

**SAN MATEO COUNTY  
DEFERRED COMPENSATION PLAN**

**INVESTMENT POLICY AND PROCEDURES STATEMENT**

**REVISED NOVEMBER 1, 2003**

## PURPOSES

This Investment Policy and Procedures Statement has been developed for the San Mateo County Deferred Compensation Plan to describe:

- Plan objectives
- Investment option categories
- Investment option characteristics
- Investment fund selection
- Standards of investment performance
- Investment fund evaluations
- Blackout Periods
- Prohibited securities
- Disclosure of fees, commissions and charges
- Investment communication to participants
- Investment education
- Review

## PLAN OBJECTIVES

The San Mateo County Deferred Compensation Plan (Plan) is a long-term retirement savings vehicle which is intended to provide a supplemental source of retirement income for eligible participants. The investment options available from the Plan will cover a broad range of investment risk and potential reward appropriate for this kind of retirement savings program. Participants bear the risks and rewards of investment returns that result from the investment options that they select. The investment options (funds) made available will be determined by the San Mateo County Deferred Compensation Committee (Committee) and may be changed as a result of periodic reviews.

The mix of investment options appropriate for a participant depends on the combination of a number of factors, including, among others, age, current income, length of time to retirement, tolerance for investment risk, income replacement/supplement objectives, and a participant's other assets. To permit participants to establish different investment strategies, the plan may offer up to 15 investment categories, which have varying return and volatility characteristics. It is the responsibility of each participant to evaluate the investment options and to select an appropriate mix. A participant should consider, among others, the following risks:

- Volatility:** The risk of significant decreases in account value (including the loss of principal) over relatively short periods of time.
- Accumulation:** The risk of not accumulating sufficient assets to retire.
- Understanding:** The risk of investing for the wrong reasons.
- Diversification:** The risk of concentrating investments and suffering large losses from a single investment category or similar categories that do not perform well.

A risk/reward structure is basic to investments. Generally, those vehicles offering the greatest return over time also carry the highest risk or volatility of return. The inherent conflict between volatility and long-range accumulation can be lessened through diversification among asset classes. To provide participants the opportunity to select risk/reward strategies and to diversify the Deferred Compensation Plan assets, the Plan will offer a number of investment alternatives.

Participants can control their exposure to accumulation and volatility risks by allocating investments among these options. For example, a participant nearing retirement with high sensitivity to volatility risk might invest more heavily in the Stable Income

Fund than a participant with many years to retirement. Many other investment options exist. This number and these types were selected because they: 1) each offer a distinct utility to the participants; 2) provide a spectrum of volatility and accumulation choices; and 3) can be administered, communicated and understood within practical constraints of the Plan's resources.

The Committee will attempt to provide plan participants with an array of suitable fund selections with an objective of reducing fund fees, expenses, and administration fees normally associated with these investments.

## DESCRIPTION OF INVESTMENT OPTION CATEGORIES

A **Money Market Option** invests in cash equivalent securities with maturities of less than one year. The average quality of the portfolio must be A1, P1, or AAA. The objective of the fund is to protect underlying principal value and produce a reasonable level of current income. While the volatility risk of this option is the lowest, accumulation risk is the highest.

A **Stable Value Option** invests in book value investments which may include General Account annuity products, Separate Account Annuity products, Guaranteed Accumulation Accounts (GAAs), Guaranteed Investment Contracts (GICs), Bank Investment Contracts (BICs), "Synthetic" GIC arrangements and money market instruments, and may invest in intermediate term fixed income securities with a duration of 5 years or less. Investments may either be made directly or through pooled arrangements. The objective of the fund is to provide higher income than a money market fund while still providing no fluctuation in principal value.

A **Certificate of Deposit Option** with an issuer that guarantees a specific rate of return over a specific period of time. The objective of the fund is to provide guaranteed investment returns with a maximum of safety of principal.

