

Pension Benefits

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Both the number of workers whose employers sponsored a retirement plan and the number of workers participating in such plans rose from 2006 to 2007.

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DB plans offer advantages for both the employees that receive them and the employers that sponsor them.

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Hedge funds are risky in part because they are exempt from the federal securities regulations that govern mutual funds.

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401(k) PLANS

401(k) Benchmarking Survey 2008

Deloitte Consulting LLP, July 2008

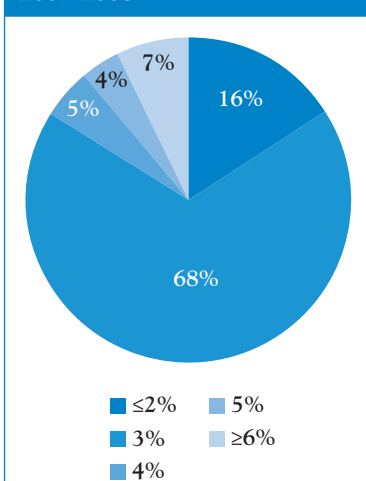
“While 401(k)s originally were built upon the assumption that employees would, with limited coaching, make appropriate decisions about how much income to defer in a 401(k) and how to invest it, employers’ thinking has evolved considerably since then. That shift is vividly demonstrated in this year’s survey by the growth of auto-enrollment features, in which employees default into plan participation. In particular, 42% of the employers surveyed now have an auto-enrollment feature—nearly double from the last survey (23%). And 26% of this year’s respondents reported they are considering adding an auto-enrollment feature—perhaps with some knowledge of the high (96%) satisfaction rate expressed by employers who have made the switch to auto-enrollment.

The survey also documented a big jump in employers using ‘easy enrollment’ systems, such as a postcard or similarly simple authorization form provided to nonparticipants which improves the ease with which employees can enroll and participate. Specifically, 15% of respondents reported using such systems, up from 11% documented in the last survey.

Companies may be ratcheting up the default deferral rate for auto-enrollment plans. For example, two-thirds (68%) reported using 3% for the default contribution rate, versus 53% in the last survey (Exhibit 1). Along similar lines, step-up provisions that automatically increase deferral percentages on the participants’ behalf were reported by a healthy 35% of respondents, nearly double the 18% reported last year.

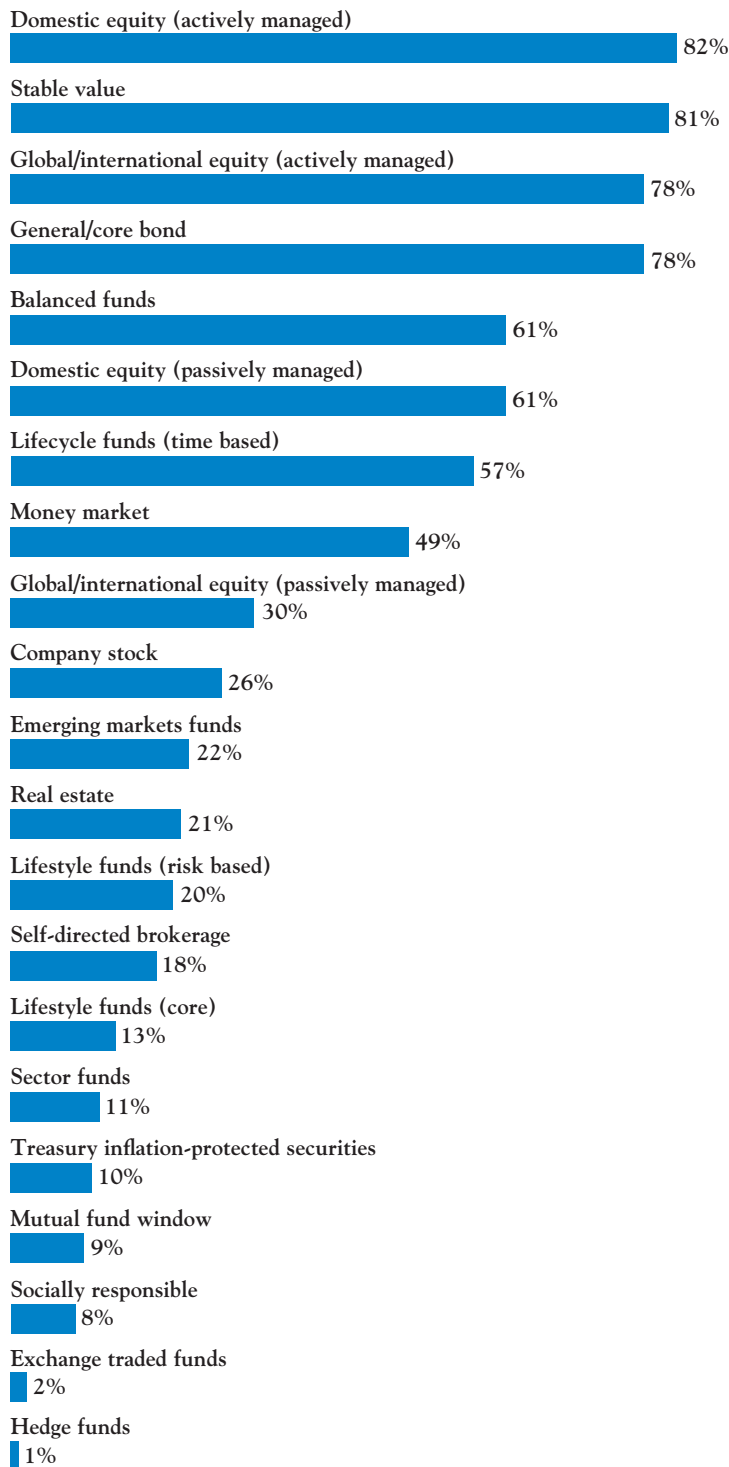
Twelve percent of respondents reported easing restrictions to participation in one way or another, versus only 1% stating they had made their plans more restrictive. This year, for the first time, the majority (51%) reported making employees eligible for plan participation immediately upon hire. That percentage has grown steadily over the years; in 2000, only 34% of employers reported having no service requirements. A similar trend is evident in the easing of service requirements for eligibility for employer contributions. In 2002, for example, only 26% of employers rendered employees immediately eligible; the percentage has now climbed to 48%.

