

## TOP STORY

### NAGDCA Executive Board Slated to Visit Capitol Hill

This year, NAGDCA's Legislative Committee has begun its work by developing two specific goals for 2007:

- Be recognized as the single voice of the public sector defined contribution community by national and state governmental entities and agencies.
- Be called upon first by government for views, information and reactions to proposed legislation and regulations that may impact the public sector defined contribution community.

In implementing these goals, NAGDCA's first orders of business is to conduct its annual "Hill Visits". NAGDCA's Executive Board is scheduled to meet with influential leaders on Capital Hill in late February. In past years, this meeting has resulted in consultation on pension bill issues, offer and seek out clarification on recently implemented regulations, provide first hand information on the current trends within the defined contribution community, and most recently, NAGDCA worked closely with legislators to have a Resolution pass to recognize a National Save for Retirement Week. Last year, NAGDCA complete ten individual meetings while on Capital Hill ranging from representative from the Ways and Means Committee to the Department of Treasury.

As a follow-up to this year's "Hill Visits", NAGDCA will again schedule a NAGDCAST to provide a Legislative Update of these meetings and an overview of the current legislative environment in Washington. Heading up this webcast will be NAGDCA's Legislative Counsel, Susan White.

Please stay tuned for developments concerning the Legislative Update webcast and the Executive Board's visit to Washington DC. You may also check [www.nagdca.org](http://www.nagdca.org) for ongoing updates.

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## PRESIDENT'S CORNER



It's hard to believe that three months ago we were all together at the 2006 Annual Conference in Kansas City, Missouri, and that the New Year is already upon us. In that short time span, the NAGDCA Executive Board has held several meetings. The fall meeting at AMR's home headquarters in Lexington, Kentucky was a great opportunity for all of the Board members to come together and plan a course of action for NAGDCA in the upcoming year. That time is also used to orientate new Board Members on NAGDCA's practices and policies.

Briefly, here are some of the goals that came out of that meeting:

- 1) As an educational leader among governmental defined contribution plans, NAGDCA is dedicated to continuing its efforts in providing up-to-date information to its members through website and clearinghouse postings,

listserv blasts, webcasts, legislative updates, and of course, the highly anticipated annual conference. We were extremely excited to offer the continuing education credits for three certifications at the 2005 Annual Conference (CFA, CFP and CPE), and we anticipate this to be an ongoing offering at future conferences.

- 2) NAGDCA will also continue to work with the United States Congress to pass another Resolution in support of a National Save for Retirement Week in 2007. This year's resolution proved to be a success for many of our members. Many plan sponsors celebrated this week by hosting educational fairs, seminars and special events which provided a tremendous amount of educational opportunities for plan participants. To view some of the activities performed by our members, please visit <http://www.nagdca.org/retirementWeek/members.cfm>.
- 3) The NAGDCA/Arthur N. Caple Foundation is well under way with its fundraising efforts and remains steadfast in its dedication to the following areas of focus:
  - **Retirement Education** - The Foundation, through the **ANC** Scholarship, provides higher education students with funding to study financial or retirement planning and to participate in related learning opportunities. Expanding the number of annual recipients and other educational opportunities will be a goal of the Foundation.
  - **Research and Information Exchange** – The Foundation will be working to identify research and information sharing initiatives that will further retirement education and readiness in the public sector.
- 4) Lastly, we all know the results of the national elections and anticipate that some change may take place. However, due to NAGDCA's non-partisan position, it will not hinder the relationships that have been established in Washington DC. Susan White, NAGDCA's Legislative Counsel, assures us that we will continue to have a strong voice on Capitol Hill, offering our expertise on the defined contribution community.

Finally, on behalf of all the Executive Board members, I want to extend a Happy Holiday wish and a profitable and healthy new year to all our friends in the government and industry sectors. May the year 2007 truly be the best of years!!!

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## INDUSTRY VIEWPOINT

### Message from the 2007 Industry President: Brian McCleave

With membership booming and the 2006 Annual Conference attendance at an all-time high, NAGDCA has emerged as a top organization for interaction between government and industry members. Our culture is one of coming together for the common good. That said, I am extremely proud of the talented group of individuals on our 2007 NAGDCA Industry Committee. The team includes:

President: Brian McCleave, Prudential Retirement  
Vice President: Tim Rouse, Fidelity  
Secretary: Janet Kendall, ING Financial Advisers  
Treasurer: Kurt Walten, NAREIT  
Member-at-Large: Michael Studebaker, Nationwide Retirement Services  
Member-at-Large: Rod Crane, TIAA-Cref  
Past President: Matt Abraham, Mutual of Omaha

#### *How You Can Make a Difference*

As this year's Industry President, I will be putting a lot of emphasis on expanding volunteer opportunities throughout our industry membership. The depth and diversity of talent that we have within our great organization is tremendous. The lifeblood of NAGDCA flows through volunteerism. There are numerous ways for you to contribute such as:

- Sponsorship of the NAGDCAST series
- Commenting on federal proposals
- Authoring publications
- Speaking at conferences
- Participating on a committee
- Sponsorship at the Annual Conference
- Contributing to Annual Meeting activities

Another way that you can make a difference is by assisting in the promotion of NAGDCA. Many industry members hold client and prospect conferences. NAGDCA is requesting, where appropriate, that membership in our Association is discussed at these conferences. Including NAGDCA membership materials in conference packets or having it available at an exhibit would be examples of how to support this effort.

Finally, great strides have been made with the Arthur N. Caple Scholarship. The 2006 Annual Conference was the site for our second scholarship award winner recognition. New developments include the formation of a foundation board. The board will focus on increased scholarships, expanding conference attendance for students, and raising appropriate funds to support the financial viability of the foundation. As a member of the Arthur N. Caple Board and your Industry President, I urge you to contribute.

***\*please consult NAGDCA staff for details on any of the ways that you can make a difference***

I consider the role of Industry President both a privilege and an honor. Please share ideas, concerns, suggestions, and any thoughts on how to improve the industry contribution to NAGDCA. Together, we will make 2007 a huge success!

