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The Current State of Commercial Real Estate

Concerns abound that commercial real estate will be the next area of the economy to experience difficulties. Many of the factors that affected residential real estate are relevant to commercial real estate. The biggest detriments are easy credit, lax lending standards and booming mortgage-backed-securities underwriting, declining property values, declining rents, and increased vacancies at commercial properties nationwide. Coupled with the fact that many landlords have been unable to refinance their mortgages, the picture is bleak. As of October 31, 2009, according to the *Wall Street Journal*, there are \$1.4 trillion in maturing loans over the next five years. Around half of these are said to be underwater, and thus cannot be refinanced at current price levels. Bad construction loans have also contributed to the negative outlook, and have taken their toll on many of the country's regional banks, who tend to lend at the local level. These are widely accepted to be some of the most risky loans in the commercial arena.

Undoubtedly, some investors will profit from this crisis by acquiring properties at opportunistic levels. REIT funds have raised billions of dollars in the past year in anticipation of a bottom, selling both new equity and weak assets in order to raise capital. We are beginning to see evidence of dealmaking as the healthier commercial real estate operators try to take advantage of market conditions. For example, in early December 2009, mall-operator Simon Property Group announced a \$2 billion outlet mall acquisition of Lightstone Group. More importantly, Simon also announced that it had secured a \$3.6 billion line of credit through over 30 sources. In fact, some commercial real estate funds have advanced at least 100% from their trough levels as investors have anticipated a rebound.

An index compiled by Moody's Investors Service found that prices of commercial real estate continue to decline, but the speed of the decline may be slowing. The Moody's/REAL Commercial Property Price Index, based on repeat sales of the same properties across the U.S., declined 1.5% from September to October. Based on the index, prices for commercial real estate were 36.4% lower than in October 2008 and 43.7% below the peak measured in October 2007.

However, monitoring the job market will be important as it affects vacancy levels, as well as default rates on commercial real estate loans. On December 1, 2009, Real Estate Econometrics reported that default rates jumped to 3.4% in the third quarter as vacancies rose and rents declined. In comparison, defaults were 1.37% in the first quarter and 2.88% in the second. When the commercial real estate market will

reach trough levels is still unknown, but most real estate companies have bleak outlooks for 2010 and cite 2011 as the year that the recovery may begin.

Socially Responsible Investing in DC Plans

According to the 2007 biennial survey conducted by the Social Investment Forum, fewer than 20% of DC plans have socially responsible investment (SRI) options. However, the survey also showed that the number of SRI funds increased in the U.S. by 258% in the past ten years. This increased interest has been attributed to a desire to align retirement plan offerings with the mission of the company, internal committee recommendations, and employee/participant requests for SRI options.

There are currently just over 150 mutual funds domiciled in the U.S. that are classified as meeting socially conscious criteria. These funds can then be subcategorized by their “social motive,” which is most commonly secular, faith-based, or green funds.

When evaluating these funds, additional analysis is essential given that, in addition to the social screens that differentiate secular, faith-based, and green funds from each other; there can be significant screening variations within each of these subcategories. For example, secular SRI funds seem to share many of the same screens and social criteria. They generally avoid firms with links to tobacco, alcohol, firearms, or nuclear power; as well as those with significant environmental, workforce, or human-rights problems. They also favor companies that are leaders in the areas of environmental sustainability and employee relations.

However, secular SRI funds differ in how consistently and strictly they apply their social criteria. SRI funds that belong to a fund family that offers non-SRI funds tend to invest more readily in the least offensive firms in problematic industries to achieve diversification. They also engage in less shareholder activism than pure-SRI firms.

Other portfolio characteristics need to be considered when evaluating these funds too. Most SRI funds tend to have significant sector biases. Primarily because of their environmental- and workforce-related criteria, secular funds tend to be light on the traditional value sectors and heavy on popular growth sectors. SRI funds also tend to be more volatile than non-screening funds, making SRI funds more prone to boom and bust cycles.

