the Research Report

4TH QUARTER 2008

MARKET VOLATILITY: ITS POTENTIAL IMPACT ON THE RETIREMENT PLAN LANDSCAPE

By Gordon Tewell, CFA, CPC

In light of the financial markets' recent turmoil and a new political administration ready to assume power, a wave of ideas – from extreme to minor– may soon be considered to revise how U.S. employees save for retirement.

Much of the consideration of changes in retirement systems is due to the plunging value of defined contribution plan accounts over the past year. According to the Employee Benefit Research Institute, during the first nine months of 2008, the average 401(k) account balance dropped between 21% and 27%, depending on the workers' ages and length of employment.

However, defined benefit (pension) plans should be included in any such discussion, as they are certainly not immune from the falling markets. Funding rules enacted as part of the Pension Protection Act of 2006 took effect during 2008. When the transition rule was enacted, no one foresaw the market collapse of 2008. The new rules and the huge drop in the markets have created hundreds of millions of dollars of obligations for companies, most of which had few obligations at the beginning of 2008.

Due to these factors and the looming Medicare and Social Security crisis, many retirement industry experts expect the 111th Congress to undertake an extensive review of Americans' retirement system.

Defined Benefit Plans Some legislators likely will argue that the solution to our retirement crisis lies in returning to defined benefit systems, in

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which retirement benefits are based on a specific crediting formulas and years of service. The proponents of defined benefit plans point out that a return to widespread re-adoption of these plans would cure in one fell swoop our retirement system's coverage, adequacy, and security ills.

However, time has shown that defined benefit plans suffer from a fatal flaw: they spread risk bearing without being clear about how, and by whom, the risks are borne. Surpluses in defined benefit plans have led to companies not being required to make annual contributions. In addition, disputes over surpluses have developed between plan participants and corporations, with regulators and even the courts stepping in to arbitrate disagreements.

Similarly, when surpluses have turned to deficits during market collapses, plan participants have become at odds with corporate bondholders and shareholders about how the financial shortfall should be funded.

Neither are defined benefit plans in the public sector immune from this flaw. The win–lose element embedded in the defined benefit plan structure is seen in conflicts between current generations of taxpayers and public employees utilizing surpluses at the expense of future generations.

A good example of this problem is when the surpluses of the late 1990s were spent on increased benefits, lower contributions and making it less expensive for plan participants to purchase years of service. Having benefited nicely from these surpluses, defined benefit plan participants loaded the current financial shortfall on the backs of younger and future employees.

Defined Contribution Plans Defined contribution plans eliminate the ambiguity about risk bearing and asset ownership by shifting the bulk of the risk to individual employees and placing assets directly in their names. However, defined contribution plans, as has been made clear over the years, are not without flaws of their own.

There is no need to delve deeply into behavioral finance to confirm that employees who are required to take responsibility for their investments under defined contribution plans are hesitant, indecisive, and even irrational planners when it comes to their financial future. Many employees have no desire to obtain the necessary knowledge and skill to manage their retirement accounts.

The fee and expenses within defined contribution plans have become the target of recent legislation and regulation. Expenses are ordinarily ill-defined and obscured, and the financial services industry has little motivation to make them more transparent or easier to understand. Additionally, since the providers of retirement services are tied so closely to the investment industry, many workers pay too much for retirement related services. These fees, paid from employees' accounts over their working lifetimes, make it more difficult for workers with defined contribution plans to achieve their savings goals.

Defined contribution plans also require that plan members bear the burden of longevity risk. With the defined contribution system still being relatively young, the long-term impact of longevity risk cannot be fully measured. However, exposing the nation's retirees to the risk of outliving their money is not an attractive aspect of defined contribution plans.

The recent vulnerability of retirement savings to drastic stock market tumbles has prompted Congress to take a closer look at defined contribution plans. George Miller, Chairman of the House Education and Labor Committee, recently stated, "The current 401(k) system has not turned out to be as secure as we want it to be. It has not provided the returns that we want it to. And it's not provided the level of savings that we want it to. It's kind of failing on a number of fronts. Should there be a serious reassessment? Absolutely."