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## **More Information on Revenue Sharing**

*By ING Financial Advisers LLC*

The practice is known by a variety of different names. Some plans and providers refer to it as revenue sharing. Others may call it an expense reimbursement allowance, or simply a "special" payment. But whatever name it goes by, plan provider payments to employer-sponsors of government deferred compensation plans have been a relatively common practice in our industry for quite some time now. This is especially true for medium sized and larger plans that are likely to devote one or more full or part-time administrators to oversee day to day plan matters.

This article will take a look at some of the issues arising out of provider payments and make some recommendations on how to avoid potential pitfalls. In today's regulatory environment, providers, plan sponsors and consultants alike can expect to face an ever-increasing level of scrutiny concerning payment flows related to plan assets. Even where the parties' intentions are the best, situations where a service provider is making payments to a plan fiduciary will almost inevitably raise questions about conflicts of interest, avoidance of kickbacks and adherence to duties of loyalty. The use of careful accounting and documentation to create a record that

amounts have been properly applied can come in handy to allay any concerns that might later be raised about the propriety of those payments.

### **Implications of the Exclusive Benefit Rule.**

We all know that, unlike most private-employer sponsored plans, state and local government-sponsored deferred compensation plans are exempt from ERISA's fiduciary requirements. State and local government enabling statutes or ordinances and plan documents vary widely in terms of assigning fiduciary status or requiring adherence to a fiduciary standard when making decisions about dealing with the plan. But, since the enactment of Code Section 457(g) in 1996, all of the assets and the income of a government sponsored deferred compensation plan are required be held in a trust (or a custodial account or annuity contract deemed to be a trust) for the exclusive benefit of plan participants and beneficiaries.

The implications of the exclusive benefit rule are profound. Plan assets and income may only be used for plan purposes and not for employer purposes. And implicit in the exclusive benefit rule standard of 457(g) is that government deferred compensation plan sponsors charged with responsibility for the administration of the plan should adhere to fiduciary principles when dealing with the assets of the plan.

### **Provider Payments Involve a Use of Plan Assets.**

For providers, expense reimbursement allowances and the like represent a cost of doing business. As any other cost item would, these reimbursements factor into vendor pricing. Consider, for example, a state government deferred compensation plan sponsor that receives an annual payment of 10 basis points (.10%) from its deferred compensation plan vendor. And let's assume that the vendor charges a fee of 60 basis points annually for its services to the plan. It's reasonable to conclude that the cost of the sponsor payment is ultimately borne by the plan since, in the absence of the expense reimbursement cost item, the provider could have offered and the plan sponsor could have negotiated for an arrangement involving a fee of 50 basis points (i.e., at a cost reduced by 10 basis points reduction) than it could otherwise. Because the cost of provider payments is borne by the plan, it becomes important to be able to show that the payments are applied in a manner that exclusively benefits the plan and for no other purpose.

### **Proper Uses and Improper Uses**

As mentioned of the outset of this article, ERISA does not apply to government sponsored deferred compensation plans. Nonetheless, interpretive guidance under ERISA is instructive, at least by analogy, in considering the issue. Under ERISA, the proper use of plan assets and plan income is limited to providing benefits and defraying reasonable expenses of plan administration. Some of these are outside expenses – for example, those associated with the engagement of a consultant to conduct an RFP process, or an attorney to draft a plan document amendment required by law. Other expenses are incurred at the employer level. The work associated with monitoring investment performance, reviewing and approving withdrawal requests, and providing communications material for participants that explain plan provisions and benefits often involves a significant expenditure of time and effort by sponsor personnel. And it's with these employer-level expenses that the going gets tricky. On the one hand, for most state and local governments, the enabling legislation authorizing the plan is clear that the employer's general fund is off limits as a source of funds to pay plan related expenses. By provision of statute or local ordinance, the plan is required to be self supporting. On the other hand, under ERISA the DOL has established the principle that payments from the plan cannot be made for the employer's benefit or to pay expenses that the employer could reasonably be expected to pay for.<sup>1</sup> Employers are allowed to recover "actual costs" related to Plan administration, using a "but for" test. In other words, the plan cannot pay for employer costs unless those costs would not have been incurred "but for" the administration of the plan. Costs can include employee payroll costs but not the costs of employer overhead. In DOL's view, the test can only be satisfied in

situations where the employee who performs the services would be laid off or transferred if the services were not performed.<sup>ii</sup> Where several people perform part-time services for the plan, this test can be difficult to meet. Optimally, where a plan sponsor is receiving payments to defray the expenses of personnel who support the plan on a part-time basis, the employer will want to be in a position to account not only for the time spent on the plan but to be able to demonstrate that in the absence of that work, the employee's hours would have been reduced or that the employer would have been re-assigned to tasks involving commensurate time expenditures.

### **An Ounce of Prevention.**

The old cliché that an ounce of prevention can be worth a pound of cure really holds true in this area. Employers and plan providers all should be able to document the purposes for which plan payments were made and to be comfortable that those payments pass muster under an exclusive benefit analysis.

By the same token, care should be taken to avoid situations that are likely to raise questions. Where an employer's costs tend to be fixed and remain relatively level from year to year, it's probably not a good idea to structure a payment as a basis point percentage of assets. Situations where providers seeking a plan's business find themselves competing largely on the basis of who can offer the largest expense allocation should also be avoided.

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<sup>1</sup> United States Department of Labor Information Letter March 2, 1997 to Kirk F. Maldonado.

<sup>2</sup> United States Department of Labor Advisory Opinion 93-06A March 11, 1993 to Steven Sacher regarding Allied-Signal, Inc.

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## **Baby Boomers' Retirement: The Impact on Public Employee Pensions and Benefits**

*By Mary Willett, Willett Consulting*

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Many baby boomers, those born from 1946 through 1964, see retirement as a new life stage, which may include staying in the workplace longer. As a result, employers are reexamining their employment practices, hiring processes and benefit structures to meet the needs of older employees as well as address labor shortages and other organizational needs. State and local governments will feel the impact of an aging employee population before private sector employers.

Baby boomers are entering retirement, but not like their parents did. This generation, which is made up of Americans born between 1946 and 1964, is reinventing this phase of their lives to incorporate work, often in modified or reduced form, volunteerism and leisure activities.