Exhibit 1. Default Deferral Percentage for Auto-Enrollment, 2007-2008



Source: Deloitte Consulting LLP, July 2008

Exhibit 2. Types of Core Investment Options Offered in Employer 401(k) Plans, 2007-2008



Source: Deloitte Consulting LLP, July 2008

The increasing popularity of lifecycle funds (with portfolios aimed at different age brackets, based upon a projected retirement date), leaps out: 57% of this year's respondents offer lifecycle funds. In 2004, only 28% of employers surveyed offered time-based lifecycle funds. The growth in the popularity of time-based lifecycle funds may have come at the expense of risk-based lifestyle funds. This year's survey shows 20% offering risk-based lifestyle funds, down sharply from 31% in the last survey. Money market funds were reported on the menus of less than half (49%) of employers, down sharply from 58% in the last survey (**Exhibit 2**).

Top indicator of a plan's success in the eyes of plan sponsors is participation rates. Curiously, given employers' long term worries about worker retention in the face of impending demographic shifts, employee appreciation ranked third, behind investment performance. This would indicate that poor investment performance would undermine employee appreciation of even the most generous or well-administered plans. Few (8%) employers identified cost effectiveness as their 'primary indicator' of plan success.

When asked to rank, based on feedback they have received, which aspects of their 401(k) plans were most confusing to employees, employers overwhelmingly (81%) identified 'where to invest/which funds to use.' The next most frequently identified source of employee confusion was 'how much to save for retirement,' chosen by 55% of respondents. Employers appear to be least concerned about lack of provider support, investment performance, or employee turnover.

Average participation rates have been on a plateau in recent years, averaging 76% this year, inching up slightly from 75% in the last survey. Meanwhile, the average deferral percentage for non-highly compensated employees stands at 5.69%—a generally respectable rate, at least for younger plan participants with decades of employment ahead of them.

A total of 436 employers participated in this year's survey. The Survey data reflects 2007 and early 2008 401(k) plan activity." ■

The complete report and industry data are available online. Web site: www.deloitte.com/dtt/article/0,1002,cid%253D210625,00.html

PENSION PLAN TRENDS

Pension Sponsorship and Participation: Summary of Recent Trends

Patrick Purcell, Congressional Research Service, September 8, 2008

“The number of private-sector workers between the ages of 25 and 64 whose employer sponsored a retirement plan rose from 51.2 million (or 57.2%) in 2006 to 53.5 million (or 59.5%) in 2007. The number of private-sector workers who participated in employer-sponsored retirement plans rose from 42 million (or 49.2%) in 2006 to 44.1 million (or 52%) in 2007 (Exhibit 3).

The proportion of 25 to 64 year-old workers in the private sector who participated in employer-sponsored retirement plans increased from 43.2% in 2006 to 45.1% in 2007.

Between 2000 and 2007, the number of private-sector workers between the ages of 25 and 64 who participated in employer-sponsored retirement plans fell from 46 million to 44 million.

The percentage of workers who participated in an employer-sponsored plan fell from 50.3% in 2000 to 45.1% in 2007.

Among private-sector workers aged 25 to 64 who were employed year-round, full-time, only 25.5% of workers at firms with fewer than 25 employees participated in an employer-sponsored retirement plan in 2007, compared to 45.5% of workers at firms with 25 to 99 employees and 65.4% of workers at firms with 100 or more employees. Among men and women who were employed year-round, full-time, 51.6% of men and 52.6% of women participated in an employer-sponsored retirement plan in 2007.

Only 43% of private-sector workers aged 25 to 34 and employed year-round, full-time participated in an employer-sponsored retirement plan in 2007, compared to 51.8% of workers aged 35 to 44, 57.4% of those aged 45 to 54, and 57.6% of those aged 55 to 64.

Black, Hispanic, and other nonwhite workers were less likely to have participated in an employer-sponsored retirement plan. Fifty-eight percent of white workers participated in a company-sponsored

Exhibit 3. Percentage of Private-Sector Employees Participating in Employer-Sponsored Retirement Plans, by Employer Size, March 2003 to March 2007

	All types	DB	DC
1-99 workers			
2003	35	8	31
2004	37	9	32
2005	37	9	32
2006	37	9	33
2007	37	9	33
100 or more workers			
2003	65	33	51
2004	67	34	53
2005	67	36	53
2006	67	33	54
2007	66	32	53

Source: Purcell, Congressional Research Service, September 8, 2008

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retirement plan in 2007, compared to 47.1% of black nonHispanic workers, 30.6% of Hispanic workers, and 48.5% of other nonwhite workers (mainly Asian-American and Native American workers).

Only 27.7% of workers whose earnings were in the lowest quartile in 2007 (under \$27,000) participated in a retirement plan at work, compared to 69.2% of workers whose earnings were in the top quartile (above \$63,000).