A **Bond Option** invests in cash equivalents and marketable fixed income securities. The average duration of a portfolio should not exceed that of the Lehman Brothers Government/Corporate Bond Index by more than 10%. The average portfolio quality shall be AA (or a comparable rating) or better by Moody's, Standard & Poor's or Fitch's ratings services. Sector and issue concentration guidelines will be dictated by the state policies of the manager of the fund(s).

The investment objective is to provide longer-term preservation of capital while earning a high level of current income. However, principal values may fluctuate over time, primarily in response to changes in interest rates.

A **Balanced Option** invests in several asset classes (typically common stocks, bonds and money market instruments). Investment returns come from both current income and capital changes. Professional investment managers make the asset allocation

decisions, and the option can be used by participants who do not wish to self-manage their asset mix. The Balanced Option is expected to produce higher longer-term returns than the Bond Fund option, although the volatility may be greater.

Asset allocation, quality and sector concentration guidelines will be dictated by the stated policies of the manager or prospectus of a fund. The investment objective is to provide a diversified investment return of current income and capital appreciation.

A **Large Capitalization\* (Large Cap) Option** invests in those companies that comprise the top 70% of the overall stock market capitalization. This asset class may contain value funds that invest in stocks of companies the investment fund manager believes the stock market undervalues and has the potential for market appreciation. This asset class may also contain growth funds that invests in stocks of companies the fund manager believes will grow at a faster rate than its peers or the corresponding market. This asset class may include funds that are blended to include both value and growth stocks. Stocks in this asset class may provide additional investment growth through the reinvestment of dividends.

A **Medium Capitalization\* (Mid Cap) Option** invests in companies that comprise the next 20% of the overall stock market. This asset class may contain value funds that invest in stocks of companies the investment fund manager believes the stock market undervalues and has the potential for market appreciation. This asset class may also contain growth funds that invests in stocks of companies the fund manager believes will grow at a faster rate than its peers or the corresponding market. This asset class may include funds that are blended to include both value and growth stocks. Mid-sized companies may be less able to weather economic shifts or other adverse developments than larger, more established companies.

A **Small Capitalization\* (Small Cap) Option** invests in companies that comprise the remaining 10% of the overall stock market capitalization. This asset class may contain value funds that invest in stocks of companies the investment fund manager believes the stock market undervalues and has the potential for market appreciation. This asset class may also contain growth funds that invests in stocks of companies the fund manager believes will grow at a faster rate than its peers or the corresponding market. This asset class may include funds that are blended to include both value and growth stocks. Small-sized companies may be less able to weather economic shifts or other adverse developments than larger, more established companies.

An **International / Global Equity Option** - The International Equity Option invests primarily in common stock of established non-U.S. issuers. This fund can be expected to be subject to risk factors not prevalent in domestic markets, including currency risk. The Global Equity Option (aka World Equity Option) invests in common stocks of established non-U.S. issuers as well as domestic common stocks as deemed appropriate by the fund managers. These funds are appropriate for a portion of a participant's account for which additional risk is acceptable in exchange for diversification from options tied solely to domestic markets. Currency fluctuation will contribute to increased return volatility.

An **Index Fund** invests identically to the market index whose return it seeks to duplicate. The objective of an index fund is to provide market diversification and a market average rate of return reflective of the market segment represented by a given index, e.g., the Standard & Poor's 500.

**Asset Allocation Funds (Model Portfolios)** offer an allocation of investments, principally stocks, bonds, and cash or cash equivalents that are appropriate for a given stage of an individual's investment life cycle. An aggressive asset allocation fund will have greater weighting in stocks than a moderate or conservative asset allocation fund. A conservative asset allocation fund will be more heavily weighted toward current income and protection of capital. The objective of an asset allocation fund is to provide a composite rate of return from current income and capital appreciation which is appropriate for a given stage of an individual's investment life cycle.

\*Market capitalization is determined by multiplying the total number of outstanding shares of stock by the market price of the stock. Market capitalization changes with the changes in the price of the stock and increasing or decreasing the outstanding number of shares. Currently, a company is categorized as large if the capitalization is over \$7.5 billion; mid cap is over \$1.25 billion up to \$7.5; small cap is under \$ 1.25 billion. However, this changes with significant swings in the stock market. To maintain consistency the 70%, 20%, 10% is used to determine equity asset classes.

