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AUTOMATIC ENROLLMENT UNDER THE PENSION PROTECTION ACT

The new Pension Protection Act (PPA) has a number of provisions designed to help participants accumulate better retirement benefits . . . automatic enrollment, safe harbor default investments, investment advice, and so on. This article focuses on the new rules on automatic enrollment.

In the PPA, Congress has endorsed and embraced automatic enrollment through the creation of two kinds of automatically enrolled plans:

- Traditional automatically enrolled 401(k) plans; and
- Safe harbor automatically enrolled plans.

By "traditional," we mean a plan that is automatically enrolled, but that is not intended to satisfy the Internal Revenue Code safe harbor design rules (which are discussed in the next paragraph). Instead, traditional automatically enrolled plans may be designed like any other 401(k) plan. The employer can select the level of matching, the level of profit sharing contributions, the vesting schedule, and so on (though, of course, the employees are automatically included in the plan at a deferral rate selected by the employer).

The safe harbor design requires that employers automatically enroll participants at specified levels of deferral, that the employer make either a specified level of matching or

profit sharing contribution and that the employer contributions vest over two years. In return for satisfying those requirements, the plan will be deemed to satisfy ADP testing, ACP testing and the top heavy rules. In other words, by design, the plan will be deemed to satisfy most of the 401(k) testing rules.

There is a critical difference between traditional and safe harbor automatic plans. Safe harbor plans must automatically enroll all of the eligible employees, both new and old. (However, if an employee has affirmatively elected to be in the plan, or to be out of the plan, the automatic enrollment will not apply to that employee.) On the other hand, traditional automatic plans can choose whether to enroll only new employees or whether to include the old employees. That is an important difference for many employers because of the potentially significant increase in cost for matching contributions where the old employees are included.

To make automatically enrolled plans (both traditional and safe harbor) more attractive, Congress preempted any state laws which would conflict with the automatic enrollment of employees. For example, California has a law that prohibits withholding from an employee's paycheck without the signed, written consent of the employee. Federal law now overrides that provision for deferrals into a plan. In addition, beginning January 2008, the new law permits plans to return deferrals if an automatically enrolled employee objects within

90 days of his first deferral. This rule is intended to overcome plan sponsor concerns about employee complaints that they were inadvertently automatically enrolled.

Also, the PPA creates a default safe harbor investment, which permits plans to invest the deferral money from automatically enrolled participants into multi-asset class investments, such as risk-based lifestyle funds, age-based lifecycle funds and managed accounts. In effect, those investments are considered to be fiduciary safe harbors.

As a result of this Congressional "endorsement," and of the changes to facilitate automatic enrollment, we believe that more and more plans will be automatically enrolling their employees. It is not inconceivable that, within five years, half or more of all plans will be automatically enrolling their employees. Based on industry studies, that should result in a 15% to 20% increase in the number of employees who are participating in these plans, as well as a significant increase in the assets in the plans.

Note: If you would like more information about the provisions of the new law, visit our website. We have posted newsletters, bulletins and PowerPoint presentations about the new law.

By: Fred Reish & Bruce Ashton

ASSET MIX: GET REAL

Which asset class is it that most investment-professionals want all 401k participants to own, but few think they should be able to buy? Need a hint? It generates steady returns, lots of current income, and shows low correlation with equities.

The answer, of course, is real estate. Despite its attractive returns and power to diversify, many experts find property an unwieldy investment for individuals.

"As a standard practice, we recommend that REITs not be offered as a stand-alone DC [defined contribution] investment option," states Sue Walton, a senior consultant with Watson Wyatt Worldwide, Chicago.

"However, do we like real estate as part of a professionally managed portfolio?" Walton asks. "Sure!" she answers, echoing the views of other consultants. Real estate has long been a tool in defined benefit (DB) portfolios, and retirement providers are working out ways, through REITs and even private property funds, to bring the benefits of real estate to DC participants.

Commercial real estate is a complex asset: Like bonds, it produces steady income and, like stocks, it offers capital appreciation. However, as a separate asset class, real estate's return profile shows little correlation with either mainstream asset and, thus, is highly effective at reducing portfolio volatility.