The percentage of part-time workers in the private sector whose employer sponsored a retirement plan rose from 37.8% in 2006 to 38.3% in 2007. Twenty-three percent of part-year or part-time workers in the private sector participated in an employer sponsored retirement plan in 2007, essentially unchanged from 2006.” ■

The 20-page white paper is available online. Web site: http://taxprof.typepad.com/taxprof_blog/files/r130122_sept_2008.pdf

PLAN ALLOCATIONS

Patience Is a Virtue: Asset Allocation Patterns in DB and DC Plans

Ilana Boivie and Beth Almeida, National Institute on Retirement Security, July 2008

In 1985, the largest differences in asset allocation were between private- (both defined benefit [DB] and defined contribution [DC]) and public-sector plans, largely because of restrictions that hampered diversification in public plans. Public-sector plans tended to invest much more heavily in bonds and less heavily in stocks and other investments, as compared with private plans.

However, each type of plan allocated the largest proportion of assets to stocks. Private DB plans designated 42.3% of funds to stocks, similar to private DC plans' 41.7% allocation. Public-sector plans allocated just 29.9% of funds to equities. All types of plans invested only a small percentage of assets in mutual funds, at 0.7% of funds for private DB plans, 1.2% for private DC plans, and 1.7% for public plans.

The different types of plans diverged the most during this time on allocation to 'other investments' (which included investments like real estate as well as insurance contracts and municipal securities). Private DB plans invested 19.6% and private DC plans invested 27.3% in these assets, while the public sector invested only 3.9% of funds in these "other investments.

By 2007, the picture had changed. The largest discrepancy was no longer between public and private funds, but rather between DB and DC plans. Public sector plans' asset allocation closely mirrored that of private sector DB plans, with both types invested most heavily in stocks. The proportion of funds allocated to stocks increased substantially, to 63% for private DB and 62.9% for public plans. Private DC plans, meanwhile, reduced their allocation to stocks,

to 37.2% of assets, but dramatically boosted their allocations to mutual funds.

Changes in equity allocations in DC plans have been much more volatile than those of public plans or private-sector DB plans. Overall, since 1985 all three types of plans showed similar standard deviations, with 0.07 for private DC, 0.06 for private DB, and 0.06 for public plans. The relative standard deviation, however, was just 3.0 for private DB and 1.8 for public-sector plans, but a sizeable 473.0 for private DC plans.

Within the last 15 years, the volatility in equity allocations for private DC plans remained similar to the 22-year total, at 0.06, while volatility for other plans declined slightly, to 0.05 for private DB and 0.05 for public plans. The relative standard deviation for the last 15 years shows that even in this shorter time-frame, changes in equity allocations in private DC plans have been much less stable than for other plans, with a measurement of 10.8 for DC plans, compared to 2.0 for private-sector DB plans and 2.3 for public-sector plans.

Using data from the Federal Reserve's Flow of Funds database and other sources, we [also] found that:

- Private-sector DC plans are more reliant on mutual funds and 'other investments' (a category that includes insurance contracts and municipal securities) than public plans or private DB plans. DC plans also hold more liquid assets than other types of plans.

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MARKUP *The Pension Scorecard for Key Legal Cases, Legislation and Regulations*

REGULATORY ITEM	PURPOSE		STATUS
FASB postpones further disclosure of postretirement benefit plan assets	<p>The Financial Accounting Standards Board (FASB) has agreed to postpone until 2009 the effective date of the changes it is making in Financial Accounting Statement (FAS) No. 132(R)-a, <i>Employers' Disclosures About Postretirement Benefit Plan Assets</i>. FASB members acknowledged that their deliberations have been slower than expected. The original effective date would have been for fiscal years ending after December 15, 2008.</p> <p>At the meeting, the board agreed to four objectives for disclosing information about plan assets in order to provide users of financial information with an understanding of (1) the nature and characteristics of the major categories of assets held in an employer's plan(s); (2) how investment allocation decisions are made by management, including the factors that are pertinent to an understanding of the employer's investment policies or strategies; (3) known or potential significant concentrations of risk within plan assets; and (4) the inputs and valuation techniques used to measure the fair value of plan assets.</p> <p>Disclosure of categories of plan assets must go beyond the broad categories of equity and fixed</p>	<p>income. The board believes that "employers should disclose the fair value of categories of plan assets based on the types of assets held in the plan, with further disaggregation of asset categories based on management's investment policies and strategies. For example, the category of common stocks could be further disaggregated between large-cap, mid-cap, and small-cap common stocks." The FASB staff believes that the list of asset categories "should include a category for investment funds segregated by type of fund (for example, hedge funds would be a separate category from mutual funds)."</p> <p>Disclosure of concentrations of risk continues to be controversial because of the cost needed to provide these figures and the fact that some entities, such as hedge funds, will refuse to provide such data. One suggestion would require the disclosure of significant concentrations of risk that have been discussed with a company's management, a committee of the board, or individuals who are responsible for making investment allocation decisions. The FASB staff believes that such disclosure would be confusing.</p> <p>Source: CCH <i>Pension Plan Guide</i>, Letter No. 1759, 11/3/08</p>	The effective date of FAS No. 132(R)-a has been shifted to fiscal years ending after 12/15/09.
Transfer of surplus assets from terminated DB plan to ongoing DC plan OK	<p>A company sponsoring a DC plan merged with a company that had sponsored a terminated DB plan. The DC plan covered all the participants of the terminated DB plan who remained employed by the company that maintained the DC plan, and all the surplus assets of the DB plan were transferred to the DC plan. This amount was at least equal to the excess of 25% of the maximum amount that the company maintaining the DC plan could receive as a reversion. Further, the amount transferred from the terminated DB plan</p>	<p>to the DC plan was allocated under the plan to the accounts of participants in the plan year in which the transfer occurred, or credited to a suspense account and allocated to accounts of participants no less rapidly than ratably over the seven-year period beginning with the year of the transfer, and the allocations were otherwise made in accordance with IRC § 4980(d)(2).</p> <p>IRS Letter Ruling 200836034 is available online. Web site: www.irs.gov/pub/irs-wd/0836034.pdf</p>	IRS private letter ruling confirms DC plan was a qualified replacement plan under IRC § 4980(d)(2).
New guidance on investment of plan assets and shareholder rights	<p>The Employee Benefits Security Administration (EBSA) has issued new guidance clarifying the obligations of plan fiduciaries concerning investments in economically targeted investments and shareholder rights. The guidance, issued in the form of two interpretive bulletins, reiterates that plan fiduciaries, who are charged by law with the responsibility for operating employee benefit plans on behalf of plan participants, may never increase expenses, sacrifice investment returns, or reduce the security of plan benefits in order to promote legislative, regulatory, or public policy goals that have no connection to the payment of benefits or plan administrative expenses.</p> <p>The bulletin on economically targeted investments supplements earlier guidance issued by EBSA addressing the limited circumstances under which ERISA fiduciaries may, in connection with investment decisions, take into account factors other than the economic interests of the plan.</p>	<p>The bulletin further clarifies, through explanation and examples, that fiduciary consideration of non-economic factors should be rare. Further, when considered, such discussion should be documented to demonstrate compliance with ERISA's rigorous fiduciary standards. The bulletin is available online at www.dol.gov/federalregister/HtmlDisplay.aspx?DocId=21631&AgencyId=8.</p> <p>The bulletin on shareholder rights updates prior guidance issued by the Labor Department on the application of ERISA's fiduciary standards to the exercise of shareholder rights and written statements of investment policy, including proxy voting policies or guidelines. The new bulletin includes clarifications of earlier guidance, as well as interpretive positions issued by the department since 1994 on shareholder activism and socially-directed proxy voting initiatives. The bulletin is available online at www.dol.gov/federalregister/PdfDisplay.aspx?DocId=21630.</p>	Workers' money must be invested and used solely to provide for retirements.

