	DCP Ultra-Aggressive Asset Allocation Fund	Blend of Core Asset Classes	n/a	n/a
13	Self-Directed Brokerage Option	Various		n/a
	Total Options: 13	Total Managers Needed: 16		

In summary, the rolling five-year procurement schedule would look as follows:

2012 (Year One)	–	5 searches
2013 (Year Two)	–	6 searches
2014 (Year Three)	–	5 searches
2015 (Year Four)	–	0 searches
2016 (Year Five)	–	0 searches

Procurement Justifications - Staff and the consultant are recommending that procurement processes be scheduled as indicated above for the following reasons:

Year One Procurements (2012):

- (a) **DCP Mid-Cap Active Growth and Value Managers Only-2** (the current manager does not meet the composition structure mandate and has been an under-performing option); and
- (b) **DCP International Managers-3** (the current manager may or may not meet the composition structure mandate and has been an under-performing option).

Year Two Procurements (2013):

- (a) **DCP Small-Cap Active Growth and Value Managers Only-2** (there are no incumbent managers in these categories);
- (b) **DCP Large-Cap Stock Fund-2** (the Board's current provider meets the investment objectives of the new core fund and is a strong performer, but there has been no recent competitive search); and

- (c) **DCP Bond Fund-2** (the Board's current providers meet the investment objectives of the new core fund and are strong performers, but there has been no recent competitive search).

Year Three Procurements (2014)

- (d) **DCP Deposit Savings Account-3** (the Board recently conducted procurement for this option in 2009 and existing contracts run through September 2014);
- (e) **DCP Stable Value Fund-1** (the Board recently conducted procurement for this option in 2009 and existing contracts run through June 2014); and
- (f) **DCP Mid-Cap Fund-Passive Manager Only-1** (the Board recently conducted procurement for this option in 2009 – no contract is required on this option because it is a mutual fund)
- (g) **DCP Small-Cap Fund-Passive Manager Only-1** (the Board recently conducted procurement for this option in 2009 and the existing contract runs through September 2014).

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

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. Mercer has developed a tentative timeline (Attachment I) 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 September, 2011.

D. INVESTMENT POLICY STATEMENT

Staff and Mercer have drafted an Investment Policy Statement (Attachment II). This document is fully reflective of the changes to the Plan's core investment menu as previously adopted by the Board. The document also proposes revisions to the Plan's procurement and fund elimination policies. Given the other items needing to be addressed at this meeting, there may not be sufficient time for the Committee to review this document in detail. Staff and the consultant will be prepared to review it, however, should time permit.

Submitted by: _____
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Approved by: _____
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