CITY OF *Los Angeles*
DEFERRED COMPENSATION PLAN

Plan Governance & Administrative Issues Committee (Committee)
Report 20-01

Committee Members
Joshua Geller
Chairperson
Hovhannes Gendjian
Thomas Moutes

Date: November 18, 2020

To: Committee

From: Staff

Subject: 2021 DCP Resource Review

Recommendation:
That the Committee:

(a) Recommend to the Board of Deferred Compensation Administration (Board) that the Board maintain the following Deferred Compensation Plan (DCP) Growth and Expense variable and Fee variable assumptions for use in projecting future DCP Reserve Fund balances:
(1) DCP Assets Growth Rate - 7%
(2) Net Enrollment Growth Rate - 3%
(3) Annual Expenses Increase Factor - 2%
(4) Special Rates Increase Factor: Personnel - 115%
(5) Special Rates Increase Factor: City Attorney - 115%
(6) Stable Value Interest Rate - 2%
(7) Participant Fees: Annual Basis Point Charge - 0.09%
(8) Participant Fees: Annual Dollar Cap - $115; and

(b) Find that the cost of investment advice services at the level illustrated in this report can reasonably be funded under the existing fee structure.

(c) Find that further action with respect to strategies for reducing the long-term projected Reserve Fund balance should be deferred until the Board has completed its assessment of investment advice services.

Discussion:
At its March 20, 2018 meeting, the Board adopted staff's recommendation to convene the Committee on an annual basis to conduct a DCP resource review. This evaluation includes a review of the key assumptions used in forecasting the long-term (ten-year) projection of the DCP Reserve Fund balance.

To assist the Committee in its review, staff has developed a supplementary report (**Attachment A**) summarizing the status of key variables used to forecast the long-term projection of the DCP Reserve Fund balance compared to the DCP target Reserve Fund balance. During the Committee meeting, staff will also project a spreadsheet forecasting tool so that the Committee may model additional scenarios for consideration.

A. Background

All of the DCP's administrative costs are required to be paid by participant fees. Two accounts are used to pay expenses: a fund held with the DCP Third-Party Administrator (TPA) which acts as a repository for participant fees and from which most DCP expenses are paid; and a fund held within the City, from which travel expenses are paid and equipment purchases are made. To maintain stability within the fee structure, the DCP maintains a Reserve Fund balance. The target Reserve Fund balance is 50% of annual DCP operating expenses. As of September 30, 2020, the target Reserve Fund balance was $1.6 million compared to the Reserve Fund balance of about $3.9 million.

The Committee last conducted a DCP resource review in November 2019. Subsequently, the Board adopted several actions which may impact the Reserve Fund balance:

- At its **February 18, 2020** meeting, the Board approved: (1) the Committee's recommendations to adopt key assumptions used in forecasting the long-term (ten-year) projection of the DCP Reserve Fund balance; and (2) a one-time 50% reduction in the quarterly fee assessed on participant accounts ("fee holiday") to be effective for the third quarter of 2020 to reduce the excess Reserve Fund balance.
- At its **April 27, 2020** meeting, staff provided a status update to the Board indicating concerns over risks of an extended decline in DCP assets given the economic and market consequences of the COVID-19 pandemic; the Board adopted staff's recommendation to defer the fee holiday until at least the fourth quarter of 2020.
- At its **August 4, 2020** meeting, staff provided on update regarding the fee holiday, indicating that, given financial market recovery, proceeding with the fourth quarter 2020 fee holiday was reasonable, but staff would continue to work with Mercer to monitor the financial markets closely and return to the Board should any further actions be required in the event of a significant market downturn.
- At its **September 15, 2020** meeting, the Board reviewed staff's evaluation of responses to the Request for Information (RFI) for financial education and investment advice services. The RFI review panel concluded that the firm GuidedChoice provided the service design model most consistent with the goals and objectives of offering competitively priced financial education and investment advice services within the DCP. Subsequently, the Board requested staff to prepare information regarding fiduciary liability insurance and past survey results on participant interest in the DCP providing financial education and investment advice services at its next meeting.
- At its **October 20, 2020** meeting, staff provided a report regarding fiduciary considerations related to the potential for offering financial education and investment

advice services within the DCP and a summary of survey results from 2015 regarding participant interest in the DCP providing these services. Subsequently, the Board adopted staff's recommendation to: (a) direct staff to schedule a presentation from GuidedChoice regarding its platform and services at the January 19, 2021 Board meeting; and (b) defer execution of the fee holiday pending a review by the Plan Governance & Administrative Issues Committee (Committee), as part of its annual DCP resource review, of the budgetary considerations of offering financial education and investment advice services.

B. Forecasting Assumptions

1) Current 2020 Assumptions

Following is a summary of the key assumptions adopted by the Board at its February 18, 2020 meeting which are used in forecasting the long-term (ten-year) projection of the DCP Reserve Fund balance:

Variable Description	Assumption
DCP Assets Growth Rate	7.0%
Net Enrollment Growth Rate	3.0%
Annual Expenses Increase Factor	2.0%
Special Rates Increase Factor: Personnel	115.0%
Special Rates Increase Factor: City Attorney	115.0%
Stable Value Interest Rate	2.0%
Participant Fees: Basis Point Charge	0.09%
Participants Fees: Annual Dollar Cap	$115.00

2) Proposed 2021 Key Variable Assumptions

Generally, staff takes a conservative approach in its review of the key variable assumptions to be used in forecasting the DCP Reserve Fund balance over the next ten years. Recommended key variable assumptions for 2021 include:

- **DCP Assets Growth Rate (recommendation: no change)** – The DCP assets growth rate incorporates both participant contributions and investment gains. The chart below provides average gross growth rates over various time periods inclusive of both contribution and investment sources of gains. Earlier years for the DCP produced much larger growth rates than later years. As a more mature plan, over the last 20 years, the average annual growth rate has been consistent at around 9%.