continued from page 4

- DC plans, where individuals make asset allocation decisions, appear diversified at a high level, but these data mask how assets are allocated at the individual account level.
- Over the past decades, public-sector pension plans have increased their equity allocation to catch up with their private-sector counterparts. Private-sector DC plans lowered their direct stock holding over the past two decades.
- Legal and regulatory obstacles to portfolio diversification have been reduced over time. This has

allowed public sector plans to better balance their asset allocations with their long-term investment goals.

- DC plans shift their allocation to and from corporate stocks more frequently than their DB plan counterparts do. This raises serious questions about the overall risk embedded in individual accounts, the consequences for retirement security, and the availability of long-term financing for productive business investments.” ■

The 12-page brief is available online. Web site: www.nirsonline.org/storage/nirs/documents/Patience%20is%20a%20Virtue.pdf

DEFINED BENEFIT PLANS

A Better Bang for the Buck: The Economic Efficiencies of Defined Benefit Pension Plans

Beth Almeida and William B. Forna, National Institute on Retirement Security, August 2008

“The value of traditional defined benefit (DB) pensions to employees is generally recognized: they provide a secure, predictable retirement income that cannot be outlived. But less well known is the value of a DB pension to an employer. Due to their group nature, DB plans possess ‘built-in’ savings, which make them highly efficient retirement income vehicles, capable of delivering retirement benefits at a low cost to the employer and employee. These savings derive from three principal sources:

- DB plans better manage longevity risk, or the chance of running out of money in retirement. By pooling the longevity risks of large numbers of individuals, DB plans avoid the ‘oversaving’ dilemma—that is, saving more than people need on average to avoid running out of cash—that is inherent in DC plans. Consequently, DB plans are able to do more with less.
- Because DB plans, unlike the individuals in them, do not age, they are able to take advantage of the enhanced investment returns that come from a balanced portfolio throughout an individual’s lifetime.
- DB plans, which are professionally managed, achieve greater investment returns as compared with DC plans that are made up of individual accounts. A retirement system that achieves higher investment returns can deliver any given level of benefit at a lower cost.

Because of these three factors, we find that a DB pension plan can offer the same retirement benefit at close to half the cost of a DC retirement savings plan. Specifically, our analysis indicates that the cost to deliver the same level of retirement income to a group of employees is 46% lower in a DB plan than it is in a DC plan. More specifically, this study finds that:

- Longevity risk pooling in a DB plan saves 15%,
- Maintenance of a balanced portfolio diversification in a DB plan saves 5%, and
- A DB plan’s superior investment returns save 26% as compared with a typical DC plan.

Because individuals do not have perfect knowledge as to whether they will remain in a given job (and therefore in a given DB plan) until retirement, taking advantage of the opportunity to save in a supplemental DC plan can provide employees with useful diversification of retirement income sources.

We compared the relative costs of DB and DC plans by constructing a model based on a group of 1,000 newly-hired employees that first calculates the cost of achieving a target retirement benefit in a typical DB plan. We expressed this cost as a level percent of payroll over a career. We then calculated the cost of providing the same retirement benefit under a DC plan.” ■

The five-page report is available online. Web site: www.nirsonline.org/storage/nirs/documents/bang_for_the_buck_faq.pdf

HEDGE FUNDS

Defined Benefit Pension Plans

Guidance Needed to Better Inform Plans of the Challenges and Risks of Investing in Hedge Funds and Private Equity

U.S. Government Accountability Office, August 2008

“The term hedge fund is commonly used to describe pooled investment vehicles that are privately organized and administered by professional managers and that often engage in active trading of various types of securities, commodity futures, options contracts, and other investment vehicles. From 1998 to early 2007 the number of funds grew from more than 3,000 to more than 9,000 and assets under management from more than \$200 billion to more than \$2 trillion globally.