Where do we go from here? The Pension Protection Act of 2006 took several steps towards making defined contribution retirement plans more effective in meeting the needs of the nation's workforce. Empowering employers to automatically enroll employees increased the likelihood of higher employee participation. Enacting legislation regarding investment default options and investment advice made it more likely that workers' contributions will be invested wisely. In addition, lower-income families should benefit as the Saver's Credit, a tax-credit for lower-income families who participate in defined contribution plans, was made permanent. However, given the current flaws in defined contribution plans and the country's low level of retirement savings, additional changes are likely to be considered.

The House Education and Labor Committee recently held two hearings on the effects of the financial crisis on retirement savings plans. At one hearing, Teresa Ghilarducci, a professor from New York's New School for Social Research, called for creating government-backed retirement savings accounts that would offer a guaranteed, inflation-adjusted 3% return. The proposal called for the government to contribute to participants' accounts, using money gained from eliminating about $80 billion in annual tax breaks for 401(k) savings. Ghilarducci's plan failed to capture the attention of lawmakers, because abolishing the tax break on defined contributions plans might lead to a decline in participation. However, the fact that the plan received a hearing before Congress is a measure of how much the financial crisis has shaken legislators' confidence in the defined contribution system.

So far, President-elect Obama has called for modest changes to the defined contribution system, such as temporarily allowing penalty-free hardship withdrawals and suspension of the required minimum distributions for retirees over age 70 1/2. The American Benefits Councils' 10-point plan, presented to Congress in October, made the same proposals. While it is currently unclear what changes to our retirement system Congress may enact next year, the goals that will guide plan design may include:

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- **Universality** a standardized opportunity to save, whether employees work for a corporation, charity, or the government.
- **Adequacy** the ability of plans to ensure that the amount required for a secure retirement is contributed to the retirement plan.
- **Simplicity** simpler designs to reduce costs and boost the returns for plan participants.

The characteristics of a revised defined contribution system may include:

- Automatically enrolling all except very short-term workers into a plan with some type of mandatory contribution.
- Using a trigger to dynamically adjust individual contribution rates to respond to asset surpluses or deficits over time.
- A default increase in contributions each time employees receive a pay raise.
- Professionally managed life-cycle options as the default investment, with asset allocation changing as the employee approaches retirement. Addressing longevity risk by including the purchase of deferred life annuities as part of the investment design.
- Making the amount of the post-retirement income benefit that the account can purchase transparent with an inflation indexed annuity as the default distribution option.
- Plans serviced by organizations with no conflicts of interest.

Similarly, a new breed of defined benefit plans could be designed using:

- Benefits that would be based on current pay, instead of employees' highest or final pay, thereby eliminating the need for an employer to currently fund benefits for future salary increases.

AROUND THE FIRM 4TH QUARTER 2008

CONGRATULATIONS

Steve Karsh, Director of Research and Scott Middleton, CFA, CIMA recently became Principals of Innovest. Margarita Hughes became Principal of InSight Employee Benefits and Communications Division of Innovest. Gordon Tewell, CFA, CPC was promoted from Senior Analyst to Consultant. Eric Overby was promoted to Analyst.

EVENTS

Steve Karsh attended the Callan Associates Investment Advisor Group Conference in Atlanta, GA.

IN THE NEWS

Margarita Hughes, CRC was interviewed by the Craig Daily Press after providing participant education to Moffat County employees. The article "Quick Tips" describes her presentation on the volatile market's impact on retirement plans.

Rich Todd's bi-monthly column in *The Denver Business Journal* included: "Our 'Socialist Leaning'" and "Stocks Tend to Bounce Back Strongly After Difficult Times".

