CITY OF Los Angeles
DEFERRED COMPENSATION PLAN

Investments Committee Report 24-01

Investments Committee
Jeremy Wolfson, Chair
Neil Guglielmo
Carl Lurvey
Joseph Salazar

Date: April 2, 2024

To: Investments Committee

From: Staff

Subject: DCP Investment Options Structure Review - Follow-Up on Capital Preservation and Asset Allocation Options

Recommendation:

That the Investments Committee (Committee):

1) Affirm the Stable Value Fund as a capital preservation option in the DCP investment menu;
2) Approve the replacement of the FDIC Savings Account option with a government money market option;
3) Affirm the use of target risk fund model portfolios and consider optimization of their current allocations **OR** request further analysis/research on target date funds with the intention of moving away from the current target risk fund model; and

a) Instruct staff to forward any applicable recommendation(s) to the Board of Deferred Compensation Administration.

Discussion:

On September 22, 2023, the DCP investments consultant, Mercer, provided a presentation (Investments Committee Report 23-01) to the Investments Committee to review the investment options structure for the DCP. The presentation included:

a) An investment options array "clean sheet", relative to Mercer's best practices and market trends for defined contribution plans
b) Overview of DCP participant demographics
c) Analysis of the DCP's investment structure including:
    i) A review of the Committee's philosophy regarding Target Risk Funds versus Target Date Funds
    ii) Consideration of a dedicated passive suite of options
    iii) Appropriateness of offering a FDIC-insured savings option versus Money Market fund and affirmation of the Stable Value Fund
    iv) Consideration of a combined US Small and Mid Cap (SMID) Equity option

v) Education on mandates such as Diversified Inflation Hedge (DIH), real assets, and Environmental, Social and Governance (ESG) options

The Committee indicated that there was not a strong interest to pursue a diversified inflation hedge or ESG options as these could be available in other ways (provided by the cost-of-living adjustments from the defined benefit plans or through the self-directed brokerage), and the recommendations regarding a passive suite of options or a combined SMID option could be considered at a later meeting. The Committee requested to first delve further into certain recommendations, and requested additional information regarding:

- Asset Allocation Options - In considering Target Risk Funds versus Target Date Funds, the Committee requested additional data be identified related to participant investment activity and whether having a defined benefit might impact the risk tolerances of DCP participants.

- Capital Preservation Options - As the current contracts with the two bank providers of the DCP FDIC-Insured Savings Account option are expiring at the end of September 2024, the Committee requested follow-up discussion regarding the consideration for a FDIC savings option versus a money market fund.

On December 19, 2023, Mercer provided a presentation (Investments Committee Report 23-02) in order for the Committee to further consider:

a) Capital Preservation Options
    i) Affirm retention of the Stable Value Option
    ii) Comparison of FDIC-insured savings option vs. Money Market
b) Asset Allocation Options
    i) Target Risk Funds vs. Target Date Funds
    ii) Managed Account Education

During this meeting, the following was discussed:

- Stable Value Fund: A review and performance of the Stable Value Fund was provided. The fund is managed by Galliard and remains highly rated by Mercer and is being recommended to be retained as an option in the DCP investment menu.

- FDIC-Insured Savings Account
  Currently, two banks serve as the underlying providers of the FDIC-Insured Savings Account option, East West Bank and BMO (formerly Bank of the West), with assets in this option allocated equally. The current contracts are set to expire September 30, 2024.

  As previously discussed by the Committee, it is recommended the DCP investment menu option alternatively offer a government money market option. While the FDIC-Insured Savings Account option has produced nominally more yield compared to a government money market option, Mercer previously indicated the difference may be attributable to fees. The yield difference may possibly be further narrowed in the future as the reference rate used by the banks to establish the interest crediting rate for the option was changed from LIBOR (more speculative) to SOFR (borrowing rate for overnight loans collateralized by Treasury securities). The consideration of yield may be offset by the fact that banks are subject to credit risk and failures can happen very quickly, as seen in early 2023, which caused unease with participants. Though FDIC backed, the insurance could take time to make investors in the option whole, with maximum coverage of $500,000 (or $250,000 per underlying bank in the FDIC-Insured Savings Account option). Further, Mercer does not generally monitor banks in the same way as they might monitor and assess investment funds. A government money market option also offers more transparency to participants and is administratively less burdensome (mutual fund search compared to a full City procurement and contract negotiation process).

Mercer has provided follow-up information in the attached presentation, which details a transition plan for such a replacement:

1. Seek Board approval.
2. Conduct a formal mutual fund search for a government money market option.
3. Reconvene with the Investments Committee to identify the optimal fund.
4. Communicate the change to the Plan's TPA so the necessary notices can be provided to participants and an effective date for implementation is set.
5. Communicate the change and effective date to both bank providers.
6. Devise a transition plan in collaboration with TPA, the legacy providers and the future money market fund provider.
7. Implement the transition.

Should the transition timeline be anticipated to go past September 2024, staff will bring to the Board consideration of contract extensions with the two current banks to provide adequate time to transition to the future fund.

- Asset Allocation Options
The Committee reviewed additional information related to the asset allocation options and consideration of target date funds. Following are key insights from the discussion:

    - Should target date funds be used, would that not divert assets away from the existing core menu funds, lessening the plan's negotiating power/fee favorability based on total assets in a fund? Given this, is it possible to have a target date fund option that might utilize the current DCP core menu funds?
        - Mercer indicated a hybrid approach could be created by utilizing the portfolio funds and creating a type of custom glide path, and could provide additional information.
    - Would DCP participants take on more risk as they are eligible for a pension from one of the City's defined benefit plans?
        - Mercer indicated additional analysis could be conducted.

Mercer has provided additional information in the attached presentation that include insights of participant behavior as it relates to the plan's target risk funds.

Upcoming Participant Survey
In the Second Quarter of 2024, staff intends to distribute a Participant Survey to all participants as part of the 2024 participant outcomes campaign. Staff will look to include include investment behavior questions such as:

1) Do you utilize the target risk funds (TRFs)?
    a) If yes, what is your intention with the investment selection?
2) How frequently do you review your investment elections?

3) Are you interested in target date funds (TDFs?)
4) What is your primary goal for your DCP funds in retirement? (e.g. installment payments, travel money, inheritance, etc.)
5) Do you invest more aggressively knowing you are receiving a pension benefit? (from LACERS, LAFPP, or WPERP)
6) Would you be interested in seeing (check all that apply):
    a) Robo-advisor
    b) Financial advisor, with additional fee
    c) More investment education opportunities

Additional questions may be included should the Committee have any requests.

