



CLEARPOINT FINANCIAL

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RUNNING THE FUND: BALANCING ACT

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DC plan menu shifts draw greater focus on transition planning

Imagine you're out driving on the interstate, on your way to the big meeting, and you pick up a nail in your right front tire. You can't drive 30 more miles on a flat, but if you stop to change it, you'll be late for the meeting, and look like a mess besides. You need some way to change the tire, but keep cruising at 65.

The logistical challenge is much like what defined contribution (DC) sponsors face when making a big overhaul to their investment options: How can I swap out these old funds for new ones, while leaving the plan open so participants can change their investments? Portfolio transitions in DC plans have been growing as 401(k)s supplant defined benefit (DB) plans, and with the passage of the Pension Protection Act, many more plans seem likely to be interested in enhancing their current fund lineup into better default options. Without the right planning and mechanics, however, the transition could be a dirty and costly job.

It is tempting to think a 401(k) transition would be a simple switch: just selling out all the shares of the old, "legacy" investment option, and using the cash to buy in to the new target—that is, in fact, the way things were done in the "good old days." However, that can run afoul of the fiduciary responsibility of the sponsor and the manager: "If you take the

approach of 'cash out and cash in,' you're potentially exposed to an entire trading day of unintended exposure to cash, when your participants want a capital market exposure," reports Brian Roberts, head of North American transition management for Russell Investment Group in Tacoma, Washington.

In that sense, the goals of DB and DC plan shifts are the same:

Few pension sponsors would dream of liquidating a portfolio one day, only to buy it back the next, so they hire transition managers to move the investments, serving, in the interim, as an asset allocator and investment adviser. Going to cash and back would entail round-trip commissions, Roberts says, and even if those charges are not generally applicable to the ubiquitous mutual fund investments in the 401(k), every day in the market counts: "By missing the 10 largest trading days for the S&P 500 in the last few years, you would have missed half the gain." If the cash exposure extends to several days, he notes, the loss can grow to several hundred basis points. "That's not annualized; that's the real thing."

More Constituencies

Ironically, a DC transition is more complex than its DB counterpart, with greater operational burdens associated with participant accounting and the "headline risk" that accompanies making changes to thousands of employee accounts. Roberts enumerates the interested parties: "You've got the legacy managers, the target

managers, and sponsor, as in a DB transition, but there are also the recordkeepers and, of course, the participants." Plan consultants, custodians, and master trustees have to be in the loop as well.

"You can't use a DB transition mindset for a DC transition," contends Ravi Goutam, chief of U.S. transition services for Barclays Global Investors, San Francisco. For a conventional DB transition, a manager might get the first call from a sponsor on a Monday, and finish the trade by end-of-day Friday but, with 401(k) moves, Goutam says, "There's more project management, and more strict adherence to timelines."

Transition managers report that proper planning for a DC transition can take from six weeks to six months. "Whiteboarding and mapping are very important, working with the client to think out the potential pitfalls, and the need to preserve daily access to the funds for participants," says Roberts.

Sometimes cash is the most effective vehicle, although, in many cases, the transition will be carried out "in kind." "Some mutual funds allow for transactions in securities, rather than cash, so we can take a slice out of the legacy fund, transform it into the target fund, and deliver an intact slice to the target manager," Roberts explains. "All decisions are toward improving the performance of the portfolio and lowering cost."



RUNNING THE FUND: BALANCING ACT (CONTINUED)

“You need to know what the historical fund flows look like,” says Kevin Hardy, Senior Vice President at Northern Trust in Chicago, and head of the bank’s global transition management unit, “and be certain you are providing enough liquidity for the participants to trade during the transition, but you don’t want to expose the old fund, or the new target funds, to too much cash.”

The sponsor has to think like an investor, too, Hardy notes. “If a sponsor announces, ‘We’re going to be transitioning on June 5th,’ it can compromise the transaction: If there are positions that will have a big market impact, or if a lot of company stock will be changing hands, it can lead to the abuse of important market information. We have confidential conversations with the sponsors on the implications of the trade,

and work with them to find the best way to communicate the news to participants.”

The Participants—It’s Their Money

A DC transition also brings closer scrutiny from the parties who really have skin in the game. “In DB plan transitions, participants seldom are aware that any changes are happening, and the effects of the transition are rolled up in the overall performance of the plan,” says Hardy. “Now, the participants are involved directly and have a bigger role to play. They ultimately decide which funds will go into the plan, and the transition can mean a big day-to-day impact for them.” This is especially relevant when a DC transition will take place at the time of a merger or spin-off, when participants’ attention will be focused even more

sharply on changes in benefits.

