Deferred Compensation Plan
BOARD REPORT 17-23

Date: June 20, 2017

To: Board of Deferred Compensation Administration

From: Staff and the Investments Committee

Subject: Plan Risk-Based Asset Allocation Funds and Investments Policy Statement

Recommendation:
That the Board of Deferred Compensation Administration approve recommendations of staff and the Investments Committee to:

(a) Adopt proposed optimizations to asset allocations within the Plan's risk-based asset allocation funds; and
(b) Adopt proposed revisions to the Plan's Investment Policy Statement.

Discussion:

A. Background

At its **October 18, 2016** meeting, the Board referred to the Investments Committee ("Committee") a review of the Deferred Compensation Plan Investments Menu and Investment Policy Statement. At its **December 14, 2016**, **January 26, 2017,** and **April 13, 2017** meetings, the Committee conducted review and analysis of these items with assistance from the Plan's Investments Consultant, Mercer Investment Consulting ("Mercer"). This report provides recommendations from the Investments Committee relative to the optimization of the Plan's risk-based asset allocation funds and proposed revisions to the Plan's Investment Policy Statement.

B. Review of Plan Investments Menu

In preparation for the initial Investments Committee meeting on December 14, 2016, Mercer conducted a review and generated a report identifying certain items that could be considered for changes and enhancements to the Plan's Core Investment Menu. These included the following:

- Consolidating the Mid Cap and Small Cap funds into a single Small-Mid ("SMID") Cap fund
- Adding a diversified real assets and/or Real Estate Investment Trust (REIT) fund
- Optimizing current asset allocations within the risk-based asset allocation, or "profile" funds

(1) Consideration of Additions to the Core Investment Menu

- **SMID-Cap Fund Consolidation** – A "SMID-Cap Fund" is a blending of two-major asset classes (Small and Mid-Cap equities) into a single investment vehicle. Mercer indicated that creating a SMID-Cap fund may provide a benefit of further streamlining a plan's investment menu by reducing the complexity participants face in trying to decide between two similar investments, the DCP Small-Cap Stock and DCP Mid-Cap Stock Funds. It could also help streamline a plan sponsor's management of its core investment menu. Staff and Committee members discussed the potential benefits of investment menu simplification vs. the value that participants may realize from being provided two investment choices across two significant segments of the US equity universe. Without arriving at a position on moving to a single SMID option, the Investments Committee's finding was that this topic was best deferred until its next review. This would allow time to complete the transition to the Plan's new Third-Party-Administrator (TPA) and minimize additional disruption to Plan participants.

- **Real Assets Funds (including REIT Funds)** – A real assets fund is an investment in physical assets such as real estate, commodities, and other asset classes which may be sensitive to changes in inflation. Mercer reported that diversified real assets funds are designed to provide inflation protection, preserving purchasing power in certain market environments. In addition, they are designed to enhance diversification as they should have relatively low correlation with stock and nominal bonds. Mercer advised, however, that some real asset funds, for example commodity funds, can be volatile and therefore might not be deemed appropriate as a stand-alone investment option. The Committee elected to focus the discussion on the possibility of incorporating them into the Plan's risk-based asset allocation funds. Mercer presented its findings on the benefits of adding real assets to the DCP Profile Portfolios at the January 26, 2017 meeting. Mercer's asset allocation modeling indicated only marginal improvement in expected risk and return for the DCP Profiles through adding exposure to a diversified group of real assets. In addition, Mercer separately analyzed at the Committee's request the effects of solely adding publicly traded Real Estate Investment Trusts (REITs) to the Profile allocations. Mercer's analysis included both US REIT Funds and Global REIT Funds. Mercer's findings were that this class of real asset likewise provided marginal benefits to the overall Profile Portfolio expected risk/return characteristics.

  Mercer further commented that from a vehicle availability perspective, most diversified, blended real asset funds are relatively new, typically with less than 5 years of history. Moreover, managers of these funds often take very different approaches to portfolio construction and allocations to real assets sub-components of the funds making them difficult to compare relative to one another. The limited universe and short track record of offerings in this space means that the City would likely be constrained in either finding a mutual fund offering or conducting an RFP for an institutional product that meets the Plan's objectives. Based on the foregoing factors, the Committee elected to not consider adding dedicated real asset and/or REIT funds at this time.

(2) Optimization of Plan Risk-Based Asset Allocation Funds

The Plan established DCP-branded risk-based asset allocation funds in 2007. These funds were designed to provide participants with diversified fund options that align with their desired investment objectives and risk tolerance. Each fund is comprised of major asset classes for which allocations vary between funds according to the desired risk-return relationship.

Mercer provided the Committee with an assessment of asset allocations within the Plan's risk profile portfolios. Utilizing a methodology called Mean-Variance Optimization (MVO), Mercer presented what it identified as an "Efficient Frontier" depicting a set of optimized Plan portfolios that offer the greatest level of return for a given level of risk.

