

Deferred Compensation Plan INVESTMENTS COMMITTEE REPORT 13-01

Date: September 24, 2013
 To: Investments Committee
 From: Staff
 Subject: Deferred Compensation Plan Investment Manager Searches

Board of Deferred Compensation Administration
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 John R. Mumma, Vice-Chairperson
 Cliff Cannon, First Provisional Chair
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Recommendation:

That the Investments Committee receive and file information contained in this report regarding Deferred Compensation Plan investment manager searches.

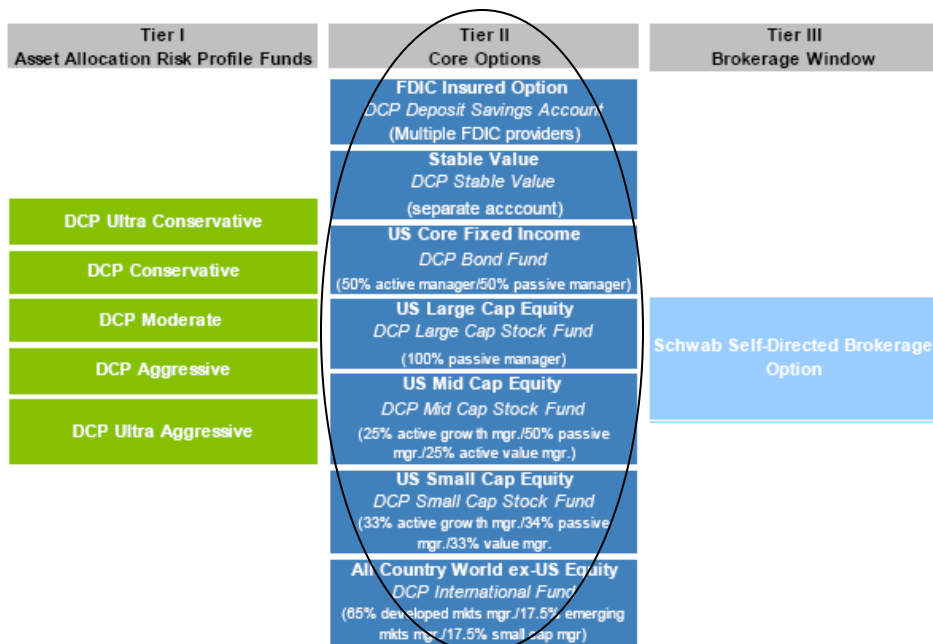
Discussion:

At its July 16, 2013 meeting the Board of Deferred Compensation Administration referred to its Investments Committee a review of Plan investment menu objectives relative to the City's procurement/contracting requirements, the Plan's investment policy, and the Board's administrative responsibilities, and instructed the Committee to return with findings and recommendations. This action resulted from concerns over the length of time it was taking to develop and issue procurements and to develop and execute contracts. To facilitate this discussion, this report provides background on the Plan's investment menu and the City's procurement processes relative to fund selection for the Plan.

A. CURRENT INVESTMENT MENU DESIGN

As detailed in the Plan's Investment Policy Statement (Attachment A), the Board has adopted an investment menu which is comprised of a range of core options. →

Included among these are Tier II options representing major asset classes. The **Bond, Mid-Cap, Small-Cap, and International** options are "blended" funds, meaning that they are composed of different sub-managers (both active and passive) which are then blended by



the Plan's recordkeeper to create single fund options for Plan participants. Fund searches for the underlying active components of the Mid-Cap, Small-Cap and International Funds are all still pending.

B. FUND VEHICLES & FUND UNIVERSE

At the Board's March 2010 meeting, staff provided a report which described the types of investment vehicles available to the Plan to fill its investment mandates. This report indicated that the Board could select from two primary vehicle types to fill the Plan's investment menu: **Mutual Funds** (a unique legal structure for pooling investor monies, open to both retail as well as institutional investors), **Institutional Funds** (separate accounts, commingled trusts, etc., generally open only to institutional investors), or both.