Participants surely will notice any unusual costs in a transition, since they are transmitted directly into the net asset value of investment options. “The worst thing, however,” explains Hardy, “is to have to tell the participants that the funds will go through a long blackout period”—where trading is shut down for several days. “Instinctively, you would think you have to close the funds for a while to get all the transactions done but, in some cases, it’s not necessary.”

Barclays’ Goutam puts it more succinctly: “Zero blackout period—that’s a baseline metric that should be used in evaluating a DC transition.” He adds: “Was it effected seamlessly, without disrupting participants’ access to their funds? Did the transition manager burden the sponsor?”

DEFINED BENEFIT PLAN SUMMIT: TURNING POINT

On December 6-8, 2006, more than 100 plan sponsors and industry experts gathered in our nation’s capital for PLANSPONSOR’s 2006 DB Summit. Titled “The Point of No Return,” the conference focused on the unique challenges confronting defined benefit (DB) plans, and their prospective role in national retirement income security policies.

Following is a brief summary of a few of the sessions. Expanded coverage—and audio files of the sessions—are available online at www.plansponsor.com

PPA Guidance—Speak Now or Forever Hold Your Peace

Speak up now was the message of a panel of industry experts at PLANSPONSOR’s 2006 DB Summit in Washington. While the 900+ pages of the PPA legislation offer a framework for improving retirement benefit offerings from U.S. employers, the details necessary for enacting the provisions of the PPA will create an enormous amount of regulations, pointed out Judy Schub, Managing Director at the Committee on Investment of Employee Benefit Assets (CIEBA).

Schub suggested plan sponsors let regulators know of problems informally before

proposed regulations come out. Panel member William Sweetnam, Principal at the Washington-based Groom Law Group, told the DB Summit audience that regulators need people to tell them how the rules will work practically. Comments to regulators should say, “Here’s the rule. It doesn’t work in this situation. How do we get from here to there?” Then, sponsors should suggest a workable solution, Sweetnam said.

Communicating DB Change to Participants—Just Be Real

At a time when new retirement legislation and pension accounting rules are prompting plan sponsors to make changes to their defined benefit offerings, whether it’s a DB plan freeze, cash balance conversion, or restructuring of DB benefits, panel members at PLANSPONSOR’s 2006 DB Summit in Washington advised audience members to just be real when communicating the changes to participants.

J. Randall MacDonald, Senior Vice President, Human Resources, at IBM, said his firm erred on the side of complete transparency when it communicated the switch from a defined benefit to a defined contribution model last year. Facts laid out for its 175,000 U.S. employees said

the move was “all about labor cost reduction.” According to MacDonald, IBM showed DB plan participants the company’s position relative to competitors, and spoke about market volatility, anticipated legislative reform, and participant longevity.

Brian Birmingham, Vice President, Institutional Market Strategy, at Genworth Financial, said relevance to participants is the key to communications. In addition to telling participants what the change specifically means to them, Birmingham also advised sponsors to address participants’ main questions realistically: “Why is the company making the change?” “Is the company in trouble?” Birmingham noted that, even if participants will not be affected, they may feel fear of plan changes—and this can be a good opportunity to reinforce the value of the DB benefit.

Do Public Plans Provide the Model for Retirement Offerings?

While defined benefit plans have been getting a bad rap lately, a panel of industry leaders at PLANSPONSOR’s DB Summit said DB plans contain elements that are too valuable to discard, and offered an idea for what the best retirement offering should look like.



DEFINED BENEFIT PLAN SUMMIT: TURNING POINT (CONT.)

Jeannine Markoe Raymond, Director of Federal Relations at the National Association of State Retirement Administrators (NASRA), suggested they are also the most economic means for sustained income after retirement. Employers are better able to shore up retirement funds than employees themselves, Raymond added. She also pointed out that economies of states are helped by maintaining the income—and spending—of workers after retirement. Media coverage of the situations in the airline, auto, and steel industries has made the DB situation seem dire but, in reality, most DB plans are well-funded.

Kenneth Friedman, Consulting Actuary at

Milliman, said there would have been no “perfect storm” if companies had put into their DB plans in the 1990s what they are willing to put into DC plans—and what they are now promising in DC enhancements as they move to freeze their DB programs.

