Deferred Compensation Program:

Improved Education and Administrative Changes Could Benefit Participants and Lower Costs

September 1999

Office of the City Auditor
Portland, Oregon

CITY OF
PORTLAND, OREGON
OFFICE OF THE CITY AUDITOR
Audit Services Division

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September 28, 1999

TO: Mayor Vera Katz
Commissioner Jim Francesconi
Commissioner Charlie Hales
Commissioner Dan Saltzman
Commissioner Erik Sten
Tim Grewe, Director, Office of Finance and Administration
Fred Cuthbertson, Director, Bureau of Risk Management

SUBJECT: Audit of Portland's Deferred Compensation Program

Attached is Audit Report #257, on City of Portland's Deferred Compensation Program. The Audit was conducted in accordance with our Fiscal Year 1997-98 Audit Schedule. It includes a summary of results at the beginning of the report.

We have reviewed draft reports with staff from the Office of Finance and Administration, the Bureau of Risk Management, and the City Treasurer's Office. They are in general agreement with the report's recommendations. A written response from the Office of Finance and Administration is included at the back of the report.

As a follow-up to our recommendations we request a written status report in six months from the Office of Finance and Administration, and the Deferred Compensation Advisory Committee detailing steps taken to implement the report's recommendations. This status report should also be distributed to the Audit Services Division, and the Commissioner in Charge of the Office of Finance and Administration.

We appreciate the cooperation and assistance we received from the Office of Finance and Administration, the Bureau of Risk Management, and the City Treasurer's Office in conducting this audit and preparing the report.

Gary Blackmer
Gary Blackmer
City Auditor

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A Report by the Audit Services Division
Report #257

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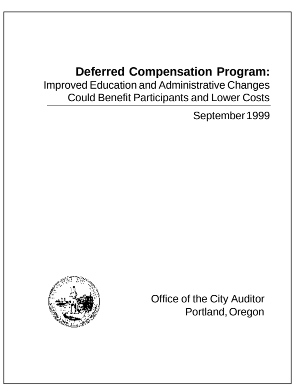
Portland, Oregon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Production/Design

This report was produced in-house using desktop publishing software on Pentium Pro personal computers, and a Hewlett Packard Laserjet PCL/Postscript laser printer. It was printed at the Printing and Distribution Division of the City's Bureau of General Services. Adobe PageMaker 6.5 was used to design and layout the finished product. Tables were drawn manually using PageMaker. Text was initially written in MS Word for Windows then pasted into PageMaker. Final editing was done in PageMaker.

Desktop Publishing: Robert Cowan

Table of Contents

List of Tables

Summary

We reviewed the City of Portland's deferred compensation program in consultation with the national benefit-consulting firm of William M. Mercer, Inc. We found that after two decades of operation, the program has accomplished much at little cost to the City. As of March 31, 1999, over 2,900 employees are actively participating in the program, over half of the approximately 5,000 full-time employees who are eligible to participate. These active participants, together with more than 1,500 other inactive and separated employees, have accumulated assets worth over $175 million.

We have also identified some opportunities to further improve Portland's deferred compensation program. We believe that additional employee education and stronger program administration can help more employees prepare for a secure retirement at a lower cost to the City and to participants.

We make several recommendations to improve the program on pages 33-35. In brief, the program officials should:

1. Develop and implement a City-sponsored education program for employees interested in deferred compensation.

2. Request a legal analysis of the City's fiduciary responsibilities, if any, as a sponsor of the deferred compensation program.

3. Strengthen the program's administrative structure and develop new policies and procedures in key areas.
4. Propose to City Council that it amend the City Code to broaden the membership of the Deferred Compensation Advisory Committee.

Chapter 1 Background

This report presents the results of our audit of the City of Portland's deferred compensation program. The City Auditor approved the audit and included it in the Audit Services Division's 1999 audit schedule. We conducted the audit in accordance with generally accepted government auditing standards and limited our review to those areas specified in the objectives, scope, and methodology section of this report.

Introduction

Deferred compensation programs are voluntary, supplemental retirement plans administered by state or local governments and some non-profit organizations under Section 457 of the Internal Revenue Code. Employees who choose to participate in these programs agree to forgo a portion of their salary and place the funds into tax deferred investment vehicles. At some time in the future, usually after retirement, participants receive these funds together with the earnings generated. Thus, participants reduce their taxable income while they are working, and receive it with accrued earnings after retirement when their income may be taxed at a lower rate. Contributions and earnings can result in larger accumulations of assets than would the same savings and earnings on an after-tax basis.

Employees may defer a maximum of 25 percent of their gross annual compensation up to $8,000 a year. Employees who are nearing retirement are allowed to catch up on deferrals not used in prior years. Under this provision, employees may defer up to $15,000 in each of the last three years before reaching retirement age. Recent changes to the IRS code provide for the $8,000 annual limit to be indexed for inflation in coming years.

Participants cannot obtain loans on their deferrals. Deferred income and earnings become available upon retirement, termination, disability, or death. In rare circumstances, participants facing an unforeseen emergency may gain access to their funds. Distribution must begin by April 1 following the year the participant turns age 70-1/2.

Deferred compensation programs provide a valuable and flexible financial tool for use by public employees in filling gaps between retirement financial needs and retirement income from employer-provided programs. Appendix A is a one-page worksheet developed by the American Savings Education Council to help workers get a basic idea of the savings they will need at retirement.

Features of the Program

Under Chapter 4.44 of the City Code, the program is to be administered by a Deferred Compensation Advisory Committee (the Committee) with the assistance of the Bureau of Risk Management. Under the Code, the Committee is comprised of three members: the Director of the Office of Finance and Administration, or his or her designee, the City Treasurer, and the Accounting Manager. The City Treasurer serves as the Committee Chairperson.

The program is currently located in the Bureau of Risk Management and has a staff of one, the Deferred Compensation Administrator. Program costs have been paid from resources in the Health and Workers' Compensation Funds.

Investment providers and options

Portland employees interested in deferred compensation can choose from among five investment providers. Participants may allocate their deferred salary among multiple investment options, but they can defer to only one provider at a time. They may, however, occasionally switch providers without transferring their account balances and thereby maintain accounts with more than one provider.

As shown in Table 1, the providers offered 146 different investment options and, as of March 31, 1999, held assets totaling over $175 million for 4,440 active and separated employees.

Table 1 Deferred Compensation Program Summary As of March 31, 1999

Provider Name	Investment Options	Number of Participants	Value of Accounts
Aetna	33	1,717 (38%)	$88,709,591 (50%)
Nationwide (PEBSCO)	54	1,687 (38%)	$55,549,768 (32%)
PACE	1	824 (19%)	$24,460,586 (14%)
Hartford	27	137 (3%)	$4,535,830 (3%)
ICMA	31	75 (2%)	$2,503,223 (1%)
Total	**146**	**4,440 (100%)**	**$175,758,998 (100%)**

SOURCE: City of Portland Bureau of Risk Management.

Three of these providers, Aetna, Hartford, and Nationwide (previously known as PEBSCO) are insurance company affiliates offering primarily two types of annuity products – fixed and variable annuities. Fixed annuities guarantee minimum interest rates, adjusted at least once a year, and provide a low-risk way to accumulate assets for retirement. Variable annuities are retirement vehicles that invest in mutual fund like investments called "subaccounts." They are sometimes referred to as mutual funds in a tax-deferred wrapper.

It should be noted that variable annuities are similar to mutual funds, but are legally distinct because the insurance features of the variable annuities require the funds to be kept in separate reserve accounts. Although mutual fund families often give similar names to their variable annuity sub-account products, in many cases, these subaccounts make different investments than similarly named mutual funds, and they have different results.

In addition to the insurance company providers, City employees may elect the PACE Credit Union that offers a federally insured deferred compensation savings account. Finally, the ICMA Retirement Corporation offers fixed-rate investments and mutual funds. According to recent legal opinions, these mutual fund investments are allowed due to ICMA's trust arrangement, where deferred compensation funds from other employers are pooled.

Roles and responsibilities.

The Risk Management Bureau of the Office of Finance and Administration is responsible for the day-to-day administration of City's deferred compensation program. The program's staff consists of a program administrator who maintains participant files, logs participant information in to a computerized data base, facilitates Deferred Compensation Advisory Committee meetings, and coordinates activities with other City offices and investment providers. Other duties of the program administrator include: answering phones and responding to walk-in inquiries, processing enrolment forms for new participants, processing changes in deferral amounts, preparing a quarterly report showing the number of participants by investment provider and balance with each provider, participating in new employee orientations, and other tasks and special projects.