## INVESTMENT OPTION CHARACTERISTICS

	Money Market Option	Certificate of Deposit / Stable Value Option	Bond Option	Balanced Option	Large Cap Option	Mid Cap Option	Small Cap Option	International/ Global Equity	Index Funds	Asset Allocation Funds
Investment Objective	Stable principal and income growth.	Moderate level of current income with stable principal value.	Higher level of current income and increasing principal appreciation values over the long-term.	Competitive returns from both current income and capital growth.	Moderate capital growth and above average current dividend income.	Long-term growth of capital, less emphasis on current income.	Maximum capital gains, little or no emphasis on income.	Long-term growth of capital, little or no emphasis on income.	Replicate the performance of a specific market index.	Prescreened, diversified portfolios, managed as a single fund.
Invests Primarily In	Highest quality money market instruments.	General and Separate Account Annuities, GICs, BICs, Money Market instruments, intermediate-term bonds.	Gov't, agency, investment grade corporate bonds.	Common stocks, investment grade bonds and money market instruments.	Common stocks of high quality, relatively mature companies with above average dividends.	Common stocks with prospects for growth superior to that of the broad market.	Common stocks that may be of smaller, higher risk businesses.	Common stocks of non-U.S. issuers with prospects for growth. Global may invest in non-U.S. as well as domestic common stocks.	Domestic stocks or international stocks or bonds, depending on the designated index.	Combinations of international stocks, domestic stocks, bonds, AND stable value, at varying proportions.
Primary Source of Return	Short-term interest income.	Intermediate-term interest income.	Long-term interest income, capital changes.	Capital growth, interest and dividend income.	Capital growth and reinvested dividends.	Capital growth and long-term growth of dividends.	Capital growth.	Capital growth.	Capital growth and/or income, depending on the designated index.	Growth and interest income.

	Money Market Option	Certificate of Deposit / Stable Value Option	Bond Option	Balanced Option	Large Cap Option	Mid Cap Option	Small Cap Option	International Equity	Index Funds	Asset Allocation Funds
Volatility Risk Potential	Lowest	Very low	Moderate	Less than stocks but more than bonds.	Similar average volatility as the S&P 500.	High short-term volatility.	Higher short-term volatility. Periods of several years may elapse before showing superior performance.	Highest short-term volatility. Subject to risk factors not prevalent in the domestic markets, such as currency fluctuations.	From high to moderate short term volatility, depending on the designated index.	Low to moderate, depending on the allocation selected.
Minimum Participant Investment Time Horizon	Less than one year.	1 to 3 Years	1 to 3 Years	3 to 5 Years	4 to 5 Years	5 Years	5 to 10 Years	5 to 10 Years	3 to 5 years	1 to 5 years, depending on the allocation selected.
Ten Year Accumulation Risk Potential	Highest	Moderate - High	Moderate	Moderate - Low	Low	Low	Low	Low	Moderate to Low, depending on the designated index.	Moderate to Low.
Participant Perception	Safe	Safe. Transfer restrictions need to be carefully communicated.	The interest rate volatility concept may be hard to understand.	Most likely to be mis-understood. Hard to communicate.	Concept easy, differences from Growth Fund are subtle.	Concept easy, actual process sophisticated.	Concept easy. Participants need to understand risks.	Concept may be mis-understood. Risk factors need to be communicated carefully.	Premise of index funds - duplicating performance of a specific market segment - must be communicated	Simple way to invest in a broadly diversified portfolio.



## INVESTMENT FUND SELECTION - STABLE VALUE FUND

There are several different types of stable value funds, including separate and general account annuity products, GIC funds and FDIC products. Also, there is not, for most of these products, a standardized database with performance and other pertinent information that would enable a search process to be conducted. There is also a need to enter into negotiations with the provider regarding investment strategy and style in situations where that is in the discretion of the plan sponsor. For these reasons, the selection of one or more stable value fund products will be conducted through a written request for proposal process to the appropriate vendors.