"The correlation between real estate and U.S. large-cap stocks is just 0.25," says Bob Boyda, Senior Vice President with John Hancock Investment Management Services, Boston. "You're deriving a huge diversification benefit from owning real estate."

The Uptake Rate

Connecticut-based Greenwich Associates reports that 70% of public pension funds and 40% of corporates now own real estate. In Wilshire Associates' Compass database, those allocations range from 2% to 15% of plan portfolios.

In DC plans, however, the uptake has been much slower. Fewer than one in four of the 2,000-odd DC plans in the Vanguard database included real estate options in 2006 and, when they were present, just 10% of participants chose them as separate holdings, reports Steve Utkus, a principal at the Vanguard Center for Retirement Research.

"In plans where REITs are offered, they're just 2% of assets," reports Lori Lucas, Senior Vice President and Head of Defined Contribution Consulting for consultants Callan Associates. She explains: "Real estate is viewed as a specialty asset, and sponsors want to keep from overwhelming participants with too many choices."

Sponsors also are concerned that participants will chase the six-year run in REIT stocks—a 14% annual return for REITs from 2000 through 2006, versus 1.7% for U.S. large-cap equities—says Jill Johnson, Senior Investment Officer with Russell Investment Group, Tacoma, Washington. She also notes that, after this run, REITs are trading at expensive levels: "The rise in the REIT market has compressed the yield on the NAREIT index from 8.5% in 2000 to 3.8% 2006."

Still, asset allocators see a strategic role for real estate in DC portfolios. "The inflation protection and appreciation potential of real estate serve legitimate retirement investment objectives," observes Mike Dudkowski, Vice President in the Pittsburgh office of Wilshire Consulting.

"[If sponsors don't think participants can handle the real estate challenge themselves,] perhaps this is where lifecycle funds can add some value," observes Dudkowski. Retirement providers are listening: In an ad hoc survey of 24 firms offering target-date and target-risk funds, 14, or 58%, currently include a dedicated allocation to real estate.

There is a long-running philosophical debate, however, over which form of real estate is more effective—privately owned real estate, or publicly traded REITs. "They're two different assets, from a portfolio -construction perspective," contends Anne Lester, Senior Portfolio Manager at JPMorgan Asset Management, who oversees the firm's SmartRetirement target-date funds. "They're very different assets in unpleasant down markets," she adds. "[Moreover,] the 100 or so publicly traded REITs are a small segment of the overall opportunity set in real estate," notes Dudkowski.

As public equities, REITs are subject to the swings of the stock market and, so, are more volatile than private funds and, as

noted above, offer less diversification. Private real estate funds are less volatile, may offer a more "pure" exposure but, typically, do not offer daily access. "Sponsors would like the diversification of direct real estate, but there's not much appetite for moving away from daily valuation and transactions, so direct real estate investment really has to fit into that context," notes Lucas.

A 401(k) Real Estate Fund

The Principal Group offers a daily-valued private real estate fund to its current 401(k) clients, although the option is limited to larger plans that incorporate commingled accounts rather than mutual funds. (It's not yet available for Principal's target-date funds, however.) "The valuation process for that fund is approved for commingled account format, but developing a net asset value per share every day for a '40 Act mutual fund is still a challenge," reports Randy Welch, Director of Investment Services at The Principal in Des Moines.

JPMorgan has made real estate a prominent part of its SmartRetirement target-date investment strategy. The commingled-account version includes an allocation of REITs from 2% to 8%, with farther-off target dates receiving a greater share, plus a steady 10% of direct real estate. (Plans that invest in the JPMorgan strategies through mutual funds are limited to REITs for the time being, and have a real estate allocation ranging from 4% to 10%.)

Reducing the swings in returns not only helps participants' assets, but can improve their saving behavior as well, says Lester: "You earn more capital in a less volatile fund, other things being equal, but there's evidence that, when people are spooked by the markets, they cut back their contributions. So, it's important to reduce the volatility in portfolio returns through broad diversification."

By: John Keefe
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Just out of Reish: Meeting Expectations

I recently met with several plan committees to educate the members on their responsibilities as fiduciaries. I thought you might like to know some of the most commonly asked questions—and the answers.

How often should the committee meet?