<u>Submitted by</u>: Esther Chang, Defined Contribution Plan Manager

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welcome to brighter

City of LA Deferred Compensation Plan

Investment Structure Review Follow-up

April 2, 2024

A business of Marsh McLennan

Overview

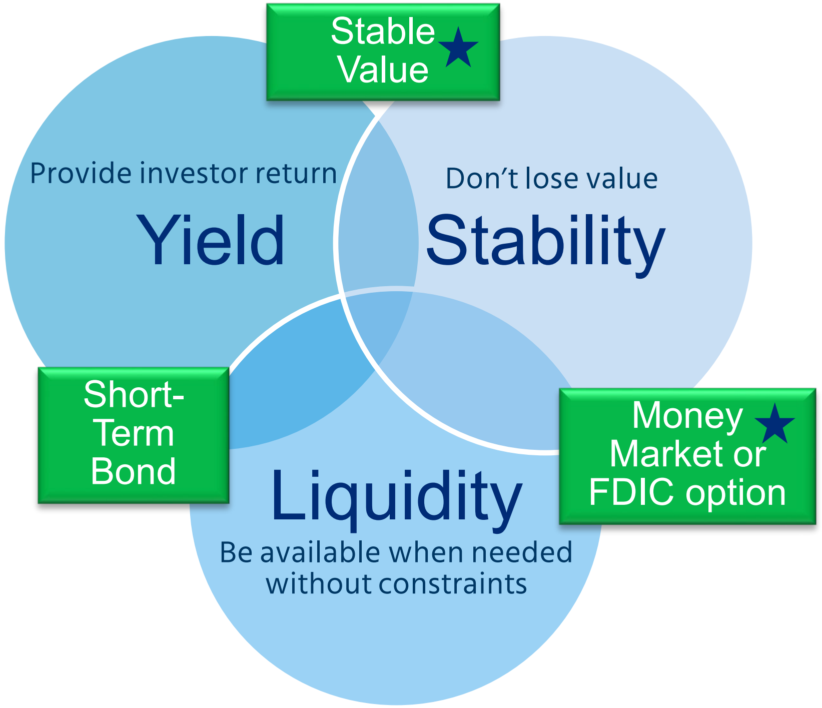
- At the December 19, 2023 Investments Committee meeting, we reviewed the City of LA DCP’s capital preservation options and Target Risk Funds
  – We reviewed in detail stable value, money market and FDIC capital preservation options
  – We discussed what peers are offering and potential alternatives for the Profile funds
  – We also explored Target Risk Profile (TRF) utilization by DCP participants and participants that have a pension plan
- Today we will:
  – Affirm the Stable Value offering in the Plan
  – Determine whether the Committee would like remove the FDIC option in favor of a money market fund.
    - Outline steps to transition the FDIC-Insured Savings Account to a Money Market Fund
  – Review Profile Fund Utilization and Asset Allocation
  – Discuss a hybrid TRF/Target Date Fund (TDF) approach
  – Discuss next steps
    - Asset allocation review of TRFs and potentially target date

Capital Preservation Option Discussion

1

Capital Preservation

Overview: City of LA DCP currently offers an FDIC savings option and a stable value fund as denoted by★.



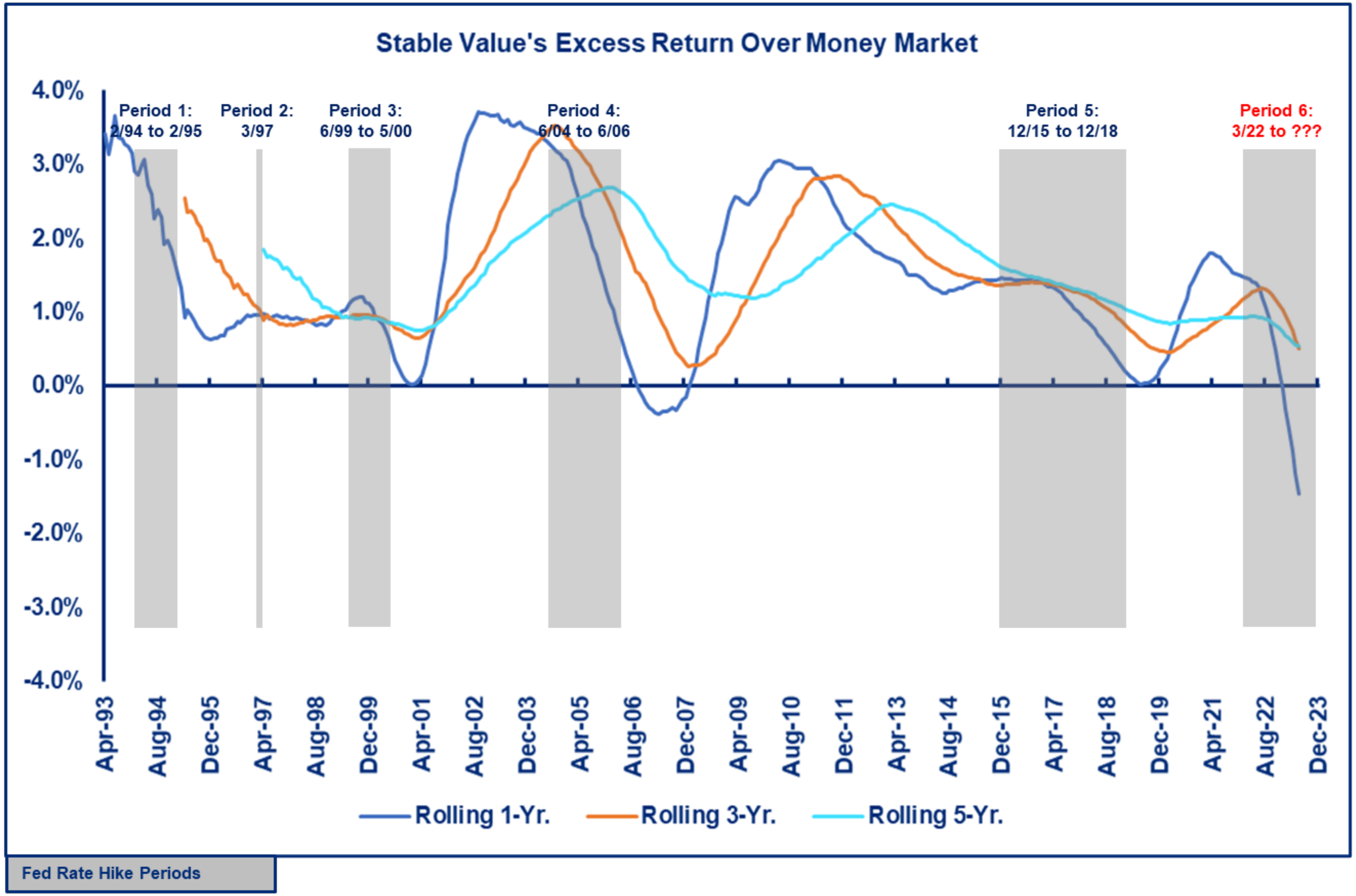
- No solution provides all three objectives
- Capital preservation option not meant to serve as a long-term investment
- Stability and liquidity should be primary objectives; yield should be secondary. However, yield becomes more important if retirees stay in the plan.