Employers are facing new challenges from this aging workforce and their new approach to retirement. With 77 million Americans reaching age 55 between now and 2020, employers are reexamining employment policies and benefit structures to meet the needs of the older employee population, as well as to address current and future labor shortages and their troubled budget situations.

### **Baby Boomers—Who Are They?**

Baby boomers represent 27% of today's population. They are better educated— About 90% have a high school diploma and 30% have a bachelor's degree or higher. They have a higher divorce rate and a greater number who have never married than any generation before them.<sup>1</sup>

By 2030, baby boomers will be between ages 66 and 84 and make up about 20% of the U.S. population. They can expect to live longer than any previous generation. Of the two-plus million boomers who are turning age 60 this year, men can expect to live an average of 22 more years and women, 28 years.

Employers in certain states are feeling more of the impact of this aging workforce. Over 50% of baby boomers live in nine states (as of 2000): California, Texas, New York, Florida, Pennsylvania, Illinois, Ohio, Michigan and New Jersey. They also represent more than 30% of the total population in 17 states (as of 2002): Alaska, New Hampshire, Vermont, Maine, Maryland, Colorado, Connecticut, Virginia, Wyoming, Washington, New Jersey, Montana, Massachusetts, Minnesota, Oregon, West Virginia and Wisconsin.<sup>2</sup>

### **Nontraditional Retirement Attitudes**

As a result of increased longevity, baby boomers expect they will be healthier and lead more active lifestyles in their later years. This is generating a new approach to retirement that is more likely to include some form of continued work, either for pay or volunteering, well beyond a traditional retirement age.

New attitudes about retiring are creating an entirely new life stage. In the past, lifetimes have been viewed as having three separate phases: (1) education—when life is focused on learning and building a career; (2) work and family—when career development and family responsibilities are the top priority; and then finally (3) retirement—which would normally begin with an immediate and abrupt end to work, followed by leisure activities and enjoying one's family.

Today, new attitudes about retirement are creating a new life stage between work and family and retirement, sometimes referred to as the Third Age.

This new stage is generally considered a time when people try new experiences, or modify their current lifestyle to remain challenged, engaged and fulfilled. They aren't ready for a full retirement, but they also don't want to continue the same daily work routine they've had throughout their career.

For some, this may include going back to school, trying a new career path or perhaps starting a business. Others, who want to remain in the same or similar career track, prefer a modified schedule (e.g., shorter hours or workweeks) or a position with reduced mental or physical stress.

According to The 2003 AARP Working in Retirement Study, about seven in ten employees state that they intend to work past a traditional retirement age, or never retire. Over half (53%) identify working for enjoyment, not money, as the reason they expect to continue working, while only about four in ten (42%) expect to need to work to help pay bills.

When just the baby boomer segment of the workforce is examined,<sup>3</sup> eight in ten workers expect to work in some capacity during their retirement years. Three in ten identify the reason as for enjoyment and one in four believe they will need the income. The majority of boomers (almost 70%) are fairly optimistic about their future years and almost half (48%) say their retirement outlook has improved over the past five years.

Unfortunately, boomer expectations and optimism about retirement may be unrealistic. Several studies on the retirement preparedness of this generation have been conducted over the past few years. These studies consistently find this generation of soon-to-be retirees is far from being adequately prepared. For example, findings generally show that a significant percentage of boomers:

- Are not saving or investing enough (and many not at all) for their retirement years

- Underestimate the amount of income they will actually need in retirement, or have not even tried to calculate this need
- Expect to work throughout their retirement years, but don't have contingency plans in place should they not be physically able to work or if unable to find suitable employment
- Rely on employer benefits and federal programs to meet 100% of their future financial needs (pension and health care) throughout their retirement lifetime.

Current employment and benefits policies may no longer be addressing the needs of the employer and the ever-changing workforce. Understanding how baby boomers and the generations that follow are approaching retirement is critical to employers' short- and long-term strategic planning.

### **Baby Boomers' Impact on the Workforce**

State and local governments will feel the impact of an aging employee population before private sector employers. This is because the public sector has a higher percentage of employees who are in the baby boom generation than the private sector. In addition, career public employees, particularly police and fire personnel, tend to retire at an earlier age.

At the beginning of this century, the Department of Labor (DOL) projected that before 2008 school districts would need to replace more than 400,000 elementary and 350,000 secondary teachers who would be retiring.<sup>4</sup> Other employment categories that were identified as being the hardest hit by boomer retirement included:

- Registered nurses
- Administrators in education
- Public administration officials
- Social workers
- Financial managers
- Lawyers
- Plumbers, pipe fitters, steamfitters
- Police and fire personnel.

The majority of these at-risk employment categories represent jobs within the public sector. As a result, many state and local government employers have already begun to take steps to address current and projected worker shortages. Employment policies, hiring processes and benefit structures are being reevaluated to ensure they meet the short- and long-term needs of the organization.

Attracting and retaining older workers is an important aspect of new employment strategies. This often includes redesigning job opportunities to include job sharing and telecommuting options as well as part-time and/or temporary assignments.

Mentoring programs also have an important role in new HR policies for older workers, offering new challenges to those nearing retirement while they pass on their knowledge and work experiences to younger employees. This can reenergize employees in the last few years of their career and potentially provide reduced employee-training costs for employers.

Offering phased retirement options is another workforce planning strategy that is being used in both the public and private sectors. These options can take various forms to meet employer and employee needs.

From the employer perspective, phased retirement programs can help retain skilled employees in the workforce. Programs can be structured to address labor shortages in specific employment

fields, and/or for a certain period of time. They also can help reduce employers' hiring and training costs.

From the older employees' point of view, phased retirement is attractive because it gives them the flexibility to gradually transition into retirement while staying with their current employer and career. Phased retirement options usually offer opportunities to reduce the work schedule (fewer days or hours) or move into retirement with a less physically or mentally stressful position.

When attitudes about phased retirement are explored,<sup>5</sup> about four in ten employees over age 50 (see Figure 3) would be very or somewhat interested in this option. Eight in ten of those expressing interest stated that this would result in their delaying full-time retirement beyond a normal retirement age.

