

*In This Issue:*

1. ***Securities Lending***
2. ***Treasury Money Market Fund Closures***
3. ***Market Effects on Endowments***
4. ***Implications of Recent Market Declines for the PBGC***
5. ***Passage of WRERA – The Worker, Retiree, & Employer Recovery Act of 2008***
6. ***IRS Provides Relief for 2009 403(b) Regulations on Written Plan Document Requirements***
7. ***The Economic Slowdown Leads Companies to Suspend Their 401(k) Matches***
8. ***The Use of Managed Accounts & Advice Technology Amid Market Volatility***
9. ***Update of Regulation 408(b)(2)***
10. ***What's New at PEI***

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**Securities Lending***What is Securities Lending?*

While stock markets and the financial industry were doing well, many investment strategies were not paid much attention or given their share of due diligence research by investors. However, as the investment landscape has worsened, the risk involved in many of these strategies has come to the forefront.

One such strategy is the practice of securities lending. Many mutual funds and exchange-traded funds lend out their securities to create additional revenue and help offset fees. A potential borrower, typically a hedge fund or someone looking to short sell a stock, will contact a lending agent that works with the inventory of all investment managers. Usually, a mutual fund or its lending agent will not lend directly to a hedge fund or

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other borrower. Instead, a prime broker will borrow the securities on behalf of the borrowing party. Using a prime broker helps to protect the lender from a borrower who cannot return the loaned securities.

A loan will be negotiated between the two parties whereby a mutual fund will lend out securities in exchange for collateral from the borrower. The borrower will typically have to post collateral worth between 102% and 105% of the lent out securities. The lender will revalue the loaned securities on a daily basis and the amount of collateral posted must be adjusted to reflect any change in value.

The collateral may be either cash or non-cash. With cash collateral, a lending fund will invest the cash in short-term investments in order to create additional revenue. A portion of this revenue will be returned to the borrower in the form of a rebate. In a case where there is non-cash collateral, the borrower will pay the lender a fee and there is no rebate given back to the borrower.

When the loan period has ended, the securities are returned to the lender and the collateral is returned to the borrower. If necessary, the rebate will be paid to the borrower. Either the fee paid by the borrower or the return earned on the reinvestment of the collateral will be divided between the lending mutual fund and its lending agent bank according to a predetermined fee split.

*Why would an investor want to borrow securities?*

There are a couple of reasons for why someone would want to borrow securities. The main reason would be to short sell a security. If an investor such as a hedge fund or alpha plus manager believes that a company's securities will decrease in value in the future, they can short sell the security in order to make money. In order to short sell a security, the investor must first borrow that company's securities. The investor will then sell the securities for the current market value. At the end of the borrowing period, the investor must purchase the same amount of securities it borrowed and return them to the lender. If the investor's prediction was correct, the securities will have decreased in price and they will have been purchased for less than they were sold for originally, thus making a profit for the investor on the entire transaction (minus any fees paid to the lender). Of course, if the security's price increased in value, the transaction would have resulted in a net loss for the short seller.

Another reason why an investor would want to borrow securities is to gain the voting rights that accompany them. While the lender retains most rights of ownership of the securities over the duration of the loan, the borrower acquires the voting rights of the stock. With these voting rights, a borrower can affect the decisions made by a company it may have an investment in.

*What are some of the risks associated with securities lending?*

One risk of securities lending involves the credit-worthiness of the borrower. There is always the risk that the party which borrowed the securities is not able to return them to the lender. The collateral posted by the borrower helps to mitigate this risk since the lender can keep the collateral in the case of the borrower defaulting.

Another risk for the lender involves the investment of cash collateral and the potential that the investment could lose value. The risk associated with the investment of this cash depends on what types of investments are made. During the mid 2000s, yields on what are considered the safest investments were low and some lending funds turned to asset-backed securities and other higher risk products in order to enhance their returns on the investment of cash collateral. Since the subprime crisis began in 2007, many asset-backed securities have become very risky in price and illiquidity due to their ties to mortgages. As a result, there has been greater awareness of the need for investors to understand where funds are investing collateral from securities lending practices.

While recent market conditions have exposed the risks in lending out securities, securities lending can be a relatively safe strategy if the lending fund conducts thorough due diligence and practices strong risk management.