## INVESTMENT FUND SELECTION - MUTUAL FUNDS

### I. Alignment of Mutual Funds

- A. Mutual funds offered by the Deferred Compensation Plan will be by groupings of like investment policy and risk (volatility of returns).
- B. Contracted fund providers will be used to determine the groupings of mutual funds including index funds, if appropriate, by investment option characteristics. These investment option characteristics are subject to annual verification by the Committee.
- C. Asset classes to be offered:

#### Asset Classes

Small Cap  
Mid Cap  
Large Cap  
Income (Bond)  
Balanced

Money Market  
International / Global  
Stable Value / Certificate of Deposit  
Index Funds  
Asset Allocation Funds

D. At the time of selection, the fund category established by the contracted fund providers for the previous six quarters, will determine the category placement of a fund under the Plan. In the event that a fund has not had consistency of placement within a category over the six quarters prior to selection, it shall be placed in the category most recently determined by contracted fund providers. The placement of a fund within its category may be a consideration in its selection. For example, if a fund has consistently, over a period of time, moved toward the outside ranges of its category; it may not be an appropriate candidate for selection since it may have a high probability of changing categories.

## II. Selection of Funds

The selection process will be documented throughout to provide a history of initial screening, funds deleted, the reasons for the deletion and factors considered by the Committee in the final selection.

### A. Initial Screening

The initial screening will produce a listing of funds that have outperformed the average of their respective categories for the five most recent five-year and three most recent three-year periods. At this point, those funds that are inappropriate for the Plan will be deleted. Deletion may occur for the following reasons:

1. The initial screening will produce a listing of funds that have outperformed the average of their respective categories for the five most recent five-year periods. At this point, those funds that are inappropriate for the Plan will be deleted. Deletion may occur for the following reasons:
  - a) The fund is closed,
  - b) The fund has a policy of not being available for deferred compensation plans,
  - c) The fund has loads that it is not willing to waive,
  - d) The fund has an expense ratio that is uncompetitive in relationship to similarly managed funds.

2. The initial list of funds produced in (1) above shall be ranked according to their annualized performance over the most recent five year investment period. Using these rankings, the following number of funds shall be selected as semi-finalists:

- a) Small Cap
- b) Mid Cap
- c) Large Cap
- d) Income
- e) Balanced
- f) Money Market Funds
- g) International / Global
- h) Stable Value
- i) Index Funds
- j) Asset Allocation Funds

B. Determination of Finalists

1. Once the list of semi-finalists is determined, each fund will be reviewed:

- a) Annual performance over each of the immediately preceding three and five calendar years will be evaluated. Consistent performance return in each year of the three and five-year period will be preferred. Consistent performance includes moderate Standard Deviation (as determined by a comparison with similarly managed funds) portfolio manager tenure, outperforming the appropriate benchmark for the three and five year periods and a consistent Risk and Return profile as determined by Morningstar.
- b) The fund's investment category placement over the last three years will be reviewed and funds that remain in the same category will be preferred.
- c) A questionnaire will be sent to the semi-finalist funds. Issues to be addressed in the questionnaire include:
  - Number of accounts per portfolio manager
  - Staff turnover - longevity of portfolio manager
  - Equity Investment style, including market timing, sector selection and security selection

- Fixed Income Investment style, including duration management, sector selection, and security selection style. This question should include review of investment process, ability to articulate process as well as consistency of style or process.
  - Fees and expenses
  - Confirm Minimum Operational Criteria compliance
2. Based on the information collected during the evaluation of the semi-finalists, funds will be reviewed and funds may be eliminated based on:
- Inconsistent performance history
  - Excessive movement within investment category
  - Qualitative factors such as excessive account turnover or an inappropriate investment style,
  - Inability to satisfy the Minimum Operational Criteria

For each fund that qualifies as a finalist the Committee will review the information collected and will select a finalist.

