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New Fixed Income Classifications

A recent FINRA announcement that the traditional method of calculating average portfolio credit quality does not properly reflect true credit risk is having a noteworthy impact on fund companies and reporting firms alike. However, it should also be drawing the attention of plan sponsors.

The traditional calculation assumed that the rate at which underlying securities defaulted was constant, when, in fact, these rates rise exponentially across the credit scale. The new methodology incorporates the non-linear nature of credit risk and has resulted in a lower average credit quality measure for a substantial percentage of fixed income funds. As an example, Morningstar, Inc. has reported that 62% of previously AA rated fixed income mutual funds are now rated A or lower using the new methodology.

The revised statistic offers a better means for fiduciaries to evaluate the fixed income portion of their plans and portfolios, and ensure proper diversification from a credit quality perspective. The change should trigger a review of fixed income investments' original purpose and confirm that they continue to make sense within the overall framework of the portfolio or plan.

The revised measure also impacts performance monitoring and peer group construction, especially within the context of an Investment Policy Statement. Given the general downward movement of the average credit quality measure for most investments, higher quality peer groups will now likely have fewer members and lower quality peer groups will likely have increased membership. Furthermore, better distinction now exists between peer groups that are defined, at least in part, by quality tiers. This may significantly alter performance comparisons for any given investment relative to its Investment Policy-defined peer group, given the dramatic differences in performance that may exist between differing quality-based segments of the market.

It is important that Committees review their Investment Policy Statements to ensure that their fixed income managers are compared to the most appropriate peer groups. The improved-upon measure should provide impetus for fiduciaries to review their fixed income investments with greater transparency than in the past.

Lifetime Income Hearing

In September the DOL and Treasury held a joint hearing on lifetime income options for retirement plans. The hearing was called to address a variety of issues such as: participant concerns affecting the choice of a lifetime income option relative to other options, information to help participants manage retirement benefits, illustrating account balances as monthly income streams, and fiduciary safe harbors for the selection of a lifetime income product. Though commentary was presented on each of the above topics, the majority of the testimony focused on the potential inclusion of a lifetime income option in retirement plans and the fiduciary liability concerns that might arise from such a construct.

Throughout the hearing a common theme among presenters was the concern that offering a lifetime income option within a retirement plan could potentially increase a plan sponsor's fiduciary liabilities. Of particular concern was the need for detailed regulatory guidance and standards for educational tools to guide the selection and implementation of such an investment option. Most of the witnesses agreed that due to the nature of a lifetime income option as an investment and the variety of complex decisions participants would need to make to set up their accounts, an extensive participant education effort would be necessary for such an option to be effective.

Due to the nature of lifetime income options and the perceived lack of participant understanding, many witnesses requested that the DOL and Treasury officials provide a variety of safe harbor protections governing such investment options. Some witnesses suggested that even if EBSA were to provide education materials, plan sponsors should still get safe harbor protections for even just distributing these materials.

At the end of the hearing, most presenters agreed that lifetime income options are beneficial and that plan sponsors should be encouraged to include such investment options in their retirement plans. However, all witnesses felt that for this effort to be successful it would need to be accompanied by vigorous education efforts and a set of safe harbor protections governing the plan sponsor's role in the selection and implementation of these lifetime income options.

Revisiting the Endowment Model

The Harvard/Yale Endowment Model has been predicated on a belief in active investing and allocation to a diverse array of high-risk, high-return instruments available mainly to larger institutional investors. Their success has encouraged various other institutions (both large and small) to emulate the model. However, despite the success of this model, some endowments have recently come under fire for losses during the peak of the financial crisis. During the 2009 fiscal year, billions in endowed wealth was lost as endowments fell by an average of 18.7 percent according to NACUBO Endowment Study.

Initially, the goal of endowment investing was centered on protecting the principal of endowed gifts and generating reliable income. However, over the last 25 years many endowments have embraced a new model of investing that relies on increased diversification of endowment portfolios. This included investments in "real assets" (such as oil, gas, timber, and private real estate), other commodities, hedge funds, and private equity. For some institutions, that relied on a portion of endowment income for annual operating budgets, steep losses resulted in significant cost-cutting in some cases.

In reaction to the market downturn, some endowments have been searching for a less risky and more sustainable approach to investing donors' contributions. Some endowments have sought to foster greater

resilience in times of crisis by investing in assets with greater liquidity and lower volatility. As an example, Harvard has reduced the practice of using borrowed money to boost returns, increased its cash allocation, cut \$3 billion in commitments to private-equity and real estate funds, and shifted assets from outside investing companies to Harvard Management Co., which oversees the endowment. However, Harvard continues to believe in its long-term strategy, and so the endowment will continue to invest in some of the higher-risk asset classes that in previous years produced outsized returns. Yale has also made small shifts to its asset allocation, but these adjustments have been modest and do not fundamentally change the composition of their portfolio.