Employees indicated that the most desired features of phased retirement would include:

- Reducing the average workweek by 16 hours or more
- Protecting the value of pension benefits and allowing them to continue to accrue during transitional employment
- Providing access to a portion of retirement benefits (e.g., partial payment) to supplement income during this period.

Although the specific features and restrictions for phased retirement options differ, they generally include offering reemployment opportunities designed specifically for retirees and transitional or "bridge" jobs before employees begin their retirement. Deferred retirement option plans, or DROPs, can also be established to help protect the pension benefits of those transitioning into retirement.

Regardless of the type of phased retirement option offered by the employer, there are certain problems that may be encountered. For example, retiring employees that return to work in the public sector are often perceived to be "double dipping" by receiving a retirement benefit at the same time as a current wage. Communication about the human resource policies and the cost savings that the employer may experience (e.g., reduced training and benefits costs) may counteract this perception.

As part of a phased retirement program, employers often establish retire-rehire rules that restrict employees' return to public employment to certain at-risk employment categories, where worker shortages already exist. Limits may also be placed on the length of time the retiree can work within a 12-month period to a specified number of hours.

### **Changes in Pension and Health Care Benefits**

At the same time as employers are dealing with the needs of an aging workforce, they are also addressing increased health and pension benefit costs. Within the public sector, defined benefit (DB) plans have a vital role in the employee benefits package. Today, approximately 96% of public employees (representing about 10% of the total U.S. workforce) are covered by state and local government DB plans.

Pensions continue to be an important recruitment and retention tool for the public sector. However, funding concerns are placing some of these plans at risk. For many employers, the pension surpluses of the 1990s have turned into funding shortfalls.

Employers are struggling to find budget dollars to meet pension contribution obligations. They are reevaluating how they invest trust assets because of the potential increased liquidity needed to pay benefits to retiring boomers and the lower projected investment earnings. Many state and local government employers are also exploring major modifications to DB plans such as:

- Converting to hybrid defined contribution/defined benefit plans

- Closing their DB plan and establishing a defined contribution/401(k)-type plan for new hires and/or voluntary elections from existing employees.

Although pension plans are a significant issue for employers, employee health care benefits continue to be their number one concern. Costs are growing at unsustainable rates, increasing by 8.2% in 2004.<sup>6</sup> Both public and private sector employers are beginning to institute cost-savings measures such as:

- Increasing employee copays and deductibles
- Switching to consumer-driven health plans and health savings accounts (HSAs)
- Adopting disease management programs
- Initiating pharmacy benefits management programs.

Employers that provide continued health care insurance to retirees are facing even greater financial challenges to maintain these programs as costs continue to increase dramatically. Some employers are eliminating or reducing these benefits for future retirees. Others are instituting new restrictions such as capping the premium amount the employer will pay or basing the employer share of the premium on employees' length of service.

### **Increasing Importance of Supplemental Plans**

As employers focus on lowering their budget costs for primary pension and health benefits, there is renewed importance of the second tier or supplemental benefits that are made available to employees. Typically, there is little or no employer funding of these supplemental benefits, which often include one or more of the following:

- Voluntary, employee-directed defined contribution plans—Sections 457, 403(b) and 401(k) plans
- Long-term care insurance
- Dental and vision supplemental insurance
- Employee assistance programs (EAPs)
- Legal services programs
- Day care.

Employers are beginning to recognize that these programs can be a critical part of the total benefits package. They are focusing more attention on the design and features of these plans to make them more attractive to the workforce and address the needs of an aging society.

For example, improving employee participation in deferred compensation plans is often a strategic priority of state and local government employers as they recognize that most employees will experience an income gap in retirement between what they need and what they will receive from primary benefits (pension and retiree health care).

Some of the recent trends to enhance deferred compensation and deferred compensation programs and encourage employee involvement include:

- Simplifying the investment lineup by reducing the number of choices and offering lifestyle or life cycle funds
- Offering managed accounts or investment advice to provide a more do-it-for-me approach to investing for retirement
- Adopting an automatic or active enrollment election policy to address the natural human tendencies to "put off" enrollment until later, and then never follow through.

The aging of the workforce is requiring employers to be more creative in their employment and benefits policies. As employees are continuing to be charged more personal responsibility for their retirement futures, with changes in health benefits and pensions as well as Social Security

and Medicare that will likely occur over the next few years, supplemental benefits will become even more important. Employers need to focus more attention and efforts on enhancing these programs to better meet the changing needs of their employees and soon-to-be retirees. [B&C](#)

For information on ordering reprints of this article, call (888) 334-3327, option 4.

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1. Demographic Profile; American Baby Boomers; Mature Market Institute, MetLife.
2. Demographic Profile; American Baby Boomers.
3. Baby Boomers Envision Retirement II—Key Findings, prepared for AARP by Roper ASW, copyright 2004.
4. "Gauging the Labor Force Effects of Retiring Baby Boomers," Bureau of Labor Statistics, Monthly Labor Review, July 2000.
5. The Attitudes of Individuals 50 and Older Toward Phased Retirement, AARP, March 2005, Knowledge Management.
6. The American Workplace 2005: The Changing Nature of Employee Benefits, Employment Policy Foundation.