Articles can be found on the Innovest website, **www.innovestinc.com.**

- A benefit that would have the same value as the accrued retirement benefit if an employee quits before retirement.
- A value that could be communicated regularly to each employee, a feature that employees find attractive in defined contribution plans.
- Benefits that would be reasonably portable, as workers tend to change companies more often.
- Benefits that would be valued as accurately as possible and fully funded at all times.
- Funding that would include an additional reserve to cover the risk that the actuarial estimate of value is incorrect.

Regardless of the modifications made to retirement savings plans, the gap will not be closed entirely between what we wish for and what we achieve. It is unlikely that changes to retirement plans will reach the ideal of providing each worker with a target retirement income starting on a target retirement date. In hopes of a more secure retirement, it is probable that American workers will continue to face difficult personal choices: save more, take more investment risk, retire later, or reduce expectations for their future life-styles. •

ARC THRIFT STORES CELEBRATE 40 YEARS OF SERVICE

In the 1960's, parents of children with developmental disabilities were faced with a monumental task; raising the necessary funds to provide an improvement in quality of life of those with developmental disabilities. Previously, parents had only one option for their children; send them to an institution where the quality of life was less than stellar. While this was the 'norm' for many families, there was a group of parents that wanted more options for their children. These parents assisted in the founding of a grass roots movement to improve the quality of life for individuals and families with developmental disabilities (today known as The ARC chapters statewide and ACL of Boulder County). With the need for funds still looming, Metropolitan ARC was formed to be a fundraising mechanism for The ARCs and ACL through operations of thrift stores selling useable goods donated by generous Coloradoans.

The first store opened in 1968 on South Broadway under the name of "Value Village Thrift Store". The proceeds generated through the store went directly into action by funding the early ARC chapter's advocacy work. As time moved forward, more stores were added as well as additional ARC chapters that were in need of monetary support. Currently, there are 20 Arc Thriftstore locations along the Front Range from Fort Collins to Pueblo. The newest store recently opened in Littleton in November 2008. Arc Thriftstores employ over 750 people, including 50 with developmental disabilities, and serve over three million customers annually in our stores.

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Arc Thriftstores created a telemarketing team to solicit donations of clothing, furniture and household items for the stores. The telemarketing agents (known as Jane and James to the community) phone up to 1.5 million households every 4 weeks to solicit donations. Our community has embraced the 'Jane' calls and through their loyal and generous giving over the years, significant donations have been collected and sold. This outpouring of support from the community has allowed them to distribute over $14,000,000 to the local ARC and ACL chapters in the last 5 years. The promise they made to the Denver public over 40 years ago still resounds as loudly as it did then. "…if you support us with your donations, we will help serve individuals and their families with developmental disabilities."

In 2001, another fundraising avenue was formed, Vehicles for Charity. VFC is a wholly owned subsidiary of Metropolitan ARC and began as another way to raise funds for the ARC and ACL chapters. While MARC had informally taken vehicles for themselves for a number of years, it wasn't until other local non-profits called us for assistance that the (interior) light clicked. Today, over 400 charities nationwide trust our program to accept donations on their behalf.

Innovest is proud to provide consulting services to such a tremendous organization! •

PAPER SALE

By Scott Middleton, CFA, CIMA®

The 2008 credit crisis and resulting financial panic have left few asset classes unscathed, including high yield corporate bonds. After being priced to perfection in 2007, high yield bonds sold off sharply during the first 10 months of 2008, down approximately 24%. In light of the decline in prices, Innovest recently updated its analysis of the high yield bond asset class.

Asset Class Overview

High yield bonds (non-investment grade bonds or junk bonds) are issued by companies that are considered to have a greater risk of not paying interest or principal on a timely basis. Many companies that are capital-intensive or refinancing debt turn to the high yield market to finance their capital needs or consolidate and pay down their lines of credit. In the 1980s, many high yield bonds were used to finance speculative acquisitions, mergers or leveraged buyouts, and some are still used for those purposes.

High yield bonds are similar to equities in that they tend to be strongly influenced by economic growth and other developments in the corporate sector. However, the bonds tend to be less volatile than stocks due to their larger income and higher position in corporations' capital structure. From a risk/reward perspective, high yield is usually positioned between stocks and high-grade fixed income.