### III. Minimum Criteria for Selection

#### A. Minimum Size and History Criteria

1. Size - to be considered, a fund should have assets pf at least \$100 million. The intent is to restrict selection of mutual funds to the size appropriate for the potential cash flow to be generated by the Plan. If, however, this restriction reduces the potential pool of semi-finalists inappropriately, this criterion may be reduced to broaden selection.
2. Period of time in operation - a mutual fund (or a clone fund under the same management) should have been in operation for a period of 5 years prior to selection.

#### B. Minimum Operational Criteria

To be considered for inclusion in the Plan and to be a semi-finalist a fund should first meet the size and history criteria above. Next it must satisfy the Minimum Operational Criteria.

1. It must guarantee transactions at the prior day's price.
2. Front end loads and fund surrender charges must be waived.
3. It must be compatible with the Plan's administrative and record keeping accounting and system practices.

The County will have the ability to request mutual funds to pay it a fee for performing administrative services.

## STANDARDS OF INVESTMENT PERFORMANCE

	3 Year Standard	5 Year Standard
<b>Money Market Option</b>	Competing Money Market Funds will be compared between industry providers.	Competing Money Market Funds will be compared between industry providers.
<b>Stable Value Option</b>	Competing Stable Value Funds will be compared between industry providers.	Competing Stable Value Funds will be compared between industry providers.
<b>Bond Option</b>	Total time-weighted rates of return that match or exceed the average return of a universe of fixed income funds.	Total time-weighted rates of return that match or exceed the average return of a universe of fixed income funds.
<b>Balanced Option</b>	Total time-weighted rates of return that match or exceed the average return of a universe of balanced funds with comparable asset allocation policies.	Total time-weighted rates of return that match or exceed the average return of a universe of balanced funds with comparable asset allocation policies.
<b>Large Cap Option</b>	Total time-weighted rates of return that match or exceed the average return of a universe of large cap funds.	Total time-weighted rates of return that match or exceed the average return of a universe of large cap funds.
<b>Mid Cap Option</b>	Total time-weighted rates of return that exceed the average return of a universe of mid cap funds.	Total time-weighted rates of return that exceed the average return of a universe of mid cap funds.
<b>Small Cap Option</b>	Total time-weighted rates of return that exceed the average return of a universe of small cap funds.	Total time-weighted rates of return that exceed the average return of a universe of small cap funds.

	3 Year Standard	5 Year Standard
International/ Global Equity Option	Total time-weighted rates of return that exceed the average return of a universe of international / global equity funds which are managed in a comparable style.	Total time-weighted rates of return that exceed the average return of a universe of international / global equity funds which are managed in a comparable style.
Index Funds	Competing Index Funds will be compared to a comparable standard index.	Competing Index Funds will be compared to a comparable standard index.
Asset Allocation Funds	Competing Asset Allocation Funds will be compared between industry providers.	Competing Asset Allocation Funds will be compared between industry providers.

Note: Morningstar Principia Pro™ will be utilized to determine universe of average performance rates by category. Funds not achieving the established benchmarks may be retained at the sole discretion of the Committee.

# INVESTMENT FUND EVALUATIONS

## POLICY:

The Committee retains the authority to periodically, but no less than annually, evaluate and deselect investment funds. Three (3) and five (5) year Standards of Investment Performance will be applied to all investment funds in the Plan. Each standard shall apply independently to the portfolio of each investment fund and is expected to be achieved net of investment management fees and expenses but not administrative, marketing, and enrollment fees, if any. For funds without comparable indices or peer groups, such as general account products, the Committee will compare the performance to other investment instruments in the market.

If an investment fund fails to meet the minimum standards of investment performance outlined in this document, the Committee may take the following steps. The Committee may, in its discretion, if circumstances warrant, proceed directly to Step 2.

## PROCEDURE:

Step 1. The investment fund should immediately be placed on a one-year probation. Retention at the end of that one-year period will be contingent on the following:

- The fund should perform above the average of its investment management universe over three-year periods; or
- The fund should perform in the top half quartile of its investment management universe over the past one-year period; and
- Risk-adjusted returns should not exceed 130% of the relative index over the three-year period; and
- Performance over these periods will be reviewed to justify retention.