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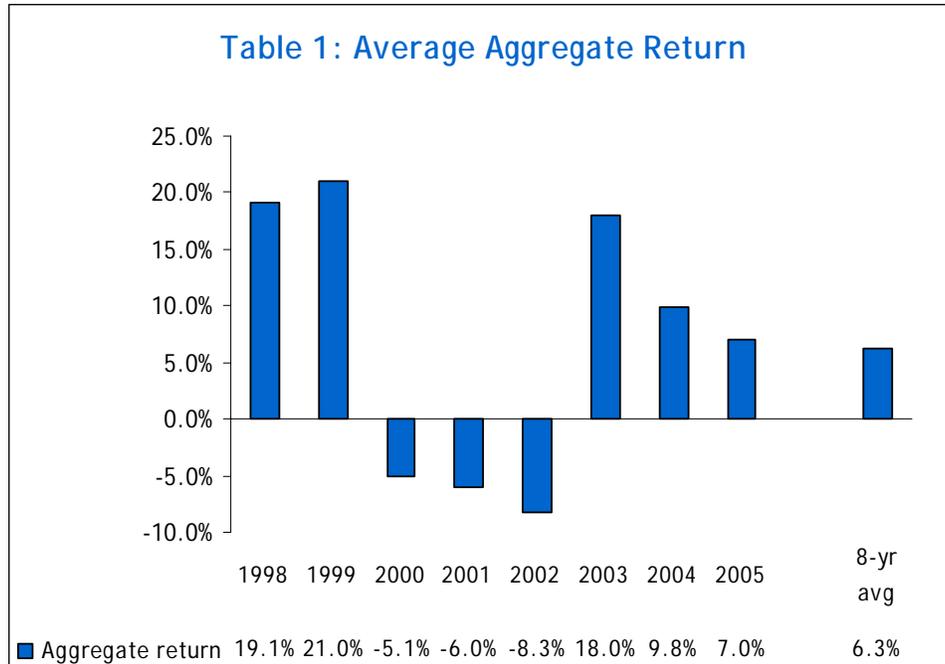
## Public Plan Trends

*By Hubert Lum, Research Director, CEM Benchmarking Inc.*

This article highlights some of the key public plan trends in performance, asset mix, investment options and costs found in the latest annual CEM Survey for Defined Contribution/Profit Sharing Plans.

The trends were drawn from 94 US public defined contribution plans from 1998 to 2005. In 2005, 23 public plans with total assets of \$201 billion participated in the CEM survey. The median size was \$0.8 billion.

Table 1 shows that over the eight-year period ended December 2005, public defined contribution plans had an average annual aggregate return of 6.3%. The benchmark return was 5.5%. The benchmark return was derived by weighting benchmark index returns by corresponding asset holdings. The difference between the average aggregate return and the average benchmark return was 0.8%. This was the value added from active management.



Source: CEM Benchmarking Inc.

Table 2 shows the changes in asset mix over the period. The most significant change was a 19% reduction in domestic large cap and broad market stock from 63% to 44%. The asset classes that increased the most were domestic small cap stock by 9%, bonds by 6% and foreign stock by 5%.

Table 2: Asset Mix								
	1998	1999	2000	2001	2002	2003	2004	2005
Large cap and broad market stock	63%	65%	61%	54%	41%	43%	44%	44%
Small cap stock	3%	9%	6%	5%	5%	9%	12%	12%
Foreign stock	2%	1%	2%	3%	3%	3%	5%	7%
Bonds	7%	7%	5%	8%	11%	12%	13%	13%
GICs/stable value	20%	10%	21%	24%	35%	24%	18%	17%
Cash and equivalents	5%	9%	5%	6%	5%	8%	8%	6%
REITs, real estate and hedge funds	0%	0%	0%	0%	0%	0%	1%	1%

Source: CEM Benchmarking Inc.

The median number of investment options offered grew from 10 in 1998 to 14 in 2005. Table 3 shows that stock-related options constituted the largest segment of investment options offered.

Throughout the period, the median number of bond options offered was one. This may explain, in part, the low proportion of bonds in the average asset mix since participants often practice naïve diversification, whereby contributions are allocated evenly across all investment options offered.

Table 3 is also a reminder that several important asset classes are not part of the average investment option menu. In 2005, only 26% of public plan sponsors offered real estate or REIT options and only 17% offered TIPS.

Table 3: Median Number of Investment Options Offered		
	1998	2005
Domestic stock	4	6
Foreign stock	1	2
Bonds	1	1
Balanced funds	1	3
GICs/stable value/cash	3	1
Other	0	1
Total	10	14

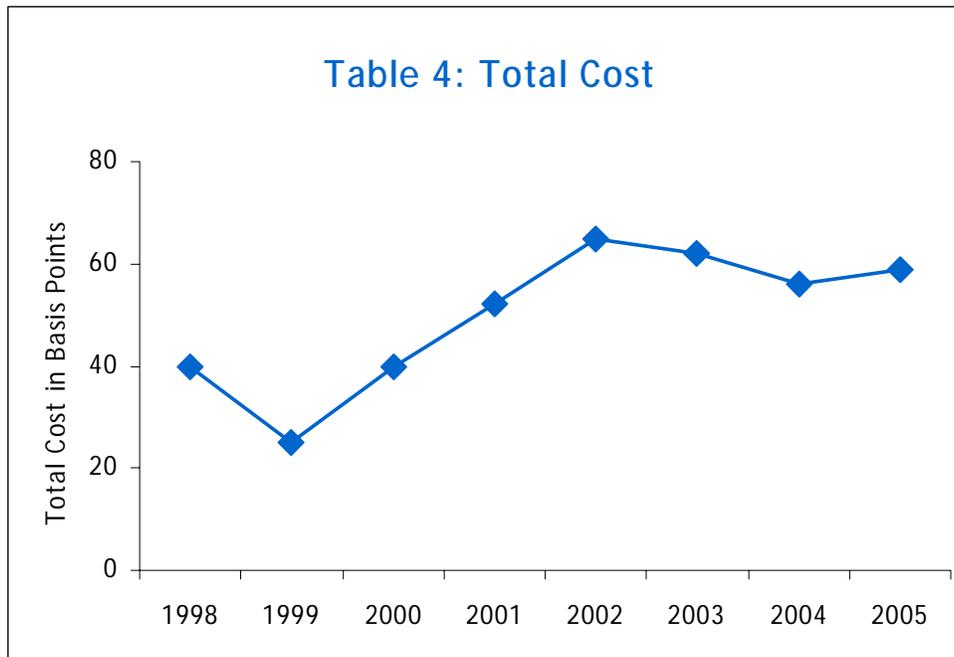
Source: CEM Benchmarking Inc.

Since 2001 (when CEM began to track default options), the number of public plans selecting balanced funds as the default grew from 0% to 32%. Over the same period, the choice of GICs, stable value funds or cash as the default fell from 100% to 68%.