Stable Value Funds:

– Seek to provide *book value payout* of principal plus accrued income for participant transactions as opposed to *market value payout*
  - In other words, value of participant account should remain stable or increase, but **should not go down**
– Tend to deliver returns similar to short- to intermediate-term bonds with volatility similar to that of a money market fund
– The DCP Stable Value Fund, managed by Galliard, is highly rated by the Mercer Research Team

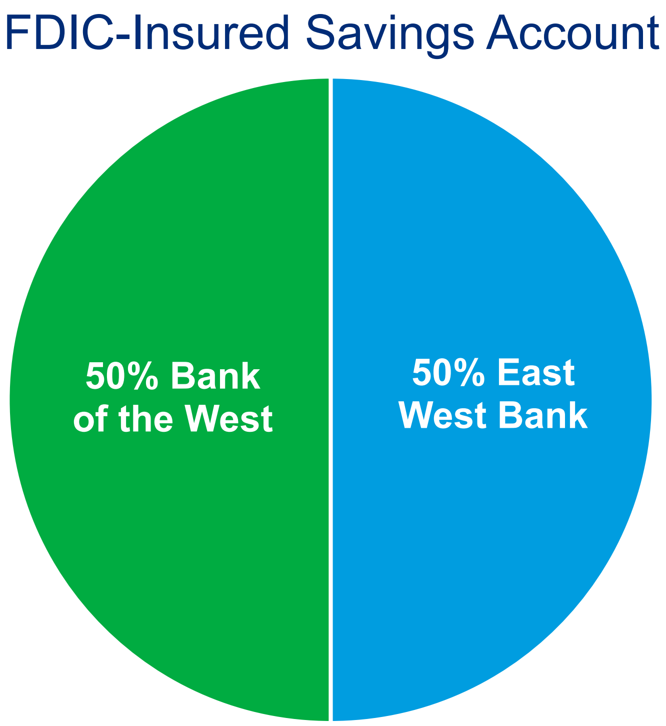
Recommendation: Retain the Stable Value Fund in the City of Los Angeles Deferred Compensation Plan

Stable Value Excess Return over Money Market



- Despite recent underperformance, Stable value funds have historically delivered higher long-term returns with similar volatility than money market funds.
- In the recent rising interest rate environment, money market funds have been outperforming many stable value funds.
- However, Mercer expects stable value to outperform money market over the long-run as the yield curve normalizes over time.

City of LA DCP FDIC-Insured Savings Account



Blended Rate: 5.55%
as of (12/31/23)

Performance as of 12/31/23 (%)

	10 Year	5 Year	3 Year	1 Year	3 Month
FDIC-Insured Savings Account	1.5	2.1	2.3	5.3	1.5
Mercer Mutual Fund Money Market Top 25%	1.2	1.8	2.2	5.1	1.3
Mercer Mutual Fund Money Market Median	1.1	1.7	2.1	5	1.3

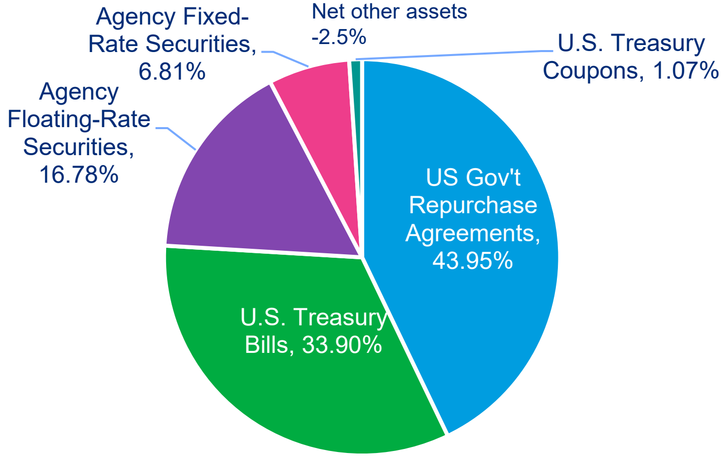
- The DCP FDIC-Insured option is invested with 2 underlying banks, though the preferred number of providers for the option is 3. Currently, it provides aggregate FDIC coverage of $500,000 ($250,000 per bank).
- The FDIC option has provided competitive yield historically relative to government money market funds, but it does come with greater complexity and arguably risk than a money market surrogate.
  - Considerations:
    - monitoring of bank providers
    - periodic RFPs required
    - recordkeeping/administrative complexity
    - government money market funds have comparable or better security of assets

Government Money Market Funds

- **Government money market funds** invest in very short maturity (typically 60 days or less), extremely high credit quality, and government-backed bonds like cash equivalent securities or US Treasury bills (T-bills). They are meant to provide a high level of liquidity (meaning moving in and out of a money market fund is quick and easy) while delivering stability (the goal is to maintain a $1.00 net asset value, which essentially means protection against loss). They also generate yield, which is extremely sensitive to monetary policy dictated by the Fed. Government Money Market fees typically range from 10 to 50 basis points for institutional investors.

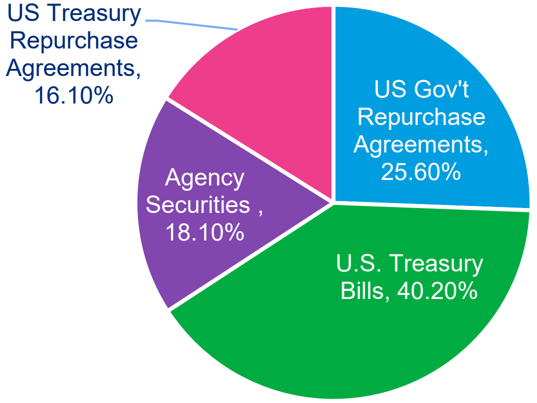
Sample Government Money Market Funds

Fidelity Gov't Portfolio I (FRGXX)



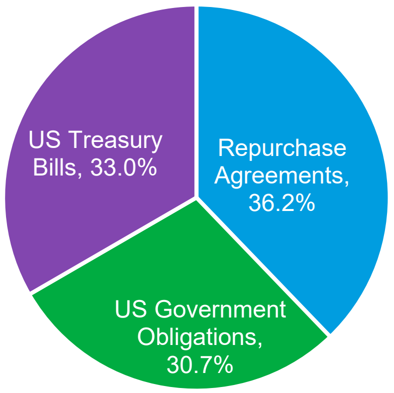
- 7-day SEC yield: 5.25%
- Weighted Avg Maturity: 34 Days
- Weighted Avg Life: 83 Days
- Assets: $197.9B

JPM US Gov't Money Market Fund I (IJGXX)



- 7-day SEC yield: 5.16%
- Weighted Avg Maturity: 43 Days
- Weighted Avg Life: 95 Days
- Assets: $267.0B