Think Twice before Freezing DB Plan

Media reports show a trend of plan sponsors freezing their defined benefit plans and moving to or enhancing their defined contribution offerings, but a panel of speakers at PLANSPONSOR’s 2006 DB Summit said there are a number of things to consider before jumping on the bandwagon.

According to Theodore Economou, Assistant Treasurer at ITT Corporation, freezing a DB plan becomes less attractive when a company realizes the move only provides funding relief over the long term and does not relieve plan liability. He suggested asset management strategies are just as, or more, effective at managing DB plan risk as freezing the plan or changing plan design.

The panel also noted that a pension freeze is a decision best postponed, as now is not a favorable time to freeze due to the interest rate environment.

THE POINT OF NO RETURN

We live in a dynamic and constantly changing world. We live longer and labor differently than our parents did.

Last month, it was my privilege to act as co-host and moderator for our first-ever Defined Benefit Summit. The setting—Washington—was auspicious and inspiring, and the topics were suitably reflective of the complexities confronting our nation’s defined benefit system. We were fortunate to have panelists who both understood and could help shed light on those complexities and an audience that was both responsive and engaged in the dialogue that ensued.

We had chosen “The Point of No Return” as the underlying theme for the conference, a choice that, as I told those in attendance, no doubt brings with it some ominous overtones. However, I reminded conference attendees that, in reality, a point of no return is simply the point beyond which you cannot go back to the point at which you started. If you are piloting a plane, it simply means you lack the fuel to return to your point of departure. It does not, however, mean that you necessarily wind up in a bad place, or that you should brace for a crash. In fact, in the vast majority of situations, it means that you wind up exactly where you intended.

Indeed, as anyone can attest who has ushered a child off to college, departed “home” for a place of their own, or said final farewells to a loved one, life has a certain relentless forward motion. Still, I’ll concede that the

point of no return has a negative ring to the ears. Perhaps it is the inclusion of the word “no” or, maybe, we just hate to have choices—even bad choices—removed from “the menu.”

Things will be different for defined benefit plans going forward, though perhaps not as dramatically, or as negatively, as some now proclaim, IMHO. It is easy to be drawn into the persistent negativism regarding pensions by the incessant drumbeat of the headlines. Still, there was a surprisingly resilient faith in the system in evidence at the conference, from both panelists and audience members alike (there were certainly “naysayers” present as well). One might well argue that attendees at a conference focused on defined benefit plans might be predisposed toward favorable outcomes for that system, but there was a certain “real world” grounding in the perspectives there that all too often is lacking from the academic treatises and simplistic headlines that bombard us today.

The vast majority of defined benefit plans are in reasonably sound financial condition, and getting better all the time, courtesy of good markets, rising interest rates, and employer contributions. By most accounts, the impact of the new Financial Accounting Standards Board (FASB) rules reportedly has been anticipated by employers and, just as importantly, the markets. By the time the

more restrictive bounds of the Pension Protection Act take hold, the improved funding status of many plans will doubtless soften that blow as well.

Changes lie ahead, both in terms of funding and plan design - that was the near-unanimous sense of those present—but those are nothing new to plan sponsors. Will the pace of change accelerate? Almost certainly. Will that continue to drive some employers to freeze and/or terminate their current defined benefit plans? Will some make shifts in the asset allocations? Count on it. Will the headlines continue to focus on those who have set those designs aside? Will there be those plans that have, through omission or commission, allowed the financial integrity of those programs to deteriorate? Be serious.

We live in a dynamic and constantly changing world. We live longer and labor differently than our parents did. The Baby Boomers (and those that employ them) already may well have, in large measure, “outgrown” the kind of career commitments that current defined benefit designs reward. What we haven’t outgrown is the need for a dignified, financially secure retirement.

We are indeed at “The Point of No Return.” Yet, there’s opportunity—and no shortage of challenges—just ahead.

ARE LABOR UNIONS BEGINNING TO LOOK BEYOND DB PLANS?

It's an oft-repeated cliché: Defined benefit (DB) plans are dinosaurs on the path to extinction. The number of DB plans has experienced a dramatic decline in the last 15 years, and the pace of demise is quickening. Almost a third (29%) of companies in the U.S. and Canada with DB plans that are currently active say they will close, freeze, or terminate their pensions by the end of 2007, according to a recent poll by Service Employees International Union (SEIU). However, while there are far fewer private sector DB plans, labor unions have clung stubbornly to the notion that workers' retirement security is best served by plans providing guaranteed retirement income. There are signs, however, that unions may be quietly changing course.