Fiduciaries may struggle with the question of adding an SRI fund and how it fits into the fiduciary equation. The Department of Labor (DOL) has addressed several times how the ERISA fiduciary standard applies in the context of “socially responsible” investments (*see, e.g., ERISA Opinion Letter 98-04A; ERISA Opinion Letter 88-16A*). The DOL states that fiduciaries are not precluded from selecting SRI funds. However, fiduciaries must first analyze the fund from a purely financial perspective and compare it on a financial basis to other available investment funds. For example, if a SRI fund behaves financially like a large cap value fund, it would be necessary to compare that fund to the universe of other large cap value funds. It would not be appropriate to only compare that fund to other SRI funds. The DOL does permit the socially responsible aspects of a fund to be used as a “tie breaker”, but only after a purely financial analysis has been made.

When selecting any investment, performance is a consideration. However, shrinking the universe of potential investments based on value judgments is widely believed to penalize performance. It is hard to

justify in financial terms an exclusionary screen based solely on a value judgment, but some of SRI's traditional exclusionary screens are lacking in foundation. For example, the SRI industry has operated under the belief that excluding alcohol is in some way essential to its mission. Unlike weapons and tobacco screens, which have a clear social justification, the alcohol screen arguably does not. While social investors would undoubtedly like a world where there is no war/violence or cigarette smoking, it is highly unlikely that they are opposed to the occasional glass of wine or beer. That being the case, alcohol use per se is apparently not the "sin" this screen is meant to address. Rather alcohol abuse and its commonly linked problems, such as drunk driving and domestic violence, is clearly the concern. However, does divesting from alcohol manufacturers do anything at all to address this problem?

Nevertheless, there are other factors that can still weigh on the decision to offer an SRI fund including the fact that adding more options can sometimes overwhelm participants and; the inclusion of a single SRI option can lead to an undesirable outcome, such as participants concentrating all of their assets in one fund instead of diversifying across asset classes. As with the addition of any investment option, fiduciaries need to do their due diligence and bear in mind the unique aspects of certain investment types such as SRI funds.

Ripple Effects of Automatic Enrollment

In the wake of the PPA and the Obama Administration's retirement initiatives, as noted in the Fall 2009 *Prudent Press*, automatic enrollment in 401(k) plans has become a popular topic. Conventional wisdom among lawmakers is that these measures will increase participation and savings rates, thus increasing the chances of workers reaching their retirement "nest egg" goals. While past findings support this assumption, a recent study suggests that in some cases automatic enrollment may actually have a prohibitive effect on an employer's company match.

A recent study surveying large 401(k) plans found that automatic enrollment could lead to lower overall account balances due to reduced, suspended, or eliminated employer matches; as well as reduced employee contributions. The growth of automatic enrollment among employers currently offering a match would increase matching contributions, therefore driving up costs and leading some employers to suspend, reduce, or eliminate their match. This study found that firms with

	<i>Scenario 1</i>		<i>Scenario 2</i>	
	Spouse 1	Spouse 2	Spouse 1	Spouse 2
Annual Salary	\$ 75,000	\$ 75,000	\$ 75,000	\$ 75,000
Monthly Salary	\$ 6,250	\$ 6,250	\$ 6,250	\$ 6,250
Employee Monthly Deferral (%)	6%	0%	3%	3%
Employee Monthly Deferral (\$)	\$ 375	\$ -	\$ 188	\$ 188
Employer Match (\$)	\$ 250	\$ -	\$ -	\$ -
Employer Match (%)	Safe Harbor Match	Participant doesn't contribute	Match Suspended	Match Suspended
Total Monthly Deferral (\$)	\$ 625	\$ -	\$ 188	\$ 188
Total Annual Deferral (\$)	\$ 7,500	\$ -	\$ 2,250	\$ 2,250
Total Annual Household Deferral (\$)	\$ 7,500		\$ 4,500	

automatic enrollment tend to have match rates 7% below those companies that don't automatically enroll their employees¹. However a recent EBRI Press Release disputes these findings.