Vanguard Federal Money Market Fund (VMFXX)



- 7-day SEC yield: 5.28%
- Weighted Avg Maturity: 21 Days
- Weighted Avg Life: 51 Days
- Assets: $292.4B

Portfolio data as of February 29, 2024. Values may not add up to 100% due to rounding. SEC Yield as of 3/27/2024

Transition From FDIC Savings Account to Money Market

We believe there are compelling reasons from an operational risk perspective to move to a government money market fund option instead of the FDIC-backed approach currently used. If the Investments Committee is inclined to replace the FDIC Savings Account with a government money market option, we envision the following next steps:

1. Seek Board approval
2. Conduct a formal mutual fund search for a government money market option in accordance with Investment Policy
3. Reconvene with the Investments Committee to review the search and identify an optimal fund
4. Communicate the change to the Plan's TPA so the necessary notices can be provided to participants and an effective date for implementation is set
5. Communicate the change and effective date to both bank providers
6. Devise a transition plan in collaboration with TPA, the legacy providers and the future money market fund provider
7. Implement the transition

We expect the timeline for such a transition to range from 5-9 months.

Risk Profile Fund Utilization

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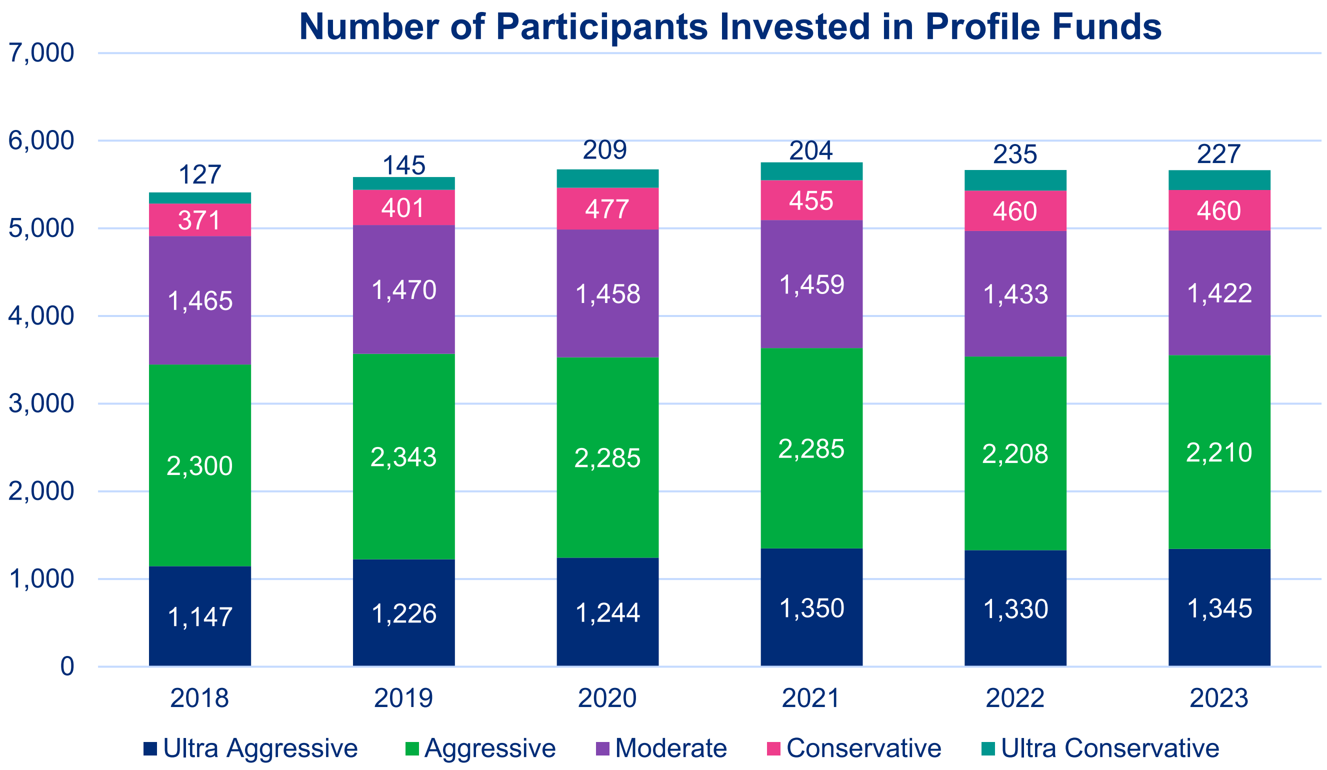
City of Los Angeles DCP Profile Fund Utilization

Participant Behavior



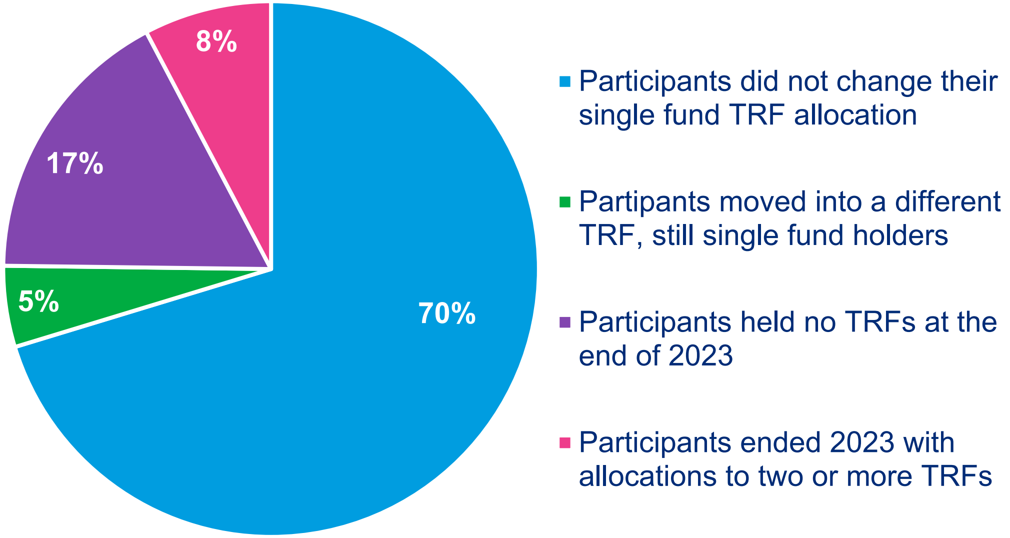
- Over the last six years, participants have shifted towards both ends of the risk spectrum, moving slightly away from the Moderate and Aggressive portfolios.
- The Ultra Conservative Portfolio has proportionately gained the most participants, while the Aggressive Portfolio has lost the highest percentage of participants.

*Data shown above represents participant counts invested in each TRF at the end of each calendar year.