Other administrative duties are delegated to the investment providers. For example, representatives from the investment providers respond to City employees who have questions about the program, provide investment education and marketing materials, and meet with employees. The investment providers also maintain records for each participants account and furnish periodic statements. In exchange for these services, depending on their investment choices, the participants pay various fees based on a percentage of the value of their assets in the program. Money collected from fees is retained by providers or directed to the underlying fund managers.

Prior to the Risk Management Bureau assuming administrative responsibility for the program in 1998, the program was administered by the Accounting Division of the Office of Finance and Administration. This transfer was initiated to improve program organization and employee communications. Risk Management reports the following accomplishments since taking over the program:

creating individual participant files, identifying missing documents and contacting participants about replacements, updating forms, writing a new procedure manual, developing a comparison of fees, and other tasks.

Audit Objectives, Scope, and Methodology

The objective of our audit was to review the administrative design and operation of the City of Portland's deferred compensation program. We compared Portland's program to deferred compensation programs in other local governments and to accepted principles and guidelines in the following areas:

- Marketing the program to City employees;
- Available investment options; and
- Administration and funding of the program.

We conducted our research between February and June 1999. As part of our audit, we reviewed pertinent sections from the Portland City Code, federal and state statutes, the State Constitution, and relevant legal opinions. We researched effective management practices as described in professional literature. We obtained information on deferred compensation administration from the National Association of Government Deferred Compensation Administrators and from the Government Finance Officers Association.

To gain an understanding of Portland's program, we interviewed City officials and provider representatives. We obtained and reviewed financial records and reports pertaining to Portland's deferred compensation program and contacted officials in other jurisdictions to obtain comparable information about their programs. Finally, we hired the national employee benefit consulting firm of William M. Mercer, Inc. to answer a series of questions on deferred compensation programs.

Chapter 2 Participant Education

For nearly two decades the City of Portland's deferred compensation program has provided City employees with a significant opportunity to save and prepare for retirement on a pre-tax basis. As of March 31, 1999, officials report that over 57 percent of eligible employees were actively contributing to the program, which held assets valued at over $175 million. Undoubtedly, the program functions as an important enticement for the City to attract and retain qualified, productive, and committed employees.

To help the program work even better, we believe improvement is possible in two areas. In this chapter, we discuss the opportunities and options to provide more City-sponsored investment education to employees. In Chapter 3, we discuss the need to strengthen program administration. By pursuing these actions, the City could help employees make more informed investment decisions, increase employee participation, and lower overall costs.

Information Helps Employees Make Good Investment Decisions

Participants in deferred compensation programs can range in sophistication from first-time investors with no investment experience, to employees with substantial portfolios and investment savvy. According to recurring surveys, even among participants who say they are knowledgeable in investment matters, a majority gave wrong answers to such simple questions as what is the basic difference between stocks and bonds, or what kinds of investments are found in a balanced fund.

Variable and fixed annuities, the most common investment option available under the City's deferred compensation program, are also little understood by the public. A recent Fidelity Investment survey, consisting of telephone interviews with 1,000 adults by the Bruskin-Golding Research Firm, found that the phrase Americans most often associate with annuities is "confusing or complex." According to the survey, 13 percent of annuity owners "don't understand them at all," while another 33 percent reported understanding them "only somewhat."

Surveys also have shown that many participant-directed accounts are conservatively invested in a manner that results in little or no real investment return after considering inflation, even among participants who said they were saving for retirement. Moreover, by their nature, investment materials can be technical and difficult for inexperienced investors to understand. Within the context of these challenges, deferred compensation administrators must select from a variety of communication approaches to help participants make informed investment decisions.

Portland delegates education to investment providers

The City's deferred compensation program does not provide City employees with information to help make investment decisions. Although in previous years the program gave employees a brochure with basic information in investment principles, the brochure is no longer distributed because it is considered dated. Instead, the responsibility for investment education is delegated to the program's five investment providers.

In order to learn about the investment options available through the program, employees must contact representatives from the five organizations authorized to offer investments – Aetna, Hartford, PEBSCO, PACE, and ICMA. A one-page information sheet is available from the Bureau of Risk Management that lists contact names and phone numbers for the five providers. A copy of this information sheet is contained in Appendix B.

Upon request from interested employees, representatives from the providers will provide investment education materials on the various options available through their company. These materials include asset allocation models, the nature and historical performance of individual investment options, and general investment principles that employees should consider regarding investment returns and risks. Representatives are available by telephone and in person to respond to employee questions.

After review of these materials, employees may select one or more investments from a single provider and initiate monthly deferrals. At any time, employees may discontinue deferrals entirely or switch deferrals to another provider, but only one provider can receive investments during a given pay period.

Investment Research is Difficult and Time-Consuming

Based on our review of the nearly 150 investment options available under the City's deferred compensation program, we believe that employees interested in making informed and wise investment decisions face a difficult and time-consuming task. Although each provider produces proprietary information on the various investment options in their portfolio, objective and complete information on the comparative performance of all the investment options from the five companies is difficult to find.

In order to assess the relative performance of various investment options available to City employees, we attempted to locate rating information from several independent sources including newspapers, industry publications, and specialized periodicals. We attempted to find basic information such as historical performance, fund objectives, relative risk, fees, and benchmark analyses. We found several obstacles to obtaining information.

First, because many of the investment options available through the program are variable annuity "sub-account" products, they frequently have similar but different names than the mutual fund upon which they are based. As discussed in Chapter 1, these sub-accounts make different investments than similarly named mutual funds and therefore have different return results. For example, the Fidelity VIP Equity-Income Fund marketed by Aetna had a 3-year return rate average of 16.06 percent while its mutual fund cousin, the Fidelity Equity-Income Fund had a return of 19.52 percent for the same period. Employees need to understand the differences in these funds in order to locate appropriate sources of information for decision-making purposes.

Another obstacle to informed decision-making is the scarcity of independent analytical information on variable annuities. Popular investment magazines such as Money or Forbes, and investment books, rarely contain information about these investment products. Although we found one source of independent analysis, the Morningstar Variable Annuity/Life Report, it did not include ratings or analysis of all of the investments available through the City's program. In addition, while the Morningstar report contained information on fund ratings, performance, and risk, we found it difficult to read because it includes technical terms and financial statistics unfamiliar to many readers.

Finally, after several weeks of research and contact with provider representatives, we were able to locate independent analytical information on funds holding 59 percent of the deferred compensation program's assets. We could not find information on the balance of the investment options holding 41 percent of the programs' assets from either Morningstar or other publications. Consequently, it is difficult, if not impossible, for an employee to compare the earnings performance of one annuity fund against another to make an informed investment decision.

Investment Education is Recommended and Accepted

Our research indicated that deferred compensation is one of the best tools available for public employees to prepare for their future retirement income. Therefore, it is critical that employers communicate the availability of the program on an ongoing basis. Our advisor, William M. Mercer, Inc., recommends that deferred compensation plan sponsors be actively involved in providing basic investment education. Based on their experience with a variety of employers and the results of employee research, Mercer found that employees look to their employer to provide information that will help them make informed decisions about their retirement plan.

According to Mercer, employees may find it easier to trust a source that is not directly selling to them, one that can provide objective information about the types of services and investment options that vendors offer. The Government Finance Officers Association and the International City/County Management Association Retirement Corporation also share this view. Their 1993 publication *State and Local Government Deferred Compensation Programs* states "the enrollment/communication function may be a function undertaken by the employer, which best knows its audience and for whom there is no conflict of interest in marketing one investment product over another."

We believe that basic investment education can help employees, especially first-time investors, feel more comfortable making participation and investment decisions, and motivate them to take more control of their financial future. Objective information can also help employees make the right investment decisions for their particular needs and goals. Education can also help the employer use the plan as a tool to attract and retain employees.

Educational programs in other jurisdictions

Deferred compensation programs in other jurisdictions are taking a more active role in participant education. According to a 1997 survey by the National Association of

Government Deferred Compensation Administrators (NAGDCA), of 47 responding local governments, the most common customized employee written communications were: enrollment booklets (77 percent), newsletters (74 percent), investment education material (74 percent), payroll stuffers (57 percent), annual reports (49 percent), retirement booklets (40 percent), and enrollment videos (19 percent).

A recent Mercer survey indicated the most common topics covered by employers' investment education efforts are: the importance of starting to save early (87 percent); determining how much retirement income is needed (82 percent); determining the amount of pre-retirement savings needed (80 percent); investment strategies for different ages (78 percent); the impact of inflation (78 percent); risk/reward trade-offs (73 percent); tax implications (70 percent); performance history of plan funds (68 percent); performance history of investment classes (66 percent); portfolio building or asset allocation (61 percent); and characteristics of investment classes (55 percent).