Average Growth Rates	
Average (Inception to Present)	**20.9%**
Average (1986-2000)-->	**36.1%**
Last 20 years average-->	**8.7%**
Last 15 years average-->	**9.0%**
Last 10 years average-->	**9.3%**
Last 5 years average-->	**9.9%**

Although a projected 9.0% annual growth rate might be more in line with recent and longer-term trends, staff recommends that the more conservative assumption for the long-term growth rate remain at 7.0%.

- **Net Enrollment Growth Rate (recommendation: no change)** – Net annual enrollment growth in the DCP over the last five years averaged 4%. Increases in voluntary enrollment may prove challenging due to the budgetary fallout from COVID-19. New hiring is likely to be constrained for some time. However, while over 1,600 employees will be retiring through the Citywide and Los Angeles World Airports (LAWA) Separation Incentive Programs (SIPs), long-term trends suggest the DCP will retain most of those participant accounts. Staff will continue executing strategies to increase DCP enrollment, including targeted outreach to those current City employees who have at least three years of City service but have not yet joined the DCP. Finally, the potential expansion of the DCP Auto Enrollment Program over time will support overall growth in net enrollment.
- **Annual Expenses Increase Factor (recommendation: no change)** – Assumptions regarding staff support services provided by the Personnel Department (Personnel), including the new Defined Contribution (DC) Plan Manager position, have been incorporated into the ten-year projection. Staff finds that a 2% annual increase in ongoing administrative expenses (also includes salary step increases for staff) continues to be a reasonable assumption.
- **Special Rates Increase Factor: Personnel and City Attorney (recommendation: no change)** – Special rates provided by the City Controller for calculation of indirect costs for the Personnel Department and City Attorney are presently 93.71% and 81.99%, respectively. As indirect salary costs are volatile and tend to trend higher, staff recommends that the more conservative assumption for indirect cost special rates remain at 115%.
- **Stable Value Fund (SVF) Interest Rate (recommendation: no change)** – Longer-term rates of return will largely be driven by economic growth. Although recent rates for the SVF have been closer to 2.5%, staff recommends that the more conservative assumption for the long-term rate of return remain at 2%.

C. DCP Reserve Fund Ten-Year Projections

1) <u>Baseline Scenario</u>

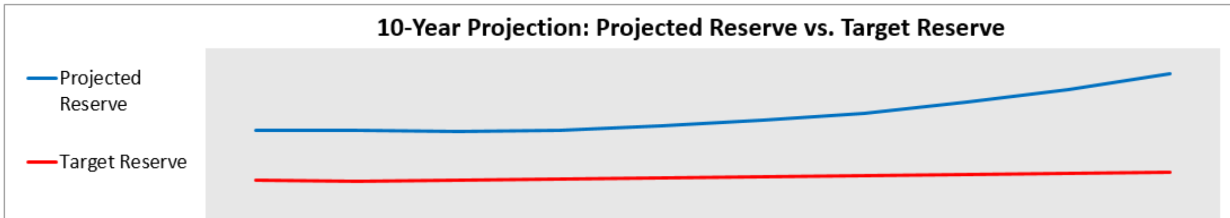
Staff has updated its ten-year forecast incorporating DCP data as of September 30, 2020, current expense information, and the proposed key variable assumptions for 2021 as described in Section B, subsection 2 above. Furthermore, staff has updated and incorporated the following new key variables in the base expenditures due to changes in the day to day administration of the DCP that have recently developed since the Committee's last DCP resource review conducted in 2019:

- Deleted percentage of salary costs associated with Senior Management Analyst II and Chief Personnel Analyst positions supporting the DCP and added new DC Plan Manager position and associated salary range

- Included a staff attrition rate (staffing tends to fluctuate over a longer period of time so adding an attrition rate is reasonable to assume over a long term projection)
- DCP TPA administrative fee reduction from $32 to $30 per participant annually resulting from the extension of the Voya contract for an additional three years effective beginning in 2022
- Increase of $10,000 in office and administrative expenses due to pending MOU to be executed between the Board Personnel
- No fee holiday

Based on the above elements, a ten-year projection of the DCP Reserve Fund balance is provided in the chart below. The projected Reserve Fund balance is above the target Reserve Fund balance over the ten-year period. The Reserve Fund balance is projected to gradually increase between 2021 and 2026 before sharply increasing between 2027 and 2030. For the purpose of comparison to other scenarios in this report, this projection will be referred to as the "**Baseline Scenario**."

Baseline Scenario



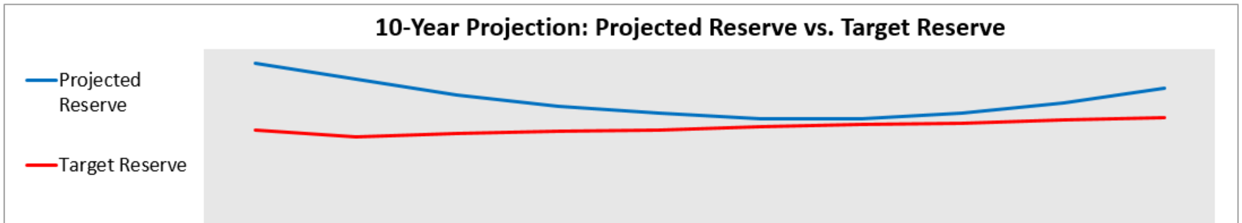
	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
Projected Reserve	$3,704,062	$3,671,872	$3,658,838	$3,712,909	$3,883,403	$4,095,062	$4,397,594	$4,842,204	$5,355,661	$5,989,843
Target Reserve	$1,671,075	$1,638,010	$1,699,774	$1,741,593	$1,763,495	$1,828,510	$1,873,668	$1,898,999	$1,967,536	$2,016,309

2) <u>Investment Advice Fees Scenario</u>

As previously reported, the Board reviewed staff's evaluation of responses to the RFI for financial education and investment advice services at its October 20th meeting. Staff reviewed the various pricing models of the proposals and determined that GuidedChoice offered the most competitive model. Plan sponsor platform costs would include a one-time set-up and recordkeeping integration fee of $200,000 and an ongoing platform fee capped at $275,000 annually. Participant costs for those utilizing managed account services would be capped at no more than $250 annually, regardless of account size. While the Board has taken no action yet on this matter, staff utilized the GuidedChoice pricing model to illustrate the impact on the DCP Reserve Fund balance of adding financial advice services at this cost level.