Staff indicated in this report that within the City's Plan, mutual funds do not involve contracts between the fund provider and the City, while institutional funds do involve contracts. Staff indicated that there are approximately 4,300 funds in the Mutual Fund universe and 3,000 funds in the institutional fund universe.

Vehicle 1
Mutual Funds
4,300

- Governed by Prospectus
- Pooled Investment
- External Custodian Not Required
- No Contract Required

Vehicle 2
Institutional Funds
3,000

- Governed by Contract
- Limited Investment
- External Custodian Generally Required
- Contract Required

C. PROCUREMENT SCHEDULE

In May 2011 the Board adopted a procurement schedule for the Plan's investment options which provided for rolling procurements for various core option sub-mandates. The concept for this schedule was that procurements would be staggered over five years, and that investment relationships with managers would generally be for five-year periods.

Presently the Large-Cap, Mid-Cap, and Small-Cap menu offerings are 100% passively managed. The Plan has two international funds which have not yet been blended into a single fund. Contracts with State Street Global Advisors (SSgA), Galliard Capital Management, and the Plan's three bank providers all expire between October-December 2014. Staff is developing RFPs for these which will be presented at the Board's November meeting.

The following table details staff/Mercer's initially proposed procurement schedule; which investment manager search applies to which investment menu option; whether the mandate is presently filled by an incumbent manager, and the fund type of the incumbent (where applicable). None of the Year 1 and Year 2 procurements have yet begun.

Investment Menu Option	Investment Manager Search	Presently Filled?	Incumbent Provider	Incumbent Fund Vehicle	Current Assets
Rotation Schedule - Year 1					
DCP Mid-Cap Fund	Active Mid-Cap Growth	No	n/a	n/a	n/a
DCP Mid-Cap Fund	Active Mid-Cap Value	No	n/a	n/a	n/a
DCP Small-Cap Fund	Active Small-Cap Growth	No	n/a	n/a	n/a
DCP Small-Cap Fund	Active Small-Cap Value	No	n/a	n/a	n/a
DCP International Fund	Active International Developed Markets	Yes	Fidelity	n/a	\$147 million
DCP International Fund	Active International Emerging Markets	No	n/a	n/a	n/a
DCP International Fund	Active International Small-Cap Markets	No	n/a	n/a	n/a
Rotation Schedule - Year 2					
DCP Bond Fund	Active Bond	Yes	PIMCO	Mutual Fund	\$103 million
DCP Bond Fund	Passive Bond	Yes	Vanguard	Mutual Fund	\$251 million
DCP Large-Cap Fund	Passive Large-Cap	Yes	Vanguard	Mutual Fund	\$1.3 billion
DCP Mid-Cap Fund	Passive Mid-Cap	Yes	Vanguard	Mutual Fund	\$170 million
DCP Small-Cap Fund	Passive Small-Cap	Yes	SSgA	Institutional (commingled fund)	\$223 million
Rotation Schedule - Year 3					
Bank Deposit FDIC Fund	FDIC Insured Savings	Yes	Bank of America, Bank of the West, City National Bank	Bank deposit account	\$302 million
Stable Value Fund	Stable Value Manager	Yes	Galliard	Institutional (separate account)	\$907 million
Rotation Schedule - Year 4					
None	n/a				
Rotation Schedule - Year 5					
None	n/a				

- Note – table does not include DWS Eafe Equity Index, with \$124 million in assets, since passive international is not included within the new International fund structure

D. PROCUREMENT PROCESS

Prior to 1999 the City's Plan had bundled contracts with two providers: Hartford Life Insurance Company and Great-Western Bank. Hartford offered its own proprietary funds, while Great-Western Bank used a contracted third-party-administrator (similar to the model presently used with Great-West).

The Board (formerly an Advisory Committee) chose specific fund options for the Plan based on the recommendations of the providers. The Plan did not use an investment consultant as part of that determination process. No competitive process (procurement or fund search) was involved in that determination process.