Table 2 shows the elements of an effective investment education program as suggested by William M. Mercer, Inc. Appendix C includes a selective list of sources for deferred compensation and investment education materials.

Table 2 Suggested Elements of an Investment Education Program

Planning and Research. The program should be based on planning and research and it should be tailored to the specific audience for whom it is intended. This requires:

- Setting communication objectives for the education program
- Identifying target employee audiences
- Understanding employees current level of knowledge about the retirement plan and investing
- Understanding how employees prefer to receive information
- Selecting media appropriate for the audience

General Plan Information. Plan booklets, summaries, and highlights brochures written in easy-to-understand language can help plan sponsors promote the retirement plan and educate employees about key features of the plan. Employees typically want to know:

- What is the plan and how does it work?
- What's in it for me?
- How do I enroll?
- How do I choose a vendor?
- What are my investment options?
- How do I manage my accounts?

Decision-Making Guidance. Employees enrolling in deferred compensation plan often must choose among multiple vendors offering a wide variety of investment options. An effective education program guides employees through the enrollment and decision-making process. It provides objective information about investment vendors and the investments they offer. It explains the role of the investment manager and offers tips on how to select a vendor.

Basic Investment Education. An effective communication program includes basic investment education topics, such as:

- Investment concepts and key terms
- Types of investments and risk categories
- Identifying individual financial profiles
- Creating a portfolio

Retirement Planning. As employees become more comfortable with investing, many plan sponsors expand their communication program to introduce employees to retirement and financial planning. Communication tools such as planning workbooks and workshops help employees better understand their role and responsibility for managing their financial future. Retirement and financial planning tools help employees:

- Estimate retirement income and expenses
- Identify sources of retirement income
- Set goals and develop a financial plan
- Establish time horizons and determine appropriate investment risk

Multimedia Approach. An effective education program uses a multimedia approach that takes into account the different ways people learn. Depending of the media selected during the planning process, a communication program may include:

- Print. Examples include plan booklets, basics of investing brochures and booklets, posters and flyers, summary plan descriptions, vendor comparisons, fund performance information, newsletters or bulletins, and workbooks.
- Personalized print. Examples include personalized retirement planning kits and personalized statements.
- Audiovisual. Examples include audiocassettes, video, Internet, and/or intranet sites.
- Interactive. Examples include meetings/brown bags, investment/retirement planning workshops, online interactive planning and modeling tools.

Ongoing Communication. An effective program requires ongoing communication and education beyond initial enrollment. It should also include regular monitoring and measurement of effectiveness (e.g., through surveys or focus groups) and be adapted or modified as indicated by measurement results.

Source: William M. Mercer, Inc.

Guidelines for Employer Involvement in Education

NAGDCA's guidebook for deferred compensation plan administrators suggests that some administrators have been concerned about the dangers of crossing the line between providing investment information and providing investment advice. Without clear definitions or guidelines, these administrators felt it was safer to avoid the subject altogether.

We asked Mercer to address this question. They responded that nationally and within the State of Oregon, there has been very little guidance concerning an acceptable level of employer involvement in the investment decision made by participants in deferred compensation programs. Mercer referred to Oregon Revised Statutes (ORS) Section 243.450 which addresses disclosures that the Oregon Public Employees Retirement System must give to eligible state employees who participate in the state deferred compensation plan. Under this statute, the required disclosure statement must provide the eligible state employees with information regarding the investment options available under the plan, including the probable income and probable safety of the deferred funds, "that persons of reasonable prudence and discretion require when determining the permanent disposition of their funds." Mercer concludes that although the ORS does not contain a similar requirement with respect to local government deferred compensation plans, it would not be unreasonable to expect that an Oregon court would apply a similar standard of disclosure for local plans.

Table 3 Investment Information "Safe Harbors" Category/Description

Plan Information. This includes materials that inform a participant or a beneficiary about the benefits of plan participation, the benefits of increasing their contributions, the impact of pre-retirement withdrawals, and the investment alternatives under the plan.

General Financial and Investment Information. This includes information that informs a participant about general financial and investment concepts, including risk versus return trade-offs and diversification, historic differences in rates of return between asset classes, the effect of inflation, estimation of future retirement needs, determining investment time horizons, and assessing risk tolerance.

Asset Allocation Models. This includes information, such as graphs or pie charts, that provides a participant with model asset allocation portfolios of hypothetical individuals with different investment time horizons and risk profiles. The Interpretive Bulletin requires that the asset allocation information be provided to all plan participants and beneficiaries, and that certain conditions must be met. These conditions relate to the following requirements:

(1) Models must be based on generally accepted investment theories that take into account historic returns of different asset classes;
(2) All material facts and assumptions upon which the model is based must be disclosed;
(3) The model must be accompanied by a statement indicating that other investment alternatives may be available under the plan and identifying where information of those investment alternatives may be obtained; and
(4) The model must be accompanied by a statement indicating that participants should consider their other assets, income, and investments in addition to the ERISA plan.

Interactive Investment Materials. This includes materials such as self-scoring questionnaires, worksheets, and computer software that give participants the means to independently assess different investment strategies. Conditions similar to those for the asset allocation models must be satisfied. In addition, the interactive materials must reflect an objective correlation between the outcomes under different models and the data that the participant supplies. The materials must disclose all material facts and assumptions, or the facts and assumptions must be specified by the participant.

Source: William M. Mercer, Inc.

Mercer and NAGDCA also point to guidance from the U.S. Department of Labor (DOL) for private employer plans that are subject to the Employee Retirement Income Security Act of 1974 (ERISA). Interpretive Bulletin 96-1 provides four broad categories of information, or “safe harbors,” that the DOL has concluded does not result in the providing of investment advice. Table 3 shows these four safe harbors of types of information that will not be considered investment advice under ERISA’s fiduciary rules. Mercer advises that although the Interpretive Bulletin applies only to ERISA plans, it can be a helpful standard for public employers in determining the appropriate degree of investment education that can be provided to participants in deferred compensation plans.

Portland Officials Have Concerns About Investment Education

Although officials responsible for Portland’s program have expressed interest in pursuing a more proactive approach to investment education, they are reluctant to alter the program’s established approach. They questioned whether additional services would increase participation and believe that employees already receive ample materials from the program’s investment providers. Concerns were also expressed about who would pay for the additional services. Finally, they were concerned about potential legal liability that could result from a direct investment education program.

We believe that while the City’s 57 percent participation rate is relatively good compared to other governments, there are indications that this rate could be better. According to a survey of local governments conducted by NAGDCA in 1997, participation rates of active employees averaged about 55 percent, ranging from a low of 14 percent in one government to a high of 96 percent in another. Similarly, in an informal poll of Oregon governments conducted by the deferred compensation administrator, participation rates of eight responding jurisdictions averaged 55 percent, ranging from a low of 34 percent for Washington County to a high of 75 percent for Metro. Rates also vary within City of Portland bureaus. Of the five largest bureaus, participation ranged from a low of 44 percent to a high of 74 percent. This data suggests to us that while the citywide average in Portland is good, room for improvement exists.

We also agree that changes in the program should be pursued carefully to avoid liability and to ensure that increased costs can be covered through changes in the administration of the program. As discussed in the next chapter, the fiduciary responsibilities of the city should undergo a more detailed legal analysis before initiating any new educational roles. However, we found that investment education is common among private and public employers throughout the country. Our consultant, William M. Mercer Inc., expects that within a few years, most employers will provide investment education and retirement planning assistance to their employees.

In addition, as also discussed in the next chapter, we believe that through restructuring of the program the additional costs of education can be recovered from participant's accounts while also lowering overall fees charged by providers. The majority of deferred compensation programs around the country currently avoid using government tax revenues to fund administration and investment education costs.

Chapter 3 Program Administration

Our audit identified administrative approaches that could help simplify Portland's deferred compensation program, move it toward self-sufficiency, contribute to improved participant earnings through fee reductions, and help ensure the City's fiduciary responsibilities are met. Some changes could be accomplished on a short-term basis, while others would require sustained attention over a longer period of time. We found Portland's administrative approach to deferred compensation is different than most other jurisdictions. First, the number of investment options in Portland is more than three times larger than average, as determined in a 1997 national survey. Second, Portland has not developed funding mechanisms necessary to make the program entirely self-sufficient, as most other jurisdictions have. Finally, we found Portland's deferred compensation program lacks written policies that clearly define the goals and objectives of the program, methods for selecting and removing options, and procedures for objectively reporting on fund performance.

Portland Offers Many More Investment Options Than Average

We found participants in Portland's deferred compensation program have many more investment choices than participants in other local government programs. Portland's deferred compensation program includes more than three times the average number of investment options offered in other local government programs. Professional literature suggests that a large number of choices can create confusion and duplication of investment options, and increase administrative costs.