Because hedge funds are typically exempt from registration under the Investment Company Act of 1940, they are generally not subject to the same federal securities regulations as mutual funds. They may invest in a wide variety of financial instruments, including stocks and bonds, currencies, futures contracts, and other assets. Hedge funds tend to be opportunistic in seeking positive returns while avoiding loss of principal, and retaining considerable strategic flexibility.

Like hedge funds, there is no legal or commonly accepted definition of private equity funds, but the term generally includes privately managed pools of capital that invest in companies, many of which are not listed on a stock exchange. Private equity funds typically make longer-term investments in private companies and seek to obtain financial returns through long-term appreciation. The amount of capital raised by private equity funds grew from just over \$2 billion in 1980 to about \$207 billion in 2007; while the number of private equity funds grew from 56 to 432 funds over the same time period. Private equity funds operate as privately managed investment pools and have generally not been subject to Securities and Exchange Commission (SEC) examinations. Investments in hedge funds and private equity are typically a small portion of total plan assets—about 4% to 5% on average—but a considerable and growing number of plans invest in them. While investment in hedge funds is less common than private equity, the number of plans with investments in hedge funds has experienced greater growth in recent years (Exhibit 4, page 8). Furthermore, survey data show

that larger plans, measured by total plan assets, are more likely to invest in hedge funds and private equity compared to mid-size plans.

Officials with most of the plans indicated that they invested in hedge funds, at least in part, to reduce the volatility of returns. They also stated that hedge funds are used to help diversify their overall portfolio and provide a vehicle that will, to some degree, be uncorrelated with the other investments in their portfolio.

Hedge fund investments pose investment challenges [that] include: (1) reliance on the skill of hedge fund managers, who often have broad latitude to engage in complex investment techniques that can involve various financial instruments in various financial markets; (2) use of leverage, which amplifies both potential gains and losses; and (3) higher fees, which require a plan to earn a higher gross return to achieve a higher net return. Whereas mutual fund managers reportedly charge a fee of about 1% of assets under management, hedge fund managers often charge a flat fee of 2% of total assets under management, plus a performance fee, of about 20% of the fund's annual profits.

Because many hedge funds may own thinly traded securities and derivatives whose valuation can be complex, and in some cases subjective, a plan may not be able to obtain timely information on the value of assets owned by a hedge fund. Further, hedge fund managers may decline to disclose information on asset holdings and the net value of individual assets largely because release of such information could compromise their trading advantage. In addition, even if hedge fund managers were to provide detailed positions, plan sponsors might be unable to fully analyze and assess the prospective return and risk of a hedge fund. As a consequence, a plan may not be able to independently ascertain the value of its hedge fund investment or fully assess the degree of investment risk posed by its hedge fund investment.

Hedge funds offer investors relatively limited liquidity; that is, investors may not be able to redeem a hedge fund investment on demand because of a hedge fund's redemption policy.

Exhibit 4 Extent of DB Plan Investments in Hedge Funds and Private Equity, 2006		
	Greenwich Associates	Pyramis Global Advisors
Sample	164 public sector plans; 420 private sector plans, including 17 collectively bargained plans; All plans had \$250 million or more in total assets	90 public sector plans; 124 private sector plans; All plans had greater than \$200 million in total assets
Share of plans that invest in hedge funds		
All plans	27%	21%
Public sector	24	17
Private sector	28	25
Private sector: collectively bargained	47	n/a
Share of plans that invest in private equity		
All plans	43	41
Public sector	51	44
Private sector	40	38
Private sector: collectively bargained	71	n/a
Source: U.S. Government Accountability Office, August 2008		

Pension plans investing in hedge funds are also exposed to operational risk—that is, the risk of investment loss due not to a faulty investment strategy, but from inadequate or failed internal processes, people, and systems, or problems with external service providers. Operational problems can arise from a number of sources, including inexperienced

operations personnel, inadequate internal controls, lack of compliance standards and enforcement, errors in analyzing, trading, or recording positions, or outright fraud.” ■

The 71-page report is available online. Web site: www.gao.gov/new.items/d08692.pdf

RETIREMENT ATTITUDES

Rethinking Retirement Survey

Charles Schwab, August 2008

“Most Americans (52%) surveyed optimistically view retirement not as a time to wind down, but as an opportunity for a new, exciting chapter in life. Younger people surveyed are concerned their retirement won’t measure up to previous generations: 49% chose ‘Previous generations had/will have a better life in retirement than my generation.’

More than half of Americans surveyed are either minimally prepared or haven’t even started to prepare for retirement yet.

- 19% chose ‘I have actively planned and am confident I will have sufficient funds.’

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Q&A O N P E N S I O N S

Retirement Plans and the Economy

Q. What impact will the state of the economy have on retirement plan savings?

A. In the long run, hopefully very little. Over an employee's working lifetime, it should be expected that the value of plan investments will go up and down. There are many different factors that drive the market; the economy is only one of them. Since the purpose of a retirement plan is to accumulate assets for retirement, an investment professional will generally suggest a retirement account investment portfolio designed to produce steady growth over time. Usually, it will be comprised of different asset classes that perform differently in different market conditions. This is why it is very important to make investment decisions with the assistance of an experienced investment professional who understands the forces that drive the price of investments, how they interact with each other, and the other dynamics that play a part in investment return.

