RECORD, Volume 28, No. 2*

San Francisco Spring Meeting
June 24–26, 2002

Session 96PD
Managing Employer Risk in Defined Contribution Plans

Track: Pension

Moderator: C. IAN GENNO
Panelists: C. IAN GENNO
MICHAEL J. METHLIE
JEFF MILLER†

Summary: Employers sponsoring defined contribution (DC) plans often believe their risks are fairly limited. This session reviews the various significant risks associated with DC plans, with a particular focus on the risks that continue to be borne by plan sponsors. Attendees gain an understanding of the risks that DC plan sponsors carry and the management of such risks.

MR. C. IAN GENNO: This is Session 96, "Managing Employer Risk in Defined Contribution (DC) Plans." My name is Ian Genno, and I'm a principal with Towers Perrin in Toronto. Much of my work is focused on helping clients with designing, financing, and communicating retirement programs, including not just pension plans but also savings programs, employer share purchase programs, post-retirement benefits, and so forth. I also serve on your behalf as a member of the SOA Pension Section Council, for those of you who are Pension Section members, and I've spent some years serving on various other Society and CIA committees. Within the community, I serve on the board of directors of a government-funded organization in the health care area.

I'll introduce two other panelists who are going to be speaking with me. First is Mr. Michael J. Methlie. Mike is an actuary with Watson Wyatt in San Francisco. Mike focuses specifically on issues relating to design, valuation, and administration of

†Mr. Jeff Miller, not a member of the sponsoring organizations, is a retirement and investment consultant with Watson Wyatt Worldwide in San Francisco, CA.

Note: The chart(s) referred to in the text can be found at the end of the manuscript.

retirement programs, developing funding and investment strategies for clients, and assisting in acquisitions and divestitures. He also works on communication issues relating to his clients' needs. Mike brings 14 years of consulting experience to the presentation today, and I'm sure he will have some interesting insights on DC plans.

Also joining us is Jeff Miller. Jeff is a consultant with Watson Wyatt, also in San Francisco. He assists clients on investment manager research and selection, asset-liability modeling, investment manager structure, and service provider selection. In addition to Jeff's experience within the asset management area of Watson Wyatt, he has also worked in the retirement practice, so he brings different perspectives to the table. Jeff is a certified pension consultant and is currently a candidate for the Chartered Financial Analyst (CFA) Program as well as the Certified Employee Benefit Specialist (CEBS) designation.

We're going to talk about managing employer risk in DC plans. Before I start, give the three of us a sense of where you are in terms of your interest and experience: By a show of hands, how many of you work a moderate to an extensive amount with defined contribution plans of one sort or another? About half the audience. We want to talk about some things that will be of direct interest to you in your work, and we hope you'll have some good questions for us, too.

I remember when I wrote part six of the actuarial exams under the old, old exam system (two systems ago). When I wrote part six, the traditional compare-and-contrast questions would ask things such as, "Compare and contrast DB plans versus DC plans." As a good student at the time, I memorized the fact that DB plans placed the risk on the employer's shoulders, whereas DC plans placed the risk on employees' shoulders. I passed the exam, so that must have been the right answer and presumably was the mantra that we were all to follow.

Having said that, now that I've worked hand in hand with DC plan sponsors over the years, one of the things that has emerged as a reality for me is that, within DC plans, employers still do bear a significant number of risks. That's what we want to explore today, and then focus on how to manage those risks. There are four different areas that we want to address in our presentation. First, we want to talk about governance and risk management, offer you a broad framework, and identify some of the risks that employers face as DC plan sponsors. Then I want to spend just a few minutes talking broadly about plan design and communication issues before turning it over to Mike, who will talk about demographic issues (basically tying together some of the plan design and communication into observations on demographics of DC plan members). And then, finally, investment issues: Jeff will offer us some insights on how to manage investment issues as they relate to employer risk in DC plans.

As we go through this, we'll use a broad definition of what "DC plan" means. Basically, we're not just talking about qualified pension plans, but we're looking beyond that to savings arrangements, employer-sponsored stock purchase plans, and all other arrangements in which employees put aside money for some future need and potentially have some latitude to decide how those dollars are invested.

Plan sponsors spend a significant number of dollars on their DC plans, both in terms of the cash contributions going in as well as the dollars spent operating those plans. So the first question I ask plan sponsors when I start working with them is, "Are you getting a bang for the buck for the dollars you're investing in this particular plan?" I hear different answers from plan sponsors.

I hear some acknowledgment from sponsors that there's a shift in terms of the balance of dollars delivered between people who stay until retirement versus people who leave before retirement.

When we look at the asset mix and the investment returns of DC plans, I sometimes see some concerns. Within our firm, research has suggested that DC plans tend to be invested less efficiently than DB plans in terms of the returns that are delivered over long periods of time. For a given level of employer contribution, DC plans often pay out fewer benefit dollars at the end of the day than DB plans do, when you look at most long-term scenarios.

There is a prevalent notion that DC plans are generally better understood by plan members. Personally, I'm not sure that's actually true. If I look at what employees do and don't understand, I find employees do generally have a good understanding of the concept of accumulating a pool of capital toward retirement. They may understand the nature of the investment risks they bear during the accumulation phase. But I find that very few employees understand issues relating to how to convert a DC balance into an income stream at retirement. So there's a prevalent notion that employees understand DC plans better than DB plans, but I challenge some aspects of that notion and suggest it's not necessarily true in all respects.

There's also a prevalent notion that administration and compliance are easier and cheaper for DC plans. Here again, in some circumstances I would question that notion. So, overall, I'd suggest that plan sponsors have to examine issues like this and think about whether they're getting the right bang for the buck on their DC plan. My follow-up question is, "Is the bang potentially explosive?"

One of the ways to look at risk is to say that risk, basically, can mean that an organization's realized goals are different from its intended or desired goals, and this can have a significant impact on the organization's overall performance. If we apply a risk-management framework in the context of a DC plan, I'd suggest that one way you could look at these plans is to think of four different categories of risk: strategic, operational, financial, and hazard risks. Within each of these categories, there are very specific risks that the employer faces in managing its DC plan.

To give you some examples, strategic risk includes having the wrong business strategy or the wrong human resources strategy. It includes opportunity costs — if the same dollars could have been deployed more effectively through other employee benefit programs. It can be the risk of competitive disadvantages, both in terms of cost competitiveness relative to your direct industry competitors, as well as benefit competitiveness in terms of your ability to attract and retain the right people within your local geographic marketplace. A further strategic risk is the potential failure of a major change initiative. For example, if you're going through a DB to DC conversion, or if you're trying to increase the emphasis on employee stock ownership within your organization, these major change initiatives could succeed or fail, and that places you at risk. Finally, a further strategic risk worth considering is the failure to innovate or to innovate quickly enough.

Under the operational risk framework, different risks that DC sponsors face include the fact that DC plans can introduce a disconnect within the employer's HR processes, potentially affecting things such as turnover patterns and retirement patterns within your workforce over long periods of time. Operationally, you also face a risk of poor service levels from record keepers and custodians and the resulting failure to satisfy employees as the customers of your DC plan. Obsolescence of technology and reliance upon outsourced service providers can also be a significant operational risk for DC plan sponsors. There are also potential risks of breach of regulations, failure to satisfy fiduciary obligations to plan members, inefficient or ineffective management processes with respect to the DC plan, and potential breach of confidentiality in circumstances where the plan sponsor tries to monitor how the DC plan is performing, but risks breaching confidentiality with respect to individual members of that plan.

On the financial side, employers face different risks. There's a question regarding the economic efficiency of DC plans in terms of how the plan assets are invested and whether they're generating the best return on the employer's initial investment, vis-à-vis the ultimate payout to plan members. Potentially, employers who sponsor DC plans face a risk of being unable to reduce their cost base with respect to that particular plan. There's the risk of investment market volatility and the impact such volatility can have on employees, which then can have a corresponding impact on employee turnover patterns and retirement patterns, as well as employee satisfaction with the plan. There are unsecured liabilities. If the plan sponsor offers a DC Supplemental Executive Retirement Plan (SERP), for example, there's a risk with respect to those unsecured liabilities that both the SERP members as well as shareholders of the organization need to consider. Finally, on the financial side, there's the potential for misuse of financial resources.

On the hazard side, there are several different risks that tend to be broader and longer term in nature. There's the risk of litigation if, for example, employee expectations are unfulfilled. There's the risk of adverse government policy. And, broadly speaking, there are a number of risks that could give rise to reputation problems for the organization if other elements of the DC plan aren't working properly and have affected the perspective of plan members or external individuals who view how the organization is running this particular facet of its business. The bottom line is that there are many different risks that DC plan sponsors face that you can categorize under several distinct headings.