A recent analysis of fees by the City Treasurer's Office identified 146 different investment options available from the program's five providers. Our review of provider quarterly statements showed that, as of March 31, 1999, participants had invested money in 121 of these funds. This compares to an average of only 35 investment options offered by other local government programs, according to the 1997 survey of deferred compensation plans published by NAGDCA. This survey included responses from 47 local government members. The range in the number of options offered by these other local government programs varied, from two choices in one program to 79 in another.

Unintended consequences

Although offering a large number of investment options may benefit the knowledgeable employee, research suggests that this approach may have unintended consequences. We asked Mercer to comment on the appropriate number of investment options for deferred compensation programs. They suggested that large numbers of options create confusion and duplication of investment options, particularly when they are available from multiple providers. For example, if a Portland employee wished to select a growth stock fund, there are over 30 options offered by three providers, including the Aetna Growth VP Fund, the Fidelity VIP Growth Fund, The Growth Fund of America, the Janus Aspen Growth Fund, and the American Century 20th Century Growth Fund. Moreover, as discussed in the previous chapter, it is difficult to obtain comparative information or the performance of those funds and their relative strengths and weaknesses.

Mercer believes that a smaller number of options could ease administration, encourage greater participation, and help employee investment decisions. They advise that administration is complicated and a clear message to participants may not be possible in programs offering a large number of investment options. According to Mercer, a well thought out selection of options offered through one provider can achieve the same or better participation. Mercer recommends that between 8 and 12 investment options is usually sufficient to offer choices in all asset categories. Mercer suggests that neither the value of a plan's assets nor the number of employees should dictate the optimum number of investment options.

The professional organization for deferred compensation administrators, NAGDCA, makes similar points in its guidebook for program administrators. NAGDCA says that program administrators are often under pressure from vendors and from certain groups of participants to offer more and more funds. NAGDCA cites research by the firm of Bryan, Pendelton, Swats and McAllister of 360 defined contribution plans. This research found a drop in participation in plans offering more than 12 investment options. Like Mercer, NAGDCA also suggests that offering a large number of funds may increase a plan's administrative costs. Additionally, GFOA suggests that from four to eight clearly differentiated investments generally constitute an appropriate number of investment options. According to GFOA, more than this number may be somewhat confusing to participants, while fewer may not provide a satisfactory range.

Program structure

One factor contributing to the large number of investment options in Portland is the structure of the City's program. Portland's structure allows each of the program's five providers to offer prepackaged marketing, enrollment, recordkeeping, administrative, and investment services to all participants (called a "multiple bundled" approach). According to Mercer, this approach is more complicated than other available structures. Mercer advises that the number of investment options increases in programs with multiple providers, each offering their full array of investments. One common administrative approach avoids this difficulty by structuring all services around a single provider (called a "bundled" approach). Alternatively, another common structure separates investment sales from education by selecting different firms for each function (called an "unbundled" approach). Some programs have created hybrid structures, combining features from both the bundled and unbundled approaches (called a "semi-bundled" approach). Appendix D shows the three basic structures that most plans use, as well as Portland's structure, and the pros and cons of each.

Portland's Program is not Self-Supporting

Although the costs of the City's deferred compensation program appear relatively low, Portland is among a minority of programs that rely on tax revenues to pay for administrative costs. Many state and local statutes authorizing deferred compensation plans generally require plans to be administered without cost to the government. As a part of our audit, we identified funding strategies that could eliminate the need for tax revenue support. Other deferred compensation programs have accomplished financial self-sufficiency through reimbursements from investment providers and direct participant charges. We believe that City officials should further investigate possible administrative changes, involving participants as much as possible during this process.

As described earlier, the City plays no role in investment education. The program's five investment providers furnish marketing, recordkeeping, and investment management services. The providers recoup the costs of these services, and earn profits, by charging the participants fees based on the value of their investments. A recent analysis by the City Treasurer's Office showed that fees ranged from under 1 percent to more than 2.5 percent annually. Of the five investment providers, only the PACE Credit Union charges no fees. The results of the Treasurer's fee analysis are included in this report as Appendix E.

The City's administrative overhead costs have historically been paid from tax revenues. City staff were unable to tell us the total cost of the program, but these costs would include: salary and benefit costs for the program's administrator, costs for legal services provided by the City Attorney's Office, personnel costs for City employees serving on the Deferred Compensation Advisory Committee, and various other indirect costs. City staff have used revenues in the Health Fund to pay for the cost of the Program's Administrator and they have used funds from the Workers' Compensation Fund to pay for legal services. Staff estimated the cost to the Health Fund for Fiscal Year

1999-2000 was $75,844; however, they were unable to determine deferred compensation costs paid from the Workers' Compensation Fund. As of July 1, 1999, the source of funding for the program changed due to concerns about the appropriateness of using the Health Fund for this purpose. Program expenses will temporarily be paid from the Workers' Compensation Fund until a permanent source can be determined.

Most jurisdictions avoid using tax revenues

We found that the majority of governmental deferred compensation programs avoid using tax revenue to fund administration and investment management costs. Instead, these costs are generally recovered directly or indirectly from participants' accounts. According to NAGDCA's 1997 survey, of the 47 responding local governments, 43 percent received government funding, while 62 percent derived revenue from participants' use of the plan. Nineteen percent of the local governments received revenue to fund administrative costs from more than one source.

Programs in other states and cities fund deferred compensation administrative costs in two major ways. Some levy an annual account maintenance fee of a specified amount. According to NAGDCA, such fees typically range for $12 to $25 per year. In Portland, charging an annual $25 fee per participant fee could potentially raise over $100,000 for administration. As an alternative to participant fees, some programs have negotiated provider reimbursements as a way to pay administrative costs. In its 1997 survey of fees, NAGDCA reported that 35 percent of local government plans received reimbursement of administrative costs from investment providers. The form of reimbursements included both product-related and flat fees. For example, King County, Washington received a product-related fee of 0.10 percent from its investment providers. A like reimbursement on Portland's $175 million deferred compensation assets could yield $175,000 annually to fund administrative costs. The City of Austin, Texas, on the other hand, had received a yearly flat fee of $25,000 from its investment provider for education. Mercer, too, reports that investment providers may be willing to make refunds to plan sponsors or third-party administrators.

Consolidating assets holds potential

Our interviews with representatives of Portland's deferred compensation investment providers suggests another mechanism to raise administrative revenue while also lowering fees paid by participants. Specifically, because the investment providers base their fees on the total value of assets under their control, Portland could consider consolidating assets with fewer providers. This would increase the total assets with the selected provider, and would create an incentive to reduce fees and reimburse the City for administrative costs. This would allow the program to be self-supporting, while reducing total fees paid by participants, thereby increasing net earnings on invested assets.

Stronger Administrative Policies and Practices are Needed

Mercer advises that a successful deferred compensation program depends on establishing clear, written goals and objectives, primarily for two reasons. First, a program with a clear purpose will generate more employee participation and larger retirement benefits. Second, any possible fiduciary obligations of the sponsor are more easily met and documented if goals and objectives are clearly defined.

Program officials have developed a number of policies and procedures for participant enrollment, changing deferral and investment amounts, and handling hardship withdrawals. However, the program lacks policies and procedures on the goals of the program, methods for oversight and review, and annual reporting. For example, City officials told us they informally review the performance of investment options available through the program. However, they have not conducted a regular, systematic process – such as an annual review of long-term performance – to evaluate program investment options based on results and to eliminate poor performers.

Mercer and other sources such as NAGDCA, suggest that sponsors of the deferred compensation programs may be considered fiduciaries. As such the City, as the sponsor of the program, would have the duty to monitor and review the performance of investments, the quality of administrative services, and overall pricing. In order to fulfill the due diligence duty of a fiduciary, Mercer recommends programs adopt an investment policy that contains performance benchmarks as well as procedures for adding or dropping investment options. They also suggest that programs follow the stated performance evaluation criteria and remove options that do not comply with long-term performance standards. Table 4 shows Mercer's suggested criteria for adding or dropping investment options from the program.

Table 4 Suggested Criteria for Adding or Dropping Funds

To select an option, there should be minimum criteria such as:

- Size of fund or product.
- Length of time product is offered.
- Load or no-load (fees).
- Manager experience.
- Ability to value daily and transfer to other options daily.

Other measures to select or deselect could be:

- Performance against peer group over designated periods — 3-year, 5-year, and 10-year.
- Performance against passive benchmarks over designated periods — 3-year, 5-year, and 10-year.
- Investment style.
- Risk and return.
- Manager change.
- SEC violations.
- Participant use

Source: William M. Mercer, Inc.