City of Los Angeles DCP Profile Fund Utilization

Participant Behavior

- The following data represents participants who started 2018 with 100% of their balance in a single target risk fund. We tracked these participants' behavior through the end of 2023.
- At the beginning of 2018, 5,185 participants were single Target Risk Fund holders.
  - 3,645 participants (70%) ended 2023 with the same allocation to a single TRF as they started with in 2018.
  - 254 participants (5%) moved into a different TRF, still only holding a single TRF at the end of 2023.
  - 886 participants (17%) held zero TRFs at the end of 2023, either reallocating to a different investment option or withdrawing from the Plan.
  - 400 participants (8%) invested in an additional TRF, ending 2023 with allocations to two or more TRFs.



	Average Age of Participants*	
	Start of 2018	End of 2023
Ultra Aggressive	39	44
Aggressive	44	49
Moderate	51	55
Conservative	56	56
Ultra Conservative	54	52

*Optimal age ranges are as follows: Ultra Aggressive: <31, Aggressive: 32 to 46, Moderate: 47 to 56, Conservative: 57 to 65 and Ultra Conservative: >65.

Risk Profile Fund Allocation Discussion

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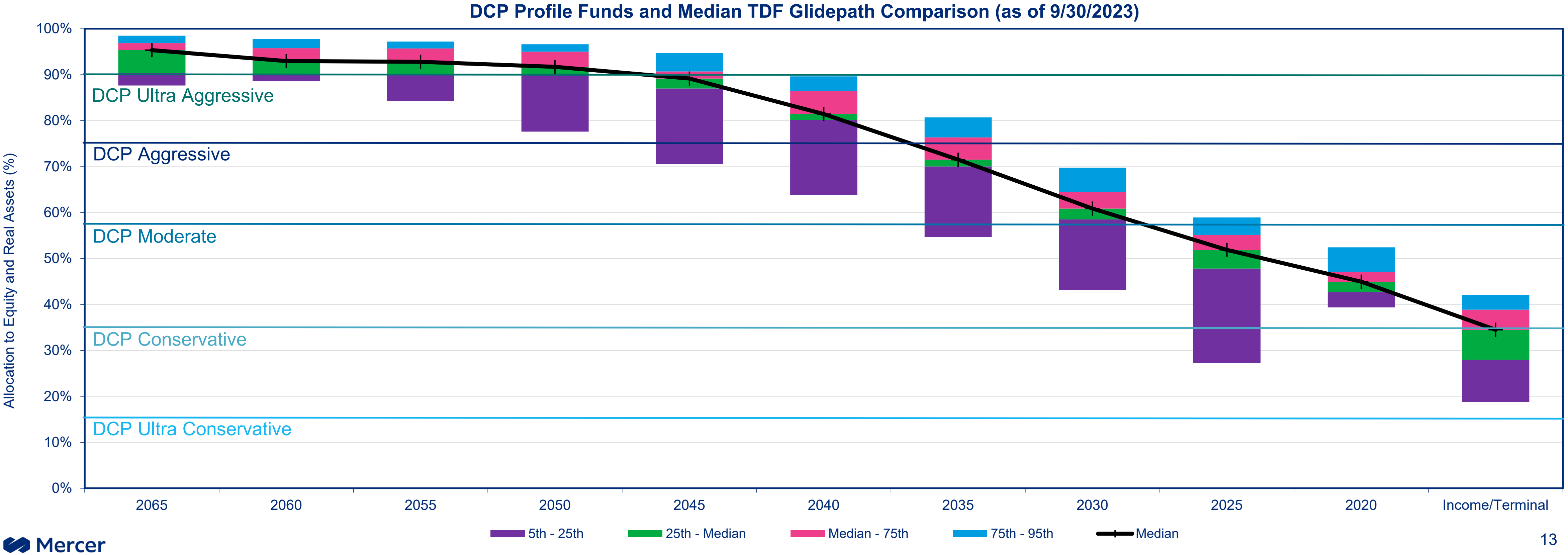
Target Risk Fund Allocations

- Currently, the City of LA DCP Plan offers 5 target risk funds, ranging from Ultra Conservative to Ultra Aggressive.
- The DCP Target Risk Profiles have, on average, a lower allocation to equity (and real assets) compared to the median target date fund across all the vintages.
  – **Recommendation based on this view of current allocations is that a review of asset allocation is warranted**



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Profile Fund and Median Allocations

- The table below shows how the DCP TRFs may be aligned to mimic the median equity exposure of comparable target date funds.
- General observation is DCP funds are more conservative, and given the presence of a DB plan for DCP participants, a review of shifting towards a more aggressive allocation would be appropriate.

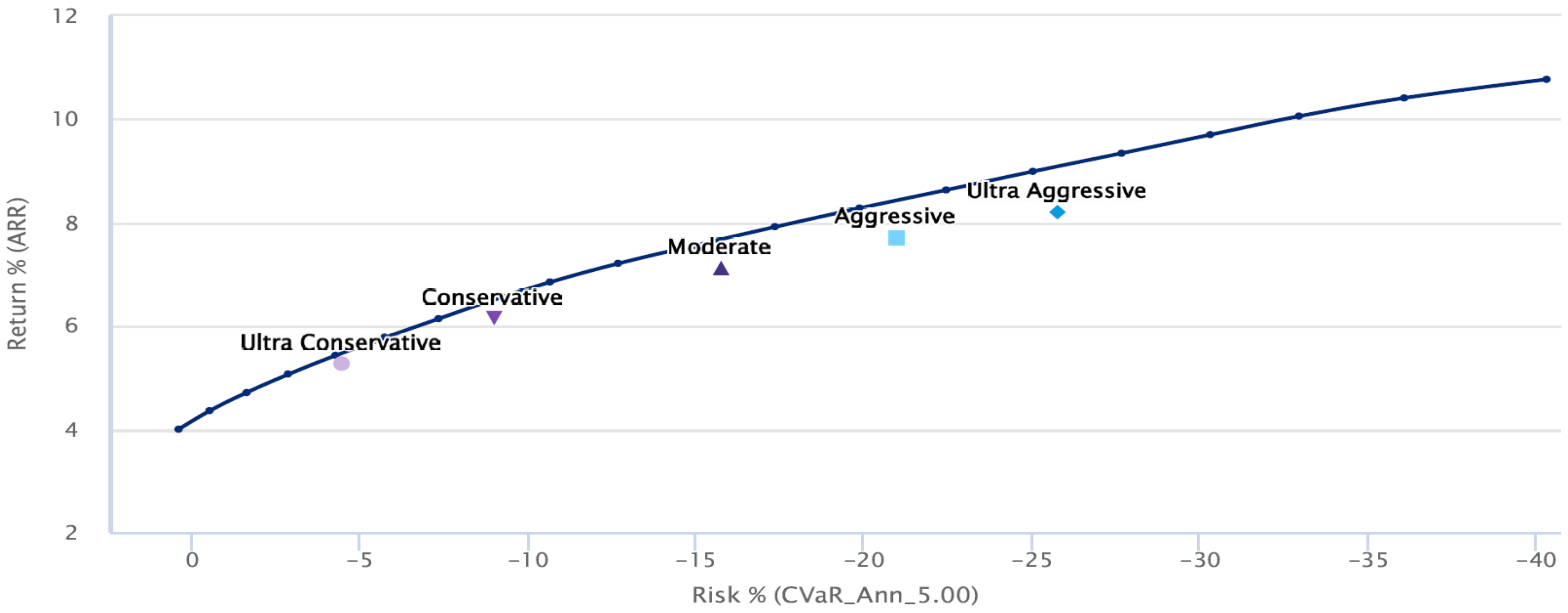
CURRENT ALLOCATIONS (%)					
	Ultra Conservative (%)	Conservative (%)	Moderate (%)	Aggressive (%)	Ultra Aggressive (%)
Stable Value	35	15	0	0	0
Bond Fund	50	50	42	25	10
Large Cap Stock Fund	6	15	20	25	30
Mid Cap Stock Fund	2	3	6	8	10
Small Cap Stock Fund	2	3	6	8	10
International Stock Fund	5	14	26	34	40
Current Equity Exposure	**15**	**35**	**58**	**75**	**90**
Current Fixed Income Exposure	**85**	**65**	**42**	**25**	**10**