The following chart illustrates an "**Investment Advice Fees Scenario**" incorporating all of the assumptions and elements of the Baseline Scenario described in Section C, subsection 1 above. In this scenario, the projected Reserve Fund balance is above the target Reserve Fund balance over the ten-year period, with the narrowest margin of the projected reserve being above the target reserve from 2026 to 2028.

Investment Advice Fees Scenario

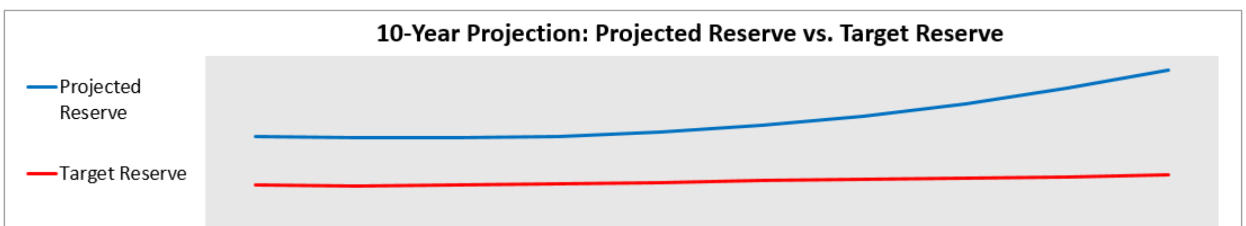


	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
Projected Reserve	$3,229,062	$2,912,372	$2,609,148	$2,367,225	$2,235,805	$2,139,512	$2,127,933	$2,252,150	$2,438,806	$2,739,651
Target Reserve	$1,908,575	$1,775,510	$1,837,274	$1,879,093	$1,900,995	$1,966,010	$2,011,168	$2,036,499	$2,105,036	$2,153,809

3) Fee Holiday Scenario

The Board previously approved a one-time fee holiday to reduce the excess Reserve Fund balance, to be applied in the third quarter of 2020; the fee holiday was subsequently deferred to the fourth quarter of 2020; and subsequently further deferred pending the Committee's resource review. The following chart, "**Fee Holiday Scenario**" incorporates all of the assumptions and elements of the Baseline Scenario described in Section C, subsection 1 above. In this scenario, the projected Reserve Fund balance is above the target Reserve Fund balance over the ten-year period. The Reserve Fund balance is projected to remain flat between 2021 and 2024 before gradually increasing between 2025 and 2026 and sharply increasing between 2027 and 2030.

Fee Holiday Scenario



	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
Projected Reserve	$3,324,854	$3,285,080	$3,264,311	$3,310,491	$3,472,936	$3,676,386	$3,970,544	$4,406,614	$4,911,358	$5,536,655
Target Reserve	$1,671,075	$1,638,010	$1,699,774	$1,741,593	$1,763,495	$1,828,510	$1,873,668	$1,898,999	$1,967,536	$2,016,309

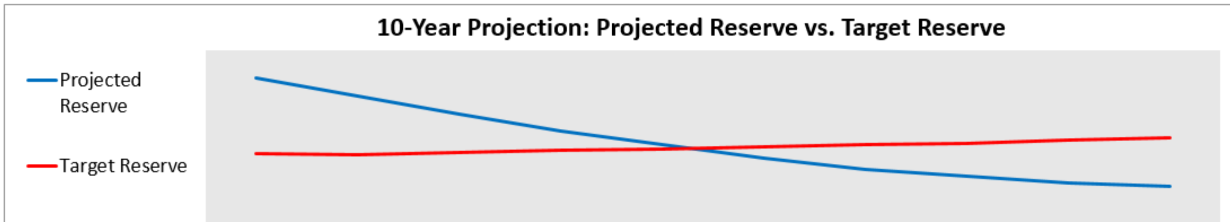
4) 30% Market Decline Scenario

Asset values can fluctuate significantly in either direction based on market returns as the DCP experienced at the end of the first quarter of 2020 due to the impact of the COVID-19 pandemic on the financial markets. Since 2008, the DCP and its participants have benefited from a long-running bull market in equities and a stable bond market, which more than offset declines in returns for the DCP's interest-bearing investment options (the Stable Value and FDIC-Insured funds). Assets have also been bolstered significantly in recent years by the growth in participant accounts and contributions.

The DCP has experienced market-related annual asset declines, however, with the worst being in 2008 (28% decline). Most recently, the DCP experienced a 13.2% decline in assets at the end of the first quarter of 2020 due to the impact of the COVID-19 pandemic on the financial markets. As was the case in the Committee's 2019 review, staff has provided an illustration of the impact of a sharp reduction in DCP assets on par with the 2008 decline.

The following chart illustrates a "**30% Market Decline Scenario**" incorporating all of the assumptions and elements of the Baseline Scenario described in Section C, subsection 1 but assuming a 30% decline in assets. In this scenario, the projected Reserve Fund balance would decrease over the ten-year period and would ultimately fall below the target Reserve Fund balance from 2026 to 2030.