However increased costs may influence a company's match and the absence of this benefit may discourage employee contributions to the plan, as participants perceive a company match as a key incentive to participate. As a result, while more employees are enrolling in the plan, they are more likely to have a lower account balance without an employer match.

To illustrate this point, consider two hypothetical scenarios of a household saving for retirement. Scenario 1 exhibits voluntary participation of one spouse, contributing 6% of salary with a Safe Harbor Match. Scenario 2 exhibits both spouses auto-enrolled in their respective plans at a 3% deferral rate, yet with no employer contributions due to the growing cost burden placed on each spouse's employer. Per the two scenarios, despite 6% in household deferrals in both scenarios, having a match serves as a key factor in increasing retirement savings.

Automatic enrollment and employer matches are plan features whose practicality varies according to each specific industry, company, and plan. While the data sample in this study is limited to large 401(k) plans, its findings certainly present noteworthy discussion points equally relevant to all plan sponsors.

Purpose of Returns Based Attribution Analysis

Returns based attribution analysis is a process whereby the returns on an investment are regressed against the returns of a reference portfolio. The objective is to determine how much of the return variance of the investment can be explained by the return variance of the portfolio. A best-fit line is determined with the format:

$$Y = \beta x + \varepsilon$$

The β term is interpreted as the sensitivity of the return variance of the investment to the return variance of the reference portfolio. Furthermore, we can regress the investment returns against multiple reference portfolios and end up with a regression line with the format:

$$Y = \beta_1 x_1 + \beta_2 x_2 + \beta_3 x_3 + \beta_4 x_4 \dots \beta_n x_n + \varepsilon$$

By summing all of the β terms and scaling them to add to 1, we can draw some loose conclusions as to the different asset exposures found within an investment. In addition, by examining the R^2 of the regression we can draw conclusions as to the goodness of fit of this model to the actual data. A low R^2 could suggest that regardless of the power of the β coefficients, the overall model is not specified appropriately. This would most likely be due to choosing reference portfolios that have very little in common with the investment that is being assessed.

The purpose of this analysis is to gain a rough understanding of how well the fund is staying within its mandate (i.e. a large cap growth fund should have a high beta coefficient to the large cap growth

¹ Soto, Mauricio & Barbara A. Butricia, "Will Automatic Enrollment Reduce Employer Contributions to 401(k) Plans?" Washington, DC: The Urban Institute. 2009.

reference portfolio). In PEI's Performance Reports you can see the estimated position of the fund within the investment space by reviewing the chart on the third page of each fund exhibit. In the event that the fund begins to drift away from its mandate, a review of the fund's continued inclusion within the portfolio may be required in order to ensure the ability to construct properly diversified portfolios.

Annuities in 401k Plans

Pairing a 401(k) with an annuity (or an annuity like feature) is gaining momentum because regardless of the amount of money saved during working years, retirees can find it challenging to manage their nest egg. Additionally, the recent market downturn highlighted the risks of today's 401(k) plans as billions of dollars evaporated from those accounts that were the primary source of retirement funds for many American workers. As such, the number of employers planning to offer annuities to participants in their 401(k) plans is expected to grow as companies look for ways to provide workers with a steady distribution of benefits during retirement. According to a recent Watson Wyatt Survey, approximately one quarter of companies that offer DC plans provide an annuity as a distribution option, and an additional 10% of companies are considering it.

There are various kinds of annuity and annuity-like options currently available to 401(k) plans that generate guaranteed lifetime income by allowing investors to either purchase annuity shares with each paycheck or invest in a mutual fund with an income guarantee. Several insurers, including The Hartford, MetLife, Genworth, Prudential Financial and John Hancock have rolled out guaranteed lifetime income products. In terms of deferred annuities, there are fixed or variable options.