The law only requires plan assets to be valued annually. Daily valuation of retirement plans is fairly new. The good news is that it creates a real-time environment in which participants can track their account's investment performance. The bad news is that it can create artificial cause for concern anytime asset values drop.

Investment selection is not just important at the participant level, it is also important with respect to a fiduciary's selection of fund offerings and investment advisors. The key to getting a retirement plan through these uncertain economic times is education and a refresher course on the protections offered under the Employee Retirement Income Security Act (ERISA).

Q. What protections do plan participants have with respect to their retirement plan accounts?

A. With all the talk of "federally insured" and "bailout," many Americans wonder if their retirement plan savings are safe. There is no federal insurance program that protects a participant's account value. The Pension Benefit Guaranty Corporation (PBGC) has an insurance program that protects defined benefit (DB) plan participants, but it does not apply to defined contribution (DC) plans. The Federal Deposit Insurance Corporation (FDIC) does not insure money invested in stocks, bonds, mutual funds, life insurance policies, annuities, or municipal securities, even if these investments were bought from a bank. And the Securities

Investor Protection Corporation (SIPC) only insures investors if the broker investing the assets becomes insolvent.

Rather, 401(k) plan assets are protected by the regulatory environment in which they are forced to operate, specifically the fiduciary standards to which ERISA holds those responsible for the operation and investment of retirement plans. For that reason, it is more important than ever for plan fiduciaries to follow ERISA's guidelines and carefully document their steps. The two benchmarks of ERISA's code of conduct are the "prudent expert rule" and the "exclusive benefit rule." Each has very practical applications in the day-to-day operation of a retirement plan, and each provides standards of practice that should be implemented and executed as part of a comprehensive administrative policy.

Q. What is the prudent expert rule?

A. The prudent expert rule is one of the cornerstones of ERISA. Interestingly, the standard of prudence as it relates to ERISA fiduciary conduct is a higher standard than for general trust purposes. ERISA requires that a fiduciary manage a portfolio "with the care, skill, prudence, and diligence, under the circumstances then prevailing, that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."

This statement differs from the classic "prudent man rule" because of the insertion of the phrase "and familiar with such matters." This standard of familiarity suggests that professionals may need to be consulted. This is a very important distinction to make. Even if participants are able to direct the investments of their retirement accounts, plan fiduciaries remain responsible for the selection and monitoring of fund offerings. To the extent those within an organization are not investment experts, it is their legal obligation to secure expert advice. In fact, the mere selection of advisors is a fiduciary act in and of itself.

The selection of advisors requires that fiduciaries keep in mind the principles of ERISA. In many instances, providers and advisors are selected for reasons other than their status as an expert. A provider may be selected by word of mouth or because the plan sponsor has other business relationships with the provider. While at first glance, there would appear nothing wrong with selecting an advisor that the

plan sponsor already works with, to do so without due diligence could be a violation of not just the prudent expert rule but also the exclusive benefit rule. The process is mandated by ERISA. For example, even if a plan's investments performed well, if the performance was by accident or advisors were selected imprudently, the plan fiduciaries could still be considered to have violated ERISA and there could be civil sanctions and costly corrections. This time of economic downturn and investor skepticism makes it more important than ever to revisit ERISA's basic guidelines.

Q. What is the exclusive benefit rule?

A. The exclusive benefit rule is another standard bearer of ERISA. This rule mandates that fiduciaries act solely in the interest of participants and beneficiaries, subject to payment of reasonable administrative expenses. In these volatile times, it is likely that there will be many inadvertent violations of the exclusive benefit rule by well-meaning business owners who are trying to keep their retirement plans and businesses on track, specifically with respect to the selection of advisors.

For example, in order to attract or retain a client, a provider may encourage a company owner to place all his eggs in one basket; in return, the employer would receive more favorable lending rates or investment offerings. While this would appear to make good sense in the aggregate, it is a classic violation of the exclusive benefit rule because the decision maker is making decisions regarding the plan operations in conjunction with his or her business interests.

All decisions made with respect to a retirement plan must be made in a vacuum and cannot be made purely based on price. Violations of the exclusive benefit rule, even if unintentional, are generally considered prohibited transactions. ERISA prohibits plan fiduciaries from benefiting through a prohibited transaction, whether or not participants benefit. For example, if a plan sponsor was offered a favorable corporate loan rate in conjunction with moving the company's retirement plan to the loan provider, this would be considered a violation of the exclusive benefit rule, and the benefit to the employer would be considered a prohibited transaction. This would be the case even if the retirement investments performed well. The prohibited transaction would need to be undone and restitution made to the plan. Correction would involve

paying off the loan or moving the plan assets to another provider. The employer would also have to pay to the plan the amount of any value received—in this case, the difference between the rate that would have been paid in interest on the corporate loan and the prevailing interest rate for an arm’s-length transaction.

Q. How do you know plan sponsors are doing it right?

A. Under audit, a plan sponsor can expect questions about whether the plan’s investment policy statement has been used and followed. A plan sponsor is going to want to be able to illustrate the process used in selecting investment options, the process used in selecting advisors, the process used for monitoring investments options and advisors, and the completeness of plan records documenting this selection and monitoring process.

