



# **State of Florida Deferred Compensation Plan**

**Investment Policy and Product Selection and Retention Policy**

## **TABLE OF CONTENTS**

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<b>I. PURPOSE .....</b>	<b>3</b>
<b>II. POLICY .....</b>	<b>3</b>
<b>III. DEFINITIONS.....</b>	<b>3</b>
<b>IV. APPROVAL AND TERMINATION OF INVESTMENT PRODUCTS.....</b>	<b>4</b>
<b>A. New Investment Product Approvals.....</b>	<b>4</b>
<b>B. Termination of Existing Investment Products.....</b>	<b>5</b>
<b>C. Criteria for Approval or Termination of Investment Products.....</b>	<b>5</b>
<b>V. REPORTING AND REVIEW.....</b>	<b>6</b>
<b>VI. FIXED ACCOUNT REVIEW .....</b>	<b>6</b>
<b>VII. SELF-DIRECTED BROKERAGE WINDOW (SDBW) .....</b>	<b>6</b>
<b>A. Selection of Stock Brokerage Firm .....</b>	<b>7</b>
<b>B. Monitoring of Brokerage Accounts .....</b>	<b>7</b>
<b>VIII. INVESTMENT ADVISORY SERVICES.....</b>	<b>7</b>
<b>IX. TABLE A.....</b>	<b>8</b>
<b>X. TABLE B.....</b>	<b>9</b>

# Investment Product Guidelines and Retention Policy

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## I. Purpose

The purposes of this document are to (1) establish the standards for the Government Employees' Deferred Compensation Plan, (2) adopt criteria for the selection and retention of the Plan's investment options, and (3) provide a method for the quarterly evaluation and monitoring of the investment options.

## II. Policy

It is the policy of the Department of Financial Services to make available a broad range of investment options that have varying degrees of risk and return. The Department of Financial Services has responsibility for insuring that a reasonable variety of investment options is available, that information regarding these options is available to participants, and that program administrative costs are kept to a minimum. The State of Florida's 457(b) Government Deferred Compensation Plan is a participant directed investment program, established by Section 112.215 Florida Statutes. An employer does not know the retirement need, time horizon, or risk tolerance of its employees, and therefore cannot make an investment allocation for the individual. Only the participant can define these needs and make appropriate investment decisions.

## III. Definitions

**Actively Managed Product** – An investment strategy that relies on active trading strategies in an effort to out-perform the financial returns generated by a market benchmark index.

**Best Interests of the Participants** – reasonable consideration of cost, continuity, return, risk, flexibility, and security of the participant's beneficial interest in the plan assets.

**Percentile Ranking** – This is the fund's tax-adjusted total-return percentile rank for the specified time period relative to all investment products that have the same Morningstar Category. (The most favorable being 1, and least favorable being 100).

**Default Fund** – an investment option created during the 2006 Pension Protection Act, allowing plans to invest a participant's assets, if it is deemed that the participant has exercised control over the assets in his or her account, into a QDIA or a Qualified Default Investment Alternative. Each approved Investment Provider has a designated QDIA currently within the Deferred Compensation Program. The Department has designated the Target Date Funds for each provider as the QDIA.

**Deferred Compensation Program (DCP)** – The program created pursuant to Section 112.215 Florida Statutes, which is embodied in the Government Employees' Deferred Compensation Plan adopted through Rule Chapter 69C-6 Florida Administrative Code.

**Department** – Florida Department of Financial Services.

**Investment Product** – a product purchased with the expectation of favorable returns. Investment Products are compiled from securities and financial instruments in order to produce investment returns in the form of income or capital appreciation.

**Investment Provider** – A private sector company approved by the Department, which offers investment products, investment education, and markets the Deferred Compensation Program to participants. Investment Provider companies sign a five-year contract and undergo a competitive bid process.

**Morningstar** – Morningstar Principia Pro Software and Morningstar Datalab Software, licensed for Morningstar, Inc., and used by the Department to evaluate and monitor the quantitative measures of investment products in the Deferred Compensation Program.