What I'm going to show you next is, for most of you, a slide you've likely seen a number of times before (Chart 1). Basically, it asks, "Once you have identified risks, what do you do to prioritize them and decide on the next steps for action?" On the X-axis, you have the likelihood of the risk occurring and on the Y-axis, the impact of the risk on the organization. A typical risk management exercise would take all the different risks that I identified for you a moment ago, decide which ones are real for the organization, and then decide how each one in particular falls into this framework.

Having done that, for the ones in the upper right-hand quadrant, area A, you'd probably say these are areas where you want to take immediate action as a plan sponsor. For the ones in the upper left, area B, you'd probably agree these are important, and you want to consider some action to take and have a contingency plan in case one of these issues goes off the rails. For C, you should consider action, but don't necessarily have to develop a specific contingency plan to have in place today. And for D, you'd normally keep those under review on a periodic basis to make sure things are staying in that D quadrant and aren't going off the rails there.

Having prioritized the risks, the next step is to ask, "What do I actually do to manage the risk?" Again, the answer will vary from issue to issue. I won't go through each of them in detail now because it will spill over into the rest of our presentation. But, basically, you want to think in terms of five steps for managing risks, once you've identified and quantified which ones take top priority. First, assess whether the risk is acceptable. Does the risk itself outweigh the potential benefits to the organization of taking on that risk? Second, decide what kind of strategy you can adopt either to reduce or eliminate the risk. Third, decide who's going to take responsibility for managing the risk, as well as monitoring ongoing actions that are being taken to address that particular risk. Fourth, having gone through those steps, assess what residual risk you still bear. Then, last, what kind of early warning mechanism are you going to put in place to address whatever residual risk is still sitting there?

To offer you a perspective on how this is being managed, not just in the United States but also outside the United States, I thought it might be worthwhile to look at some examples from different countries. As a first example, I'm going to offer you a perspective from the United Kingdom, where the Institute of Chartered Accountants in England and Wales has recently adopted some novel mechanisms for internal control and managing risk within organizations. It's a requirement for companies that are listed on the London Stock Exchange. These requirements affect all aspects of the operation of a U.K. business. So it's not specifically focusing just on DC plans in the context of our discussion today, it's focusing on the whole business and that, of course, would include its pension arrangements.

When you look at the suggested process for addressing corporate risks, shown here on material that I've taken from the British Institute (Chart 2), it's easy to identify how many of these general corporate risk management concepts easily translate into issues or actions that you would take in the context of a DC plan. For example, identifying success factors and objectives for the plan is an important step in managing risk for a DC plan, as it would be for any other business initiative that an organization undertakes. Identifying and prioritizing risk is important as well, as is agreeing on control strategies and how to actually manage the risk that the organization faces. In the lower left corner, there are some very important issues from a DC plan perspective — how to monitor the key risks you face and having certain early warning mechanisms in place so you could take remedial action, if appropriate.

One of the things the Turnbull report in the U.K. also focuses on is keeping it simple (Chart 3). It's easy to overengineer the process, and you don't want to do that. Rather than make it a process-focused initiative, you want to make it a results-based initiative. Keeping it simple is a key to helping you achieve that. This would mean you make sure objectives are prioritized. You would assign responsibilities for different elements of risk management for the DC plan to key individuals. You should make sure there's a reporting process to senior management and the board, and that such reports are clear, succinct, and easily understandable. You also need to reorient training around the significant risks, which, when you focus on the DC plan, includes initiatives such as employee education and employee communication, as well as training for the individuals responsible for managing the DC plan.

There are also a number of pitfalls that the Turnbull report in the U.K. identifies if risks are not appropriately addressed and managed within organizations. I would suggest that these have a direct correlation to DC plans and how those plans are managed.

I'll offer you a perspective on another country now, Canada. What's happening north of the border? In Canada, the Office of the Superintendent of Financial Institutions (OSFI) is a federal regulator that, among other things, is responsible for federally registered pension plans, both DB as well as DC. OSFI has mandated that federally registered plans should go through a self-assessment process on a regular basis. Essentially, that self-assessment process entails five key steps, which, if you view it in the U.S. context, would involve the exact same words, exact same process and thinking — just not the same mandated process here as you would see if you were operating north of the border.

The first step in the self-assessment process is to look at the mission statement for the DC plan and to ask, "Is the mission for the plan clearly stated, and has that mission been communicated to plan members?" It's surprising in practice how many plans have been implemented, and had a clear focus or objectives at the outset, but it gets lost in the shrouds of time. If you ask management five years later, they can't necessarily articulate as clearly any more what the original mission statement of the plan was. Indeed, if you then ask the question, "Have you communicated that mission statement to plan members?" sometimes you don't get a "yes" answer to the question. So one of the suggestions the government in Canada has is that you should have a mission statement, be able to articulate it, and be able to say, "Yes, we've communicated this to plan members, so they know what it is as well."

Second, you need to take a look at responsibility and accountability and make sure they are clearly identified for five different areas — legislative compliance, plan funding, investments, benefit administration, and communication — and evaluate exactly how that accountability has been defined and allocated for each of those areas.

Third, with respect to that responsibility and accountability, you have to ask, "Do we have clear written terms of reference for each of those five areas?" There are governors of the plan, certain administrators of the plan, who are responsible for them. Have the names of those individuals or those committees been clearly disclosed to plan members so that the plan members and beneficiaries know who is accountable for these issues?

Fourth, how does the supervision process work? Are there clear and objective measures of performance for each of those five areas? Is there a process for regular evaluation and reporting to appropriate stakeholders? Quite often within DC plans there are well-oiled mechanisms for reviewing how the investment managers are performing and looking at the record keeper's service levels to plan members. But some of the other areas I just described sometimes aren't as well looked after in terms of a regular ongoing monitoring process and having specific quantifiable measures of performance to which you can look.

Last, take a look at the governors. They are expected to assess their own qualifications in terms of whether there's an appropriate set of criteria for selecting them and for maintaining their knowledge level as governors of the plan. Do they have the right training and orientation to fulfill their obligations to plan members? And do they, in fact, have in place a process for self-assessment, not only of their own roles, but also for how the plan is operating generally?

If you consider the perspectives offered by the Turnbull example in the U.K. and the OSFI example in Canada, it naturally leads you, if you're senior management in an organization that sponsors a DC plan, to say, "There are really some useful questions I should be asking myself." Ask yourself, "How could the actual outcomes differ from what I originally intended with respect to this plan? Do I understand the risks the employer as well as the employees face within this plan? And understanding those risks, am I comfortable with the balance of risks between plan members and the plan sponsor?"

"How effective is my process for making and documenting decisions?" One of the key things you want to ensure is that if you've made a decision, there should be clear documentation. If the need arises at a later stage, you can always defend decisions that you've made because you'll have documentation that shows what the underlying rationale was and how support for that rationale was developed.

"How effective is the ongoing monitoring process for the DC plan, and are there appropriate controls in place to ensure that monitoring process is operating as intended?"

Take a look at employee communications and ask yourself, if you're senior management, "How comfortable am I with the communications that we're offering to plan members?"

Consider early warning mechanisms. "What early warning mechanisms are in place so that we can avert potential problems or at least address problems as they're initially arising?"

And finally, "How comfortable are we that, if called upon to do so, we could actually defend the decisions that we've made on behalf of the plan sponsor that directly affect plan members?" These are some key questions that you should address in managing the risks of a DC plan sponsor.

Turning now to plan design and communication issues, I'll just go through this section relatively briefly so I don't steal some of Mike's thunder in his presentation. Some of the plan design issues you face include articulating clear objectives for the plan design and making sure your message to employees is clearly thought through. Sometimes plan design elements send mixed messages to plan members. I've seen examples of plan designs in which there wasn't clear articulation or clear thinking in terms of whether the plan is really short term or longer term in nature. Sometimes I see mixed messages in how the plan design is linked to business results and what that means in terms of the risks that employees face. I also sometimes see mixed messages in the degree of responsibility that employees bear to manage their own financial security at retirement. You need to take the underlying message, which might look mathematical or legal in terms of its articulation, and break that down into the true message that employees are picking up when they look at the plan design and how it affects them over the course of their careers.

Also from a plan design perspective, you need to ensure the design prompts the desired employee behavior. Mike is going to show you some examples of plan design issues that tie back into demographic observations in the data for DC plans.

Jeff is going to talk about investments. Whether you're looking at index funds, actively managed funds, or life cycle funds, the nature of the investment options you offer is really a design issue that needs to be considered by the plan sponsor up front in developing the plan design. In reality, I often see the form of the investment options being addressed after the design has been developed, as part of the implementation process of selecting investment options and investment managers. I'd suggest that plan sponsors, in terms of managing some of the risks relating to plan design, need to think about the form of the investment options up front as part of the design process.