Mercer provided an analysis of the Plan's risk-based fund portfolios under four scenarios:

1. Current state – how existing allocations plot absent any change
2. Optimizing mix of current assets already available in the Plan
3. Including the addition of only Real Estate Investment Trusts (REITS)
4. Including the addition of Real Assets in the form of TIPS, Commodities, and REITS

Mercer's report indicated that when current asset allocations were plotted along the Efficient Frontier, they were found to be generally very efficient with only minor optimizations needed to move them directly onto the Efficient Frontier. They further found that the addition of REITS and Real Assets (scenarios 3 and 4) would only provide negligible improvement to the Profile Portfolios, as stated previously in this report.

Specifically, the following optimizations were proposed:

- Moderate, Aggressive, and Ultra Aggressive Profile Funds:
    - Eliminate Stable Value exposure; increase core fixed income exposure (within Moderate and Aggressive Profiles)
    - Increase US large cap equity within the Ultra Aggressive Profile Fund; decrease US large cap within the Moderate Profile Fund
    - Decrease mid and small cap equity exposure
    - Increase international equity exposure

- Ultra Conservative and Conservative Profile Funds:
    - Slightly increase US large cap equity; decrease US mid and small cap equity exposure
    - Slightly increase international equity exposure (in Conservative only)
    - Maintain same allocations to Stable Value and core fixed income

These optimizations are expected to result in an improved risk/return relationship as well as minor changes to blended-fund portfolio fees. The changes in fees are detailed in the tables below.

Current Profile Funds	*Expense Ratios*	*Ultra Conservative*	*Conservative*	*Moderate*	*Aggressive*	*Ultra Aggressive*
Stable Value	0.32%	35.0%	15.0%	10.0%	5.0%	0.0%
US Aggregate Fixed Income	0.22%	50.0%	50.0%	30.0%	20.0%	10.0%
US Large Cap Equity	0.02%	5.0%	12.5%	25.0%	25.0%	25.0%
US Mid Cap Equity	0.53%	2.5%	5.0%	10.0%	15.0%	20.0%
US Small Cap Equity	0.41%	2.5%	5.0%	10.0%	15.0%	20.0%
AC World ex US All Cap Equity Unhedged	0.75%	5.0%	12.5%	15.0%	20.0%	25.0%
Profile Fund Expense Ratio (Current)		**0.28%**	**0.30%**	**0.31%**	**0.36%**	**0.40%**

Optimize Current Assets	*Expense Ratios*	*Ultra Conservative*	*Conservative*	*Moderate*	*Aggressive*	*Ultra Aggressive*
Stable Value	0.32%	35.0%	15.0%	0.0%	0.0%	0.0%
US Aggregate Fixed Income	0.22%	50.0%	50.0%	42.0%	25.0%	10.0%
US Large Cap Equity	0.02%	6.0%	15.0%	20.0%	25.0%	30.0%
US Mid Cap Equity	0.53%	2.0%	3.0%	6.0%	8.0%	10.0%
US Small Cap Equity	0.41%	2.0%	3.0%	6.0%	8.0%	10.0%
AC World ex US All Cap Equity Unhedged	0.75%	5.0%	14.0%	26.0%	34.0%	40.0%
Profile Fund Expense Ratio (Proposed)		**0.28%**	**0.29%**	**0.35%**	**0.39%**	**0.42%**

Mercer indicated and the Committee members found that since the implementation of these optimizations is modest, there was no immediate need to take action. Although staff and the Committee recommend that the Board approve the optimization models as outlined in this report, it is further recommended that an implementation plan for the changes be deferred until after the transition of TPA providers is complete. This minimizes the disruption to Plan participants as well as provides staff and Voya with the opportunity to develop a thorough transition and communications plan.

The final report presented by Mercer to the Committee is provided as **Attachment A** to this report. Page 4 of the report provides a chart of the Efficient Frontier with both the current and proposed optimized Profile Portfolios plotted along the frontier. Additionally, Page 5 of the report provides a comparison of the expected risk/return for both the current and proposed optimized Profile Portfolios.

C. Revisions to the Investment Policy Statement

With assistance from Mercer, staff is proposing several revisions to the Plan's Investment Policy Statement in order to refine and update the document, which are indicated in **Attachment B**. Key revisions include:

- Amending the IPS to state that it will be reviewed no less than once every three years;
- In **Section 3: Responsibilities of Plan Participants**, adding language that clarifies participant assumption of risk when investing in the market;
- In **Section 4: Parties Responsible for Plan Management**, adding a definition of the "Prudent Investor" standard for greater clarity; and
- In **Section 4**, adding language allowing investment manager of separate accounts to vote security proxies in the interest of the Plan. A separate account is a fund

investment vehicle wherein the plan owns the account and underlying securities in the fund. This differs from a mutual fund wherein investors in the fund are the fund owners. This language would allow the manager of a DCP separate account vehicle to vote on behalf of the Plan in the event that there was a voting measure pertaining to an individual security within the portfolio. Mercer noted that when a contract is established between the Plan and a separate account manager, specific instructions pertaining to voting measures are provided within the contract. The language added to this section does not apply to proxy voting on administrative and governance issues for mutual funds. The Plan currently doesn't have a policy regarding proxy voting for mutual funds on behalf of Plan participants, and the Committee does not recommend establishing such a policy at this time.

Submitted by: ______________________________
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