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RUNNING THE FUND: BALANCING ACT

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?”

How To Evaluate

The cost of the transition should not be a big factor in comparing managers, contends Hardy. “All managers should provide the transition service at a low fee.” The more important considerations,

he says, are when the trade will take place, and understanding what the legacy and target securities look like and how to hedge them. “If both are liquid, you can move quickly to get the conclusion you need. However, for emerging-market funds, or small-cap, or a concentrated portfolio, it will take longer, and you might get unusual returns during the transition. It’s essential to understand the risk to avoid a performance drag.”

More DC Transitions Coming

Transition managers see recent changes in DC regulations as a spur to growth in these transitions. “With the passage of the Pension Protection Act,” reports Brian Roberts of Russell Investment Group, “there’s definitely an increased interest from sponsors in adopting target-date funds as default options. The ‘prudent choice’ of 401(k) investments is no longer measured by the number of options participants can choose from; now, it’s defined by more rational and long-term options. We’ve already completed some significant transactions to change defaults.

“We see the DC transition market as a window that has opened,” he says, “but likely will not close any time soon.”

By: John Keefe
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THE POINT OF NO RETURN

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 POINT OF NO RETURN (CONT.)

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.

By: Nevin E. Adams
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SPECIAL REPORT: NONQUALIFIED DEFERRED COMPENSATION

Nonqualified deferred compensation designs play key role in attracting, retaining executive talent

These questions lie at the heart of every well-considered benefit program—why does the program exist, and what do we hope to achieve by making it available? The answers—or lack thereof—are often telling.

While deferred compensation programs have been around for decades, their focus and their purpose(s) have varied. For respondents to the PLANSPONSOR/MullinTBG Nonqualified Deferred Compensation Survey, the ability of these programs to attract and retain management remains high on the list of program purposes cited. In fact, that dominates the purpose expressed by the largest public companies, long the leaders in this space. Smaller companies—and by that we mean those with less than \$1 billion in annual sales—place a much higher emphasis on the 401(k) plan restorative design of some programs. While employers of all sizes acknowledge the prominence of these programs as a vehicle for retirement savings, large public companies lead the pack in acknowledging the value in flexibility for pre-retirement savings. Think of it as the deferral of compensation with a purpose.

If the purposes of these programs vary according to company size, so also do the types of other plans offered. The vast majority of firms across the four respondent segments provide programs that allow workers to defer their own income, and a consistent minority across all segments,

roughly a quarter, offered incentive programs. However, public employers in general were notably more likely to offer nonqualified defined benefit plans (SERPs), and larger public employers even more so. Large employers—those with more than \$1 billion in annual sales—also were significantly more likely to offer restricted stock, and somewhat more likely to offer stock options than were smaller, publicly traded employers.

Asked to cite the security vehicle, the instrument backing up the employer's promise to pay benefits, rabbi trusts dominated the list of responses. Nearly half of large publicly traded employers used the vehicle, as did two-thirds of large privately traded respondents. Rabbi trusts were also the instrument of choice for more than half of smaller publicly traded employers.

Funding Vehicles

As for funding, three-quarters of large publicly traded employers informally fund these programs, as does a comparable representation among privately traded firms (just 58% of smaller publicly traded firms do so, however). The means of funding were as varied as the market segments. Large publicly traded companies were fairly evenly split in their use of mutual funds (37%) and corporate owned life insurance (COLI) (38.9%) and also used company stock (11.1%), and even cash (16.7%). Smaller publicly traded firms were much more likely to use

cash (42.9%), and equally likely (and more likely than their larger cousins) to use mutual funds, COLI, and company stock. Not surprisingly, privately held firms were much less likely to rely on company stock, but roughly equally as disposed toward cash as their counterparts in the publicly traded segment. Smaller privately held firms expressed a heavy reliance on mutual funds, while large privately held firms were roughly twice as likely to choose cash as similar-size firms in the publicly traded sector.