The easy answer is: as often as is necessary. However, as a practical matter, plan committees tend to meet on a quarterly basis. In effect, there are three "event-driven" meetings and one "overview" meeting. By "event-driven," I mean that the focus of the non-annual meetings tends to be on specific issues (such as mutual fund manager changes), follow-up on current projects (such as automatic enrollment or watch-listed investments), changes in the law, and so on. The annual meeting should include a complete review of all of the investments and services.

What should be on the agenda?

Over the course of the year, all of the following items should be addressed at one meeting or another:

- *Investment Options.* The major headings of an investment policy statement should be the agenda for the part of the meeting dealing with the investments, including the selection and monitoring of investment options, review of the plan's investment services (both plan- and participant-level investment advice), and review of the investment policy statement itself. These discussions also could include the addition of new asset classes (or investment categories) or new features (e.g., brokerage accounts, mutual fund windows).
- *Services.* The services used by the plan should be monitored at least annually, including the plan-level investment consultant; compliance services (e.g., testing, 5500s, etc.); the recordkeeper; enrollment and investment education services; and, yes, the plan's attorney. The services should be reviewed for quality, effectiveness, and adherence to the governing agreements.
- *Fees and Expenses.* This topic rapidly is becoming the No. 1 issue for consideration by plan committees—or, at least, it should be. The committee should focus on the reasonableness of the expenses and on understanding and evaluating all indirect revenues being paid to and from the plan's providers.
- *External Changes.* This might include things like Roth deferrals, automatic enrollment, and qualified default investment alternatives (or QDIAs), as well as age-based lifecycle funds, education for participants, and so on.
- *Quality of Participant Investing.* It is not well known that fiduciaries have significant responsibilities for the quality of participant investing. In fact, if a plan does not satisfy 404(c), fiduciaries are liable personally for imprudent participant investing. Fiduciaries also are responsible for monitoring the plan's enrollment services and investment education to determine, among other things, whether they are working.
- *Levels of Participation.* Fiduciaries have a responsibility to implement a plan's eligibility provisions and to oversee the communications with their eligible employees. However, the scope of that duty is not well-defined. As a result, fiduciaries periodically should evaluate the plan's communication and enrollment services. That can be done by reviewing, among other things, data about the actual levels of participation and then comparing it with industry benchmarks supplied by the plan's advisers or providers.
- *Adequacy of Deferrals.* This area is also largely unexplored. However, there is a duty for fiduciaries to select prudently and monitor their providers of participant education. Fiduciaries should solicit input from their advisers and providers about the available services to educate participants, about appropriate deferral rates, and should consider services to help participants increase their deferrals.

Some attorneys are concerned that minutes may be used against a committee. However, my experience is that, when properly prepared, minutes can be helpful in showing that a committee has engaged in a prudent process. The minutes, together with other materials reviewed by a plan committee, should be kept in a due diligence file for at least seven years.

They should list the people attending the meeting, the items discussed, the materials reviewed, any input from advisers, and the decisions reached. In my opinion, there should be little in the way of discussion in the minutes.

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By: Fred Reish

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SPECIAL REPORT: TOGETHER “NEST”

In a time of change, plan sponsors seek the comfort of "all-in-one" solutions.

Despite the admonitions of our youth, overstretched plan sponsors have always found a certain appeal in the efficiency of a bundled approach to delivering retirement plan services.

There are cautionary tales aplenty, of course:

- concerns that bundled solutions inherently are limited in their ability to deliver best-of-breed servicing to an ever-expanding array of services; and
- worries that problems with a single element of the bundle necessitate either learning to live with that issue in the interests of preserving the package, or dumping the entire package as a result—the plan sponsor equivalent of throwing the baby out with the bath water.

However, the retirement outsourcing bundle has improved dramatically in the past several years, in terms of the breadth of services offered, the quality of services provided within that bundle, and—ironically, perhaps—the ability to readily excise a potentially nettlesome component.

Not that backing out of a TRO solution appears to be the norm, but plan sponsors still seem to appreciate the ability to embrace a bundled solution in stages.

Just as important, in this --post-Pension Protection Act (PPA) environment, being able to have all your eggs in one "basket" feels a lot like having all your ducks in a row.

By: *Nevin E. Adams*
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