As of December 31, 2007, U.S. high yield bonds' total value approached $629 billion and comprised approximately 20% of the U.S. corporate bond market.

NEW INSTITUTIONAL CLIENTS JOIN INNOVEST

Innovest was recently hired to provide investment consulting services to **Black Creek Capital, Community First Foundation, DCT Industrial, Kennecott Utah Copper, Kroenke Sports Enterprise, Platte River Whooping Crane Trust, Regional Transportation District Salaried Employees DC Plan Trust, South Dakota School of Mines and Technology Foundation,** and **The Sports Authority.**

Long-term returns have been strong: from 1987 to 2007 the average annual total return for the asset class was +9.4%. During this same time frame, calendar year returns ranged from a high of +43.8% in 1991 to a low of -6.4% in 1990.

The Potential Risks of Investing in High Yield Bonds

Economic Risk Economic risk is the vulnerability of a bond to downturns in the economy. In recessions, high-yield bonds typically lose more principal value than investment-grade bonds. Prices of these bonds suffered dramatically in recessionary periods of 1990-1991 and 2000-2002 when they declined to 72% and 75% of par respectively.

Downgrade Risk Downgrades result when rating agencies lower their rating on a bond, such as a change by Standard & Poor's from a B to a CCC rating. Downgrades are usually accompanied by bond price declines.

Default Risk Defaults occur when a company fails to pay interest and/or principal payments to its debt holders. While long-term default rates have averaged 4.4%, defaults tend to spike dramatically during recessions, such as in 1990-1991 when they were as high as 16% and 2000-2002 when they reached almost 10%.

Taxation Ideally, taxable investors should own high yield bonds in tax-deferred or tax-exempt accounts, since a large portion of the bonds' returns would otherwise be taxed at ordinary income rates.

The Potential Benefits to Investors

Current Income High yield bonds typically pay higher yields than investment-grade bonds because they carry greater risks. Over the past 20 years, the median yield on below-investment-grade bonds was 10.69%. However, with the severe dislocation in the credit markets, nominal yields jumped to 17.88% as of October 31, 2008, which was the highest level since the 1991 level of 19.12%.

Capital Appreciation An economic upturn or improved performance at the issuing company can have a positive impact on the price of a high yield bond. Should the bonds' prices move toward par from their price of 65%, investors would receive capital appreciation in addition to current income.

Recovery Rates In the event of bankruptcy or liquidation, bondholders ordinarily have priority over stockholders in a company's capital structure. The percentage of this eventual payment compared with the original investment is called the "recovery rate." While the long-term recovery rate on defaulted bonds has averaged 41.5%, in recessionary periods such as 1990, 2001 and 2002, recovery rates fell to approximately 25%.

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Portfolio Diversification High yield bonds typically have low to moderate correlations to equities and other fixed income sectors. Adding high yield securities to a portfolio may help to decrease overall risk and improve the consistency of portfolio returns. Because of the large risks in owing individual high yield bonds, diversification and professional management are always essential.

Future Prospects With the U.S. economy in what might be considered a severe recession, why would investors want to own low-quality bonds as a component of a diversified portfolio? While the fundamentals of the asset class might deteriorate even further, it appears that current prices and yields discount an overly pessimistic scenario for the asset class.

In re-evaluating its forward-looking return assumptions, Innovest recently formulated expectations of the asset class, including projections of future default rates, recovery rates, price appreciation and income. In the near future Innovest consultants will be discussing with their clients the updated expected returns for all asset classes, including high yield bonds, and potential changes to portfolio allocations. •

INNOVEST BLOG

Please visit our blog through our website: www.innovestinc.com

This is designed for our clients and friends to read our thoughts on a variety of investment and fiduciary issues. We have links to websites, research, and other blogs that can be helpful navigating the world of investments and stewardship. Keep us informed of your thoughts.

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