MEDIAN ALLOCATIONS (%)					
	Income/Terminal (%)	2020 (%)	2030 (%)	2040 (%)	2065 (%)
Stable Value	29	13	0	0	0
Bond Fund	41	42	35	20	5
Large Cap Stock Fund	12	19	22	27	32
Mid Cap Stock Fund	4	4	7	9	11
Small Cap Stock Fund	4	4	7	9	11
International Stock Fund	10	18	29	36	42
Proposed Equity Exposure	**30**	**45**	**65**	**80**	**95**
Proposed Fixed Income Exposure	**70**	**55**	**35**	**20**	**5**

Efficient Frontier Analysis

- The chart below shows optimal combinations of risk and return for a portfolio. The City of LA DCP Target Risk Funds are slightly below this line, indicating that they could be rebalanced to provide a more optimal risk/return profile. Further, shifting out on the risk spectrum may be appropriate given DB coverage and market alternatives (i.e., target date fund comparables).

Efficient Frontier



Hybrid Approach

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Hybrid Target Date Fund Discussion

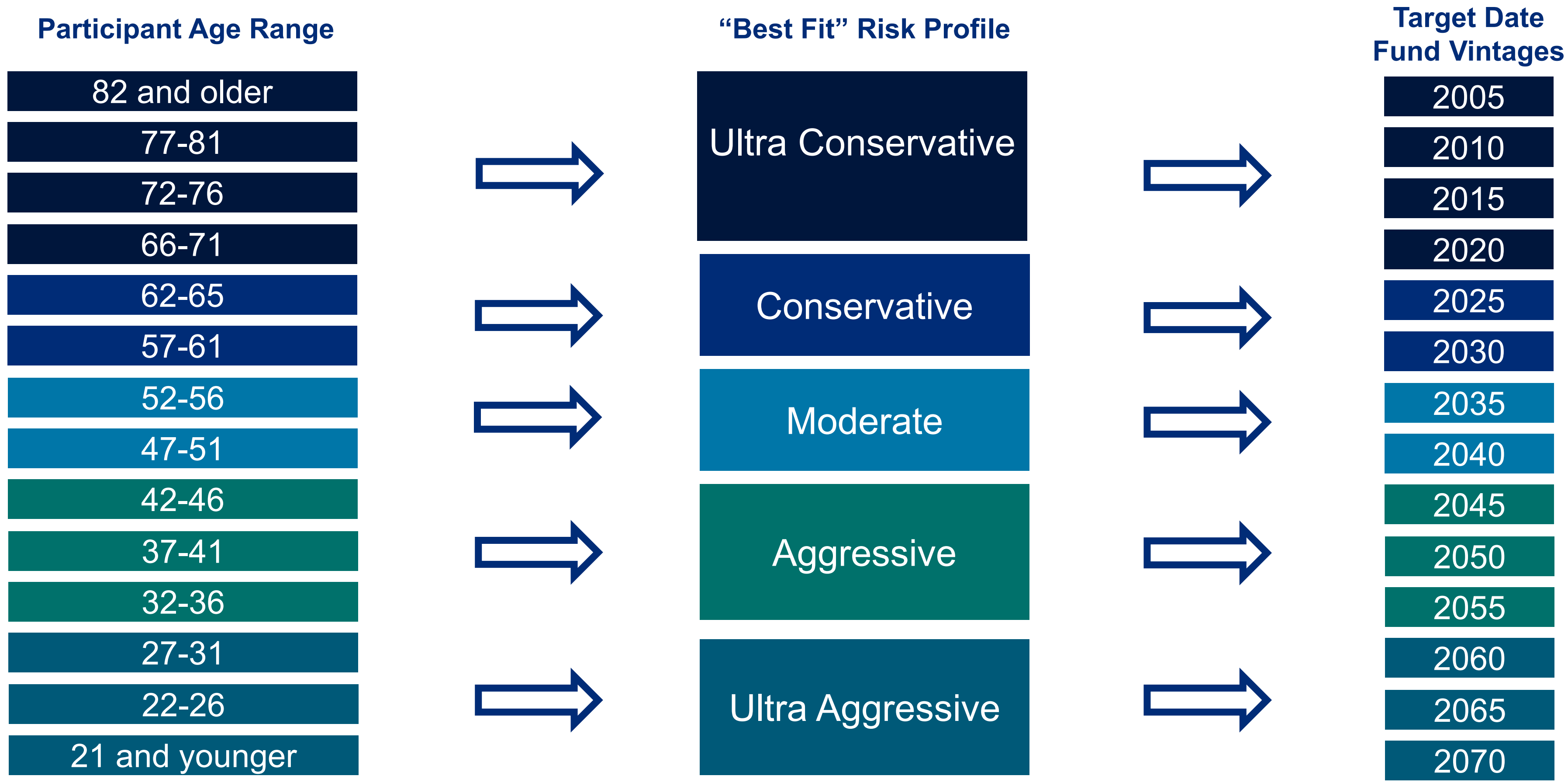
Background

- At the last meeting, we reviewed the possibility of adding off-the-shelf (“packaged”) target date funds (TDFs).
  - The Committee expressed concern with moving away from the current Risk Profile approach which has been successful.
  - Also, the introduction of new TDFs may cause assets to move out of the DCP core options, which would reduce the purchasing scale of the overall Plan to drive lower costs.
- The Committee wished to further explore a hybrid approach to the Investment Structure which would retain the current Risk Profiles but provide a custom TDF mix alongside these for participants that wished to have an auto-rebalancing feature as they near retirement.
  - Benefits:
    - Can be targeted to suit DCP participant demographics taking into account the DB benefit feature
    - Can incorporate existing funds within the DCP core line-up making offering easy to understand
    - Promotes building scale of assets
  - Drawbacks: More complex from a fiduciary and participant perspective and requires more involvement regarding allocation decisions on both fronts

How might a Hybrid Structure work?