**Morningstar Category** – A classification based on an investment product’s statistics and composition over the past three years.

**Morningstar Rating** –The Morningstar Rating for mutual funds, commonly called the star rating, is a measure, published by Morningstar Inc., of a fund's risk-adjusted return, relative to other mutual funds in its category. Funds are rated from one to five stars, with the best performers receiving five stars and the worst performers receiving a single star.

**Mutual Fund** – A professionally managed collective investment product that pools money from many investors to buy stocks, bonds, short-term money market instruments and other securities.

**Observation Status** – The condition of a mutual fund having a Morningstar 5-year percentile ranking within category greater than 50<sup>th</sup> percentile at quarter end **and** a Morningstar 5-year rating of less than 3 stars **or** a Morningstar 5-year percentile ranking within category greater than 75<sup>th</sup> percentile at quarter end.

**Participant** – An employee that completes enrollment documents in the State of Florida Deferred Compensation Program and agrees to all terms and conditions that apply.

**Passively Managed Product (Index Fund)** – An investment strategy that produces the same level and pattern of financial returns generated by a market benchmark index.

**Performance Benchmark** – A market benchmark index that is designated by an investment product’s prospectus is used to measure investment performance.

**Sharpe Ratio** – A risk-adjusted measure that is calculated by dividing the excess return by total risk incurred by an investment to determine reward per unit of risk.

**Termination Review Status** – The mutual fund is in observation status for four consecutive quarters.

**Termination** – At least two consecutive quarters in termination review status **and** a Morningstar 1-year percentile ranking within category greater than 50<sup>th</sup> percentile at quarter end.

#### **IV. Approval and Termination of Investment Products**

Selection of investment products to be made available through the Deferred Compensation Program and replacement or termination of investment products must be approved in writing by the Department and reviewed with written comments by the State Board of Administration (SBA) pursuant to Section 112.215(4)(a) F.S. prior to the change becoming effective.

##### **A. New Investment Product Approvals**

Approval of new investment products must be made by the Department using the quantitative criteria listed in Table A and the qualitative criteria listed in Section IV C. The Department shall evaluate recommendations made by Investment Providers and if all criteria are met, submit proposed new investment products to the SBA for review pursuant to 112.215(4)(a) F.S. The Department has final approval for all investment product changes. This process must be completed and documented by the Department prior to the offering of new products to participants. This process does not apply to products offered in the Self Directed Brokerage Window.

## **B. Termination of Existing Investment Products**

A product may be terminated based on either quantitative criteria listed in Table B or qualitative criteria listed in Section IV C. The Department shall submit proposed investment product terminations to the SBA for review and comment. The Department makes the final determination for product retention or termination. Once approved for termination, the fund is removed from the DCP and assets and deferrals will be mapped to similar investment products no earlier than 60 days and no later than 30 days notice to participants. This process does not apply to products offered in the Self Directed Brokerage Window.

## **C. Criteria for Approval or Termination of Investment Products**

In deciding which investment products to approve for availability in the DCP or terminate from the DCP, the Department shall review the following factors quarterly:

1. Qualitative Factors
  - a. Costs – average of investment objective
  - b. Liquidity
  - c. Transaction limitation
  - d. Diversification
  - e. History – how long the investment product has been in existence
  - f. Management tenure or departure
  - g. Reputation and regulatory record of an investment management firm
  - h. Level of assets under management
  - i. Absolute returns
  - j. Adherence to investment style
  - k. Merger of fund companies

\*Initiation of a civil or criminal proceeding by any governmental entity alleging violations of state or federal securities laws or regulations constitute sufficient grounds for disapproval or termination of any investment product.

2. Quantitative (Performance) Factors
  - a. When evaluating mutual funds for approval, the Department shall consider the specific criteria outlined in Table A.
  - b. When evaluating mutual funds for termination, the Department shall consider the specific criteria outlined in Table B.
3. Limitations

With the exception of redemption fees or restrictions imposed with the approval of the Department for excessive trades or inappropriate market timing, investment products offered through the program shall not have restrictions, penalties, market value adjustments or surrender charges relating to exchanges or withdrawals and must offer full liquidity to participants. Commissions shall only be allowed for stock and exchange traded fund transactions through a self-directed brokerage window.

