



HEALTH WEALTH CAREER

**PASSIVE FUND SEARCH RECOMMENDATIONS**  
CITY OF LOS ANGELES DEFERRED COMPENSATION PLAN  
SEPTEMBER 17, 2018



**MAKE TOMORROW, TODAY**



# CONTENTS

- 1. Introduction .....1
- 2. Proposed Investment Fund Searches .....4
  - Passive Bond .....5
  - Passive Large-Cap Equity .....7
  - Passive Mid-Cap Equity .....9
  - Passive Small-Cap Equity .....11

Appendix

# 1

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## Introduction

The Investment Policy Statement (IPS) of the City of Los Angeles Deferred Compensation Plan stipulates that investment manager searches/procurements for specific investment categories generally will occur once every 5 years. The current 5-year terms for the Plan's various investment providers will expire between 2019 and 2020. At the July 2018 Board of Deferred Compensation Administration (Board) meeting, the Board approved 2018-2019 investment manager search plan for the Deferred Compensation Plan investment menu and directed the Investments Committee to develop recommendations to the Board with respect to the type of search process (mutual fund and/or institutional manager procurement) to be applied to each investment mandate; proposed investment and evaluation criteria for each mandate; and recommendations for provider selections. As a result, staff have been working with the Board's investment consultant, Mercer Investment Consulting, to develop a timetable for the implementation of searches over the next couple of years. Per this timetable, in 2018, we will be conducting searches for all of the Plan's passive investment managers. Our recommendations as to which type of investment vehicle search (i.e., mutual fund and/or institutional manager procurement) the Board should conduct in each category based on the specifics of the respective investment mandates will be discussed in this report.

In addition, we outline recommended minimum qualifications for each of the searches which follow the principles outlined in the IPS' Investment Selection and Termination section. These recommended minimum qualification screens are tailored to each specific mandate and are based on our expertise conducting similar searches. These minimum requirements broadly establish that prospective investment strategies are accessible in the recommended investment vehicle type; they are passively managed, seek to track closely the performance and characteristics of their respective indices; hold a sufficient, yet not too small, amount of assets so that the Plan would not represent a significant percentage (more than 20%) of the particular strategy total assets; and maintain investment expenses that are low to minimize net tracking error.

## Search Evaluation

After the initial screening is completed, Mercer will compile search documents containing the candidates that meet the foregoing minimum qualifications in each category. In the search reports, we will provide detail on the qualitative and quantitative evaluation factors that the Board has outlined in the IPS. Dimensions considered include the following:

### *Qualitative Factors*

- Investment team strength (Idea Generation)
  - Number of investment staff
  - Number of portfolio management staff
  - Tenure of lead portfolio management team
  
- Portfolio construction
  - Indexation strategy (e.g., sampling, full replication, etc.)
  - Number of holdings relative to index
  - Portfolio statistics (e.g., P/E ratio, growth rate, yield to maturity, duration, etc.) relative to benchmark
  - Off benchmark exposure
  - Cash holding
  
- Implementation
  - Transaction cost management
  
- Business Management
  - Investment expenses
  - Ownership structure

### *Quantitative Factors*

- Long-term performance relative to the index (i.e., tracking error)

### *Consultant Ratings*

All investment funds are candidates for ratings pursuant to ongoing fund monitoring and due diligence that Mercer conducts for all of its clients. These ratings will be included in the data items reported to the Committee and can be used by the Committee as an additional measure in assessing the relative strength of each fund.

## Timing

Assuming the Board is in agreement with the recommendations herein, we will begin conducting the searches immediately and in alignment with the timeline previously reviewed by the Board at its July 2018 meeting. Our anticipated timing for completion of all searches will be eight weeks, and staff will schedule a series of Investment Committee meetings, covering the specific mandates, to coincide with this anticipated delivery.