The most popular crediting rate tie for the programs represented in the survey were the underlying funds (either stand-alone mutual funds, or portfolios under a COLI product), cited by roughly half of the large publicly traded plans, and more than half of those in the smaller end of the market. The second-most-cited option across all market segments, save smaller publicly traded plans, was an outside index, such as Moody’s bond index. Lifestyle or lifestyle fund groups were the choice of roughly one in 10 across all segments, as was company or stock performance.

Responding to 409A

When it comes to responding to the new mandates of 409A, large public companies definitely have shown the most activity. While a minority of privately held employers had gone so far as to eliminate elective deferrals, none of the publicly traded respondents had taken that course. Similarly, only a distinct minority of

SPECIAL REPORT: NONQUAL. DEFERRED COMPENSATION (CONT).

employer respondents opted to take the relatively extreme position of terminating their prior plan and establishing a new one. Instead, roughly a third of publicly traded employers had grandfathered pre-409A program deferrals and established a new program for post-2004 deferrals, a path also taken by roughly one in five smaller privately traded employers.

Nearly half of smaller publicly traded employers had adopted the form and timing of election and distribution requirements, slightly ahead of the one in three of their larger employer brethren that had taken that step. Overall, regardless of employer type and size, it appears that these decisions were made in tandem.

Other Offerings

Overall, publicly traded employers were much more likely to offer executive financial planning (51.5% public versus 27.9% private). However, in the larger corporate sector, the gap narrows substantially (56% versus 37.5%, respectively). Employers of all sizes provided group life insurance and group long-term disability (LTD). Roughly half provided supplemental executive life insurance, but larger employers were more likely to do so. Larger employers were also noticeably more likely to offer supplemental executive disability insurance. Long-term care insurance, a staple at three-quarters of smaller publicly traded plans, was offered by less than half of other employer respondents.

Communication Critical

In view of the complex issues underlying the decision to defer compensation, it is perhaps no surprise that education/communication was cited as most important to executives in making the decision to participate in these

programs—generally more important than design elements such as plan flexibility, investment options, and Internet access. This was particularly noteworthy among larger plans whose long-term experience with these programs has provided a true "voice of experience" that can provide a best practices template for less tenured approaches.

The importance of communication manifests itself in other ways, as well. While the overall volume of participant and/or retiree questions about these programs seems relatively modest, plan sponsor survey respondents clearly are unsure about their ability to respond to many of these issues, notably fund allocation and retirement income adequacy.

Service Stations

Finally, asked to rank the factors most important in a nonqualified deferred compensation plan provider, the quality of service and recordkeeping systems was a prohibitive favorite, cited by more than half of employer respondents in all market segments, and nearly two-thirds of large employers in the privately traded segment.

Not surprisingly, in view of the emerging dynamics of 409A, expertise in the space ran a relatively close second across all segments—and, in fact, was cited just as frequently by smaller publicly traded companies. Price and consulting expertise did not register as priorities, and the ability to integrate with a 401(k) provider barely did so, doubtless reflecting both the growing independence of these programs, and their importance as a separate retention resource. It is an emerging trend that already is evident, at least implicitly,

to plan sponsors—and to the providers and advisers who seek to help them grow and flourish.

Methodology

In October and November 2006, approximately 1,500 corporate sponsors of nonqualified plans were asked to participate in this study. By the close of the survey, a total of 338 usable responses were received. The questionnaire, developed jointly by MullinTBG and PLANSPONSOR, consisted of approximately 58 questions including the following topics: NQDC plan demographics, NQDC plan design, purpose of NQDC plan, funding methods, recordkeeping, and other executive benefits offered. The charts that follow represent the data from publicly traded and private corporations, with a further breakdown by annual revenues—more or less than \$1 billion.

For any questions about the research, please contact Pattiann Firmiss, executive vice president, MullinTBG at (847) 444-2123 or by e-mail: pattiann.firmiss@mullintbg.com. Securities offered through M Holdings Securities, Inc., a Registered Broker/Dealer, Member NASD and SIPC. MullinTBG is owned and operated independently from M Holdings Securities, Inc.

By: Nevin E. Adams
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401(k) Inside and Out
34700 Pacific Coast Hwy, Suite 302
San Juan Capistrano, CA 92624
(888) 899-4015
(949) 488-8726