While Mercer and the National Association of Deferred Compensation Administrators (NAGDCA) believe that it is likely that the sponsors of deferred compensation programs have a fiduciary duty, this fact has not been tested or confirmed by law or court rulings. In order to help clarify whether the City has any fiduciary obligations regarding the program, additional legal analysis is needed.

We also asked Mercer to suggest best practices for administration of deferred compensation programs. Mercer said that the best programs are designed and operated to meet specific, written goals that coordinate with the sponsor's other benefits. Vendors are selected and monitored to provide cost-efficient, and good performing investment options. The program features and investment choices are communicated to employees through written materials and meetings to ensure employees understand the program. Several best practices that Mercer recommended are shown in Table 5.

Table 5 Recommended Administrative Practices for Deferred Compensation Programs

Several "best practices" recommended by the William M. Mercer company include:

- Adoption and review of a marketing plan fo the program.
- Adoption of an administrative agreement that sets out all parties' duties and responsibilities for the program.
- Adoption of an investment policy and guidelines.
- Periodic review of investments and plan administration.
- Periodic meetings with investment managers.
- Periodic financial audits.

Source: William M. Mercer, Inc.

Some Obstacles to Change Exist

Some administrative changes to the program may be difficult to make. Mercer notes that the process of monitoring and reviewing investment options is complicated if they are packaged within programs controlled by an investment provider. For example, because some providers offer standard packages of investment options and educational materials to jurisdictions throughout the country, they may be hesitant to customize their program for a single city or county. The selection and removal process is further complicated if a multiple provider approach is used, as it is in Portland. Mercer notes that in such situations, removal may not be allowed and the choice of options to add may also be restricted.

In addition, while consolidating assets with fewer providers could lower fees and provide aministrative support revenue, officials told us that the City's contracts with some of its providers include penalty clauses that would make restructuring and consolidation difficult. Should the City wish to eliminate one or more of the program's providers, the contracts may allow the excluded firm to assess a substantial penalty. For example, City staff report that one of Portland's investment providers has a four-percent penalty in its contract. While other jurisdictions have found ways to avoid paying such penalties, contract provisions may represent a significant obstacle to change. Our preliminary review of contracts did not reveal other obvious penalties, but more detailed discussions and legal analysis would be necessary to determine the best approach to negotiate consolidation and fee reductions.

Oregon law presents an additional constraint to administrative change in the City's deferred compensation program. Programs in other cities and states have opted to go directly to large mutual fund companies for investments because they have lower fee structures than variable annuities. For example, officials from the State of Oregon deferred compensation program told us they will consider such a strategy as soon as their old variable annuity contracts expire. By going directly to a mutual fund company, state deferred compensation officials hope to eliminate a whole level of fees, lowering participant fees by a half percent in the future. However, while statutes allow Portland's deferred compensation plan to invest in mutual funds if the investment is made through the state program, state law prohibits the local governments from directly investing in mutual funds. At the time of our audit, Portland officials were considering the addition of the state program as an option for City employees.

Chapter 4 Recommendations

In order to improve participant education and strengthen program administration, we recommend that the Risk Management Bureau of the Office of Finance and Administration and the Deferred Compensation Advisory Committee take the following actions:

1. Develop and implement a City-sponsored education program for employees interested in deferred compensation.

Such a program should provide basic investment education materials using a variety of communication tools to help employees make informed decisions about deferred compensation. To aid in the development of these materials, program officials may wish to conduct a survey of City employees to determine the kind of investment materials most needed and desired. We have identified features of an investment education program that could serve as a basis for the employee survey.

We believe that new materials should be developed considering “safe harbor” investment education guidelines and should ensure that employees with varying degrees of investment experience have useful decision-making resources.

2. **Request a legal analysis of the City's fiduciary responsibilities, if any, as a sponsor of the deferred compensation program.**

   Questions to be addressed by the legal analysis should include whether the City has due diligence responsibilities for providing information to employees, the appropriateness of "safe harbor" guidelines developed by DOL, and whether disclaimers of responsibility for investment choices should be issued.

3. **Strengthen the program's administrative structure and develop new policies and procedures in key areas.**

   We believe the City should commit to making short-term and long-term changes necessary to help simplify the program, move it toward financial self-sufficiency, and demonstrate that the City is meeting its fiduciary duties as the program's sponsor. While the obstacles we discussed in this report may call for a longer timeframe for structural changes, other administrative changes could be accomplished more quickly.

   Officials could begin the process of strengthening the program's administration by establishing clear, written goals and objectives. Other steps that could be pursued without delay include adoption of an investment policy and development of systematic procedures to monitor and review the performance of investments, the quality of administrative services, and overall pricing.

   Program officials should work long-term towards consolidating the program with fewer providers in order to leverage lower fees and produce revenue for program administration. In order to address obstacles to consolidation and program restructuring, officials should consider exercising expiration dates on provider contracts, closing some existing investment options to new investors, negotiating lower contract penalties, and seeking reimbursement of penalties from new providers.

4. Propose to City Council that it amend the City Code to broaden the membership of the Deferred Compensation Advisory Committee.

In order to broaden representation on the Advisory Committee, the program should expand the current three-member committee to include representatives from major bureaus, employee groups, and outside investment experts. Broader representation could help the committee consider program changes that best meet the needs of City employees.

Appendix A
Ballpark Estimate

BALLPARK ESTIMATE

Planning for retirement is not a one-size-fits-all exercise. The purpose of Ballpark is simply to give you a basic idea of the savings you'll need when you retire.

So let's play ball!
If you're married, you and your spouse should each fill out your own Ballpark Estimate worksheet taking your marital status into account when entering your Social Security benefit in No. 2 below.

1. How much annual income will you want in retirement? (Figure 70% of your current annual income just to maintain your current standard of living. Really.) $__________

2. Subtract the income you expect to receive annually from:

***Social Security:** If you make under $25,000, enter $8,000; between $25,000 - $40,000, enter $12,000; over $40,000, enter $14,500 (For married couples, the lower earning spouse should enter either their own benefit based on their income or 50% of the higher earning spouse's benefit, whichever is higher. -$__________

***Traditional Employer Pension**: a plan that pays a set dollar amount for life, where the dollar amount depends on salary and years of service (in today's dollars) -$__________

***Part-time income** -$__________

***Other (inheritance, etc.)** -$__________

This is how much you need to make up for each retirement year: $__________

Now you want a ballpark estimate of how much money you'll need in the bank the day you retire. So the accountants went to work and devised this simple formula. For the record, they figure you'll realize a constant real rate of return of 3% after inflation, you'll live to age 87, and you'll begin to receive income from Social Security at age 65.

3. To determine the amount you'll need to save, multiply the amount you need to make up by the factor at right.

Age you expect to retire:	Your factor is:
55	21.0
60	18.9
65	16.4
70	13.6

$__________

4. If you expect to retire before age 65, multiply your Social Security benefit from line 2 by the factor at right

Age you expect to retire:	Your factor is:
55	8.8
60	4.7

+$__________

5. Multiply your savings to date by the factor at right (include money accumulated in a 401(k), IRA or similar retirement plan).

If you want to retire in:	Your factor is:
10 years	1.3
15 years	1.6
20 years	1.8
25 years	2.1
30 years	2.4
35 years	2.8
40 years	3.3

$__________

Total additional savings needed at retirement: **$__________**

Don't panic. Those same accountants devised another formula to show you how much to save each year in order to reach your goal amount. They factor in compounding. That's where your money not only makes interest, your interest starts making interest as well, creating a snowball effect.

6. To determine the ANNUAL amount you'll need to save, multiply the TOTAL amount by the factor at right.

Ilf you want to retire in:	Your factor is:
10 years	.085
15 years	.052
20 years	.036
25 years	.027
30 years	.020
35 years	.016
40 years	.013

See? It's not impossible or even particularly painful. It just takes planning. And the sooner you start, the better off you'll be.

This worksheet simplifies several retirement planning issues such as Social Security benefits and earnings assumptions on savings. It also reflects today's dollars; therefore you will need to recalculate your retirement needs annually and as your salary and circumstances change. You may want to consider doing further analysis, either by yourself using a more detailed worksheet or computer software or with the assistance of a financial professional.

Source: American Savings Education Council

An automated Ballpark Estimate worksheet is available at: www.asec.org

Appendix B
City of Portland
Deferred Compensation
Information Sheet

As of August 1999

DEFERRED COMPENSATION

The Deferred Compensation Plan is a voluntary plan available to eligible City of Portland employees to help save for retirement on a tax advantaged basis. Deferred compensation is allowed and regulated under Internal Revenue Code Section 457 for public employees. The sole purpose of deferred compensation is to assist employees in saving for retirement.