There are issues and risks with respect to benefit adequacy, with respect to facilitating workforce management, and with respect to how plan members would take an accumulated balance at retirement and convert it into an income stream. There, again, design issues that need to be addressed up front.

On the communication side, plan sponsors face a number of different issues and risks. The first issue is ensuring that employees understand the risks they bear and understand the responsibilities they need to take on themselves and how to execute those responsibilities effectively. Employees often are faced with a number of choices, especially within a DC framework. That could include choices of whether or not to participate; the level of contribution, if the plan is voluntary; the investment decisions, if those decisions are open to them to make; what to do with benefit payouts; and how to manage those benefit payouts after they leave. Also, if there is a plan conversion, the plan sponsor needs to ensure employees understand all the issues relating to the conversion.

For each of these employee choices, there is ultimately going to be a positive or a negative outcome from the employee's perspective. Employees will rate you, as a plan sponsor, on whether this particular issue worked out well or worked out poorly from their perspective. Their assessments on each one of these issues will impact how these choices have to be communicated to plan members, and it's going to influence the nature and level of risk to which the employer is ultimately exposed if employees later come back and say, "You know what? You didn't do a good job for me in helping me identify this particular issue." And that risk ultimately can come back to haunt the plan sponsor later.

Broadly speaking, some of the key communication issues relate to the balance — and it's a subtle, but important, distinction — between providing information to plan members versus providing advice. It is a very critical issue to think about as a plan sponsor. You must consider the adequacy of information in empowering plan members to make informed, appropriate decisions for themselves and provide the right tools to assist them with those decisions. From an investment perspective, you should look at one of the key catch phrases within the investment industry — the concept of "knowing your client" — and make sure the information you deliver to plan members is relevant, is actionable, and is tied into what your client — the plan member in this case — really needs to help him or her.

To offer a U.S. perspective on communication issues and investment issues within DC plans, Towers Perrin recently conducted a survey of some of our key clients in the U.S. We asked the question, "How knowledgeable do you think your plan members are about making investment decisions for their retirement savings?" As I look at this graph (Chart 4), what strikes me is that roughly half of the plan sponsors say, "I think my plan members are somewhat knowledgeable in their ability to make investment decisions for their retirement." When I listen to that answer, "somewhat knowledgeable," it says to me that's faint praise of employees' ability to manage the investment decisions they need to make. I'm concerned by such faint praise.

A quarter of the plan sponsors are neutral on this question. And a quarter, which to my mind is a very significant proportion, actually express a concern that their employees are not knowledgeable about how to manage investment issues within the DC plan. That's a significant portion of your workforce — and it poses a significant risk. Even though employees initially bear that risk, ultimately their potential dissatisfaction with the plan or their dissatisfaction with how you've communicated the things they need to think about to make informed investment decisions can come back to haunt you. I don't think you, as an employer, would want to have potentially a quarter of your workforce posing that type of risk for the organization.

Another question we asked in this survey was, "How important is it for employers to play an active role in educating plan members about investment decisions?" (Chart 5) Overwhelmingly, the plan sponsors we surveyed rated investment education for employees as being important, particularly for employees nearing retirement age. Employee education is a real issue that employers are beginning to recognize.

So having recognized that, we then asked the question, "If you think it's important, what kind of investor education do you currently offer to your plan members?" (Chart 6) What we saw in response was that roughly two-thirds of the U.S. employers we surveyed said, "We provide some form of detailed information." There's a question in terms of the frequency of that information, but at least on an annual basis, two-thirds of the employers we surveyed provide detailed financial information and investor education to employees. But I see a significant minority — a third of plan sponsors — say they provide either very rudimentary information or, indeed, no investor education and information to plan members. To my mind, this is a significant percentage of employers putting themselves at risk in the future.

I have one last slide (Chart 7) before I turn over the presentation to Mike. We then said, "Well, if a third of employers aren't offering any or are only offering very rudimentary communication to plan members, what is holding you back from providing investment information and education to your plan members?" We saw quite a number of different responses, as shown in Chart 4. In particular, there are three key responses in the context of managing employer risk in DC plans that I draw to your attention, and those are the three that are shaded darker.

Three-quarters of plan sponsors cited a concern about fiduciary responsibilities, related to offering investment education and advice, as a key barrier or impediment to providing further information to employees. Jeff is going to talk about fiduciary issues in the context of how investment options are developed and monitored for DC plans.

A third of the plan sponsors we surveyed expressed a concern about their ability to select and monitor the provider of advice. So to the extent that, perhaps, that role is being outsourced to a record keeper, or other service provider, there's a genuine concern in selecting the right provider of that advice to plan members — and monitoring the nature of the advice that's being provided to ensure it's appropriate, it's relevant, it's actionable, and it will help plan members make more informed decisions.

Finally, a small minority, roughly 1 in 10 plan sponsors we surveyed, expressed a concern about their ability to guarantee employee privacy, which highlights a potential risk for employers. So broadly speaking, a number of risk management issues were identified in the survey, from a communication perspective.

Now, Mike will focus on some of the demographic issues, how to tie them back to plan design and communication, and also how to tie them forward into some of the DC investment issues that Jeff will then address.

MR. MICHAEL J. METHLIE: Thanks, Ian. Ian pointed some of different types of risks that apply to DC plans, and there are a lot. He also pointed out the importance of employee education and communication and plan design in managing these risks. I will be discussing a few additional risks that he didn't talk about, and cover some of risks he did mention in more detail, but do so from an employee demographics perspective.

Before I discuss specific risks to DC plans, I'd like to step back and talk about retirement risk in general. One way of looking at retirement risk is for employers to ask the following question: "Can employees afford to retire when they want to with the retirement programs that are in place?" or, if you look at it another way, "Can employees retire when we (the employers) want them to?" The answer to this question depends on many factors.

Retirement plan availability and participation are key factors, as is plan design. Do you sponsor a DB plan, a DC plan, or both? How rich are your plans? Do you offer retiree health care coverage? Retiree health is often a benefit that's overlooked in retirement plan design, and more and more employers are shying away from offering it. But employees definitely consider retiree health coverage when thinking about retiring.

Clearly, DC plan investment performance is another important factor. If the performance of your DC plan is poor, you're not going to be able to retire. I'm not going to spend too much time on investment risks, since Jeff Miller will do so later in this presentation. Then, finally, the level of personal assets at your disposal, as well as government security programs — whether they'll be around when you retire — will all be factors in whether or not employees can afford to retire when they want to or, again, when the company wants them to retire.

Another way of looking at retirement risk is to ask a question that is more post-retirement in nature (whereas the first question was more pre-retirement), and this is, "Will retirees outlive their retirement assets?" This component of retirement risk is not as much a risk for employers as it is for employees. However, if you want your employees to retire in an orderly fashion, post-retirement risk can also be a concern for employers.

There are two categories of post-retirement risks here that I've labeled "individual risks" and "systematic risks." Individual risks clearly are those risks particular to individual employees. They are, for example, the risk of making poor investment choices, excessive consumption (i.e., using up your nest egg before you expire), chronic illness, and/or the need for and availability of long-term care in retirement. Another often-overlooked individual risk is longevity risk. These risks are all issues that a lot of retirees and employees approaching retirement don't always think about.

Systematic risks apply to society as a whole. One such risk is macroeconomic shifts. If you hit a recession or if you have high inflation, what is that going to do to your economic security in retirement? Reduction or elimination of government security programs is also a big systematic risk. Employers and employees alike may be left holding the bag if the government starts cutting programs. Employers should be thinking of this possibility in designing and communicating their own retirement programs.

Now I want to talk about some risks specific to DC plans from a demographics perspective and from an employee versus employer perspective. We will be talking mostly about employer risks in this presentation, but I wanted to touch a little bit on some of the employee risks too.

One of these is clearly investment risk, and as we all know, individuals take on that risk in a DC plan, not employers. From a demographics angle, this risk is different for younger and older employees. If you're young, there's a risk that you may invest too conservatively and not have enough assets when you reach retirement age to retire. A counterargument that I've seen lately is that many younger employees have not experienced a recession until just recently. They may have been investing very aggressively and have now been burned. Younger employees may be more likely not to diversify and put all of their money in employer stock, for example.

At the other end, older workers may have a hard time with the volatility of their DC account balances and may not be able to pinpoint how much money will be available at retirement.

From a design perspective, DC plans offer portability and in-service distribution features. In-service distribution provisions are common in DC plans — plan sponsors pretty much feel like they have to make these available. Employees like them. They're very helpful in increasing participation and in attracting employees. Unfortunately, DC plan portability and in-service distribution features can be harmful in ensuring benefit adequacy upon retirement.