30% Market Decline Scenario

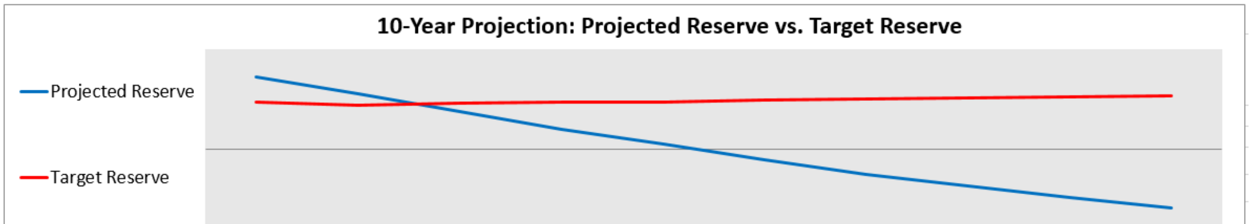


	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
Projected Reserve	$3,365,970	$2,965,261	$2,551,014	$2,168,752	$1,865,194	$1,562,298	$1,306,791	$1,146,684	$1,005,327	$930,935
Target Reserve	$1,671,075	$1,638,010	$1,699,774	$1,741,593	$1,763,495	$1,828,510	$1,873,668	$1,898,999	$1,967,536	$2,016,309

5) <u>Combined 30% Market Decline and Investment Advice Fees Scenario</u>

The following chart on page 8 showcases the impact on the Reserve Fund balance by combining scenarios 2 and 4 above. The Reserve Fund balance would fall sharply over the ten-year period, falling below the target Reserve Fund balance beginning in 2023 and ultimately becoming negative beginning in 2026. However, it should be noted that in the event of a sharp and extended decline in DCP assets, options would be available to the Board to mitigate the impact on revenues through adjustments to fees and expenses. Further, it should be noted that it may be equally if not more likely that DCP assets grow on average at rates higher than 7%, thereby adding to excess balance amounts.

Combined 30% Market Decline and Investment Advice Fees Scenario



	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
Projected Reserve	$2,890,970	$2,205,761	$1,501,324	$823,069	$217,597	$(393,251)	$(962,870)	$(1,443,369)	$(1,911,528)	$(2,319,256)
Target Reserve	$1,908,575	$1,775,510	$1,837,274	$1,879,093	$1,900,995	$1,966,010	$2,011,168	$2,036,499	$2,105,036	$2,153,809

D. Findings and Recommendations

Staff believes it is prudent to maintain a conservative approach to gradually reducing the projected Reserve Fund balance to be in line with the targeted balance. There are three primary ways to reach this objective:

- Reducing the participant asset-based fee or fee cap
- Executing periodic fee holidays
- Adding new services

Staff's view is that providing investment advice services which could have substantial retirement security and accumulation benefits for individual participants may be more impactful than fee reductions or fee holidays. Fee reductions (whether structural or one-time), when broken down by individual account, are of modest monetary value. For example, a reduction of one basis point on a $100,000 account balance is equal to $10 annually.

The fundamental determination of whether to add investment advice services has yet to be made by the Board. However, staff's finding is that the cost of investment advice services at the level illustrated in this report can reasonably be funded under the existing fee structure. Staff, therefore, recommends that the Committee reach such a finding to be included in its report to the Board. Staff also recommends that the Committee reach a finding that further action with respect to strategies for reducing the long-term projected Reserve Fund balance should be deferred until the Board has completed its assessment of investment advice services.

Submitted by: ______________________________
Mindy Lam, Personnel Analyst

Submitted by: ______________________________
Jenny M. Yau, Senior Management Analyst II

Approved by: ______________________________
Steven Montagna, Chief Personnel Analyst

ATTACHMENT A

CITY OF Los Angeles
DEFERRED COMPENSATION PLAN

DCP BUDGET & RESOURCE REVIEW

November 18, 2020

FLOW OF FUNDS OVERVIEW

PARTICIPANT FEE REVENUES

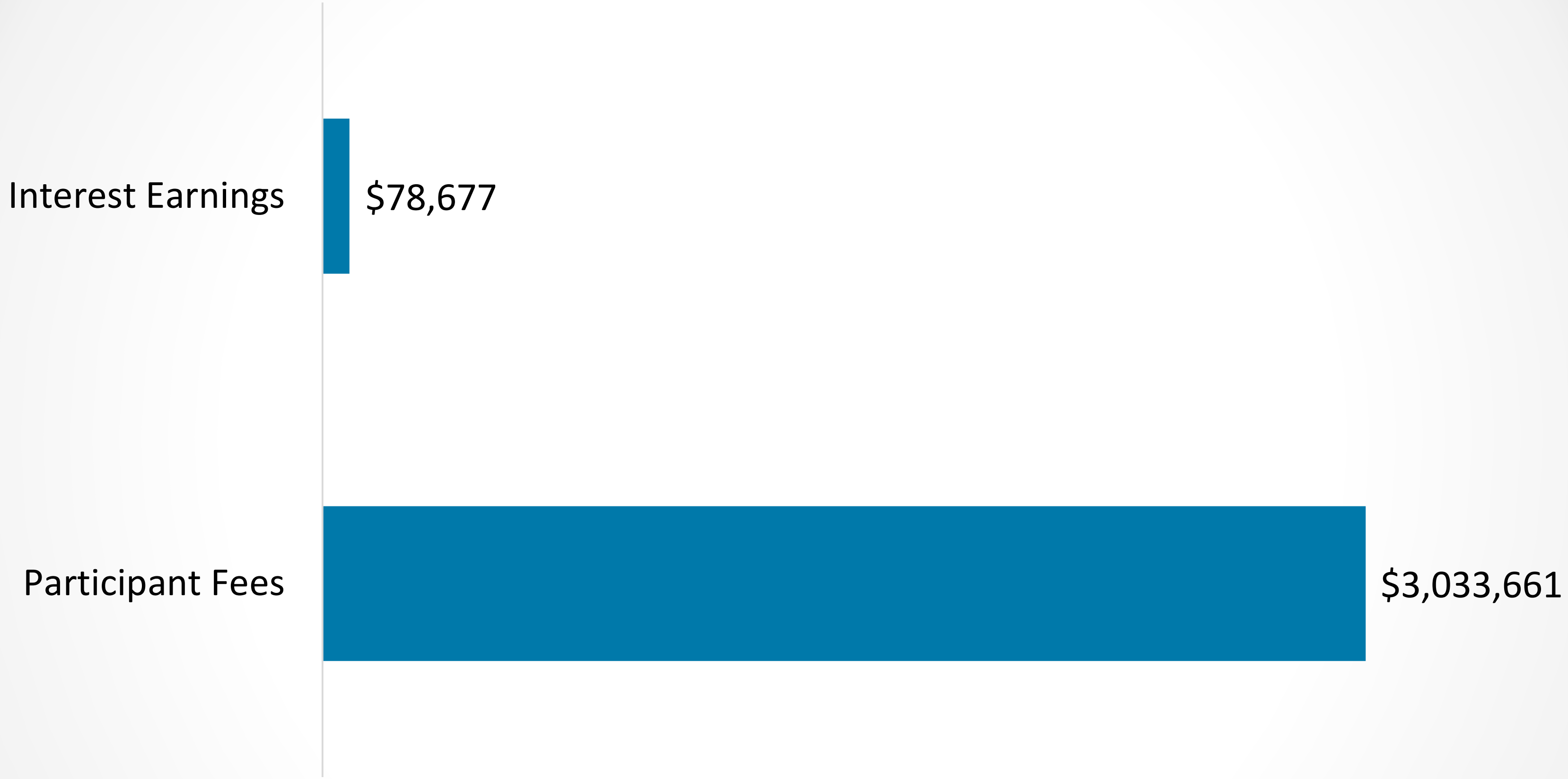
Reserve Fund (Held with DCP Third-Party Administrator (TPA))