Another way to be sure plan sponsors are doing it right is to educate them. In an interesting DOL settlement, plan officials

and the board of directors of a company were banned from any type of fiduciary involvement in their company’s employee benefit plans for one to two years unless they completed “fiduciary training.” This case highlights the importance of fulfilling ERISA plan fiduciary obligations. At the very least, any plan sponsor must know who a fiduciary is, remembering that titles mean little, and the liability involved. Noncompliance is personal, not corporate. More often than not, they will need carefully selected professionals assisting in the operation of a plan.

Q. How can plan sponsors be helped to uphold ERISA?

A. Risk-management is essential. All plan sponsors should have a play book, a carefully drafted investment policy statement (IPS) that documents a plan’s investment and investment provider selection as well as the monitoring process. It is also widely suggested that independent plan trustees be named as opposed to relying on a corporate trust department, even

if the role of the independent trustee is merely to select a corporate trustee.

Plan sponsors should also consider a periodic investment fiduciary review, which will reveal how well they are doing with respect to upholding their ERISA obligations. Again, the two keys are document and educate. Plan sponsors are urged to document investment, vendor, and manager search and selection, IPS creation, monitoring, reporting, and processing.

With respect to education, a system of fiduciary governance should be set in place through a series of sessions identifying plan strengths and weaknesses, the IPS process, fiduciary and investment selection, and review systems. Plan sponsors also need to develop a system for keeping up with regulatory changes.

Amy Cavanaugh is a retirement plan consultant and frequent author and public speaker on a wide range of retirement topics. She is a partner in *pensionpodcasts.com*.

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- 27% chose ‘I have actively planned but am worried I will not have sufficient funds.’
- 16% chose ‘I have minimally prepared but am confident I will have sufficient funds.’
- 24% chose ‘I have minimally prepared and am worried I will not have sufficient funds.’
- 15% chose ‘I haven’t started preparing for retirement yet.’

At least \$500,000 will be required to live comfortably in retirement, according to the survey’s median response. That’s twice the median net worth of today’s preretirees.

‘Living within my means’ (40%) and ‘investing wisely’ (39%) are the top two strategies for achieving a financially secure retirement, according to the survey.

People believe old age has been delayed to 75 or later. Yet, most Americans surveyed still think people should start receiving Social Security benefits at age 63.

The massive size of the Baby Boomer generation is the major problem ahead for our retirement system, according to 76% Americans surveyed.

Americans of all ages feel uncertain about the long-term prospects of Social Security and the strains it’s putting on our country. Of those surveyed, 60% fear for the future of the program, 45% are frustrated by its prospects, 15% are optimistic, and only 5% feel secure. A third of Gen Y individuals surveyed do not expect to receive any Social Security benefits.

Sixty-eight percent of Americans surveyed want to fix Social Security, not ditch it.

When asked approximately what percentage of your retirement funds will come from specific sources, 50% chose ‘Myself and/or my spouse, through personal savings, investments, inheritance, IRAs, 401(k), 403(b), etc.’ 20% chose ‘My employer, through a pension,’ and 25% chose ‘The government, through Social Security.’

Across all generations, 80% say they acquired financial management skills on their own. About half ‘know a little’ about money management but only 4% have a high level of expertise. When asked to grade who they trust for reliable information about financial security during retirement, respondents gave professional financial advisors a C+, and gave employers a C.

Seventy percent want their employers to provide professional financial advice. Sixty-nine percent want advice about retirement preparation beyond 401(k), 403(b) or similar plans. Three-quarters of those surveyed want to make their own investment decisions but have access to help when they need it.

When asked what they like about investing in a 401(k), 403(b) or similar plan, 43% picked ‘My employer provides a match on part of the money I save’ and 28% chose ‘It’s an easy way to save for retirement because it comes right out of my paycheck.’

A total of 3,866 interviews were conducted among 21- to 83-year-olds.” ■

Survey results are available online. Web site: <http://rethinkingretirement.schwab.com/about/reinventing.php>

RETIREMENT SAVINGS

How America Saves 2008

Vanguard, August 2008

“More than 300 Vanguard plans had adopted automatic enrollment by year-end 2007, triple the number of plans that had the feature in 2005. Large plans have been more likely to implement automatic enrollment designs. In 2007, Vanguard plans with automatic enrollment accounted for 15% of plans but one-third of total participants. In the aftermath of the 2006 Pension Protection Act (PPA), two-thirds of automatic enrollment plans have implemented automatic annual savings rate increases, up from just one-third in 2005.

Target-date funds continue to grow in importance in defined contribution (DC) plans as an automatic investment approach. Six in 10 plan sponsors offered target-date funds at year-end 2007, up two-fold from three in 10 at year-end 2005. Four in 10 participants owning target-date funds have 100% of their account in a single target-date fund. Among new enrollees owning target-date funds, seven in 10 have 100% of their account in a single fund.

As of year-end 2007, one-quarter of Vanguard DC plans have chosen a qualified default investment alternative (QDIA), including plans with both automatic and voluntary enrollment. Of those plans choosing a QDIA, 84% selected a target-date fund and 16% a balanced fund. Only 4% of Vanguard plans still use a money market or stable value fund, down from 25% at year-end 2005.