That's particularly true with regards to portability. While it should become even easier to roll over assets among qualified plans due to recently adopted changes in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), there still remains the real possibility that some employees will cash out their DC assets when they change jobs and spend it on something else besides retirement.

From the employer perspective, Ian talked about some of the workforce-management issues. One thing in particular is that for older employees, it may be hard with a DC plan to (1) attract, (2) retain, and (3) orderly retire older workers. They just may not have enough money, especially if they were hired mid-career and have no source of income from a DB plan. In addition, if employees are not saving adequately for retirement either in DC plans or in their personal savings, they may not be able to retire when they want to or when the company wants. In addition, if there's a recession like we're in now, you will have a lot of older employees hanging around longer than expected, so managing these risks becomes a problem for employers.

Another employer risk is that 401(k) matching costs are increasing. In general, because of EGTRRA changes, most plan sponsors will see an increase in their matching costs. In addition, as employees age, as an employer's workforce ages, employers will see an increase in all benefit costs. Workforce aging and its impact on plan costs is another risk that employers may need to manage.

Do employers get a bang for their buck out of their DC plan(s)? It's really hard to measure what benefit comes out of a DC plan, but it's really easy to measure what goes into a DC plan. Employers have their matching costs, and those are fairly stable from year to year. You have record-keeping costs and other administrative costs. That's not hard for employers to determine. It is hard to determine what employers (and employees) are getting out of a DC plan. Are employers getting any value, and if so, how do you measure it? Are they able to retire their employees efficiently? Can employees afford to retire?

Watson Wyatt has done some research in this area. We published a study called the 401(k) Value Index, in which we surveyed 300 companies representing about 2.5 million active employees. The index attempts to measure how a 401(k) plan meets

HR business goals and delivers value to participants and employers alike. The study focuses on three main areas, two of which I'll talk about today. Those are participation and benefit adequacy. Jeff's going to talk about the third, investment efficiency.

Some of the key results from the survey that we did in 2000 — and we're doing another one in 2002 — were that 73 percent of the non-highly compensated employees and 89 percent of highly compensated employees participated in 401(k) plans. That's not bad. If you look at other research, you'll see anywhere from 70 to 75 percent participation levels.

We also found that participation has a clear statistical link with various workforce demographics, as well as plan design factors. This has been supported by independent research studies as well. With increasing age, you find that employees are more likely to participate in a DC plan. It's the same with salary. Highly compensated employees have more disposal income. Higher paid employees are going to participate more often and at higher savings levels. There's also an industry correlation. Certain industries have no problem with participation levels. For example, if you have a very professional workforce and/or a very well educated workforce, you're likely to have high DC plan participation.

Company size is a little different. I thought, coming from a DB background, that a company's size would have a positive correlation with participation levels, but the opposite is true. It's actually harder for bigger companies to communicate to and educate employees to get them to participate, whereas, in smaller companies, it's a lot easier to target your message.

The presence of a DB plan is another factor. Again, if there's another qualified plan in place, employees are more likely to be aware of their benefits and more likely to participate and save for their retirement.

Finally, there's a clear link with DC-match generosity. The higher the match is, the higher participation and deferral rates are.

The one area that we didn't study — but I've seen other research in this area — is the effect of individual traits. A lot of studies have been done lately that are showing that, of course, age and salary are important factors in determining participation levels, but the biggest drivers may actually be the personalities of your employees, whether one is a saver or a spender, whether they are risk-tolerant or risk-seekers.

Let's talk a little about what it means to have good participation. What makes a good DC plan? How do we know if a company's plan is performing well? Let's just look at two hypothetical companies, for example. Company A has 70 percent participation and has no-match and a young workforce. Company B has a 75 percent participation rate, but has a generous match and an older, mostly professional workforce. Which company do you think has the better performing plan? I hope you would agree that Company A's 70 percent participation is actually a better result, given its plan design and workforce demographics.

The 401(k) Value Index allows companies to measure the value provided by their DC plans particular to their own workforce demographics and plan design. A 70 percent participation level sounds pretty good for a company that doesn't have a match. That gets to my next point.

You can't always control many of your workforce demographic attributes. You can try to recruit the types of people you want, based on age, experience, salary, educational background, or even individual traits. You can do all the screening you want, but your workforce may ultimately depend on where you are located, how much you're willing to pay, etc. To increase DC plan participation, you would be better off focusing on a couple of the things Ian mentioned before. The two biggest pay-offs are (1) employee communications and (2) employee education. The employer actions that have the biggest impact on boosting employee participation in DC plans, according to the results of our 401(k) Value Index study, are (1) communicating at least quarterly with employees (you get a 4 percent boost) and (2) providing personalized statements (you get a 6 percent boost).

FROM THE FLOOR: And what's the difference between communicating and providing the statements?

MR. METHLIE: Communicating is providing employees general information on the plan, or maybe about investing. It's not necessarily individualized, whereas giving them a statement is more personalized. A statement shows employees what their assets are, how they're investing their assets. The two may overlap.

When we looked only at companies in the top 10 percent of our study, we were able to identify some things these companies are doing right, and again, it was clear that they communicate often via many different mediums to their employees. For example, the top 10 percent showed significantly higher use of mailings and brochures from vendors. They also used e-mail more often to communicate. They used Internet access for communicating, as well as for plan administration. They're twice as likely to target customized communications at different groups, and that's important if you have a workforce where certain employee segments are just not participating.

Third-party investment advice and financial planning seminars were other features that stood out in our study. Employers that offer these usually saw increased participation in their plans. Hewitt just did a study that was completed in early 2002. They found that about 21 percent of plan sponsors are currently using the Internet for online communications and to give investment advice, and about 27 percent of companies are thinking about doing so in the next two years. So, companies are getting the message, albeit slowly. But it's clear from the evidence to date that communication and education (as much as you can budget), will most likely provide a bigger bang than increasing your match, and that's probably not a new message for anybody who's been dealing with 401(k) plans for a while.

Another thing employers could do on the design end, and I'll just talk about this quickly, is something called automatic enrollment. I'm not sure if anybody in here knows what that is. It's also referred to as a negative election. A plan sponsor requires their employees to elect out of the 401(k) plan, as opposed to elect into the plan. So, you're in the plan by default unless you make a positive election to not participate. If employers make use of automatic enrollment, they need to decide to whom it will apply. Do you want it to apply to just new employees or to all of your eligible employees? You also have to come up with some default deferral rates, as well as investment elections, and you usually wind up picking pretty conservative investment elections.

It's too early to tell whether this design option is successful for the plan sponsors we know that have adopted negative elections. It's still not that popular, but there are a group of companies out there doing this now. I think most have seen an increase in participation, and it certainly helps with their compliance testing. One drawback, though, is higher matching costs. In California, at least, there's also some concern over whether it's even legal. You may also have higher administration costs. There will be a lot of smaller accounts that you didn't have before, so you're going to have higher administration costs. Then, there's the issue of effectiveness. A lot of these companies are getting more employees into their DC plans, but the employees are staying at the default deferral and investment elections, which is not what you want ideally. But at least it's better than nothing.

Another performance measure in the 401(k) Value Index study is benefit adequacy. Basically, we wanted to see whether employers are able to generate adequate retirement income in their DC plans so that their employees could retire. Ian mentioned this before. DB plans typically are perceived as a better employer funding vehicle for providing the same level of retirement income for less money. In general, studies have shown that target income replacement at retirement should be somewhere around 70 to 90 percent. I think it's going to get harder for younger employees, in particular, to meet this goal from the traditional retirement income sources: the employer, personal savings, and the government. There's a fourth stool leg out there lately, which is basically to continue working. Recent research that we've done at Watson Wyatt estimates that someone who is age 35 years right now probably will see about a 30 percent reduction in Social Security benefits by the time they retire. So with that gone, making the 70 to 90 percent is going to be a lot harder, and there's going to be much more pressure on DC plans or retirement plans in general.

Another benefit adequacy (and employee attraction) issue for DC plans is that older, mid-career hires may not be able to save enough for retirement. As you know, the power of DC plans is the compound interest. If you're not in a DC plan for very long, you really don't benefit from the interest compounding.

As mentioned earlier, one good thing about DC plans and retirement plans in general is that rollover rules have been expanded recently, thanks to EGTRRA. There are fewer restrictions on rolling over money among 401(k) plans, DB plan, and 403(b) plans, so that should bode well for people who switch employers in mid-career, assuming they had a retirement plan with their previous employer.