Other institutions have also learned from the financial crisis and adjusted their portfolios. Changes that have been seen in endowment investing include increasing diversification, increasing liquidity, reducing equity exposure, and/or better understanding the downside potential of each strategy. When evaluating different structures, an institution should develop an investment model that best suits the mission and goals for which its endowments was established. Each institution has its own unique set of circumstances and it should consider investment strategies based on its unique needs.

ERISA 408(b)(2) Regulation

In an effort to help plan sponsors and plan fiduciaries simplify the process of deciding whether the fees charged by service providers to the plan are “reasonable”, the DOL issued new fee disclosure requirements for service providers. The long-anticipated regulation applies to all retirement plans covered by ERISA, including 401(a), 401(k), 403(b) and defined benefit plans. The final regulation will be effective July 16, 2011.

In essence, the regulation states that arrangements or contracts between a plan and a “covered” service provider may only be reasonable when the covered service provider discloses to the plan sponsor and fiduciaries, in writing, the following:

- a description of the services being provided;
- a description of all fees charged by the service provider or any of its affiliates for these services;
- a description of all fees paid through investments including expense ratios, revenue sharing and any transaction based fees
- a description of all applicable termination fees which would apply if the contract or arrangement is terminated

A service provider is considered “covered” if they enter into an arrangement with a plan and expect to receive \$1,000 or more in compensation for the services provided. Covered service providers generally include plan recordkeepers, investment advisors, accountants, attorneys and third-party administrators, but may include any party that provides services to the plan. It is important to note that the new regulations will require service providers who currently charge a total bundled fee to plans to now provide a complete breakdown for each underlying service provided along with the accompanying fees charged for each service.

Industry service providers have expected this regulation for several years now and many have already prepared to meet this new regulation’s requirements. Although the effective date of the regulation is more than six months away, plan sponsors should not wait until then to see how their service providers will

meet the disclosure requirements. Plan sponsors should consider having conversations with their service providers now to understand how this information will be disclosed and in what format.

Participant Fee Disclosure

On October 20, 2010 the DOL published its participant fee disclosure regulation in an attempt to provide information that will allow all participants, in participant-directed plans, to properly analyze their investment options. The new guidelines are issued under Section 404(a) of ERISA, and are set to become effective for the first plan year beginning on, or after, November 1, 2011 (for calendar-year plans the effective date is January 1, 2012).

The recently finalized regulation is intended to have fiduciaries provide participants with meaningful information to make educated decisions regarding their plan and alternatives. The disclosure information falls into 3 broad categories: general plan information, expenses, and investment-related information. Plan sponsors are accountable for complying with the recent regulations; however, they are permitted to rely on information received from plan service and investment providers. Plan sponsors should consider consulting with their vendors, consultants, and/or legal counsel to ensure proper compliance with the new regulation.

Roth 401(k) Conversions

A provision in the Small Business Jobs and Credit Act of 2010 was for the in-plan conversion of a traditional 401(k) to a Roth 401(k), with tax on the 2010 converted amounts deferred until 2011 and 2012. Previously, workers holding traditional 401(k) accounts could only convert to Roth accounts by moving assets out of their Traditional 401(k) Plan to a Roth IRA. This provision will allow participants the ability to convert to a Roth 401(k) within their employer-sponsored retirement plan. This provision will also apply to participant-directed 403(b) and 457 Plans.

For participants to take advantage of this provision, the plan must offer a Roth option or add the option to the plan. Second, the converted amount must be available for distribution or rollover in their plan, and participants must meet certain criteria. The participant may convert **employer contributions** if they are 59 and 1/2, the money has been in the Plan for at least two years, or they have participated in the plan for five years. A participant may convert their **own contributions** if they are 59 and 1/2 and no longer work for the company.

Plan sponsors may wish to discuss whether to offer a Roth option if not already doing so, and if necessary, whether it is prudent to offer an in-service distribution to allow participants to take advantage of this provision in 2010. Consideration may also be given as to whether any communication or education campaign is warranted to help participants make an informed decision regarding conversion and how it relates to their individual tax situation. However, due to the law taking effect late in the year, several trade groups such as ICI, Americans Benefit Council, and the Spark Institute have asked regulators for additional guidance on some of the technical aspects of the law such as 20% mandatory withholdings, possible recordkeeping issues, and 1099 reporting.

What's New at PEI

PEI was fortunate to speak at a pair of industry conferences during the past several months. David Hudak and Fred Stewart presented a workshop titled, “What You May Not Know About Your Investment Advisor” at the PSCA National Convention. The presentation highlighted how hidden conflicts of interest exist in the investment consulting industry. It also instructed attendees on how to conduct their own advisor check to determine if a conflict exists. Attila Toth participated in a panel discussion at the PlanAdviser National Conference on “Hidden Traps of ERISA”.

PEI welcomed Lindsey Campanelli as our newest Investment Analyst, joining the firm in early October. She joins one of the largest analyst teams in the industry. PEI has over 20 analysts whereas 95% of firms employ less than 12 full-time associates according to research from Ann Schleck & Company.

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 as a firm and serve our clients.

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