To participate in the plan, you should request enrollment forms from the Employee Benefits Office. In addition, you must complete an investment enrollment form which can be obtained from the investment provider you choose. The providers are as follows:

- **Aetna Investment Services, Inc.**
  Maggie Wolf 221-5459
  George Clymer 221-5415

- **Hartford Life**
  Betsy Dart 234-9851 ext.107
  Bryce Anderson 652-8044

- **ICMA Retirement Corporation**
  Michael Smith (800)735-7202 ext.5985 (voice-mail)

- **PACE Credit Union**
  Malynda Morrow 234-9851 ext.117

- **Nationwide Retirement Solutions, Inc**
  (formerly PEBSCO)
  Leonard Matz 642-9221 (all bureaus except Police)
  Thomas Fryback 460-2739 (Police Bureau)

If you have any questions on the Deferred Compensation Plan or to request enrollment forms, please call Carol Carlson in the Employee Benefits Office in the Bureau of Risk Management at 823-6140.

We are located at: 1211 SW Fifth, Room 1150
Portland OR 97204-3711

Inter-office mailing address: 105/1150

Appendix C
Resource Guide

The following is a selective list of resources for general information about deferred compensation programs and investments. The list also includes some examples of employer-sponsored web sites providing information about deferred compensation programs in other jurisdictions.

The National Association of Government Deferred Compensation Administrators

A professional association for state and local deferred compensation officials. NAGDCA sponsors conferences and publishes a variety of guides with information about deferred compensation programs. Contact NAGDCA at: 167 West Main Street, Suite 600, Lexington, KY 40507, telephone: (606) 231-1904
www.nagdca.org

Morningstar, Inc.

Morningstar's variable annuity and mutual fund performance reports include specific information and rankings on many of the investments options included in Portland's program. Available for reference at the Multnomah County Library, Central Branch.
www.morningstar.com

U.S. Securities and Exchange Commission

The web site for the U.S. Securities and Exchange Commission includes general information and advice about mutual funds.
www.sec.gov/consumer/inwsmf.htm

American Savings Education Council

A coalition of private and public sector institutions which undertakes initiatives to raise public awareness about what is needed to ensure long-term personal financial independence. Their web site includes an interactive version of the "ballpark estimate" worksheet included as Appendix A in this report.
www.asec.org

Retirement World

Retirement World maintains a web site to provide information about retirement issues for public sector employees.
www.retirement-world.org

Oregon Savings Growth Plan (OSGP)

OSGP is the deferred compensation program for Oregon State employees and participating local governments. The program maintains a web site that includes information about fund performance, fees, and educational workshops. Their address is: OSGP, Archives Building, 800 Summer St NE, Salem, OR 97310, telephone: (503) 378-3730.
www.pers.state.or.us/osgp

City of Los Angeles, Deferred Compensation Plan

A web site sponsored by the City of Los Angeles provides employees interested in deferred compensation with educational materials and performance information.
www.livinggold.com/perform/access.htm

City of New York, Deferred Compensation Plan

The City of New York's deferred compensation plan maintains a web site that includes a variety of basic investor education materials. It also shows historical fund performance compared to benchmarks.
www.ci.nyc.ny.us/html/olr/html/dcp/dcphome.html

Utah Retirement System

The web site for the Utah Retirement System includes general information about deferred compensation, as well as current and long-term performance information compared to appropriate benchmarks.
www.urs.org/defined.htm

State of Tennessee, Deferred Compensation Program

The State of Tennessee's web site provides comprehensive information about participation in deferred compensation, investment options, investment performance, projected benefits, and includes links to other useful web sites.
www.treasury.state.tn.us/defcomp.htm

State of California, Savings Plus Program

The California Department of Personnel maintains a web site for the Savings Plus Program that includes program information, investor education material, and fund historical performance.
www.dpa.ca.gov/benefits/retire/savplus/svplmain.htm

Appendix D
Deferred Compensation Program Administrative Structures

Source: William M. Mercer, Inc.

Bundled Approach

- Pricing of services is established assuming a preset package of investment and administrative services.
- Investment provider generally provides all marketing, enrollment, recordkeeping, administrative, and investment services.
- Fees may be netted from the disclosed investment return or from disclosed investment management fees and used to offset costs of plan administration; costs for setting up the plan and enrolling new participants are high, and assets under management may be low. The provider's need to break even may result in deferred sales charges or minimum contract periods to assure that the provider retains assets or is recompensed for loss due to termination, withdrawal, or transfer.

Advantages

- Plan sponsor can maintain plan with little oversight or direction.
- Employees often see less in disclosed fees, although fees may be larger than a fee-for-service arrangement, depending on plan size.
- Plan sponsor has little or no responsibility for relationships with investment providers.
- Plan sponsor has to deal with one organization only.

Disadvantages

- Plan sponsor may have to make long-term commitment or transfer existing assets.
- Plan sponsor loses some flexibility and control.
- Terminating relationship is difficult and often costly.
- Selection of investment products is limited to those of investment provider or those funds the provider has chosen to make available.
- If the investment provider is an insurance company, there is potential credit risk exposure due to investment of funds with one company.
- Cost of services is difficult to determine because pricing is interrelated and generally dependent on the purchase of the entire package.

Unbundled Approach

- Different providers are hired for investment services and for administrative services.
- Pricing of services is independent of investment and service providers selected.

Advantages

- For large, mature plans, a reasonable fee can cover plan costs.
- Investment selection is independent of administrative arrangement.
- Funds can be selected based on performance and investment strategy, not provider affiliation.
- Plan sponsor has more flexibility in determining how fees are structured.
- Plan sponsor can diversify fixed investments and reduce credit risk.
- Plan sponsor has flexibility in design and structure of investments.
- Less disruption when changes are made because investments or administration arrangements can be changed independently from one another.

Disadvantages

- Plan may not have enough assets to make fees reasonable.
- Participants may see more disclosed fees, although overall fees are usually not higher.
- Requires more involvement by plan sponsor.
- Plan sponsor must deal with multiple providers, although third-party administrator (TPA) usually handles much of the administrative interface as well as contractual and procedural details.

Semi-bundled Approach

- Combines features of both bundled and unbundled plans.
- Usually is a bundled package provider providing marketing, enrollment, and/or recordkeeping services for non-related investment providers in addition to its own investment options.
- Insurance companies started this approach by providing mutual funds within variable annuities.
- Recognizes that even smaller plan sponsors want flexibility to choose some of their own investment options and that no fund company can excel in all areas, all the time.
- Larger plans can negotiate the ability to have the vendor maintain records and provide administrative service for an agreed upon number of investment options that the sponsor selects, regardless of whether the vendor has an existing alliance arrangement with that fund family.
- Investment companies that have no resources to develop a distribution network make it financially attractive for providers to use their funds to fill gaps in their product line.

Advantages

- Plan sponsor has to deal with one organization only.
- Employees often see less in disclosed fees.
- Plan sponsor has some flexibility to choose investment options.
- Packaging may reduce costs.

Disadvantages

- Possible cost fluctuations when changes to investment lineup are made due to complexity and interrelation of pricing components.
- Flexibility to choose investment options may be somewhat restricted and changes difficult to make.
- Investment provider has incentive to direct funds to its products and to restrict use of outside funds.
- Sponsor not likely to know true cost since pricing components are not usually disclosed.

Multiple Bundled Approach *(currently used by the City of Portland)*

- Bundled services are provided by more than one provider.
- Multiple bundled arrangements are more complicated than the single bundled approach.
- A wide array of investment providers can be made available to employees.

Advantages

- Plan sponsor has little or no responsibility for relationships with investment providers.
- Employees often see less in disclosed fees, although fees may be larger.
- Perceived wide array of investment choices.
- From perceived competition that will driver providers to provide more services, participants can choose the better competitor.

Disadvantages

- Participants are confused by all the choices and communications are a challenge.
- Plan financial reporting is difficult because of the need to consolidate information from several sources.
- Participants receive multiple statements of account.
- Providers complain that they don't get a big enough share of the "pie" and that they are being discriminated against.
- It's difficult to partner with the providers to work efficiently and in the best interests of the plan.
- Transfer restrictions between competing fund sponsors create confusion and frustration among participants.
- Transfers between providers can create significant administrative problems for the City.
- The perceived choice is not really available since investments are tied to services and there are penalties to transfer to other providers.
- Multiple bundled programs reduce the City's ability to negotiate price and services, due to lack of an exclusive arrangement.