- Target Risk Fund allocations remain static, thus requiring participants to periodically reassess their risk versus the dynamic de-risking nature of a target date fund.
- These allocations (as presented earlier) can be related to a certain age of participant. An automatic “roll-down” of to a progressively more conservative allocation can be prescribed to help participants who may otherwise fail to reassess their risk – i.e., a custom target date glide path. This could either supplement or replace the current Risk Profiles.

Illustration of Translating Risk Profiles to TDFs



Hybrid Approach – Two Ways to Build the Glidepath

- The tables below shows the allocation illustrations with underlying funds for each vintage of custom target date funds.
- Custom TDFs could underlying DCP options (top table) or DCP Risk profiles Using the current underlying funds within each DCP Target Risk Profile, we have adjusted the allocations to create the below vintages.

Option 1 illustration – TDF Glidepath with underlying DCP funds

Comparable Target Risk Fund:	Ultra Aggressive			Aggressive			Moderate		Conservative		Ultra Conservative			
Target Date Fund	**2070**	**2065**	**2060**	**2055**	**2050**	**2045**	**2040**	**2035**	**2030**	**2025**	**2020**	**2015**	**2010**	**2005**
Stable Value	0%	0%	0%	0%	0%	0%	3%	11%	19%	31%	35%	35%	35%	35%
Bond Fund	12%	16%	22%	27%	33%	39%	44%	48%	50%	50%	50%	50%	50%	50%
Large Cap Stock Fund	29%	28%	26%	24%	23%	21%	19%	17%	13%	8%	6%	6%	6%	6%
Mid Cap Stock Fund	10%	9%	8%	8%	7%	6%	5%	4%	3%	2%	2%	2%	2%	2%
Small Cap Stock Fund	10%	9%	8%	8%	7%	6%	5%	4%	3%	2%	2%	2%	2%	2%
International Stock Fund	39%	37%	35%	33%	30%	28%	24%	18%	12%	7%	5%	5%	5%	5%
Equity	**88%**	**84%**	**78%**	**73%**	**67%**	**61%**	**53%**	**42%**	**31%**	**19%**	**15%**	**15%**	**15%**	**15%**
Fixed Income	**12%**	**16%**	**22%**	**27%**	**33%**	**39%**	**47%**	**58%**	**69%**	**81%**	**85%**	**85%**	**85%**	**85%**

Option 2 illustration – TDF Glidepath using Risk Profile funds as holdings

	2070	**2065**	**2060**	**2055**	**2050**	**2045**	**2040**	**2035**	**2030**	**2025**	**2020**	**2015**	**2010**	**2005**
Ultra Aggressive	89%	57%	21%											
Aggressive	11%	43%	79%	87%	53%	20%								
Moderate				13%	47%	80%	80%	30%						
Conservative							20%	70%	78%	22%	0%	0%	0%	0%
Ultra Conservative									22%	78%	100%	100%	100%	100%

Conclusion & Next Steps

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Conclusion and Next Steps

- We recommend:
  1. Affirming Stable Value option with the Capital Preservation category
  2. Considering transition to Government Money Market option from current FDIC option
  3. The Committee express its preference on the managed allocation fund tier
     - Target Risk Profiles only?
     - Introduce Target Date Funds via a custom approach using the DCP fund line-up as underlying investors in the TDFs?
       - Will TDFs replace TRFs or will a hybrid approach be offered where both are available?
  4. Assuming TRFs are retained, conducting asset allocation analysis on each of the Funds to optimize their expected risk/return characteristics in light of DCP demographics

Appendix

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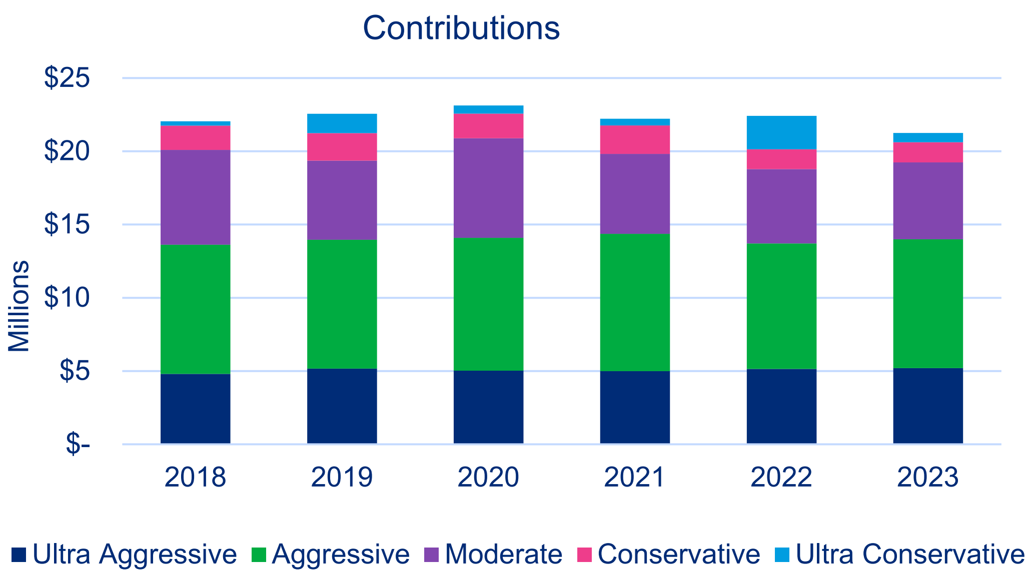
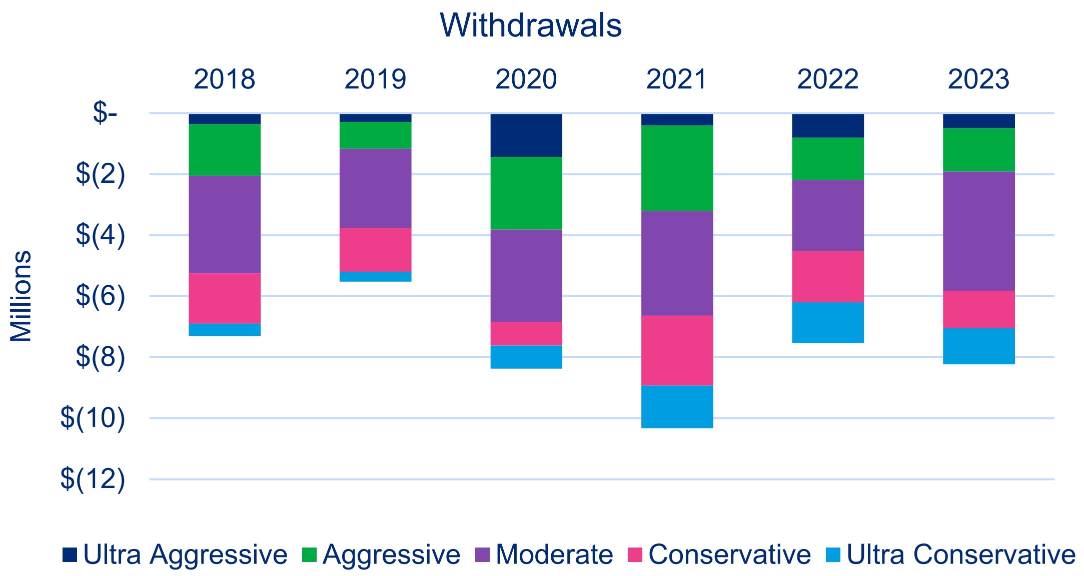
City of Los Angeles DCP Profile Fund Utilization