# 2

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## Proposed Investment Fund Searches

- Passive Bond
- Passive Large-Cap Equity
- Passive Mid-Cap Equity
- Passive Small-Cap Equity

## Passive Bond

### PROPOSED SEARCH VEHICLE

Estimated Mandate Size<sup>1</sup>:

**\$285.6 million**

Recommended Fund Search Type:

***Institutional Manager Procurement and Mutual Fund***

#### Rationale:

- Conducting a pooled investment search (commingled and mutual funds) would provide broad access to high-quality index fund managers.
- The universe of available passive bond funds comprises of 15 commingled funds and 196 mutual funds.
- The median cost of the passive commingled fund universe for a mandate size of \$250 million is 5 basis points<sup>2</sup> compared to the median cost of passive mutual fund universe of 15 basis points. Our experience is that very large investors can obtain significantly better pricing via an institutional product in the current environment.
- Using Institutional Products, such as commingled funds, may lead to additional operational costs for custody and unitization. At this mandate size, however, “all-in” fees including other operating costs for Institutional Products could still provide cost savings versus using a Mutual Fund vehicle.
- Mutual fund search run concurrently would assure that high-quality product at reasonable expense would be secured.

### PROPOSED PASSIVE BOND SEARCH MINIMUM CRITERIA (SCREENING)

- Availability in pooled investment vehicle
- Vehicle open to new investors
- Vehicle compatible with Voya platform
- Strategy track record of 10 years or longer (specific vehicle may be shorter)
- Tracks the Bloomberg Barclays US Aggregate Bond Index
- Annualized tracking error<sup>3</sup> relative to the benchmark should be within +/- 0.30% over the 7- and 10-year periods (or longest available)

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<sup>1</sup> As of 7/31/2018

<sup>2</sup> Source: Mercer Global Asset Manager Fee Survey – February 2018. Median fees provided for asset breakdown of \$25M, \$50M, \$100M, \$250M and \$500M.

<sup>3</sup> Tracking error for these purposes is defined as the benchmark return less the subject fund return

## Passive Bond

### **PROPOSED PASSIVE BOND SEARCH MINIMUM CRITERIA (SCREENING), continued**

- Minimum assets under management in strategy (all vehicles) of \$20.0 billion or greater
- Investment expense ratio equal to or less than 0.03%



## Passive Large-Cap Equity

### PROPOSED SEARCH VEHICLE

**Estimated Mandate Size<sup>1</sup>:**

***\$2,328.3 million***

**Recommended Fund Search Type:**

***Institutional Manager Procurement and Mutual Fund***

#### **Rationale:**

- Conducting a pooled investment search (commingled and mutual funds) would provide broad access to high-quality index fund managers
- The universe of available passive large-cap equity funds comprises 28 commingled funds and 163 mutual funds
- The median cost of the passive commingled fund universe for assets over \$500 million is 4 basis points versus 11 basis points for Institutional Mutual Fund vehicles<sup>2</sup> and our experience is that very large investors can obtain significantly better pricing via an institutional product in the current environment.
- Using Institutional Products, such as commingled funds, may lead to additional operational costs for custody and unitization. At this mandate size, “all-in” fees including other operating costs for Institutional Products could still provide cost savings versus using a Mutual Fund vehicle.
- Mutual fund search run concurrently would assure that high-quality product at reasonable expense would be secured.

### PROPOSED PASSIVE LARGE-CAP EQUITY SEARCH MINIMUM CRITERIA (SCREENING)

- Availability in pooled investment vehicle
- Vehicle open to new investors
- Vehicle compatible with Voya platform
- Strategy track record of 10 years or longer (specific vehicle may be shorter)
- Tracks the S&P 500 Index
- Annualized tracking error<sup>3</sup> relative to the benchmark should be within +/- 0.20% over the 7- and 10-year periods (or longest available)

<sup>1</sup> As of 7/31/2018

<sup>2</sup> Source: Mercer Global Asset Manager Fee Survey – February 2018. Median fees provided for asset breakdown of \$25M, \$50M, \$100M, \$250M and \$500M.

<sup>3</sup> Tracking error for these purposes is defined as the benchmark return less the subject fund return

## Passive Large-Cap Equity

### **PROPOSED PASSIVE LARGE-CAP EQUITY SEARCH MINIMUM CRITERIA (SCREENING), continued**

- Minimum assets under management in strategy (all vehicles) of \$50 billion or greater
- Investment expense ratio equal to or less than 0.03%

## Passive Mid-Cap Equity

### PROPOSED SEARCH VEHICLE

Estimated Mandate Size<sup>1</sup>:

*\$192.0 million*

Recommended Fund Search Type:

*Institutional Manager Procurement and Mutual Fund*

#### Rationale:

- Conducting a pooled investment search (commingled and mutual funds) would provide broad access to high-quality index fund managers
- The universe of available passive mid-cap equity funds comprises 9 commingled funds and 53 mutual funds
- The median cost of the passive commingled fund universe for a mandate size of \$100 million is 6 basis points<sup>2</sup> compared to the median cost of passive mutual fund universe of 25 basis points. Our experience is that very large investors can obtain significantly better pricing via an institutional product in the current environment.
- Using Institutional Products, such as commingled funds, may lead to additional operational costs for custody and unitization. At this mandate size, “all-in” fees including other operating costs for Institutional Products could still provide cost savings versus using a Mutual Fund vehicle.
- Mutual fund search run concurrently would assure that high-quality product at reasonable expense would be secured.

### PROPOSED PASSIVE MID-CAP EQUITY SEARCH MINIMUM CRITERIA (SCREENING)

- Availability in pooled investment vehicle
- Vehicle open to new investors
- Vehicle compatible with Voya platform
- Strategy track record of 7 years or longer (specific vehicle may be shorter)
- Tracks the Russell Mid-Cap Index or a similar index (e.g., S&P Mid-Cap 400 Index or CRSP US Mid-Cap Index)
- Annualized tracking error<sup>3</sup> relative to the benchmark should be within +/- 0.30% over the 7- and 10-year periods (or longest available)

<sup>1</sup> As of 7/31/2018

<sup>2</sup> Source: Mercer Global Asset Manager Fee Survey – February 2018. Median fees provided for asset breakdown of \$25M, \$50M, \$100M, \$250M and \$500M.

<sup>3</sup> Tracking error for these purposes is defined as the benchmark return less the subject fund return

## Passive Mid-Cap Equity

### **PROPOSED PASSIVE MID-CAP EQUITY SEARCH MINIMUM CRITERIA (SCREENING), continued**

- Minimum assets under management in strategy (all vehicles) of \$5 billion or greater
- Investment expense ratio equal to or less than 0.04%

## Passive Small-Cap Equity

### PROPOSED SEARCH VEHICLE

**Estimated Mandate Size<sup>1</sup>:**

***\$129.6 million***

**Recommended Fund Search Type:**

***Institutional Manager Procurement and Mutual Fund***

#### **Rationale:**

- Conducting a pooled investment search (commingled and mutual funds) would provide broad access to high-quality index fund managers
- The universe of available passive small-cap equity funds comprised of 14 commingled funds and 98 mutual funds
- The median cost of the passive commingled fund universe for a mandate size of \$100 million is 7 basis points<sup>2</sup> compared to the median cost of passive mutual fund universe of 29 basis points. Our experience is that very large investors can obtain significantly better pricing via an institutional product in the current environment.
- Using Institutional Products, such as commingled funds, may lead to additional operational costs for custody and unitization. At this mandate size, “all-in” fees including other operating costs for Institutional Products could still provide cost savings versus using a Mutual Fund vehicle.
- Mutual fund search run concurrently would assure that high-quality product at reasonable expense would be secured.

### PROPOSED PASSIVE SMALL-CAP EQUITY SEARCH MINIMUM CRITERIA (SCREENING)

- Availability in pooled investment vehicle
- Vehicle open to new investors
- Vehicle compatible with Voya platform
- Strategy track record of 7 years or longer (specific vehicle may be shorter)
- Tracks the Russell 2000 Index or a similar index (e.g., S&P 600 Small-Cap Index or CRSP US Small-Cap Index)
- Annualized tracking error<sup>3</sup> relative to the benchmark should be within +/- 0.30% over the 7- and 10-year periods (or longest available)

<sup>1</sup> As of 7/31/2018

<sup>2</sup> Source: Mercer Global Asset Manager Fee Survey – February 2018. Median fees provided for asset breakdown of \$25M, \$50M, \$100M, \$250M and \$500M.

<sup>3</sup> Tracking error for these purposes is defined as the benchmark return less the subject fund return

## Passive Small-Cap Equity

### **PROPOSED PASSIVE SMALL-CAP EQUITY SEARCH MINIMUM CRITERIA (SCREENING), continued**

- Minimum assets under management in strategy (all vehicles) of \$10.0 billion or greater
- Investment expense ratio equal to or less than 0.04%

## Appendix – Disclosures

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