In general, with fixed annuities, each contribution purchases a certain amount of promised income depending on interest rates and the participant's age at the time of investment. Regular contributions into the contract allow participants to dollar cost average into a contract throughout their accumulation years, as opposed to making a one-time annuity purchase at retirement.

In contrast, the guaranteed income level in a variable annuity is based on market performance of the contract's underlying investments. The contracts offer participants protection against market downturns via "step-ups" or increases that kick in on the participant's anniversary. If the portfolio value decreases, the guaranteed amount remains the same, providing a guaranteed income floor.

The jury is still out on these products. The first consideration is the higher cost, or the premium paid for the insurance, which is typically a minimum of 65 basis points (although these fees vary widely by product and issuer). Second, with deferred annuities, participants may pay for the guarantee, but never actually benefit from it. The guarantee feature may be lost if the account value is rolled over into an IRA or another employer plan without the annuity option. Also, participants may pay for the guarantee, but take a lump sum payment upon retirement and never annuitize. Third, it is difficult to value the guarantee. A detailed analysis of each product would be necessary to determine the attractiveness of the offering. Moreover, it can be difficult to calculate and compare returns across different products from different companies. Lastly, investors are exposed to some investment risk; i.e. the credit risk of the insurer. The guarantee is only as secure as the insurance company offering the annuity.

However, this attitude towards annuities is expected to shift given 2008's decline in retirement savings and heightened risk awareness. The DOL announced in early December 2009 that it will explore steps it can take to encourage employers to offer lifetime annuities or similar lifetime distribution options in their defined contribution plans, which should further increase demand. The IRS has also recently issued a private letter ruling (PLR) which should help pave the way for DC annuities. The PLR defines for the first time what an annuity really is for the purpose of DC annuitization, and when the annuity election occurs.

What's New at PEI

PEI is proud to enter 2010 as our business now spans 3 decades. As we enter a new decade, PEI would like to share some background on the firm's development and growth. From a single office in 1992, Michael Sasso, Rich Torbinski, and Attila Toth had a vision of providing independent investment consulting services to small and mid-sized pension plans and working exclusively for the benefit of our clients. Over the past 18 years, PEI has stayed true to this vision and has grown to become one of the leaders in independent investment consulting services.

Today, PEI has 5 offices; Warren, NJ (headquarters), Atlanta, Chicago, Dallas, and Los Angeles and employs a staff of 36. Our staff is comprised of 11 investment consultants, over 20 investment analysts, and several key support personnel. Based on several industry surveys, we have a larger, more experienced analyst staff than the majority of our peers. Our investment analysts regularly conduct due diligence on over 150 investment managers and over 1,000 investment products used by our clients.

PEI currently provides consulting services to over 170 individual clients and over 250 unique portfolios in 23 states as well as Canada and Puerto Rico. Our clients span 42 unique industries; such as Healthcare, Non-profit Organizations, Pharmaceuticals, Financial Services, Law, Real Estate, Construction, and Consumer Goods.

Our business of consulting is segmented across DC and DB plans, as well as Taft Hartley plans, foundations & endowments, operating accounts, and non-qualified plans. With approximately \$20 Billion in assets under advisement, PEI's average client portfolio size is over \$70 million. However, our client's portfolios range from approximately \$1 million to well over \$1 billion.

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 help our clients in achieving their investment objectives and meeting their responsibilities as fiduciaries, as well as to continue to grow as a firm.

This newsletter has been prepared exclusively for informational purposes. Every effort has been made to provide accurate and authoritative information in regard to the subject matter in this newsletter; however, accuracy and completeness cannot be guaranteed and is not warranted as such. Numerous sources were used in compiling the data for this newsletter. PEI does not assume responsibility for the accuracy or completeness of such information. The information contained in this newsletter is provided with the understanding that PEI is not engaged in rendering legal, accounting, or actuarial advice. If such advice is required, the services of a competent professional of this kind should be sought. The information contained in this newsletter does not constitute the recommendation of any investment advisor or their services nor does PEI assume responsibility for the conduct of any investment manager.