

CITY OF LOS ANGELES
DEPARTMENT OF WATER AND POWER
INTRADEPARTMENTAL CORRESPONDENCE

Date: December 3, 2014

To: Retirement Board Members

From:  Mary C. Higgins, Interim Retirement Plan Manager

Subject: Board Agenda Item No. 8: Report on Gateway Investment Advisers, LLC, On-Site Due Diligence Visit – (December 10, 2014, Regular Retirement Board Meeting)

Recommendation

That the Board of Administration (Retirement Board) of the Water and Power Employees' Retirement Plan (Plan) receive and file this report on the on-site due diligence visit to Gateway Investment Advisers, LLC, (Gateway) in Cincinnati, Ohio.

Summary

Senior Investment Officer Carlo Manjikian and Investment Officer Ravi Sharma (staff) met with representatives from Gateway on October 28, 2014, in Cincinnati, Ohio, to review and discuss the organization and investment portfolios being managed by Gateway on behalf of the Plan.

The Retirement Board hired Gateway in January 2012 to manage an active and replication covered calls mandate for the Retirement Fund (RF) and the Retiree Health Benefits Fund (RHBF) with a combined market value of approximately \$803.4 million, as of October 31, 2014.

Mr. Manjikian and Mr. Sharma interviewed the personnel directly responsible for managing the Plan's assets and observed the capabilities of the management team and the resources available to Gateway to manage the Plan's portfolios.

Key functional areas discussed were the overview of the company, investment process and risk controls, portfolio operations, performance, disaster recovery, and business continuity. Gateway is currently not on watch status.

Company Overview

Gateway Investment Advisers, Inc., was founded in 1977 in Cincinnati, Ohio, as an employee-owned registered investment adviser focusing on option-based investment strategies. In 1995, to accommodate the retirement of a founding partner, the firm was reorganized into Gateway Investment Advisers, LP, and sold a minority interest to Alex Brown and Sons, a regional investment bank in Baltimore, Maryland. In 2004, Gateway repurchased Alex Brown's stake in the company and became 100% employee owned. In 2008, Gateway became a wholly owned subsidiary of Natixis Global Asset Management, LP, a division of Natixis S.A. of Paris, France, one of the largest money management firms in the world. As part of this combination, Gateway was reorganized as Gateway Investment Advisers, LLC.

As of June 30, 2014, Gateway managed \$12.8 billion in total assets under management, of which \$1.3 billion is in the covered calls strategy. Institutional client types include both taxable and tax exempt investors in the public fund and sub advised investment landscape.

Investment Process and Risk Controls

Staff discussed the investment process with Mr. Michael Buckius, Chief Investment Officer and Portfolio Manager, Mr. Paul Stewart, President and CEO, and Mr. Harry Merriken, strategist for the covered calls strategy, respectively. Gateway's investment philosophy holds that consistency is the key to long-term investment success and that generating cash flow, rather than seeking to leverage fluctuations in the prices of securities, can be a lower-risk means to participate in equity markets. Gateway believes market volatility can be converted into cash flow and risk can be managed effectively using the tools provided by the index options market.

The active covered calls strategy invests in an index-tracking portfolio of common stocks (S&P 500 for WPERP) while also selling index call options. Selling index call options reduces the volatility of the investment portfolio, provides a steady cash flow and is an important source of the strategy's return. Total return encompasses both change in value and income. The passive strategy seeks to follow the rules of the CBOE Buy Write Index (BXM) as closely as possible.

The combination of the diversified stock portfolio and the steady cash flow from the sale of index call options is designed to provide the strategy with a low volatility equity profile. The signature characteristics of this profile are high equity market correlation and reduced volatility in terms of standard deviation of returns and reduced downside risk. Over a full market cycle, this strategy and its low volatility equity characteristics can result in risk-adjusted returns similar to the equity market.

Gateway's portfolio management team formally meets weekly to discuss the current portfolio positioning and regularly discusses potential changes in the model portfolio and individual accounts. The structure of Gateway's portfolio management area facilitates regular coordination and sharing of information and is designed to foster a collaborative approach to portfolio management among the portfolio management team. Staff visited with the portfolio management team in this trading area. Mr. Buckius demonstrated multiple trade scenarios and gave an example of how he and his team interact with the marketplace.

As part of its investment management process Gateway seeks to reach a consensus when decisions are made. Proposals are debated and positions are challenged as part of this process. This balances the flexibility to respond quickly to market circumstances with the breadth of experience and opinion that the Investment Management team brings to the table. There are no quantitative rules, static triggers or algorithms that drive management decisions.