Another benefit adequacy risk is the risk of cashing out DC plan assets before retirement. There is a 20 percent required withholding (except for rollovers) and a 10 percent early withdrawal penalty before age 59½, if you want to take your money early. Both these restrictions help reduce the risk of cash-outs (employees taking their money and running), which would, again, help improve benefit adequacy in DC plans at retirement.

However, the cash-out problem is not huge. FMR Corporation did a study that found cash-out incidence decreases as your DC account balance increases, and that may be intuitive. It also decreases as age increases. Again, that's probably intuitive. It also decreases with company size. At larger companies, you typically tend to see a lot more investment options, cheaper fees, and better employee communications. So people in large employer plans often do not cash out their balances. In general, 67 percent of people keep their balances in the plan or roll them over upon employee termination (i.e., roughly 1/3 cash out). In terms of dollars, though, it's only 5 percent of DC plan assets that are actually cashed out. So not a lot of money is cashed out each year, but it's certainly something plan sponsors should be aware of, particularly if you have a younger workforce.

Going back to the topic of benefit adequacy, in the 2002 Retirement Confidence Survey that was just released — and again, I'm repeating some things that Ian said — 67 percent of workers have started saving for retirement, and nearly 34 percent consider themselves on track for planning and saving. The message is that not only do you have to participate in 401(k) plans, you also have to save at a level that's high enough so you can actually meet the retirement goals you have for yourself.

Just as with DC plan participation, there are a lot of different demographic factors that will determine whether or not you're likely to defer or save enough money. The biggest thing that we found (and other research has shown) is that individual traits are really big factors, particularly in determining the amount of money that somebody will defer. You either are the type of person who likes to save, or you're not. It's easy to participate and just put in a small amount, but to defer the higher amounts needed to adequately save for retirement, you really need to possess certain individual personality traits.

Again, we found that with plan design, a higher match can certainly boost benefit adequacy but, obviously, there's a cost to the employer. If you couple a DB plan with a DC plan, you also see higher deferrals. In our study, we saw on average about 0.75 percent higher deferrals into 401(k) plans with the presence of a DB plan.

Finally, for increased benefit adequacy, it all comes down, again, to communications. If you have effective communications, you'll have not only higher participation, but most likely higher deferrals as well. Again, the key here is that by knowing your demographics, you can target whatever you want to do — your plan design and your communication efforts — to help improve both participation and benefit adequacy.

Next, I want to talk about a couple demographic issues, what's happening in the employer workplace, what's happening out in the world right now. It's no surprise to anybody that the labor force is shrinking. Baby boomers are getting older, and in the next 10 to 20 years, there will be a dramatic shift in the labor market. We're already seeing an increased participation by women and part-time workers in the workforce, and that should continue. We're also seeing a lot more interest in phased or delayed retirement. Basically, employers are trying to get employees who are close to retirement to hang around a little bit longer in anticipation of the anticipated labor shortage.

Faced with a smaller projected labor pool, plan sponsors really need to ask themselves if their DC plan(s), and for that matter their retirement program(s), are sufficient to meet their future workforce needs — not only today's needs, but also their needs 10 years or 20 years from now. I'd guess that a lot of sponsors with just DC plans would probably say "No." In the next 10 years, the over-55 population is going to balloon 33 percent higher, with the 35 to 44 group going down 20 percent. That will have some huge implications for employers who need to attract and retain employees.

So what does this impact have on plan sponsors and, in particular, plan sponsors of DC plans? Well, for starters, there are going to be greater cost pressures on employer-sponsored plans, not just DC plans, but also on DB plans, retiree medical, active medical, pretty much every benefit plan out there. There's going to be a lot of cost pressure. Social Security cutbacks are very likely. I'm not saying cutbacks will happen, but it's pretty likely that some sort of cutbacks or higher taxes will be needed, or some combination of them. Cutbacks in government programs would put more cost pressure on the employer plans. But they also might have a positive outcome, and that would be that employees might actually be spurred to increase their private savings, as well as their 401(k) savings, when they see that Social Security may not be there for them. So it may not be all bad news. One exception, if there are going to be higher Social Security taxes, is that low-paid people will probably not benefit. They won't have that extra income at their disposal.

Now I would like to touch upon privatization of Social Security. It's out there. It's been proposed. If it does happen, this could also have an impact on DC plans in the future. Some thought leaders believe that 401(k) participants would be more likely to invest conservatively if more of their retirement dollars are in DC-type accounts, and that makes sense to me. Again, what could the employer do? It all comes down to just understanding the issue, educating themselves, and then educating their employees.

I don't know if this is going to happen or not, but as a DB actuary, I can't help but think and hope that there will be an increased preference for DB plans in the future. The risks noted by my colleagues, as well as the longer life expectancies and the projected labor shortage, are going to require plan sponsors to be a little bit more creative in solving their workforce needs. If you have a DC plan, it may work for you in the future. It may not. DC plans may keep people around longer if employees don't have enough money to retire. A rich DB plan could have people walking out the door at age 55, so basically plan sponsors have to be aware of what's happening in their workforce trends and be able to respond sooner than later.

And finally, I'd like to talk a little bit about post-retirement risks. The employers can't do as much in this area as they can for pre-retirement risks. A lot of post-retirement risks really just apply to retirees themselves.

Clearly, as a plan sponsor, if you don't have a DB plan or an annuity purchase option in your DC plan, there is a higher risk that your employees may outlive their retirement assets. T. Rowe Price did a survey that showed that retirees want income certainty, but they really want independence and control over their investments more than anything. They're just not willing and able to go to the insured options sometimes, even though they're out there. DC plan lump sums are attractive to many retirees. However, lump sums require retirees to manage not only the investment risk but also the longevity risk, which becomes pretty huge as employees live longer and longer.

One interesting anecdote comes from a study that EBRI did. They found that over half of retirees today underestimate how long they will live. Women were a little bit better than men in estimating, but up to two-thirds of men underestimate how long they're going to live.

FROM THE FLOOR: Did you just say that half underestimate and half overestimate?

MR. METHLIE: I'm sorry. Did I say it wrong? More than half of the men underestimate. Less than half of the women underestimate, but the net is underestimation.

Here is something else to note for post-retirement. If there is a recession, or if you make bad decisions, or if you have health problems, you may not have time to recover from those if you have your DC-type assets, if you don't annuitize, seek other protection, or have other assets.

Finally, as employees are planning for retirement, it's clear that plan sponsors need to send a message that employees should not focus on averages — it just masks longevity risk and investment risk. Chart 8 demonstrates that. It's an example of what happens to somebody retiring at age 65 with $200,000 in assets and spending about $15,000 a year, with four percent growth in that annual expenditure. How long will the assets last if the return is 10 percent annually, or, on average, you get 10 percent? That money will last up to 27 years, on average. But what happens if you're on the other side of that average? Employees really need to be aware that there's a big chance, 50/50, that they'll be on the other side. Modeling is very dependent on assumptions, so you need to be looking at more than one investment return or more than one inflation return scenario.

I did a hypothetical example of what would happen if somebody retired in 2000. The retiree could very easily experience −20% returns in 2001 and 2002 or in 2000 and 2001. You can see from the chart that it brings down the 28 years to almost 18 years. It's a big drop. You really can't recover from something like that. So, it's something to think about, and plan sponsors need to be educating their employees on this topic.

What can employers do to manage some of the demographic elements of retirement risk? I mentioned before that the biggest thing they'd probably need to do in the next 10 years is to encourage longer worker lifetimes, either part-time work, or phased retirement. I have a couple of statistics here. Social Security retirement age has dropped about six years since 1950 and is now around age 63. Yet, by 2030, the ratio of workers to pensioners is expected to be three to one, so we're kind of going in the wrong direction there. People are retiring sooner, and yet there are not going to be as many people left in the workforce to support them, which means Social Security and a bunch of other things are just going to have to come down.

Where is that money going to come from? We think it's going to come from working in retirement. There was a survey done. I don't know who did it, but I think it just recently came out in 2002 and it said two-thirds of future retirees are expecting to work in retirement. That amount is 25 percent right now. If you look at all active employees, two-thirds already got the message that they're going to need to work in retirement to support their standard of living. Another survey I've seen lately said that to live at the same standard of living of somebody retiring at age 65 today, someone who retired in 2030 would have to work to age 76. There's a lot of longevity risk that's out there that plan sponsors and employees alike are not aware of, and it's partly our job — or at least my job as a consultant — to make sure they're aware of it.

You can look at a few other things. I mentioned before that you could have a DB plan as well as a DC plan. It's expensive, but it's clearly shown that in terms of participation in the DC plan, as well as from a benefit adequacy standpoint, it's your best bet of making sure that employees have enough money for retirement, as well as providing insurance through retirement plans.