- **TPA Admin. Fees**
- **Staff Salaries**
- **Consulting**
- **Communications**
- **Auditing**
- **Training (non-travel)**
- **Office & Administrative**
- **Elections**

City Fund #896

- **Travel**
- **Equipment**

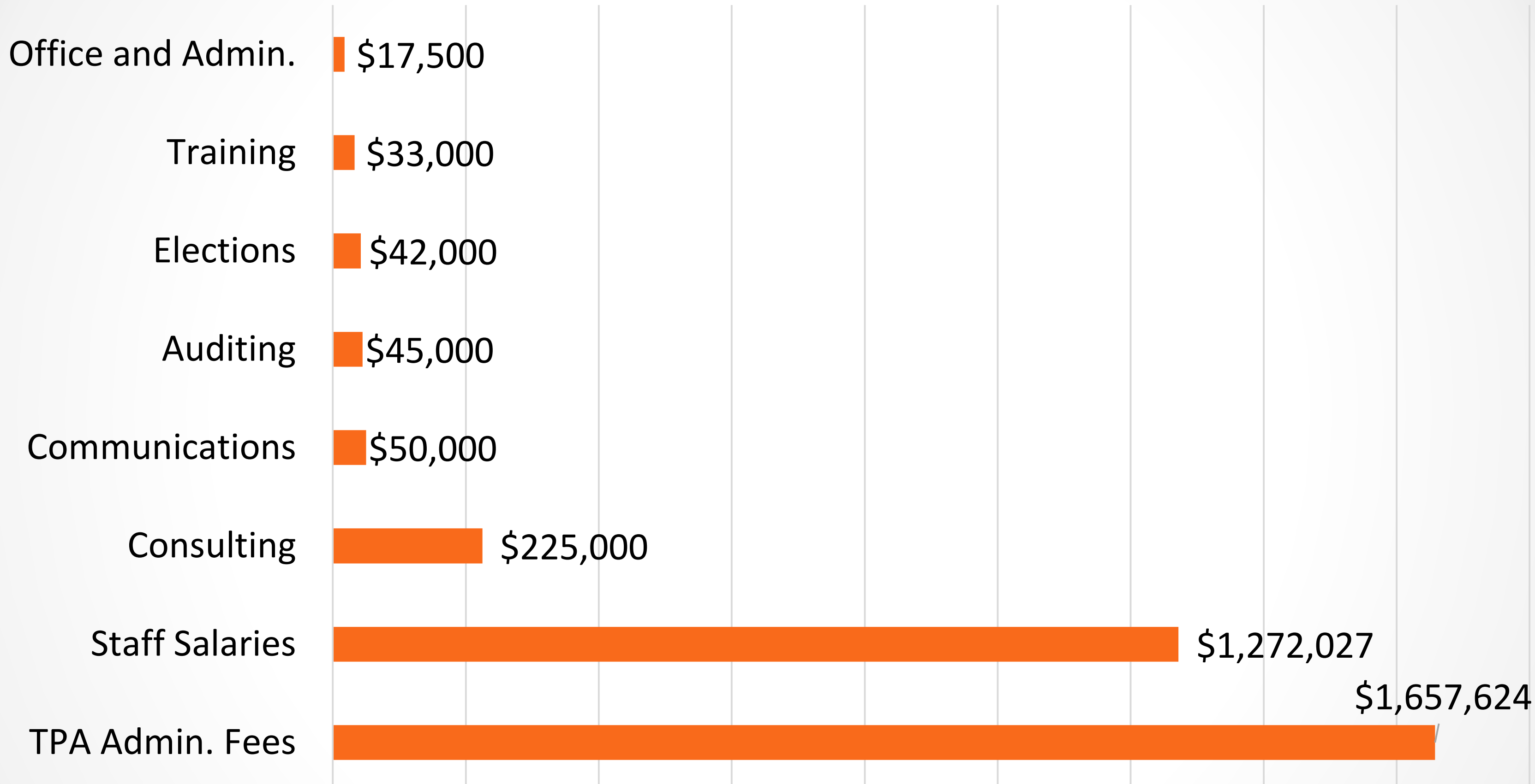
PROJECTED 2021 REVENUES



Annual Total - $3.1 million*

*As of quarter ending 9/30/2021.