Contributions & Withdrawals



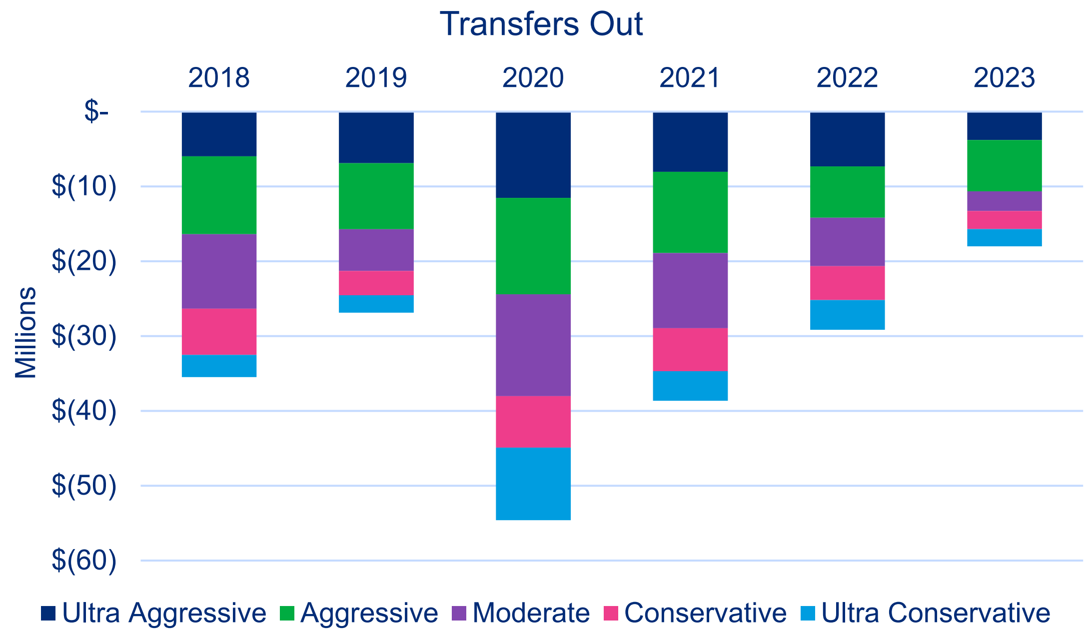


- Over the last six years, contributions into the Aggressive Portfolio have been highest, while withdrawals out of the Moderate Portfolio have been the highest.
- Participant contributions peaked in 2020 and withdrawals peaked in 2021.

*Data shown above represents participants that had 100% of their balance in a single TRF at the beginning of 2018.

City of Los Angeles DCP Profile Fund Utilization

Transfers In & Transfers Out



- Over the last six years, the majority of transfers in went into the Ultra Aggressive Portfolio, while transfers out mostly came out of the Aggressive Portfolio.
- 2020 saw the greatest amount of transfers in as well as transfers out.

*Data shown above represents participants that had 100% of their balance in a single TRF at the beginning of 2018.

Target Risk Funds vs. Target Date Funds Comparison

- Target Risk Funds do not change their allocation to equity over time, it is ***static*** – requires participant to periodically re-assess their risk level and fund choice.
- Target Date Funds have a ***dynamic*** asset allocation that generally allocates less to equity as participant ages – allows participant to pick a fund once for the duration of their career.

	Target Risk Funds	Target Date Funds
Investor Type	"I like to think about this every two or three years"	"I like to make one decision that will last for a long time"
Investor Decision	Subjective – requires participant to know risk tolerance	Objective – requires participant to know expected date of retirement Participants are more likely to have the knowledge to select a fund based on their retirement age than to understand their risk tolerance
Communications	Initial risk profile questionnaire, then on-going communication to encourage re-evaluation of risk profile	Up front communication to describe fund intention
Asset Allocation	Diversified portfolios; automatically rebalance to static allocations Leverage existing investment options	Diversified portfolios; automatically rebalance to a more conservative portfolio over time Participant inertia is a powerful force – having an asset allocation option that rebalances as participants age is valuable
Demographics	Designed to suit a large population	Designed to suit a large population. Demographics change over time. Use of custom funds can help address specific plan features and demographics.
Plan Sponsor Responsibility	Current custom funds require asset diversification, asset allocation, style and rebalance decisions	Custom target date funds would require similar decisions, with the addition of glide path choices. Could also look at using highly rated 'off the shelf' funds to ease decisions.

DCP Profile Fund Considerations

Potential alternatives to DCP Profile Funds (Target Risk Funds):

'Off-the-shelf' Target Date Funds	Many highly rated providers of target date funds. Adds another manager to oversight. Removes some of the sponsor decisions. Would consider impact to stand alone fund fees.
Custom Target Date Funds	Can customize attributes to demographics. Administratively complicated (unless outsource).
Managed Accounts	This service is similar to a personalized target date fund. However, unless participants are engaged or record keeper can feed a lot of data automatically, becomes an expensive target date fund.
Combination Solution	The market is constantly evolving. Funds using both target dates and managed accounts, personalized target date solutions, multiple glide paths (conservative/aggressive), and alternative glide paths are available.

Recommendation:

1. Affirm use of target risk model funds and consider optimization of current portfolios

OR

2. Conduct further analysis/searches on target date funds with the intention of moving away from current model portfolios.

Important notices

References to Mercer shall be construed to include Mercer (US) LLC and/or its associated companies.

Past performance is no guarantee of future results. The value of investments can go down as well as up, and you may not get back the amount you have invested. Investments denominated in a foreign currency will fluctuate with the value of the currency. Certain investments, such as securities issued by small capitalization, foreign, or emerging market issuers, real property, and illiquid, leveraged (including through the use of derivative instruments), or high-yield funds, carry additional risks that should be considered before choosing an investment manager or making an investment decision.

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