## **V. Reporting and Review**

The Department will conduct quarterly performance reviews for each investment provider's products in the program. In addition, in person reviews will be held semi-annually in the Department's Deferred Compensation Office in February and August. Prior to each semi-annual review, the investment providers will be given a list of the Department's concerns so they may have ample time to prepare a response.

## **VI. Fixed Account Review**

At least twice annually, the Bureau shall request and review the following information from each Investment Provider Company that offers a guarantee of principal and interest account:

1. Average Maturity and Average Life of the fixed account
2. Effective Duration to Average Maturity and Average Life, as appropriate for use in the Crediting Rate Formula.
3. Market Value vs. Book Value
4. Investment Policy Statement Compliance Letter (semi-annually)
5. Underlying Investment Portfolio guidelines regarding allocation to Sectors, Ratings, Derivatives, types of securities.
6. Sector weightings
7. Average ratings of corporate bonds held and % of whole portfolio with ratings below BBB+
8. Crediting Rate Formula
9. Reporting of any changes in the operation of the fund
10. List of people who can make changes involving the fund

## **VII. Self-Directed Brokerage Window (SDBW)**

The Department offers participants the opportunity to invest in individual stocks, additional mutual funds, exchange traded funds (ETFs), options, and other investment alternatives through a self-directed brokerage window. The sole purpose of this alternative is to enhance the DCP by providing additional investment choices so as to accommodate the participant's desire for greater investment flexibility.

In offering the SDBW, the Department and the SDBW Company will notify participants that the investment alternatives available through the SDBW have not been subjected to any selection process, are not monitored, require investment expertise to prudently manage, and have risk of substantial loss.

#### **A. Selection of Stock Brokerage Firm**

The Department will select the on-line brokerage firm to provide the SDBW for electing participants. In making that decision, the Department will consider the following factors: (1) the expense structure of the brokerage accounts, (2) the administrative needs of the Plan, including record keeping and adherence to the DCP rules, and (3) Best Interests of the Participants as defined in section III of this document.

#### **B. Monitoring of Brokerage Accounts**

The Department will monitor the SDBW for proper operation including accounting for transactions and record keeping. However, while the brokerage accounts are available investment alternatives, these investment alternatives within the SDBW are not designated by the DCP and, therefore, are not selected or monitored by the DCP. Instead, the SDBW is intended to provide the electing participants with a broad selection of investment alternatives.

### **VIII. Investment Advisory Services**

The Department offers participants the opportunity to enroll in managed account products. Managed accounts are personalized investment portfolios that are tailored by an investment company to meet the specific needs of the participant. These services are aimed at providing participants the necessary guidance to invest in funds that will aid them in reaching their retirement goals. Services range from financial advice concerning a participant's account with no active trading of funds by the advisor, to an advisor actively managing a participant's account by periodically rebalancing their holdings according to their specific investor profile. These services will be offered to all participants in the DCP for a fee.

**IX. Table A**

**Quantitative Approval Criteria for New Products**

Monitoring Guidelines for Investment Products in the Deferred Compensation Program

<b>Approval Characteristic</b>	<b>Approve</b>	<b>Disapprove</b>
<b>Ranking (relative return)</b>	Morningstar percentile ranking within the fund’s category is less than or equal to the 50 <sup>th</sup> percentile for a 3 and 5-year period if available. A minimum of three years history is required.	Morningstar percentile ranking within the fund’s category is greater than the 50 <sup>th</sup> percentile for the previous 3 and 5-year period. A minimum of three years history is required.
<b>Risk Adjusted Returns</b>	Morningstar 3-year (and 5-year if available) rating is greater than or equal to 4 <u>or</u> Morningstar Sharpe ratio greater than or equal to the 50 <sup>th</sup> percentile if the Morningstar rating is 3 stars.	Morningstar 3 or 5-year rating is less than 3 stars.
<b>Manager</b>  (Team approaches will be evaluated on a case-by-case basis.)	Manager tenure on the fund is greater than or equal to <u>three</u> years.	Manager tenure on the fund is less than <u>three</u> years.
<b>Fees</b>	Investment management fees must be less than the Morningstar average for the fund’s particular category and must lie within the range of current products in the Deferred Compensation Program.	Investment management fees are higher than the Morningstar average for the fund’s category or higher than current products in the Deferred Compensation Program.