PROJECTED 2021 EXPENDITURES



Annual Total - $3.3 million*

*As of quarter ending 9/30/2021.

TARGET RESERVE FUND BALANCE

- The adopted target Reserve Fund balance is 50% of annual operating expenses (approximately **$1.7 million** in 2021).
- The historical Reserve Fund balance has been maintained above that target.
- The Board previously established a “structural deficit” in relationship of revenues to expenses to gradually reduce the Reserve Fund balance.
- As of 9/30/20, the Reserve Fund balance was about **$3.9 million**.

Reserve Fund Balance

Reserve Fund
(Held with TPA)
+
City Fund #896

Target Reserve Fund Balance

50% of Annual
Operating Expenses

RESERVE FUND KEY ASSUMPTIONS

Current

→

Expenses Inflation Adjustment Factor	*Net Enrollment Adjustment Factor*	*Plan Asset Growth Adjustment Factor*	*Stable Value Fund Interest Rate Assumption*	*Basis Points Charged Against Participant Accounts*	*Fee Cap*
2.0%	**3.0%**	**7.0%**	**2.0%**	**0.09%**	**$115**

Current

→

Personnel Avg. Special Rate	*City Attorney Avg. Special Rate*
115 %	**115%**

These assumptions were last approved by the Board on February 18, 2020.

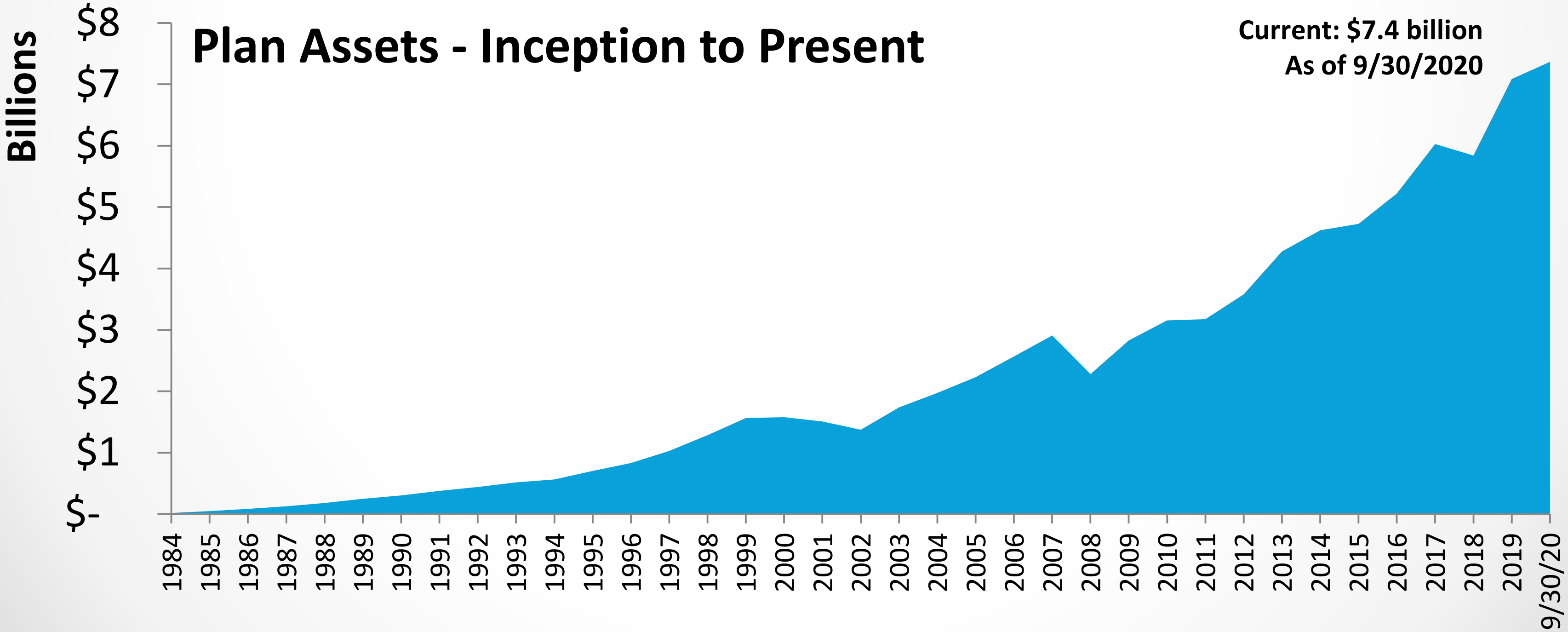
KEY ASSUMPTIONS

Plan Assets Growth

Current: **7.0%**

Where Applied: Total overall growth rate for DCP assets

Considerations: 7% is a conservative assumption; 5, 10, 15, and 20-year growth trends higher than assumption



KEY ASSUMPTIONS

Plan Assets Growth

Historical Plan Assets Inception to Present

Year		Assets	% Change
1984	$	17,990,298	N/A
1985	$	48,584,697	170%
1986	$	84,762,277	74%
1987	$	126,921,243	50%
1988	$	180,395,336	42%
1989	$	249,105,465	38%
1990	$	303,691,355	22%
1991	$	378,018,448	24%
1992	$	441,306,161	17%
1993	$	516,401,147	17%
1994	$	564,392,235	9%
1995	$	702,779,928	25%
1996	$	831,689,383	18%
1997	$	1,029,129,147	24%
1998	$	1,285,271,264	25%
1999	$	1,564,440,301	22%
2000	$	1,578,565,882	1%
2001	$	1,508,545,448	-4%
2002	$	1,373,444,396	-9%
2003	$	1,737,260,679	26%
2004	$	1,973,665,625	14%
2005	$	2,230,031,810	13%
2006	$	2,566,734,158	15%
2007	$	2,909,282,960	13%
2008	$	2,279,918,897	-22%
2009	$	2,828,435,629	24%
2010	$	3,154,860,910	12%
2011	$	3,174,274,111	1%
2012	$	3,578,684,906	13%
2013	$	4,277,754,120	20%
2014	$	4,622,493,622	8%
2015	$	4,726,682,745	2%
2016	$	5,221,905,502	10%
2017	$	6,027,047,083	15%
2018	$	5,839,909,116	-3%
2019	$	7,085,845,898	21%
As of 9/30/2020	$	7,366,037,685	4%