Recent press reports have alleged that the AFL-CIO and SEIU are reconsidering retirement plan design. "[However,] press reports misconstrued the AFL-CIO and SEIU positions," says Richard Ferlauto, Director of Pension and Benefit Policy for the American Federation of State, County and Municipal Employees (AFSCME) in Washington. The AFL-CIO's discussion was not about changing union plan design, he says, but about the best way to provide retirement security for all U.S. workers so that a repeat of the 1930s—when millions retired into poverty—does not happen. Both the AFL-CIO and SEIU were contacted for this article, although neither commented.

The SEIU is considering new designs for retirement plans, but only for workers with no retirement benefits at all, says Jack M. Marco, Chairman of Marco Consulting Group in Chicago, and a consultant to the SEIU. There are absolutely no discussions of making changes to DB plans already in place for SEIU members, says Marco.

Some unions, however, are reconsidering plan design for the future, even for those currently covered by DB plans. Retirement plan design is a topic currently being discussed by the National Coordinating Committee for Multiemployer Plans (NCCMP) members, says Randy DeFrehn, Executive Director of the NCCMP in Washington. The discussion centers on how to provide retirement income security for the next 20 or 30 years. The question being asked, he says, is, "Will the current defined benefit structure continue to serve us as well as it has in the past, or will changing demographics require changes?" A handful of unions are rethinking

retirement plans and trying to move outside the boxes of traditional DB and defined contribution (DC) plans, agrees David Blitzstein, Director of Negotiated Benefits for the United Food and Commercial Workers International Union (UFCW) in Washington. Some of the larger unions, including the UFCW, are thinking hard about the subject and trying to expand the debate beyond just DB versus DC, he says.

The SEIU also is trying to see if there is something in between a DB and 401(k) plan that employers would be willing to adopt—for example, a DC plan with employer contributions and automatic payroll deductions for employees. Contributions would be deposited into lifecycle-like funds, so that employees do not have to make investment decisions.

The ultimate goal is to determine what plan designs meet both the needs of the sponsor and the needs of the participants, says DeFrehn, particularly as to making sure that participants get the benefits they are entitled to when they retire.

Hybrid models, such as cash balance plans, are being considered also. Multiemployer cash balance plans already exist, says DeFrehn, although mostly as supplements to DB plans that provide - annuities. One advantage to cash balance plans is that they provide participants with more downside protection than DC plans, he says.

One current retirement structure that appears to be off the table for the unions is the traditional 401(k). Low-paid employees do not have the money to contribute to 401(k)s, says Marco, and also do not have the expertise to make the right investment choices. DC 401(k) plans are an adequate supplement, but should not be a worker's primary retirement plan, says Ferlauto.

Unions are rethinking retirement plan design because they have to, says Blitzstein. "Defined benefit plans are in full-scale retreat," he says. "They are being frozen, and employers are trying to get out from under the liabilities." Multiemployer pension plans, with few exceptions, notes Blitzstein, are not growing, partly because it is difficult to convince employers to participate in such programs.

Employer resistance to DB plans also comes into play. Employers generally balk at setting up or contributing to a DB plan. Consequently, sometimes a compromise is needed to get any level of retirement security for union members. Unions have an obligation to get retirement coverage for members, says Blitzstein. There is a huge coverage gap in the U.S., and organized labor wants to close that gap. "We want to bring people into the system and to prepare for the retirement portion of their lives," he says.

Labor unions, however, now are organizing very-low-paid workers whose employers are particularly unwilling to set up or contribute to DB plans, says Marco. "It comes out of the challenges of organizing the lowest-paid workers such as janitors." These workers usually have no benefits; in addition to seeking higher wages, the SEIU is negotiating to get health insurance and retirement plans.

Another issue being tackled alongside plan design is funding of current DB plans. Taft-Hartley funds are, as a rule, better funded than single-employer plans, says Marco. In Taft-Hartley plans, Marco points out, contributions are negotiated so contribution levels cannot be manipulated. The same is not so true, however, with union-negotiated plans sponsored by the employer. The problem there, says Marco, was that unions negotiated the benefits but not the funding of the plans. "It was similar to the public model, and it was up to the employer to fund that plan, and that's been the problem," he says.

The bottom line issues are how to keep employers already contributing to continue contributing to workers' retirement and, if not contributing, how to get them to do so, says Blitzstein. "We could stick our heads in the sand, become defensive, and ignore the changes around us, or look at the situation and rebuild a system we helped to create 50 years ago," he says. "I prefer to rebuild rather than watch the whole system disappear."



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