When the City's Plan was unbundled in 1999, it issued separate RFPs for Plan Third-Party-Administration (TPA) and investment providers. Investments RFPs have been issued periodically over the years to search for various mandates. Over time, there was a tendency for the RFP to result in fewer and fewer proposals, and as a result the RFP would be canceled and the Board would conduct a fund manager search instead using the resources of its investment consultant.

To address this situation, the Board, working with staff, developed a proposed procurement process which would meet its objectives of designing a fair and transparent process leading to best-of-class providers, considering the broadest possible pool of investment managers, and meeting the Board's fiduciary obligations to act in the best interests of Plan participants. The Board was specifically interested in being able to consider mutual fund offerings without requiring that fund management companies participate in a procurement process which was not applicable to them since, if selected, a contract would not be executed.

In May 2010, the City Attorney agreed that mutual funds would not have to demonstrate compliance with general contracting requirements given that the Board would not be entering into contracts with mutual fund providers. In addition, the City Attorney agreed that vendors would not need to submit specific fund data to the Plan in the form of a response to an RFP questionnaire, but could provide that directly to the Plan consultant through the consultant's open database. All of this was intended to facilitate the efficiency of the Board's fund selection process.

At the Board's February 19, 2013 meeting, the Board adopted an additional change to its Requests for Proposal (RFPs) to improve the efficiency of its procurement processes. Specifically, the Board took action to allow proposing firms the ability to **defer submission of certain required contracting forms and documents to the contract execution date**, and to be able to **pre-submit where possible other general contracting requirement documents for the purpose of identifying oversights in those documents such that vendors could correct them in advance of an RFP due date**.

The Board made these changes out of concerns that vendor confusion over the City's general contracting requirements could lead to confusion in the submission of bid responses by institutional providers. Staff recommended that the Board apply this new

process on a pilot basis with the pending Custodial Services RFP, which likely will involve a handful of respondents, before applying it to the much larger pending Investment Manager RFP, which could involve dozens or more responses from institutional providers.

These procurements were delayed by approval of the Board's contract with Mercer Investment Consulting. The Board relies on Mercer to assist in the evaluation of its investment searches. The development and approval process for this contract was lengthy, with the contract being only recently approved. The Custodial Services RFP can now be released.

E. FACTORS INFLUENCING INVESTMENT PROCUREMENTS

The following are areas of concern related to the City's current rules/processes involving procurements and contract development and specifically as these impact investment manager searches:

- Resources (consulting costs and staff time) involved in developing procurements and executing contracts are considerable
- Time involved both in negotiating contracts as well as moving them through the City's approval process is lengthy and less predictable (this is a concern because, unlike other services contracts, an institutional investment manager will not manage money without an executed contract in place)
- The longer the delay in filling the mandates of its investment menu design, the longer the menu is not being maintained in a manner consistent with the Investment Policy Statement
- Since the mid-cap, small-cap and international fund options presently hold relatively smaller asset pools, and since under the present menu design each sub-mandate would manage only a portion of those assets, potential cost advantages for using institutional products may not exist, especially when weighed against the cost of the procurements and the cost of securing a fund custodian
- Relatedly, some highly rated managers may choose not to participate in the process as they evaluate what's required in responding to an RFP vs. the amount of assets they could potentially manage

Some options the Committee may wish to consider as part of its consideration of this topic include:

- (1) Moving forward to complete its restructuring of the Plan's investment options using a mutual-fund only search process
- (2) In the interest of efficiency and cost-containment, re-examining the potential benefits of institutional funds relative to the factors involved in procuring them, and considering applying RFP searches to certain categories and mutual-fund searches to other categories; or applying mutual fund searches only
- (3) Considering deferring the Fund Custodian search if a mutual fund search process is used exclusively

The Board's consultant is developing cost estimates for the various procurement processes discussed in this report, which will be provided at the meeting. Staff is also researching with the City Attorney's Office options for conducting fund searches.

Submitted by: _____
Steven Montagna

Approved by: _____
Alex Basquez