CEM research has shown that assets in an investment option, when designated as the default, were 2.3 times higher than assets in the same option when it was not the default. Given the tendency of participants to leave their contributions in the default option, the trend to a higher performing default is encouraging.

Table 4 shows that total cost, which generally rose from 1998 to 2002, has been relatively stable over the past four years. Total cost is the sum of investment management cost and administrative and fiduciary costs.

This recent stability in total cost may be attributable to two offsetting trends. The first was the negative impact of an increase in high cost assets (domestic small cap stock and foreign stock) in the average asset mix. The second was the positive impact of an increase in low cost passive mandates, which increased from 17% to 24% of total assets from 2002 to 2005.



Source: CEM Benchmarking Inc.

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## Managed Accounts vs. Lifestyle or Lifecycle Funds

*By Tim Chapman, President, PMFM, Inc.*

The recently passed Pension Protection Act (PPA) has focused a lot of attention on investment advice and default options in ERISA plans. The PPA legislation provides a safe harbor for plan fiduciaries investing participant assets in certain types of default investment alternatives when participants do not make their own investment elections. The default options being considered by most plan sponsors are Lifestyle funds (risk-based allocation); Lifecycle funds (age-based allocations); or individually managed accounts. While 457 Plans do not fall under ERISA, the debate over which of these options best meets the needs of plan participants in 401k and 403b plans is certainly of interest in the 457 marketplace too.

Any of the choices listed above can help plan participants reach their retirement goals if used properly, but none of the three choices are perfect. Let's look at what is good and bad about each option.

Lifestyle and Lifecycle funds are "single" fund solutions. For years our industry has preached the importance of diversification, which to most participants means owning more than one fund. Risk-based and age-based funds are well diversified of course, but the challenge is communicating that to participants. When a participant does not see any activity in their account and only sees one fund on their account statement, they tend to question the value being added and wonder they are not more diversified. Participants also tend to judge the Lifestyle or Lifecycle fund performance relative to all the other funds offered in their retirement plan. Properly diversified portfolios will often underperform the more aggressive asset classes, particularly in strong bull markets like the late 90's. Many participants will succumb to the lure of "greener grass" based on short-term performance, or at the very least will add a few more funds to their portfolio thereby undermining the intended overall asset allocation.

Virtually all risk-based or age-based funds are managed using strategic asset allocation. Changes are made to the underlying allocation to rebalance, to replace an investment manager within an asset class for performance or style drift, or to gradually reduce equity exposure as the participant nears retirement. Even though the general philosophy governing these funds is the same, there can be tremendous differences in the actual make-up of the portfolios. For example, when given the same inputs – age, expected retirement date, risk tolerance, etc. – there can be very disparate results in the equity/fixed income mix from one portfolio to the next. One of the greatest concerns of defaulting participants into such options is the very real probability of the participant experiencing a large investment loss in severe bear market conditions such as the 2000-02 period.

For these reasons, the critical factor to success using Lifestyle or Lifecycle funds is the participants understanding of them. Meeting that challenge require excellent communication and education programs, and most importantly, a workforce that *wants* to be educated on these issues.

Individually managed accounts overcome these problems because participants see more than one fund in their account, plus they see the activity on an ongoing basis as the portfolio allocation changes. Managers using a tactical asset allocation philosophy might also be able to add value in bear market conditions by limiting downside risk in the portfolio. The biggest disadvantage of individually managed accounts is the cost. While Lifestyle or Lifecycle funds tend to be very inexpensive options, managed accounts might cost 1% per year or more. These costs are typically paid by the participant through deductions from their account so they do not add to the overall cost of the plan for participants not choosing to have their account managed.

One other advantage to managed accounts is the opportunity for one-on-one interaction between the plan participant and a financial professional. Study after study has shown that most participants prefer the investment advice be delivered face to face. Not only does this enhance their understanding and appreciation of the employer's plan, it also enhances their chances of success in reaching their retirement goals. The financial advisor can bring outside assets into the planning process, help the participant set realistic goals, and encourage greater deferral percentages when needed. The success of many managed account offerings suggests that participants are very willing to pay more in fees to get more personalized service and have the peace of mind in knowing their retirement decisions are being made by a professional.

Regardless of which option a plan sponsor chooses – Lifestyle fund, Lifecycle fund, of Managed Accounts – offering these vehicles to plan participants, along with automatic enrollment and automatic defaults, will hopefully result in more Americans being on track to retire with dignity and live out their Golden Years without running out of money.

Tim Chapman is President of PMFM, Inc., a registered investment advisory firm located in Athens, Georgia. PMFM offers investment advice and managed accounts to the retirement industry through their 410kToolbox, 403bToolbox, and 457Toolbox services. In 2004, Defined Contribution News named Chapman "Advice Provider of the Year" in the 401k market.

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## **We Really Can Help Participants Get On Target with Investment Management: We've been learning how for 25 years**

*By Rick Rodgers, Managing Director, InSight Employee Benefit Communications division of Innovest Portfolio Solutions*

Ask defined contribution plan participants what providers, consultants and employers can do to help them effectively manage their investments, and most will tell you "I want someone to tell me what to do." Are we listening? Since the beginning of America's conversion from defined benefit plans to defined contribution plans, about two and one-half decades ago, industry professionals and plan sponsors have created and utilized a myriad of programs and methods aimed at helping participants properly and effectively manage their investments. Unfortunately, most of these programs have failed to produce their intended results for the majority of participants. But it's not all bad news – some of these programs have been effective, and we can learn something from our efforts.

In the 1980s investment menus seemed to continually increase in size, in response to demands by some, for greater choice. Perhaps we thought that a massive basket of investment choices would prompt participants to conduct independent research and develop an interest in investment management, out of necessity. Needless to say, this was not an effective solution, and most participants' investments were defaulted to a single, very conservative fund.

At the beginning of the 1990s there was a virtual industry-wide consensus to help participants invest through education. Plan providers spent millions producing glossy eye-catching materials and began conducting on-site educational seminars. In addition to fundamental investment education, there were worksheets and questionnaires to help participants identify their personal tolerance for risk, and sample or risk-based asset allocation models. These methods actually did produce positive results for those participants attending the on-site meetings. However, getting participants to attend these meetings has always been difficult and this approach was viewed by many as failure, when analyzing the success ratio relative to all participants in a plan.