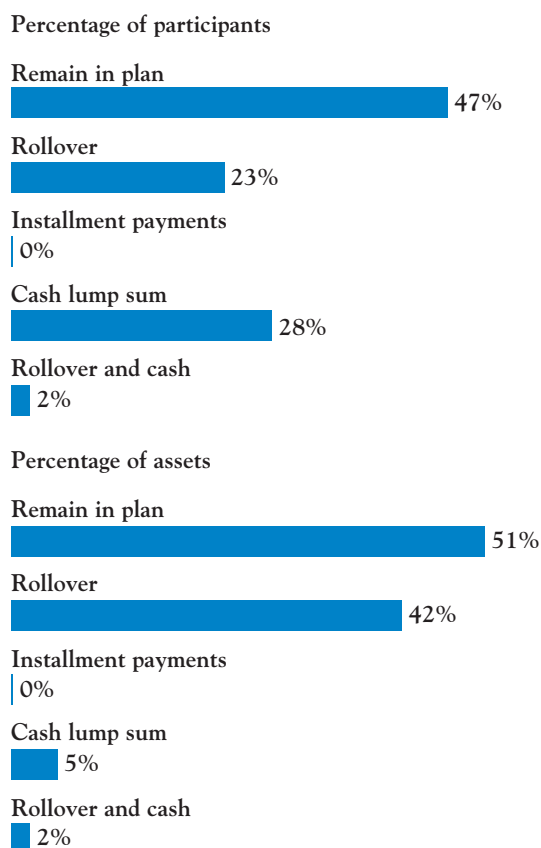
At year-end 2007, the Roth feature was adopted by 24% of Vanguard plans; 6% of participants within these plans had elected the option.

Three-quarters of employees participated in their 401(k) plan and the average deferral rate was 7.3% (median 6.0%), essentially the same as 2000. The composite participation rate for all eligible participants across all plans was 66%, a statistic perhaps more representative of the savings challenge facing workers.

Participants allocated 73% of their account balance to equities and 74% of their 2007 contributions to equities—a slight uptick in equity exposure during the year, though still below the levels of 2000. Equity allocations continue to vary dramatically among participants. About one-third of participants have taken extreme positions, holding either 100% equities (17% of participants) or less than 20% of equities (14% of participants).

Participant account balances continued to advance in 2007. The average Vanguard account balance grew

Exhibit 5. Plan Distributions from Vanguard Defined Contribution Plans, 2007



Source: Vanguard, August 2008

to \$78,411 (the median was \$25,196) at year-end. Average and median account balances have grown by 60% and 70% respectively since 2000.

A shift away from company stock holdings first observed in 2006 continued into 2007. Among those plans offering company stock, the number of participants holding a concentrated position of more than 80% of their account balance fell almost by half, from 15% in 2005 to 8% in 2007.

Only 15% of participants made one or more trades (exchanges) during 2007. Overall trading levels remained very low. The majority of participants make

no trades in a given year—not even to rebalance their account to a target asset allocation.

In 2007, 16% of participants had a loan outstanding and on average had borrowed about 12% of their account balance—figures essentially unchanged over recent years. Participants borrowed only about 2% of aggregate plan assets.

During 2007, 4% of participants took an in-service withdrawal, taking about one-quarter of their account balances. All in-service withdrawals during 2007 were less than 1% of aggregate plan assets. Hardship withdrawals, a subset of in-service withdrawals, were up over earlier years, but affected less than 2% of participants.

During 2007, about one-third of all Vanguard participants could have taken their account balance as a cash distribution because they had separated from service in the current or prior years. However, only 17% of these participants did so, while the majority (83%) continued to preserve their plan assets for retirement (**Exhibit 5, page 11**). In terms of assets, 97% of all plan assets available for distribution were preserved, and 3% were taken in cash.” ■

The 70-page report is available online. Web site: <https://institutional.vanguard.com/iwe/pdf/HAS08.pdf>

FIDUCIARY DUTY

Private Pensions: Fulfilling Fiduciary Obligations Can Present Challenges for 401(k) Plan Sponsors

U.S. Government Accountability Office, July 2008

“In our survey, the primary decision maker for selecting service providers for investment options was the sponsor committee for 283 of 445 respondents and sponsor management for 108 respondents. For selecting providers of record keeping, the primary decision maker was the sponsor committee for 256 of 445 respondents and sponsor management for 135 respondents.

In our survey, 362 of 448 sponsors said they benchmark the investment performance of the 401(k) plan. Of those who do benchmarking, 297 respondents said they benchmark each option to the performance of a peer group as one way of monitoring performance. As part of this monitoring of fund options, efforts of sponsors may include reviewing reports about the performance of the funds, holding meetings, placing poorly performing funds on a watch list, ultimately removing funds or replacing them with better options, and documenting their decisions.

The entity primarily responsible for monitoring the performance of the plan investments as compared to investment goals or policy was frequently the plan sponsor committee (214 of 443 respondents) or an external investment/financial adviser (107 respondents).

Regulation on investment duties specifies factors for sponsors to consider for prudent investment decisions. This planning may be documented in a written investment policy

statement (IPS), which 339 of 440 sponsors responding to our survey have. According to our survey, 208 of 339 respondents said the sponsor’s committee was the primary decision maker for establishing a written IPS.

Of 445 sponsors responding to this survey question, 308 said they use a third-party investment adviser. For 170 of 438 sponsors, a sponsor committee monitors plan investment decisions for potential conflicts of interest, while an external investment/financial adviser does so for 94 of the sponsors.

While plan sponsors may hire various advisers and consultants to provide advice on the selection and monitoring of investment funds, fiduciary duties may be distributed differently depending on the service arrangement. For example, an investment adviser who recommends investment funds to a plan sponsor for a fee, may be a fiduciary under ERISA. In contrast, if the sponsor is selecting funds from a broker and the broker provides no investment advice, the fiduciary obligations may lie entirely with the sponsor under ERISA.

For this report we collected and analyzed industry research and information from the Department of Labor, as well as previous GAO work. We also conducted a Web-based survey in coordination with *Plansponsor Magazine*.” ■

The 40-page report is available online. Web site: www.gao.gov/new.items/d08774.pdf