DC plans have the ability to offer annuity options, however you don't see too many of these now. If anything, companies are running away from annuity options in DC plans. DC plan sponsors want administration to be paperless to reduce their costs. A couple of years ago, the government allowed employers to start taking annuity options away, and that is leaving retirees with really no option but to roll their DC plan balances over to an IRA or other qualified plan, or take a lump sum. Employees may not be getting the necessary education on what they need to do upon termination. It's unfortunate, but plan sponsors should think about keeping annuity options or putting them back in at some point. My personal feeling is that the way technology's going, with electronic signatures, it won't be that hard at some point to electronically get the spousal consent for qualified joint & survivor annuities that currently makes offering annuities burdensome for many DC plan sponsors.

Finally, employers could do such things as offering pre-diversified investment funds in DC plans. That's pretty commonplace today, but still not everywhere. Catastrophic post-retirement medical coverage, extending COBRA to Medicare, offering long-term care insurance — these are possible post-retirement health care solutions. Plan sponsors are starting to wake up, but it kind of goes all together with whether you have a DB plan or a DC plan or both. Employers need to be worrying about heath care in retirement as well, or employees will not be able to retire. Now Jeff is going to talk about investment risk. Thank you.

MR. JEFF MILLER: We want to leave time for some questions at the end, so I'm going to move very quickly through the first few pages. Trust me that the good stuff is at the end. I wanted to reintroduce or introduce some of the fiduciary responsibilities under 404(a). Acting prudently with respect to plan assets and diversifying plan assets are probably the most important, and those are the ones I'm going to address today. Acting loyally and complying with plan provisions, I think we have to sort of take those for granted. Also, with respect to 404(c), I want to remind you that it's out there. It's a buzzword you hear quite a bit.

For those of you who don't know what 404(c) is, it is intended to alleviate some of the plan sponsor fiduciary liability responsibility associated with employees and participants making investment selections. To be 404(c) compliant, we've listed three bullet points. One is to have three diversified investment alternatives. That tends to be a pretty easy criterion to meet these days. Second is frequency. In light of market volatility these days, having the ability to trade daily seems to make sense. And last, the most important and the most difficult criterion to meet really is providing sufficient information to make informed investment decisions. A lot of you know that it's the biggest challenge, as Mike mentioned, and that sending an employee a prospectus probably isn't the best way to help them out.

I'm going to talk about fiduciary precautions. The first of two things that I think are the most important in assisting a plan sponsor in meeting those obligations is, obviously, an investment policy. I'll talk a little bit more about that later. Then, secondly, is documenting investment oversight to a committee. I was at a client meeting this morning where the client had not met in a year. They have $350 million in DC assets, and there are numerous, numerous memos in the file about underperforming funds, manager changes, and when we call the client, it's always talk to Mike, talk to Steve, talk to Bill. It's an unfortunate situation and participant interests are being neglected. So we really, really think it's important to document who's on the committee and who's responsible for what.

I'll just share some insights on what we think makes the most sense as far as being on a committee. It should have anywhere from four to 10 members, and have a good cross section. So, it should include people from treasury, finance, HR, and oftentimes somebody from legal, inside and/or outside counsel. Regarding the investment policy, particularly given what's going on with the Enron situation, we're really emphasizing procedural prudence. It's not necessarily the outcome, but it's how you got there. If there's anything that I can point out here it's that the policy states considerations for investment option and investment manager selection requirements.

A lot of times, what you're seeing there is not just the numbers, but also some of the softer risk issues. So, portfolio manager tenure, for example, is a big deal these days, particularly because you see a lot of merger and acquisition activity with some of the financial service firms. So when you initially selected an investment option, X manager was running the fund. Then that manager left. It's a completely different strategy. Those are the kinds of things that we think you really need to watch out for, and you have to dig a little bit deeper to get to some of that data. Lastly, and we've seen this pop up quite a bit recently, put some guidance in the policy for monitoring and selecting an outside, independent investment consultant.

I'm going to shift gears here a little bit and talk about the number of options in the plan. I think that the challenge that plan sponsors face these days is striking a careful balance between offering participants enough options across the risk/reward spectrum but not offering so many that it makes it a difficult communication challenge. Also, recognize that the people on the committee have other jobs as well, and they have to dedicate an enormous amount of time if you offer 40 funds. What I would point here is that the number of options is growing. I don't think that's any surprise, but in 1999 to 2000, we had well over 10 to 12 options in quite a few plans, and now the average is somewhere around 11 or 12.

With that as the backdrop, what's going on in the marketplace? I'll share with you some smart practices that I don't think you'll find only with our firm. That includes eight to 10 core funds, so clearly, you can see that the industry or the marketplace is well over that average. Second, there are lifestyle asset allocation funds. For those of you who watch late-night TV and see some of those infomercials, this is kind of a set-it-and-forget-it approach. Some of those are dynamic, meaning that it's a conservative, it's a balance, or it's an aggressive option, and the asset allocation will not change over time. There are others that they call life cycle, which involves targeting a retirement date, and the asset allocation changes accordingly.

Brokerage window is a hot topic these days. I don't know that a lot of folks offer that, other than to accommodate a vocal minority of participants. What they're trying to do there is, rather than add a gold fund to the core option, they're saying go to the window. You can pay your $100. You can buy whatever you'd like out there. So they're trying to keep that core option lineup clean.

I think Mike mentioned that one thing you're seeing with the investment advice product is not necessarily a change in the asset allocation, but an uptick in both participation and the amount of the deferrals. I think that's a good trend. Some folks are arguing that the adoption rate there is very low. But I think if you go back historically and look at the adoption rates in 401(k) plans in the late 1980s, mid-1980s — even if you looked at the adoption rate of cell phones — you'd see a similar trend.

Company stock in a DC plan is also a hot topic today. I'd like to point out that the average percentage of company stock in an employee's 401(k) account for plans with greater than 5,000 participants is 23 percent. That's a very substantial number.

Company stock in a DC plan does align employee and company interest beyond the employment contract, so that's one reason to offer company stock. On the other hand, looking at it from a pure investment perspective, have any of you seen an efficient frontier? That's what we've done here, so you have return on the vertical axis and risk on the bottom axis (Chart 9). What we've done with our model — and I don't think you'd find any different results from any other firm — is that we've required or mandated a certain amount of company stock in each of these portfolios. And you can see, if you go to the far right, we required 30 percent in one stock and then ran the model. And if you move to the left, we decrease the amount of company stock mandated in the portfolio. You can see here what you're basically doing is not sacrificing any return, but you're reducing the risk significantly. We encourage plan sponsors to consider, from a pure investment perspective, that company stock is not a great idea to offer in a defined contribution plan.

I would also emphasize that there are some special rules for those of you who want to be 404(c) compliant. There are some special rules for employer stock. I'm not going to go through those, but I just want you to recognize that they exist. Lastly, I'm going to touch quickly on fees. In addition to company stock, they have also become a hot topic, particularly for some of the larger plans. I mentioned a client this morning of $350 million. The fees are creeping up to the top of the priority list because the plan's been around awhile, and the asset growth is there. Why are they important? We've just run some brief numbers here. Please don't pull out your calculators and check me. Just trust that one of the reasons we think they're important is that, again, if you compare DB investment strategies to DC, typically you're going to see higher fees on the defined contribution side. Ultimately, that translates into fewer dollars in the participant's pocket at the end of the day.

FROM THE FLOOR: Did you have some sort of study that showed that DB plans have a higher rate of return than DC plans?

MR. MILLER: Yes. We're updating that survey as we speak. What we've done, and I'll just touch on this quickly, is gone in and pulled out 500 employers who offer both DB and DC plans and compared the rate of returns on a rolling five-year average. In general, not surprisingly, the DB plan assets outperform the DC plan, and we attribute a lot of that to fees. We've identified probably 50 basis points, or half a percent, simply due to fees.

What we're running into, particularly at the large end of the market — so large, call it $200 million in assets — is the record keeping is "free" now. It's not coming up on the radar of investment committees because they're not paying any hard dollar costs. What we're saying is, you could be leaving some money on the table. Our intent here is not to squeeze absolutely every dime out of the service provider. We think there is tremendous value in the service they provide. You do want them to have a healthy profit margin, but we also think the plan sponsor needs to recognize how much they're paying.

Again, the dates are old, but the relationship holds true, regardless of when you look at the time periods. A typical U.S. equity mutual fund has an expense ratio of 1.04 percent. If you look at some institutional mutual funds in 2000, that was 76 basis points. So even though your record keeping is free, there is a way to put more money in participants' pockets simply by moving to a cheaper share class, into an institutional mutual fund. So that 25 basis points, the difference, goes directly into participants' pockets. I bring that to your attention because I think it's going to become increasingly important to look at those fees, particularly as the assets continue to grow.