### **Treasury Money Market Fund Closures**

Several money market funds that invest mostly in U.S. Treasuries have closed to new investors as low yields on government debt are deteriorating shareholder returns. Treasury yields are at their lowest point in 50 years, a result of extraordinary demand from investors seeking the safest investments. As of 1/15/09, the one-month Treasury yield was 0.03%. In the three weeks following the collapse of the Reserve Primary Fund in mid-September, \$347 billion was pulled out of prime money market funds and \$300 billion was placed into money market funds that invest only in U.S. government debt, according to Bloomberg. At the end of November 2008, around \$750 billion was invested in Treasury money market funds, an increase of 150% from November 2007, as reported by Crane Data.

Current Treasury yields are so low that fund companies are worried that returns will not be sufficient enough to cover management fees, potentially resulting in a loss to investors. To combat this, many fund companies are choosing to lower management fees and/or close their Treasury money market funds to new investors. Some of the fund companies that have announced the closing of Treasury money market funds include Vanguard, Fidelity, JPMorgan, Barclays, Evergreen, and Allegiant.

By closing out new investors, a fund company can protect current shareholder returns as well as management fees. Without new investors, a fund does not have to buy as many new Treasuries with yields that are lower than those of their current holdings, thus avoiding a decrease in returns per shareholder. Another reason for the closing of some of these funds is the fear that the large wave of new investors could easily remove their money, possibly requiring the fund to sell holdings at a loss in order to meet redemptions.

### **Market Effects on Endowments**

As a result of the continued turmoil in the world's financial markets, college and university endowments have generally suffered severe investment losses in 2008. Even the large endowments of Yale and Harvard, which have dodged the effects of recent market downturns with their intricate investment strategies, have failed to avoid the effects of the current crisis. In fact, from early July to late October, it was estimated that the endowments of Harvard and Yale had each plummeted by over 20%. What is all the more disturbing is that many of the investments within these endowments have not been realistically appraised yet. Once real estate and private equity losses are factored in, declines could well exceed 30% for the period.

For many collegiate institutions with larger endowments, a non-traditional investment approach may be partly to blame. This approach de-emphasizes more traditional investments such as publicly traded stocks and bonds in favor of investments in less liquid assets such as timberland, real estate, and private-equity funds. While this hedging strategy helped tremendously in mitigating losses in past market downturns, it has not fared well in the current market. This is due to increased exposure to commodities, timber/agriculture, and real estate which have been hit particularly hard in recent periods. In addition, relatively low exposure to better performing market segments, such as U.S. Treasuries, has hampered performance. In contrast, endowments with limited exposure to alternative, and sometimes riskier, investments such as the University of Pennsylvania's endowment have posted declines, but have been weathering the storm far better.

Regarding endowments, the current state of the economy affects more than just the investment returns. In periods of economic decline, government support and charitable donations also tend to decrease, while distribution requirements stemming from student financing hardships caused by job losses, investment losses, and reduced borrowing power tend to increase.

Many institutions depend on revenue generated from their endowment to fund general operating costs. With the drop in endowment values, the revenue provided may not be sufficient to fund the institutions operating costs. In light of this, many institutions will be forced to cut their budgets which could include, among other things, moderating salary increases for faculty, limiting renovations, and possibly reducing student aid. Furthermore, tuition increases may be instituted to offset endowment losses.

### **Implications of Recent Market Declines for the PBGC**

The sharp declines experienced in all corners of the global equity markets in 2008 have become a double-edged sword for the Pension Benefit Guaranty Corporation ("PBGC"). On the one side, deteriorating financial markets, as well as sharply slowing economic growth, has created an environment in which the agency's services are likely to be in significantly greater demand than in recent years. Takeovers of a growing number

of underfunded pension plans due to both an increasing number of corporate failures and weakened plan financials are widely expected to put a greater strain on the insurer in the foreseeable future. On the other side, the PBGC's assets have been meaningfully reduced by investment losses of its own, as its equity investments have suffered along with those of most other investors.