### **Self-service and DIY**

Later in the 1990s, the retirement industry continued the education theme, now with a “do-it-yourself” (DIY) spin. Participants were encouraged to educate themselves on the Internet, using interactive programs designed to help them with asset allocation and retirement planning. On paper, this looked like a great idea. If participants wouldn’t come to meetings to learn and /or wouldn’t read the educational materials, maybe they would teach themselves online. Many providers even began immediately converting their primary method of delivering customer service from 800 telephone access to the Internet. If it caught on with participants, providers could save a bundle in human capital by having participants teach and service themselves. However, retirement plan self-service and DIY investing never became popular among the majority of participants. Even though providers and plan sponsors spent millions on interactive investment tools, the utilization rates remain in single digits, even today.

Another trend that has evolved over the past decade has been professionally-designed and managed investment portfolios. This includes risk-based portfolios, target-date portfolios and managed accounts. Risk-based portfolios are usually a series of three mixes of investments that are designed for three different risk tolerance levels - conservative, moderate, and aggressive. These portfolios have static allocations, which means the participant must choose the portfolio that is consistent with their current risk tolerance and later move to a more conservative portfolio.

While the risk-based portfolios provide an answer to the participant requests of “do it for me” they don’t respond to the “tell me what to do” request of participants, because the participant must take the initiative to determine which portfolio is appropriate today, when to change in the future, and possibly, when to make changes several times in the future.

The next generation of professionally-managed portfolios were target-date portfolios. These are a series of multiple portfolios that have different investment allocations designed for different “target” retirement years. Distinguishing the portfolios by a target retirement year makes it easy for the participant to identify and choose the appropriate portfolio. They are easier to use for the participant, because the investment mixes are dynamic, rather than static, meaning that each portfolio’s allocation is automatically adjusted to become more conservative over time.

The industry’s newest answer to “tell me what to do” and “do it for me” are managed accounts. This is an asset allocation service that participants access online or via an 800 telephone number. The managed account service provider creates a series of portfolios for varying risk levels. Generally, the portfolios utilize only the investments currently offered in the plan’s core investment menu. When participants use an online version of the service, a risk questionnaire helps identify which portfolio to use today. Alternatively, when a participant contacts the service via telephone, a representative assists in determining appropriate risk tolerance and initial portfolio selection. Like target-date portfolios, some of the managed account services automatically adjust asset allocation over time, while other service providers require the participant to check-in periodically to review their objectives and make allocation adjustments.

All three of these options provide a professionally-designed solution for the investor. Target-date portfolios and some managed accounts also provide a professionally-managed solution. However, all of them still require the participant to take the initiative to execute, either by reading a brochure, completing a risk questionnaire or contacting a professional. This continues to be the problem that the industry keeps overlooking.

### **What Can We Learn?**

Remember, the first sentence of this story stated that most participants will tell you “I want someone to tell me what to do.” Despite creating all of these innovative professionally-managed investment solutions and making selection of the appropriate portfolio seemingly elementary, the majority of our DC plan participants are still not utilizing the services. What does participant behavior indicate? They don’t want DIY. They want someone to tell them what to do.

On-site education and individual counseling are the most effective methods of assisting participants with investment management. We should use the technology and investment options/services spawned from the past decade to help professionals improve efficiency when educating and counseling participants, rather than expecting participants to subscribe to DIY investing.

*Rick Rodgers is Managing Director of the InSight Employee Benefit Communications division of Innovest Portfolio Solutions. Teach him at RickR@innovestinc.com or (303) 221-5900.*

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## **WASHINGTON REPORT**

*By Susan J. White and Jonah Mainzer, Susan J. White and Associates, Inc.*

The end of 2006 brings not only the end of the 109<sup>th</sup> Congress but also the end of twelve years of Republican control Congress. Many issues—especially the appropriations bills which fund the federal government-- were left to wither during the Lame Duck session of Congress and these will have to be reintroduced during the next session of Congress.

### **Elections**

Election results in both the House of Representatives and the Senate left both Chambers of Congress in control of the Democrats for the first time since 1994. One race in Florida remains undecided and is apparently headed to court. Currently, Democrats have gained thirty seats in the House and unless the courts overturn the results in Florida this is how it will remain. These results give the Democrats a 233-202 edge in the House.

In the Senate, Democrats were able to defeat six Republican incumbents and were able to take control by a narrow 51-49 margin. This fifty-one includes two independents who have both announced that they plan to caucus Democrat.

Many of these races were extremely close and recounts were ordered automatically depending on the state and margin of victory. As an example in both Virginia and Montana the Democratic challenger defeated the Republican incumbent by under .5%.

### **Committee changes**

The Democratic takeover of Congress means that Democrats will now chair Congressional Committees. These announcements were made in the weeks following the election and have so far contained no surprises as Democrats, with the exception of the Select Committee on Intelligence have chosen the Ranking Members of the Committees as Chairmen.

In the Senate, Democratic committee, but not subcommittee, assignments have already been announced and as expected Sen. Max Baucus (D-MT) replaced Sen. Charles Grassley (R-IA) as chairman of the Finance committee which has jurisdiction over state and local government defined contribution plans, as well as Social Security. The Senate also has a Special Committee on Aging which does not have any legislative jurisdiction, but studies all matters pertaining to aging, including overviews of retirement income programs—both public and private-- women's retirement matters. The incoming chairman of that committee is Sen. Herb Kohl (D-WI) and he replaces Sen. Gordon Smith (R-OR) who recently cosponsored National Save for Retirement Week.

In the House, Congressman Charles Rangel (D-NY) will take over the helm of the Committee on Ways and Means, for retiring Rep. William Thomas (R-CA). Ways and Means has jurisdiction

over state and local government defined contribution plans and also has a subcommittee that deals exclusively with Social Security and Representative Sander Levin (D-MI) is the replacement for Rep. Jim McCrery (R-LA) as subcommittee chairman. The Administration has already indicated that it wants to reopen the debate on Social Security, so this subcommittee will be key.