Historical and Projected Growth Rates

Last 15 years average-->	**9.0%**
Last 10 years average-->	**9.3%**
Last 5 years average-->	**9.9%**
Projected Investment-Only Rate of Return (Mercer)	**4.86%**
Projected Total (Investments + Contributions) Annual Growth Rate -->	**7.0%**

KEY ASSUMPTIONS

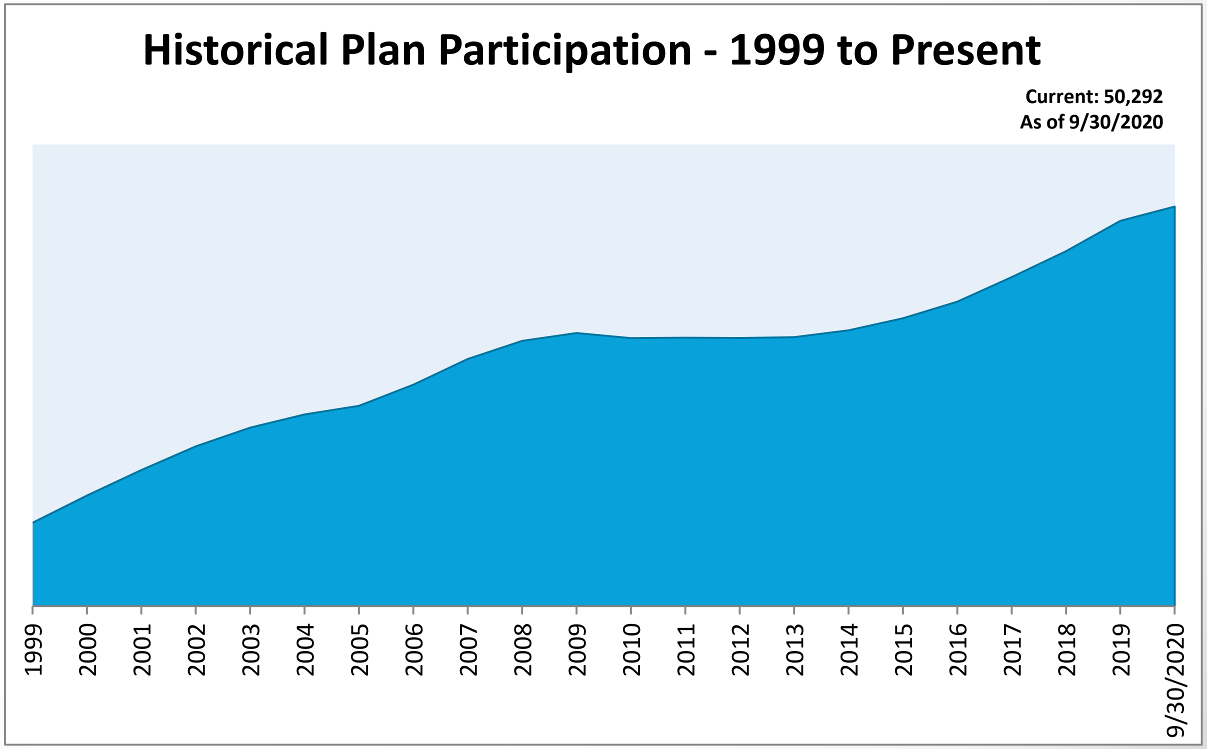
Net Enrollment

Current: **3%**

HISTORICAL NET ENROLLMENT		
Year	**Participants**	**% Change**
1999	26,319	-
2000	28,382	**8%**
2001	30,315	**7%**
2002	32,109	**6%**
2003	33,528	**4%**
2004	34,528	**3%**
2005	35,182	**2%**
2006	36,784	**5%**
2007	38,733	**5%**
2008	40,106	**4%**
2009	40,702	**1%**
2010	40,316	**-1%**
2011	40,348	**0%**
2012	40,325	**0%**
2013	40,389	**0%**
2014	40,906	**1%**
2015	41,818	**2%**
2016	43,076	**3%**
2017	44,938	**4%**
2018	46,904	**4%**
2019	49,209	**5%**
9/30/2020	50,292	**2%**

Where Applied: Estimated growth in participant accounts

Considerations: Budget challenges may slow hiring and new accounts but auto enrollment may add growth



KEY ASSUMPTIONS

Administrative Expenses Inflation

Current: **2%**

Where Applied: Salary, consulting, communications, training, auditing, and office and administrative costs

Considerations:

- Cost of living increases may be below this rate over near and mid-term
- Positions often filled at lower level than budgeted position authority
- Communications, training, and office and administrative costs often lower than budgeted amount