The PBGC's Annual Management Report for the fiscal year 2008 (which ended September 30<sup>th</sup>) reported total assets of approximately \$62 billion, down from more than \$68 billion as of September 30, 2007. Nevertheless, during the fiscal year 2008, the agency's liabilities were reduced as a result of favorable changes in interest factors and other positive events, to the extent that its deficit actually declined from the prior fiscal year end from approximately \$13 billion to \$11 billion. However, during the fourth quarter of 2008, equity markets plunged sharply and grim economic forecasts and corporate earnings reports have increased concerns over escalating numbers of bankruptcies and a greater level of underfunded plans (and the extent to which they are underfunded).

An additional issue for the PBGC is the fact that early in 2008 it made a decision to change its own investment policy from a 75%-85% fixed income/15%-25% equity allocation to a much more aggressive 45% equity/45% fixed income/10% alternative investment allocation. This decision has come under heavy fire from multiple parties, including the House Education and Labor Committee, which appear to be highly uncomfortable with the emphasis on equities in light of recent losses and volatility. The agency's position is that the new target allocation will generate higher returns over the long-term, while reducing risk due to the benefits of improved diversification. Though the agency recently made manager selections for the alternative portion of its portfolio (specifically for private equity and real estate advisory services), it is still in the process of implementing its new policy guidelines and continues to face intense scrutiny from many quarters on this issue.

### **Passage of WRERA - The Worker, Retiree, and Employer Recovery Act of 2008**

In a surprise turn of events, The Worker, Retiree, and Employer Recovery Act of 2008 ("WRERA") passed both the House and the Senate unanimously, and was signed into law by President Bush on December 23, 2008. For defined benefit plans, the most significant provisions of WRERA provide temporary relief from funding requirements that were to take effect in 2009.

The most noteworthy provisions specific to defined benefit pension plans include:

Asset Smoothing - Allows plans to apply "smoothing" to their market value calculations of plan assets, including contributions, distributions and expected earnings, averaging gains and losses up to a 24-month period. However, this new provision does not adjust the fairly narrow "corridor" that restricts the smoothed value to remain within at least 10% of the fair market value of plan assets.

Transition Relief - Eliminates the “cliff” transition rule, allowing plans with a funding shortfall to lower their required contributions by basing these contributions on a lower percentage of the funding target. Therefore, many plans need only fund up to the transition percentages, instead of to 100%, from 2008 through 2010. These percentages are now 92% funding target for 2008, 94% in 2009 and 96% in 2010.

Benefit Accruals – Delays by one-year, the requirement to limit or suspend benefit accruals for plan participants in plans that fall below the 60% funding target.

Small Lump Sum Distributions - Lifts the restriction under PPA on lump sum distributions of less than \$5,000. These small distributions can now be made without the consent of plan participants of underfunded plans.

Plan Expenses - Requires that plan expenses must be included in target normal cost as part of a plan’s funding calculations. This requirement goes into effect for plan years in 2009, but plans can apply the provision to 2008. This approach can benefit plans that otherwise may need to revise 2008 plan cost calculations because they did not include these expenses based on the previous PPA provisions.

### **IRS Provides Relief for 2009 403(b) Regulations on Written Plan Document Requirements**

The IRS recently issued Notice 2009-3, providing relief for sponsors of 403(b) plans with respect to the pending 403(b) regulations regarding the requirement of a written plan document in place by January 1, 2009. Although the final 403(b) regulations were initially published on July 26, 2007, this relief was intended to provide additional time for plan sponsors to put a written plan document in place, with the purpose of properly outlining the terms of the plan as well as investment provider and plan sponsor responsibilities.

Notably, Notice 2009-03 also provides that plans will be treated as compliant with the aforementioned regulations during the 2009 calendar year if:

- 1) By December 31, 2009, the plan sponsor has a written document in place that fulfills the requirements of the regulations.
- 2) During 2009, the plan sponsor operates in accordance with a reasonable interpretation of 403(b) and final regulations.
- 3) By the conclusion of 2009, the plan sponsor makes a good faith effort to retroactively fix any operational failure during the calendar year to conform to the terms of the written 403(b) plan; with such relief applying only to the operational failures during the 2009 calendar year, not including any prior or subsequent calendar year.