Appendix E
City of Portland
Deferred Compensation
Investment Provider Fees

CITY OF
PORTLAND, OREGON
OFFICE OF FINANCE AND ADMINISTRATION
BUREAU OF RISK MANAGEMENT

1211 S.W. Fifth, Room 1150
Portland, OR 97204-3711
(503) 823-5101
FAX: (503) 823-6120
TDD: (503) 823-6868

To: Bureau Directors

Rm: Carol Carlson

Re: Deferred Compensation
Investment Provider Fees

Dt: March 17, 1999

Enclosed is an Investment Provider Fees spreadsheet for your information and for posting in your bureau.

It has come to our attention that some employees do not understand the fees which Deferred Compensation participants pay for their participation in the plan. Therefore, we have developed this worksheet to show the fees in a consistent format for each of the investment options.

The City's Deferred Compensation Plan is a voluntary plan; it is available to eligible City of Portland employees; and it helps them save for retirement on a tax deferred basis. Employees choose to invest their money in one of five investment options offered by the City. Currently the plan has 3100 participants with $150 million dollars invested.

Each of the Investment Providers use different terminology while referring to the Fund and Carrier fees. We have created the enclosed spreadsheet to display the data in a consistent format. Also, we have compiled averages for each of the investment options and have shown the average fund, carrier, and total fees. The attachments to the spreadsheet show the detail of the various funds by using this consistent format of fund, carrier, and total fees. Each of the Investment Providers are willing to discuss their funds and fees with our employees.

Please post this information in your bureau. If there are questions regarding the fees or the Deferred Compensation plan, please call me at 823-6140.

Encl

CITY OF PORTLAND
DEFERRED COMPENSATION
INVESTMENT PROVIDER FEES - MARCH 1, 1999

INVESTMENT PROVIDER	SET-UP; MAINTENANCE; SALES FEES	WITHDRAWAL FEES	AVG FUND FEES %[1]	AVG CARRIER FEES %[1]	AVG TOTAL FEES %[1]	COMMENTS
AETNA	None	None	0.76	0.68	1.44	
HARTFORD	None	Declining scale 5% - 0% over 12 years	0.943	0.85	1.793	Withdrawal fees onl assessed at transfer t Hartford vendor whi employed at City of
ICMA	None	None	0.85[2]	0.55[2]	1.40[2]	
PACE	None	None	None	None	None	Insured to $100,000 NCUA, an agency o federal government
PEBSCO	None	Assessed if City of Portland cancels contract	0.99[2]	0.49[2]	1.47[2]	

[1]The fees in these columns are average figures only and do not reflect any one specific account. Actual costs are disclosed on the attached lists.

[2]Applies to both old and new monies.

City of Portland, Oregon
Summary of Fees and Charges
Aetna

Fund	Fund Fee %	Carrier Fee %	Total %
Global/International			
Aetna International VP	1.15	0.60	1.75
Fidelity VIP Overseas Portfolio	0.92	0.75	1.67
Janus Aspen Worldwide Growth Portfolio	0.74	0.75	1.49
Oppenheimer Global Securities Fund/OVAF	0.76	0.75	1.51
PPI Scudder International/Scudder VLIF International	1.00	0.75	1.75
Aggressive Growth			
Aetna Index Plus Mid Cap VP	0.60	0.60	1.20
Aetna Index Plus Small Cap VP	0.60	0.60	1.20
Aetna Small Company VP	0.95	0.60	1.55
Janus Aspen Aggressive Growth Portfolio	0.76	0.75	1.51
PPI MFS Emerging Equities/Alger American Small Cap	0.81	0.75	1.56
Growth			
Aetna Growth VP	0.80	0.60	1.40
Aetna Value Opportunity VP	0.80	0.60	1.40
Fidelity VIP Growth Portfolio	0.69	0.75	1.44
Fidelity VIP II Contrafund Portfolio	0.71	0.75	1.46
Janus Aspen Series Growth Portfolio	0.70	0.75	1.45
PPI MFS Research Growth/ Amer Century VP Cap Apprec	0.85	0.75	1.60
PPI MFS Value Equity/Neuberger & Berman AMT Growth	0.90	0.75	1.65
PPI T. Rowe Price Growth Equity/ Alger American Growth	0.75	0.75	1.50
Growth & Income (Stocks)			
Aetna Growth and Income VP	0.59	0.60	1.19
Aetna Index Plus Large Cap VP	0.55	0.60	1.15
Aetna Real Estate Securities VP	0.95	0.60	1.55
Fidelity VIP Equity-Income Portfolio	0.58	0.75	1.33
Growth & Income (Stocks & Bonds)			
Aetna Balanced VP, Inc.	0.60	0.60	1.20
Calvert Social Balanced Portfolio	0.80	0.75	1.55
Janus Aspen Series Balanced Portfolio	0.83	0.75	1.58
Asset Allocation			
Aetna Ascent VP	0.80	0.60	1.40
Aetna Crossroads VP	0.80	0.60	1.40
Aetna Legacy VP	0.80	0.60	1.40
Income			
Aetna Bond Fund VP	0.50	0.60	1.10
Aetna High Yield VP	0.80	0.60	1.40
Janus Aspen Series Flexible Income Portfolio	0.75	0.75	1.50
Oppenheimer Strategic Bond Fund/OVAF	0.83	0.75	1.58
Stability of Principal			
Aetna Money Market VP	0.35	0.60	0.95
Average Fees	0.76	0.68	1.44
	0.76	0.68	1.44

City of Portland, Oregon
Summary of Fees and Charges
Hartford

Fund	Fund Fee %	Carrier Fee %	Total %
Putnam International New Opportunities	1.750	0.850	2.600
Fidelity Advisor Overseas	1.660	0.750	2.410
Hartford International Opportunities	0.795	0.900	1.695
Janus Worldwide	0.960	0.850	1.810
American Century: Twentieth Century Ultra	1.000	0.850	1.850
Putnam Vista	1.040	0.850	1.890
Janus Twenty	0.930	0.850	1.780
Hartford Capital Appreciation	0.665	0.900	1.565
Fidelity Advisor Strategic Opportunities	1.240	0.750	1.990
Skyline Small Cap Value Plus	1.510	0.850	2.360
Hartford Stock	0.475	0.900	1.375
American Century: Twentieth Century Select	1.000	0.850	1.850
Fidelity Advisor Growth Opportunities	1.180	0.750	1.930
Hartford Index	0.415	0.900	1.315
American Century Income & Growth	0.710	0.850	1.560
Fidelity Advisor Growth & Income	1.590	0.750	2.340
Scudder Growth & Income	0.760	0.850	1.610
Hartford Dividend and Growth	0.705	0.900	1.605
American Century Value	1.000	0.850	1.850
Hartford Advisers	0.655	0.900	1.555
American Century Balanced	1.000	0.850	1.850
Fidelity Advisor Balanced	1.170	0.750	1.920
Calvert Social Balanced	0.810	0.900	1.710
Putnam High Yield Advantage	0.970	0.850	1.820
Hartford Bond	0.535	0.900	1.435
Hartford Mortgage Securities	0.475	0.900	1.375
HVA Money Market	0.465	0.900	1.365
Average Fees	0.943	0.850	1.793

City of Portland, Oregon
Summary of Fees and Charges
ICMA Beginning 04/01/99

Fund	Fund Fee %	Carrier Fee %	Total %
Proprietary Funds			
VantageTrust Index Funds			
Overseas Equity Index	0.87	0.55	1.42
Mid/Small Cap Stock Index	0.61	0.55	1.16
Broad Market Index	0.46	0.55	1.01
500 Stock Index	0.45	0.55	1.00
Core Bond Index	0.47	0.55	1.02
VantageTrust Actively Managed Funds			
Aggressive Opportunities	1.27	0.55	1.82
International	1.12	0.55	1.67
Growth Stock	0.77	0.55	1.32
Growth & Income	0.91	0.55	1.46
Equity Income	0.67	0.55	1.22
Asset Allocation	0.77	0.55	1.32
U.S. Treasury Securities	0.59	0.55	1.14
Cash Management	0.55	0.55	1.10
VantageTrust Stable Value Fund			
PLUS Fund	0.52	0.55	1.07
VantageTrust Model Portfolio Funds			
Long-Term Growth	0.94	0.55	1.49
Traditional Growth	0.83	0.55	1.38
Conservative Growth	0.73	0.55	1.28
Savings Oriented	0.70	0.55	1.25
Mutual Fund Series			
Series/Momentum Growth American Century Ultra	1.20	0.55	1.75
Series/Aggressive Growth Putnam Voyager Fund	1.11	0.55	1.66
Series/Larger Company Growth Mass. Investors Growth Stock Fund	0.96	0.55	1.51
Series/Capital Appreciation Fidelity Magellan	0.76	0.55	1.31
Series/Growth Fidelity Blue Chip Growth Fund	0.85	0.55	1.40
Series/Contrarian Growth Fidelity Contrafund	0.82	0.55	1.37
Series/Growth and Income Fidelity Growth & Income Portfolio	0.83	0.55	1.38
Series/Social Responsibility Neuberger & Berman Soc. Resp. Trust	1.35	0.55	1.90
Series/Special Situations Gabelli Value Fund	1.57	0.55	2.12
Series/Value American Century Value	1.20	0.55	1.75
Series/Balanced Income Fidelity Puritan Fund	0.78	0.55	1.33
Series/Income Lindner Dividend Fund	1.01	0.55	1.56
Series/Balanced Vanguard Wellington	0.69	0.55	1.24
Average Fees	0.85	0.55	1.40