### **Upcoming Agenda**

The 110<sup>th</sup> Congress will convene on January 4 and will stay in session until the President's State of the Union at the end of the month. This is not the usual practice, as both chambers typically wait to get down to business until after the State of the Union. Appropriations bills for Federal Fiscal Year 2007 will likely be the first order of business as only two of the eleven annual Appropriations bills have been signed into law. The rest of the government is being funded in the short term by a continuing resolution, funding the government at the previous years levels. Congress will also have to immediately begin work on the Federal Fiscal Year 2008 appropriations bills and so the Democratic Leader's Office in the House has announced its intention to fund the remainder of 2007 through a continuing resolution.

After a failed attempt to reform Social Security during the 109<sup>th</sup> Congress, President Bush has vowed another attempt. Incoming Ways and Means Committee Chairman, Representative Rangel has announced that he is willing to work with the Administration to find solutions to the funding concerns of the program; however, he has also indicated that authorizing private accounts under Social Security is a "non-starter".

On all other fronts related to pension legislation, it is unclear how Congress or the Administration might proceed. Some possible highlights for the coming year and possible agenda items for NAGDCA include:

- Introduction of Joint Congressional Resolution for a National Savings for Retirement Week
- Department of Treasury release of regulations on 403(b) plans and to implement the Pension Protection Act of 2006
- Reintroduction by Senator Smith (R-OR) of S. 3951, the Women's Retirement Security Act of 2006
- Expansion of benefits under some of the healthcare and other public employee benefit provisions recently passed as part of the Pension Protection Act of 2006.
- Continued review by the General Accounting Office (GAO) and Congress regarding the financial status of state and local defined benefit plans
- Social Security Reform
- Congressional oversight hearings on the status of state and local defined contribution plans and how plans are working, who is covered and how many jurisdictions offer such plans

We look forward to continuing to work with NAGDCA as the 110<sup>th</sup> Congress convenes and we wish you all Happy and Safe New Year!

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## **AROUND THE COUNTRY**

### **State of California to Issue a Request for Proposal for Seven Investment Products**

The State of California's Department of Personnel Administration (DPA) recently released a Request for Proposal (RFP) soliciting bids for seven (7) investments in the following categories:

1) Bond Index, 2) Large Cap Equity Index, 3) International Equity Index, 4) Mid Cap Equity Index, 5) Small Cap Equity Index, 6) International Value Equity (actively managed), and 7) International Growth Equity (actively managed). Three of these investments will be added to the current investments available in the Savings Plus Program's Deferred Compensation Plan [Internal Revenue Code (IRC) Section 457] and Thrift Plan [IRC Section 401(k)] and four of these investments will replace investments that will be discontinued in 2007.

The proposed investments must be qualified to accept both IRC Section 457 and Section 401(k) plan assets. Also, the proposing firms and the proposed investments must meet minimum qualifications and mandatory business and licensing requirements as specified in the RFP.

DPA will select these investments through a competitive process that considers firm background and experience, specific investment strategy, investment philosophy and process, investment performance, fees, and other operational information. It is DPA's intention to award one contract for each investment mandate. The Agreement(s) resulting from this RFP will be for a five-year period beginning August 1, 2007 with the option to extend the Agreement(s) up to two additional one-year periods.

If you are interested in receiving a bid package, please visit [www.cscr.dgs.ca.gov/cscr](http://www.cscr.dgs.ca.gov/cscr). Select "View By Contract Number or Agency" then select "Agency" and scroll to "Department of Personnel Administration" and click the submit button. If you are unable to download the bid package, you may call our Bidder's Hotline at (916) 445-9007 to request a hard copy. Final proposals are anticipated to be received by January 22, 2007.

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## NAGDCA Member Benefit Spotlight

To remind members of benefits they receive that they may not be aware of, we will be spotlighting a benefit of membership in each edition of *The Contributor*. For more information on this or any benefit of membership, please visit our website at <http://www.nagdca.org/> or contact NAGDCA staff at (859) 514-9161.

### Networking

- An Annual Conference with unparalleled networking opportunities
- An on-line Membership Directory that assists in locating other members
- Government and industry member listservs to enable open channels of communication. The NAGDCA listservs provide an outlet for individuals to gather information in a timely manner.

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## New Members

Please visit the NAGDCA on-line directory for member's full contact information. You will need a username and password to access the information.

### Local Government Primary Member

Debra Dillon  
Southern California Association of  
Governments

### NAGDCA Government Secondary Member

Marc Esen  
Montgomery County

**NAGDCA Associate Industry Member**

Aaron Adkins  
Nationwide Retirement Solutions (NRS)

John F Begley  
Fidelity Investments

Charles Bleakley  
MetLife Resources

Mike Falcone  
Independent Consultant

Marion Firetto  
ING Financial Advisers LLC

Nancy Zeller Foo  
MetLife Resources

Greg Hyland  
MetLife Resources

Sue Kocsis  
ING Financial Advisers LLC

Jay LaChapelle  
ING Financial Advisers LLC

Chris Marx  
MetLife Resources

Marie Panciocco  
ICMA-RC

David Russo  
MetLife Resources

Scott Vensor  
MetLife Resources  
Michelle Waterfield  
ING Financial Advisers LLC

**Student Member**

James Heinzer  
University of Missouri at Columbia

Melissa Kwan  
University of Colorado at Denver & Health  
Sciences Center

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## **ABOUT THE CONTRIBUTOR**

*The Contributor* is published quarterly by the National Association of Government Defined Contribution Administrators, Inc. (NAGDCA). NAGDCA encourages the submission of articles on topics relating to defined contribution/ deferred compensation retirement savings/plans. Articles that appear under the by-line of an individual express the opinions of the author and not those of NAGDCA as an organization. The deadline for submissions for the next issue is March 23, 2007. Articles should be approximately two pages in length and should be submitted in Word format. Please direct all newsletter items and questions to NAGDCA, 201 East Main Street, Ste. 1405, Lexington, KY 40507. You may also e-mail submissions to Robert Hansel at [rhansel@AMRms.com](mailto:rhansel@AMRms.com). Please contact Robert Hansel at 859-514-9161 with any questions or comments.

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