### **The Economic Slowdown Leads Companies to Suspend Their 401(k) Matches**

In recent months, worsening economic conditions have caused business activity to slow significantly, increasing the need for companies to aggressively cut costs. As a result, a number of high profile companies have suspended or reduced their employer contribution or “match” for their 401(k) Plans. In addition to struggling auto giants GM and Ford, notable plan sponsors such as FedEx, Eastman Kodak, Motorola, Frontier Airlines, and Cushman & Wakefield have all suspended their matching contributions for 2009. Additionally coffee giant Starbucks may reduce or restructure its 2009 employer contributions.

A recent survey indicated that 2% of plan sponsors plan on eliminating their matching contributions in 2009, while 4% plan on reducing their matches. Fidelity has indicated that, as of December 2008, only a small number of its 18,000 plans have suspended or terminated their matches. As the impact of the recession continues, attention will continue focus on how many other companies will follow suit in early 2009.

### **The Use of Managed Accounts & Advice Technology Amid Market Volatility**

In response to the market turmoil, participants in defined contribution plans have taken a more active role over their retirement assets, while also seeking guidance on the appropriateness of their investments. A growing resource has been the implementation of managed accounts and advice technology to assist participants with their retirement savings. Since 2007, New York Life and Vanguard have seen increases in implementation by plan sponsors for these services. However, utilization by participants in plans currently offering such services has remained fairly stagnant even in recent months. A number of recordkeepers noted increased call volume by plan participants in the months of September and October; when the market saw some of its most volatile trading, with a relative drop-off in activity towards the end of 2008. However, New York Life also noted a year-over-year increase in participants acting on advice recommendations for 2008. The ongoing response by defined contribution participants to market volatility will be interesting to follow, especially as a growing baby boomer population is forced to evaluate its retirement readiness.

### **Update on Regulation 408(b)(2)**

In 2007-2008, the Department of Labor proposed regulation under ERISA Section 408(b)(2) that explains the prohibited transaction exemption in ERISA which required contracts and arrangements between Plans and Service Providers to be “reasonable.” The regulation was finalized by the Department of Labor and sent to the Federal Office of Management and Budget in September, as a final step before issuance. As of early January 2009, the final regulation has not been issued despite official guidance of a late-2008 release. With the change in the administration and broader

economic concerns, the regulation may or may not be released in its present form; it may go back to the legislative body or be incorporated as part of a broader set of regulations.

As proposed, section 408(b)(2) would provide relief from ERISA's prohibited transaction rules only if the contract and arrangement between the plan and the service provider is reasonable, if the services are necessary for the establishment or operation of the plan, and if no more than reasonable compensation is paid for the services. However, to fully comply with their fiduciary duty, plan sponsors will need to understand, review and monitor the aforementioned arrangements in order to assess reasonableness of the fees for the services provided. The implications of the proposal may have a broad impact on the way service providers, such as registered investment advisors, broker-dealers, recordkeepers and third-party administrators disclose their compensation and conflicts of interest. While many of these parties have come a long way towards full disclosure, others may need to provide significant amendments and provide more transparency in order to comply with the proposed regulation.

In conclusion, despite uncertainty associated with the proposed regulation, plan sponsors have an existing fiduciary duty to obtain, understand and evaluate the arrangement between the plan and service providers to ensure that the arrangements are reasonable. As plan sponsors become more educated and comply with their obligations, the need for transparency of services and disclosure of potential conflicts of interest will remain as mandated by the DOL, ERISA, and/or industry best practice.

**What's New at PEI**

As part of our national growth plans, PEI recently hired Tom Harty as an investment consultant in our Chicago office. This is the first of our four regional offices to now have a permanent local presence. Tom brings a tremendous amount of experience and expertise to PEI, especially in the government and 403(b) markets. We are excited to be able to continue our growth especially in this challenging economic climate and are excited to have Tom as the newest member to PEI. Underpinning our success has been our core philosophy – do everything in the best interest of the client. By being true to this tenet, we hope to continue to grow and develop our regional offices.

Currently, PEI services clients in over 20 different states and covering many industries. PEI has clients in advertising, airlines, law, manufacturing, medicine, information technology, education, insurance, media, entertainment and many other industries. Below is a graph of broad sectors our clients represent.