I will just leave you with some questions that we ask or encourage plan sponsors to think about because we think these are important and we think it's a fiduciary issue. Thanks for your time.

MR. GENNO: Thanks, Jeff, Mike. Any questions, comments, or observations from the audience?

FROM THE FLOOR: Is there any way to get small employers into the institutional mutual funds? Is there any way that small employers can aggregate themselves with other small employers to get the institutional fund shares?

MR. MILLER: I haven't seen any plan sponsors aggregating plans. It's absolutely possible. Again, what I didn't mention is what's driving cost. Regardless of the plan size, there are a couple things that play there. One is an account balance. An attractive account balance is probably somewhere around $30,000. Number of payrolls is a big driver. People don't recognize that there is a tremendous amount of work that goes into reconciling payrolls. The third thing is the demographics, and by that I mean the location of employees. If we're sending two people to Brisbee, Arizona, to do employee communications, that's going to impact costs. So that's the long way of saying it's absolutely possible in smaller clients to get those. But again, you have to look at the total cost there.

FROM THE FLOOR: I have a question for Mike. In one of the slides it said 401(k) deferrals are 0.75% higher with a DB plan. Do you mean if the company offers both a DB and a DC plan that the deferrals were higher in their 401(k) plan?

MR. METHLIE: Yes, that's correct.

FROM THE FLOOR: Why would that be? What is the reasoning?

MR. METHLIE: Well, that's just what we found when we looked at DC plans only and then at combined DB and DC plans. We found that, on average, employees were deferring about 0.75 percent more. And we reasoned that by having another DB plan present, employees are just more aware of retirement, and they're more apt to save on their own. That was really what we got from that finding. I'd like to hear what someone else thinks about that.

MR. GENNO: We've seen the same experience among Towers Perrin's clients. The presence of a DB plan — sometimes with the additional efforts that are made to communicate the need for retirement planning and how retirement plans work — can heighten people's awareness of planning for retirement and they're more likely, statistically, to contribute to a DC plan of some type. Or if they contribute, they contribute a bit more.

MR. RON GEBHARDTSBAUER: A bill has passed the House that would encourage employees to have more investment advice. I guess the bill relaxes some of the fiduciary concerns, as long as the investment advisor that you bring in and let your employees use states that they possibly have a conflict of interest and that they may get fees. For instance, a Fidelity person will get commissions if you buy from their mutual funds. I'm wondering whether you think this is a good idea or not. Investment advice, of course, is a good idea, but allowing the fox into the chicken coop? Should they exclude the foxes, and only allow independent people there?

MR. METHLIE: Personally, I feel the fox is already in the chicken coop. It's just how much more do you want to let them in. Again, my personal feeling is that more communication, more education is better for the employees overall. Of course, it's better for the Fidelities of the world as well, but as long as it's disclosed, I'm for it.

MR. MILLER: I would just add that I think that plan sponsors are conscious of that, and what we've seen is they do want a third-party provider. I also think there will be some changes in the marketplace. You may see some consolidation there. I also wouldn't be surprised to see investment advice move to a less Web-based approach, more one-on-one.

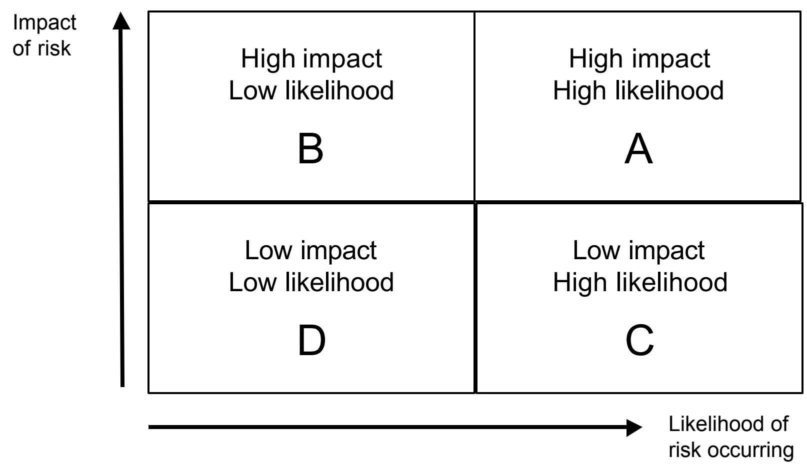
MR. PAUL PETROFF: Going back to a comment made earlier regarding this issue of understanding versus appreciating a benefit that an employer provides. I think the track record or the history of the last 15 years is that the DC plans are better appreciated. They may not be understood as well. But as people are nearing retirement, they're coming up to that point where they don't understand what to do. I'm hopeful that will give a little bit more impetus for more DB plans in the future because I think as we age, as baby boomers get a little older, we'll appreciate the DBs a little more than the DCs right now.

Another comment I wanted to make was regarding 404(c) and disclosure of fees and the way the plans operate. It seems to me that that's a risk that employers have in the DC environment. It was alluded to in terms of basis points and service for free, but the actual underlying costs of these plans, to the extent that they're being paid by the participants and not by the plan sponsor, are oftentimes buried and not well disclosed. And I think that's a significant risk to the sponsors going forward, that over a number of years, if at some point the extent of fees is found out — I think the example was a 20 percent reduction in ultimate benefit at retirement, potentially, from a 100 basis points of fees — that's a real risk that the sponsors need to recognize.

MR. GENNO: Thank you very much for joining us today.