KEY ASSUMPTIONS

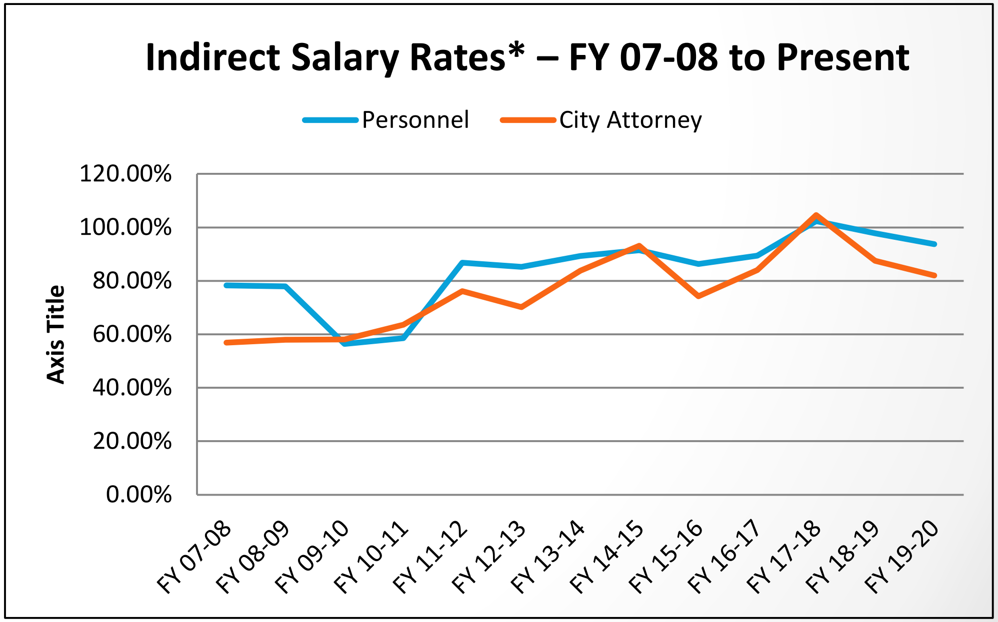
Indirect Salary Costs

Current: Personnel – **115%**, City Attorney – **115%**

Where Applied: Indirect salary costs

Considerations: Rates can be volatile and have large impact on costs

Historical Indirect Salary Rates*		
Fiscal Year	**Personnel**	**City Attorney**
FY 07-08	78.30%	56.91%
FY 08-09	77.94%	57.96%
FY 09-10	56.43%	58.03%
FY 10-11	58.56%	63.59%
FY 11-12	86.77%	76.17%
FY 12-13	85.23%	70.19%
FY 13-14	89.30%	83.83%
FY 14-15	91.51%	93.09%
FY 15-16	86.28%	74.25%
FY 16-17	89.37%	84.04%
FY 17-18	102.34%	104.67%
FY 18-19	97.76%	87.45%
FY 19-20	**93.71%**	**81.99%**
All Avg	**84.12%**	**76.32%**
5-Yr Avg	**93.89%**	**86.48%**



*Indirect salary rates are determined by the Office of the Controller each fiscal year. The latest published Rate is **Special Rate 42** for FY 19-20.

KEY ASSUMPTIONS

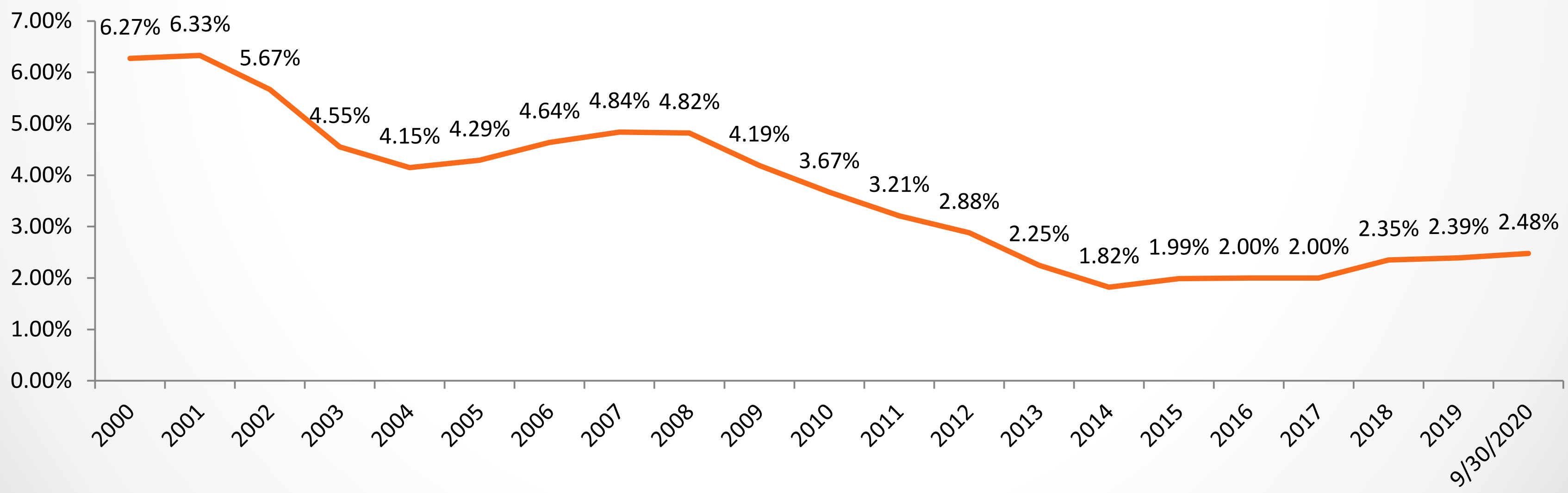
Stable Value Fund Interest Rate

Current: **2%**

Where Applied: Estimated interest earnings

Considerations: Annual return over last five years averaged 2.15%

Historical Annual Return - 2000 to Present



KEY ASSUMPTIONS

Participant Fees

Current:

Basis Points: **0.09%**/Fee Cap: **$115**

Where Applied: Fees assessed against participant accounts, up to fee cap

Considerations:

- Reductions to Third-Party Administrator (TPA) fees have created structural long-term savings (reductions to TPA administrative fee effective in 2017 and 2022)