City of Portland, Oregon
Summary of Fees and Charges
PEBSCO Beginning 05/01/99

Fund	Fund Fee %	Carrier Fee %	Total %
Select Spectrum Series			
NSAT Small Company	1.07	0.40	1.47
INVESCO Dynamics	1.08	0.40	1.48
Warburg Pincus Adv. Emerging Growth	1.22	0.40	1.62
American Century: 20th Century Intl. Discovery	1.68	0.40	2.08
Neuberger & Berman Partners Trust	0.91	0.40	1.31
Dreyfus Appreciation	0.91	0.40	1.31
Morgan Stanley Institutional. Equity Growth B	1.05	0.40	1.45
Dreyfus Third Century	1.03	0.40	1.43
Fidelity Advisor Growth Opportunities A	1.14	0.40	1.54
Oppenheimer Global A	1.13	0.40	1.53
Templeton Foreign	1.08	0.40	1.48
American Century Income & Growth	0.66	0.40	1.06
Dreyfus Premier Mid Cap Stock A	1.35	0.40	1.75
Nationwide Fund D	0.60	0.40	1.00
Nationwide S&P 500 Index	0.35	0.40	0.75
INVESCO Total Return	0.86	0.40	1.26
Federated Bond Fund F	1.08	0.40	1.48
Nationwide Money Market	0.60	0.40	1.00
Fidelity Advisor High Yield T	1.14	0.40	1.54
LifeDesigns Series			
LifeDesigns: Aggressive Fund	1.71	0.25	1.96
LifeDesigns: Moderately Aggressive Fund	1.63	0.25	1.88
LifeDesigns: Moderate Fund	1.60	0.25	1.85
LifeDesigns: Moderately Conservative Fund	1.52	0.25	1.77
LifeDesigns: Conservative Fund	1.47	0.25	1.72
Prestige Advisor Series			
Prestige Balanced Fund Y	1.10	0.25	1.35
Prestige Large Cap Value Fund Y	1.15	0.25	1.40
Prestige Small Cap Fund Y	1.35	0.25	1.60
Prestige Large Cap Growth Fund Y	1.20	0.25	1.45
Prestige International Fund Y	1.30	0.25	1.55
Passage Series *			
** Expenses as of May 1, 1998*			
American Century: Twentieth Century Growth	1.00	0.65	1.65
American Century: Twentieth Century Ultra	1.00	0.65	1.65
The Bond Fund of America	0.68	0.65	1.33
Davis New York Venture Fund	0.89	0.65	1.54
Delaware Group Decatur Fund - Decatur Income Fund	0.68	0.65	1.33
Dreyfus S&P 500 Index Fund	0.50	0.65	1.15
Evergreen Income and Growth Fund	1.27	0.65	1.92
Federated US Gov't Securities Fund: 2-5 Years	0.54	0.65	1.19
Fidelity Asset Manager	0.79	0.65	1.44
Fidelity Contrafund	0.70	0.65	1.35
Fidelity Equity Income Fund	0.70	0.65	1.35
Fidelity Magellan Fund	0.66	0.65	1.31
The Growth Fund of America	0.70	0.65	1.35
The Income Fund of America	0.59	0.65	1.24
INVESCO Industrial Income Fund	0.95	0.65	1.60
Janus Fund	0.86	0.65	1.51
MAS Fund Fixed Income Portfolio	0.48	0.65	1.13
Massachusetts Investors Growth Stock Fund	0.72	0.65	1.37
MFS Growth Opportunities Fund	0.84	0.65	1.49
MFS High Income Fund	1.06	0.65	1.71
Nationwide Growth Fund	0.64	0.65	1.29
Putnam Investors	1.00	0.65	1.65
Putnam Voyager	1.02	0.65	1.67
Seligman Growth Fund	1.16	0.65	1.81
T. Rowe Price International Stock Fund	0.85	0.65	1.50
Average Fees	0.99	0.49	1.47

Response to the Audit

CITY OF PORTLAND

OFFICE OF FINANCE AND ADMINISTRATION

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Timothy Grewe, Director
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Portland, Oregon 97204
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MEMORANDUM

TO: Gary Blackmer, City Auditor
City Hall, Room 310

FROM: Tim Grewe, Director, Office of Finance and Administration

DATE: September 20, 1999

RE: Deferred Compensation Program Audit, Report #257

COPIES: Mayor Vera Katz

Thank you for the opportunity to respond to your final draft of the Report #257, "Deferred Compensation Program: Improved Education and Administrative Changes Could Benefit Participants and Lower Costs". The report contains some valuable information that we intend to draw upon in developing a strategy and process for improving the City's deferred compensation program. The City has initiated certain efforts to improve the program and we intend to develop the needed process to make other improvements as well. Although we agree that certain improvements can be made, we strongly believe that further legal analysis is needed before initiating any structural changes to the City's program. Additionally, we believe that a successful strategy for improving the City's program must involve surveying City plan participants. We believe that a formal survey of plan participants will enable the City to assess plan participant needs as well as the costs, benefits and feasibility of implementing changes to the program.

The report offers several recommendations that we believe will strengthen the program. One such recommendation is establishing clear, written goals and objectives for the program. The program recently transitioned to the Bureau of Risk Management where strengthening the program's administrative structure has already been identified as an area of need. This process has already begun with the development of the program's procedure manual, auditing and updating participant files, the creation of a database for participant tracking, and establishing written policies and plan interpretations consistent with Internal Revenue Code rulings. The Bureau has also been responsible for updating plan participant forms as well as analyzing and distributing information on investment provider fees.

Another area of improvement is the development of general educational materials for plan participants. We agree that the City needs to improve its process of communicating with plan participants and educating them with respect to the City's deferred compensation plan process, i.e. the rules and regulations of the City's plan as defined in the City code. The Bureau of Risk Management will be developing a brochure that summarizes the value of participating in the program, how to enroll in the program, how to make changes as needed, as well as other pertinent plan provisions. Other future plans include coordinating quarterly investment provider meetings as well as publishing informational articles in the Bureau's "City Life" publication distributed to all City employees. We also agree that barring potential legal and/or fiscal constraints, the program would benefit from the development of educational materials that outline general concepts such as the importance of retirement savings, the benefits of tax deferred savings, asset allocation as well as other general investment related concepts.

Before embarking upon a process to implement these types of changes, as well as others, to the City's program, we believe it is important to identify the potential financial and legal risks associated with changing the educational component of the City's program. A critical first step is a legal analysis of the City's fiduciary obligations to plan participants and availability of safe harbors that protect the City if it expands the educational component of the deferred compensation program. We will ask the City Attorney's Office to address these issues in order to firmly establish the legal foundation for additional program activities.

Following this effort, we will then develop a survey instrument to solicit responses from plan participants. The survey instrument will be designed to query participants about their current likes and dislikes of the City's program, need for and interest in enhanced investment education, and willingness to pay for an enhanced program, etc. This information, when coupled with the legal analysis described above, will enable the Bureau of Risk Management to develop a proposal to enhance the current deferred compensation program, responding to direct needs of plan participants while staying within the appropriate legal boundaries. Because the City's current program already enjoys a high participation rate (our survey of similar 457 plans offered by governments in Oregon shows that our participation rate of 56 percent very nearly equals the highest reported rate of 60 percent), program enhancements should be directed at creating more value to plan participants in addition to increasing the overall rate of participation.

We may find that addressing the needs of plan participants may very well result in an increase in program costs. These increased costs will either need to be paid by plan participants or through a budgetary increase approved by City Council. For this reason we want to be sure that any proposed increase in program service levels and associated cost is well documented, targets specific needs, and best utilizes the ability of the City's providers to take on additional work tasks in order to minimize program costs. As part of this effort, we may at that time find a need to expand the role and representation of the deferred compensation committee to make sure that the expanded program continues to meet the needs of plan participants.

We will update your office on our progress as we proceed with our efforts to improve the deferred compensation program. Thank you for this opportunity to respond to your audit report.

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