Chart 1

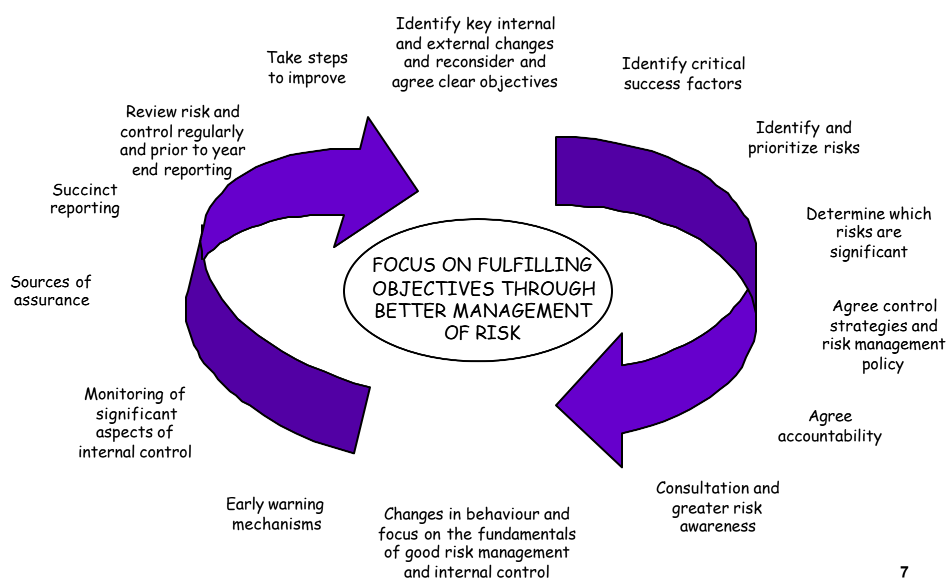
How to Prioritize Risks



6

Chart 2

U.K. Perspective — Implementing the Turnbull Report

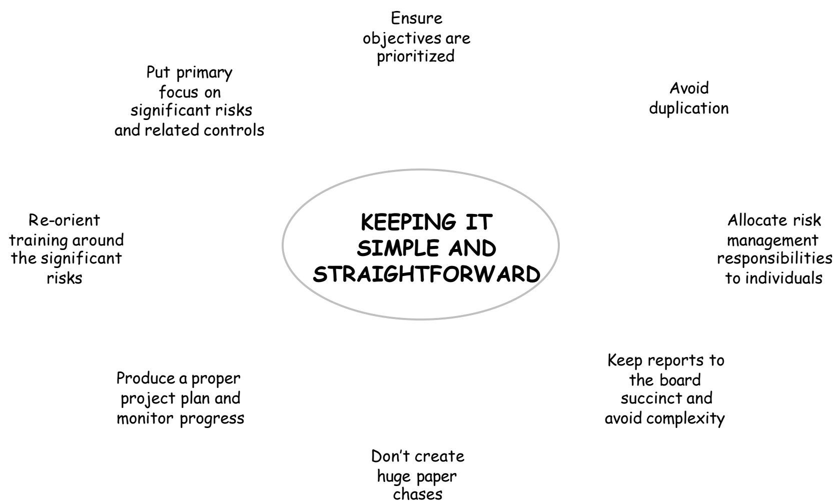


Source: Institute of Chartered Accountants in England and Wales

7

Chart 3

U.K. Perspective — Implementing the Turnbull Report

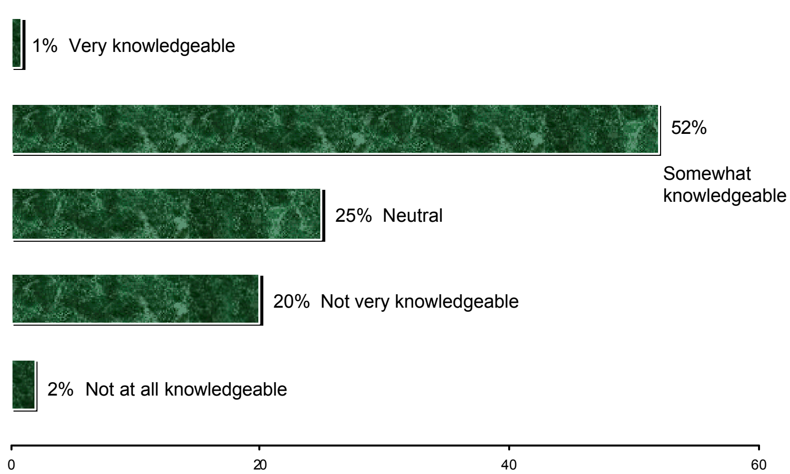


Source: Institute of Chartered Accountants in England and Wales

8

Chart 4

U.S. Survey - How knowledgeable are employees about making investment decisions for retirement savings?



Source: Towers Perrin survey of DC plan sponsors, © May 2002

20

Chart 5

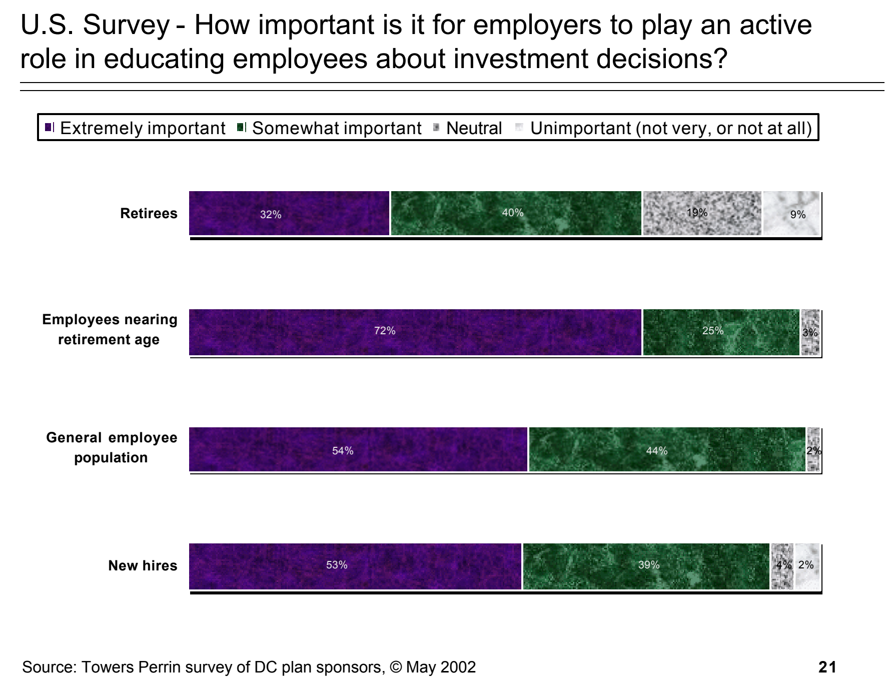


Chart 6

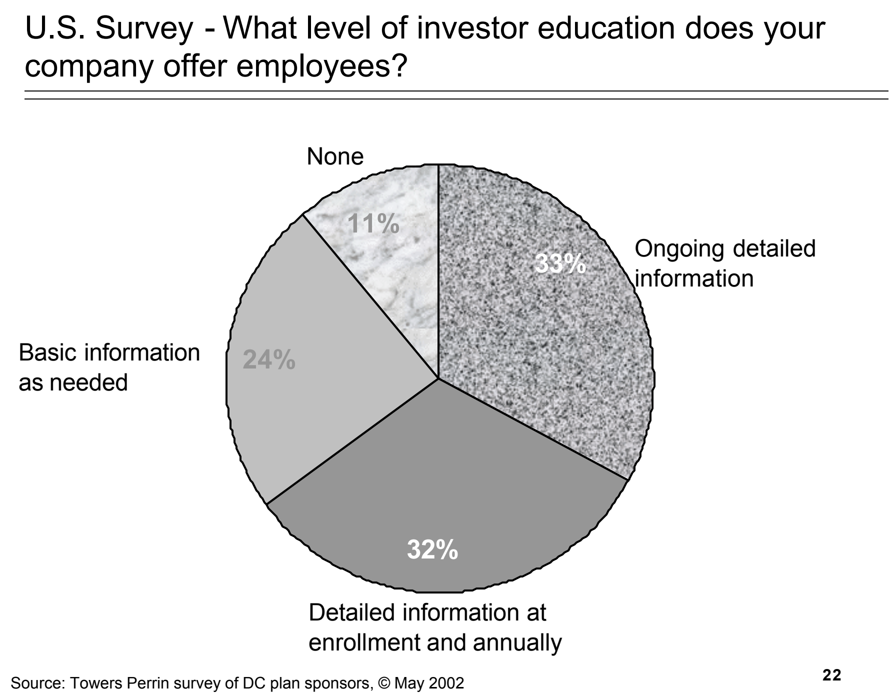
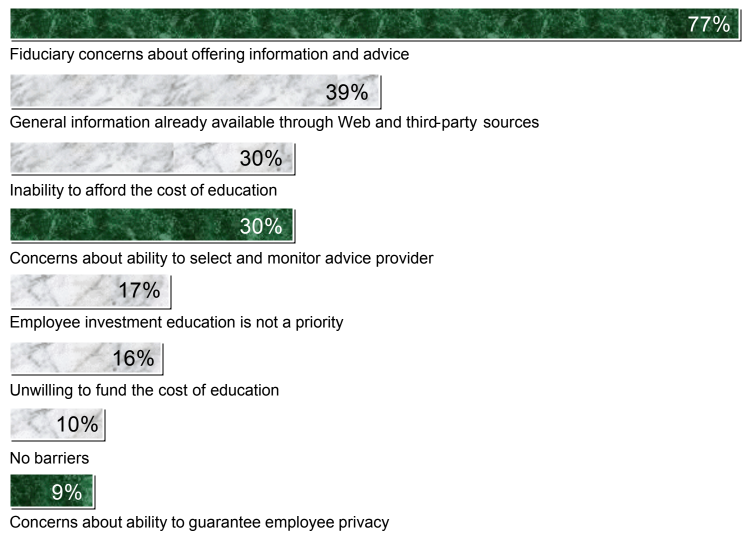


Chart 7

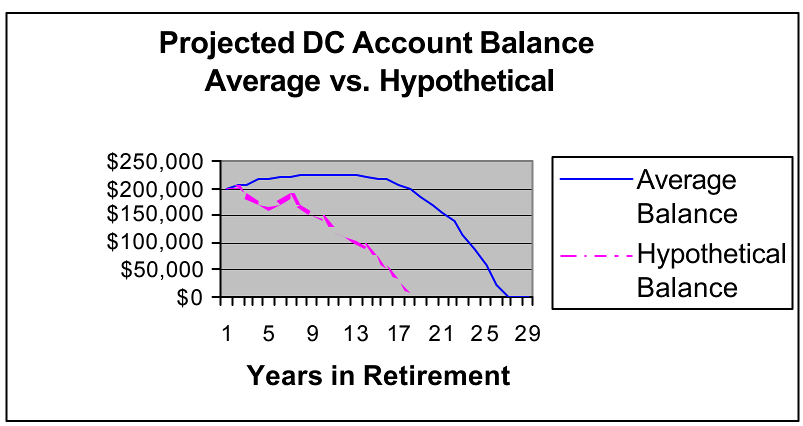
U.S. Survey - What's holding companies back from providing investment information to employees?



Source: Towers Perrin survey of DC plan sponsors, © May 2002 23

Chart 8

Postretirement Risks



Assumptions: $200,000 starting balance; $15,000 annual withdrawal, increasing at 4% per year. Average balance earns annual 10% investment return consistently each year over projection period. Hypothetical balance earns 10% on average over 20-year period, but due to negative returns early in retirement (-20% in each of the first two years, then periodic ups/downs, with an average of 10% earned over the entire projection period), account balance runs out earlier than average. 38

Chart 9

Efficient Portfolios with Minimum Company Stock Allocations