**Note:** New products may be approved using only 3-year data if 5-year data is unavailable. However, 5-year data will be utilized in the existing fund analysis when available.

**Note:** Index funds are not required to have the 3-years of manager tenure needed for fund approval. These funds track an index and the manager strategies do not change drastically from year-to-year.



**X. Table B**

**Quantitative Factors  
Investment Product Monitoring**

**Observation, Termination Review Status, and Termination  
Criteria for Existing Products**

Product Monitoring Criteria Characteristic	Observation Status	Termination Review Status	Termination
<ul style="list-style-type: none"> <li>• Morningstar percentile ranking over 5-year rolling average</li> <li>• Morningstar 5-year star rating</li> <li>• Morningstar percentile ranking over 1-year rolling average</li> <li>• Fund management fees listed on Morningstar and given by the IPs</li> </ul>	<ul style="list-style-type: none"> <li>• Morningstar 5-year percentile ranking within category greater than 50<sup>th</sup> percentile at quarter end <b><u>AND</u></b> Morningstar 5-year star rating less than 3 stars; <b><u>OR</u></b></li> <li>• Morningstar 5-year percentile ranking within category greater than 75<sup>th</sup> percentile at quarter end</li> </ul>	<ul style="list-style-type: none"> <li>• In observation status for four consecutive quarters</li> </ul>	<ul style="list-style-type: none"> <li>• At least two consecutive quarters in termination review status <b><u>AND</u></b> Morningstar 1-year percentile ranking within category greater than 50<sup>th</sup> percentile at quarter end</li> </ul>

**Note:** Index funds are not ranked against active funds, and new index products must demonstrate a tracking error to a prescribed benchmark of 50 basis points or lower over the most recent year, using monthly data. For existing products, probation occurs when a tracking error falls between 50 and 100 basis points and termination occurs for a tracking error greater than 100 basis points for four consecutive quarters. For measurement purposes only, the monthly prorated mutual fund expense ratio is added back to the total monthly returns.

**Note:** All funds are measured without loads.

**Note:** It will be possible for an investment product to move from a termination review status or observation status to regular status when the product meets total return requirements by being in the top half of peers over the most recent three year rolling annualized time period available as defined by Morningstar’s Percentile Ranking within category and have a three year Morningstar rating of 3 or more stars.

**Note:** Existing funds with less than 5-years of history will be analyzed using 3-year data. 5-year data will be utilized when available.

**Note:** When analyzing funds for possible addition to the Deferred Comp Program, Target Date Funds shall be treated as one fund by averaging its performance, manager tenure, etc. If the group average fee of the Target Date fund increases more than 6.4%, the investment manager will be contacted by the Department and a decrease in status and termination of fund may occur.

**Note:** If mutual fund management fees increase more than 4.3% quarter over quarter, the investment manager will be contacted by the Department and a decrease in status and termination of fund may occur.

**Note:** Different share classes in the same fund would be considered the same fund, and cannot be used by multiple providers.

**Note:** Vanguard index funds may change share classes without giving participants the 60 day notification period. The Department views this as a share class change within the same fund and not a replacement. The investment company will notify each participant in the Vanguard fund about the change in share class on their next quarterly statements or as soon as feasibly possible.

**Note:** The Department may deviate from this policy if it is determined that the deviation is in the “Best interest of the Participant”.

Approved: \_\_\_\_\_  
Jeff Atwater, Chief Financial Officer

Date: \_\_\_\_\_