Investment funds that do not satisfy the retention criteria at the end of that one-year period will be considered for replacement – see Step 2.

Step 2. A fund search may be initiated and a replacement fund selected. Plan assets already deposited with the dropped fund will have a transition period of a length set by the Committee, but not less than 90 days, in which he or she may transfer their



assets to the replacement fund or a fund option of the participant's choice. During the transition period, reminders will be sent to participants monthly prior to eliminating the fund.

In the event a participant does not voluntarily select a replacement fund(s) by the end of the transition period, the Committee will direct the provider to transfer the current balance of the dropped fund to the replacement fund within the asset class with the same provider. In the event the same provider does not offer another investment in the same asset class, the dropped fund will be transferred to the stable value fund of that provider.

Other reasons for probationary review of investment funds may include:

1. Change of investment manager by fund provider
2. Change of subadvisor
3. Significant change in ownership or control
4. Significant change in fund management style or drift
5. Substantive change in portfolio turnover that significantly exceeds the fund's history
6. Any violation of SEC rules or regulations or breach of fiduciary duty
7. Operational difficulties concerning fund transfers or pricing
8. Excessive costs or trading practices
9. Negligible use by participants

## **BLACKOUT PERIOD**

### **POLICY:**

In accordance with the Sarbanes-Oxley Act of 2002, the Plan will give plan participants a minimum of 30-day advance notice of “blackout periods” affecting their rights to direct investments, take loans (if available) or obtain distributions. Blackout periods may occur when plans change record-keepers, record-keeping systems or investment options. Individual participants will receive a blackout notice that contains, among other things:

- The reasons for the blackout period,
- A description of the rights that will be suspended during the blackout period,
- The start and end dates of the blackout period,
- A statement advising participants to evaluate their current investments based on their inability to direct or diversify assets during the blackout period.

## **PROHIBITED SECURITIES (DERIVATIVE GUIDELINES)**

### **CASH EQUIVALENT HOLDING**

#### **POLICY:**

Derivatives generally refer to financial instruments that derive their values from underlying cash market investments. Examples of derivatives include, but are not limited to, financial futures, forwards, options, options on futures, collateralized mortgage obligations and swaps.

The investment manager(s) shall not, in the money market option or the cash portion of any other option, enter into a derivatives contract, purchase securities on margin, or sell short unless expressly authorized to do so in writing by the Committee.

## **DISCLOSURE OF FEES, COMMISSIONS AND CHARGES**

### **POLICY:**

All fees, commissions and charges for each selected investment option must be fully disclosed to the Committee before the option can be made available to plan participants. That is, in its review of a fund's performance history, the Committee must be shown the fund's gross performance less all applicable fees, commissions and charges, and the resulting net return.

In addition, these fees, commissions and charges will be disclosed to all participants at enrollment and at any other time as appropriate. It will be disclosed to plan participants the nature of all variances between gross return and net return.

## **INVESTMENT COMMUNICATIONS TO PARTICIPANTS**

### **POLICY:**

Information about each investment option will be given or made available to Plan participants to help them to make informed investment choices. The Providers shall provide at least quarterly statements of fund performance to each participant.

Upon request, copies of investment fund prospectuses or similar equivalent information will be provided to participants as well as such other information as the Committee has available such as a list of underlying investments for a given fund.

## **INVESTMENT EDUCATION**

### **POLICY:**

It is the Committee's objective to provide participants with ongoing investment education. The purpose of the investment education program is to provide information and tools to assist in the development of a personal investment strategy for employees and facilitate the achievement of savings and retirement goals.

## REVIEW

### POLICY:

It is the intention of the Committee to review this document at least every three years and make necessary amendments.

If at any time a fund investment manager or provider feels that these policy standards cannot be met, or that the guidelines constrict management, the Committee should be notified in writing so that recommendation for changing the policy, if deemed appropriate, can be made by the Committee to the County.

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Chair, Deferred Compensation Plan Committee  
San Mateo County