Portfolio Construction

Gateway covered calls strategy consists of two elements: 1) a stock portfolio that tracks the performance of the S&P 500 Index; and 2) written index call option contracts to reduce risk and improve risk-adjusted return. Management, as part of its investment process, focuses on volatility and cash flow available in the market, as opposed to a "buy-list" or fundamental stock research on individual companies.

First Element — Diversified Equity Portfolio:

- A diversified equity portfolio whose investment objective in aggregate is to substantially track the performance of a broad-based index as closely as possible over time.
- Fundamental equity or sector research is not used.
- For tax-exempt investors the objective is to own all stocks included in the index at their respective index weights while incorporating any client mandated restrictions.
- Positions in index-tracking Exchange Traded Funds may be used to enhance liquidity and reduce frictional trading costs.

Second Element — Written Listed Index Call Options:

- Exchange-traded index call options actively sold against approximately 100 percent of the value of the underlying equity portfolio.
- Typically diversifies across six to ten combinations of strike price and expiration date to limit exposure to any one contract.
- Typically maintains a weighted average strike price that is at – or near – the-money.
- Typically maintains a weighted average time to expiration of 30 to 50 days.
- For BXM replication mandates, one single S&P 500 index call option is sold against the full value of the underlying equity portfolio and is rebalanced monthly in accordance with the rules of the BXM Index.

Legal & Compliance

Staff met with Ms. Donna Brown, General Counsel/Chief Compliance Officer and Ms. Tricia Tomich, Staff Attorney. Gateway implements a risk based compliance program which is primarily responsible for ensuring compliance with SEC regulations.

There is an internal oversight committee consisting of Mr. Stewart and each of the portfolio managers in addition to Ms. Brown and Ms. Tomich. This group meets four times a year to review potential risks related to operational and investment compliance. Staff was given a sample agenda from the August 28, 2014, Oversight Committee meeting. General topics include brokerage selection, account performance, private account matters and risk review.

Additionally, an external audit committee comprised of two members from the parent company Natixis and two members from Gateway perform monitoring duties in support of the annual firm presentation to the SEC. Ernst & Young, LP, conducts the annual financial audit. Gateway also retains a firm called Vista 360, an independent third party consultant, that advises Gateway and Ms. Brown on various compliance issues by conducting two on-site reviews per year and reports on their findings.

Performance

Staff discussed the RF and RHBF account performance with Gateway. As of August 31, 2014, the active accounts for the RF and RHBF portfolios underperformed the benchmark for the one-year holding period by 2.89% and 2.87%, respectively, but outperformed the benchmark for the since inception period by 1.73% and 1.75%. The passive account portfolios underperformed the benchmark for the one-year by 0.16% but outperformed the benchmark for the since inception periods by 0.23% and 0.26%, respectively.

Disaster Recovery and Business Continuity

Staff met with Mr. Gary Goldschmidt, Chief Operating Officer and Chief Financial Officer, to discuss the firm's disaster recovery and business continuity plans. Gateway has a rigorous business continuity plan that includes total firm connectivity and potential off-site relocation.


A company-wide Business Continuity and Disaster Recovery (BC/DR) program is in place at Gateway. Senior Management plays an active role in managing the BC/DR plan, which is based on a series of threats (level 0 to level 3) and response to each is proportionate to the severity of the incidence. The disaster recovery team is primarily comprised of company officers, led by the Chief Operating Officer. Mr. Goldschmidt is responsible to manage and oversee the declaration and resulting implementation of the plan. The maintenance and ongoing update to the BC/DR program is the responsibility of the Chief Information Officer and the IT staff. The staff is responsible for collecting significant input from business unit staff to keep all operational processes up to date. The BC/DR outlines Gateway's guidelines and procedures for managing threats and major emergencies that may adversely affect, threaten, or disrupt the conduct of activities necessary to operate the business.

At the center of Gateway's approach is a fully functional "hot site" located in Gateway's Hunt Valley, Maryland, office. The data center in the Maryland office contains servers that are capable of supporting all mission critical business processes. Critical data stored and processed in the main Cincinnati office are duplicated onto the Hunt Valley servers. While some data is copied to the hot site after business hours, the majority of the information is replicated on a near real-time basis. In addition to the backup site, all servers and critical information are backed-up to tape every evening with the tapes stored off-site.

The plan includes the possible temporary relocation of a large contingent of Gateway employees to the Maryland office as well as provisions for virtual office access, if necessary.

Summary and Findings

Mr. Manjikian, Mr. Sharma, and management staff from Gateway covered a comprehensive agenda with respect to various areas of the firm. Staff observed various areas of the firm and discussed the front, middle, and back office operations while speaking with multiple key personnel across the organization. Gateway presented effectively and covered key philosophy and management issues associated with the Plan's portfolios and staff did not observe any areas of concern during the visit.



Jeremy Wolfson
Chief Investment Officer

MCH/JW/CM/RS: mea