



New Investment Strategies for a Defined Contribution Pension Environment

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Introduction

Observations

- Behavioral patterns may indicate a need for alternative solutions
- Fiduciary scrutiny continues to create a reluctant to introduce new financial strategies versus current market MPT theory
 - *According to ERISA plan sponsors should know and understand the applicability of investment innovations*

Objectives

- Explore investment solutions that accommodate behavior
 - *Is inertia a signal for change?*
- Influence changes in plan design liability centric and risk minimization strategies



Innovations

- Investment product research and development perspective of practitioners
 - *Synthetic Defined Benefits*
 - *Participant Advice Solutions/Automatic 401(k)*
 - *Company Stock Solutions*
 - *Asymmetrical Risk/Return Solutions*



The Realities of Retirement

- Fewer pensions and defined benefit plans means responsibility has shifted to the individual
 - *Number of DB Plans has decreased by 50% in last 20 years*
 - *401(k) plans often don't provide for lifetime income*
 - *Only 30% of 401(k) plans offer an annuity option.*
- The Social Security system as we know it today will likely be different in the future...even today, Social Security accounts for just 23% of total income for retirees (with income of \$31,000+)
- Medicare and prescription costs are going up for many...
- Because we are living longer, we have to plan for a longer time horizon. But the truth is we actually underestimate how long we will live and how much income we will need.
- To avoid running out of money, we may be compelled to take more investment risk which could exacerbate the problem.

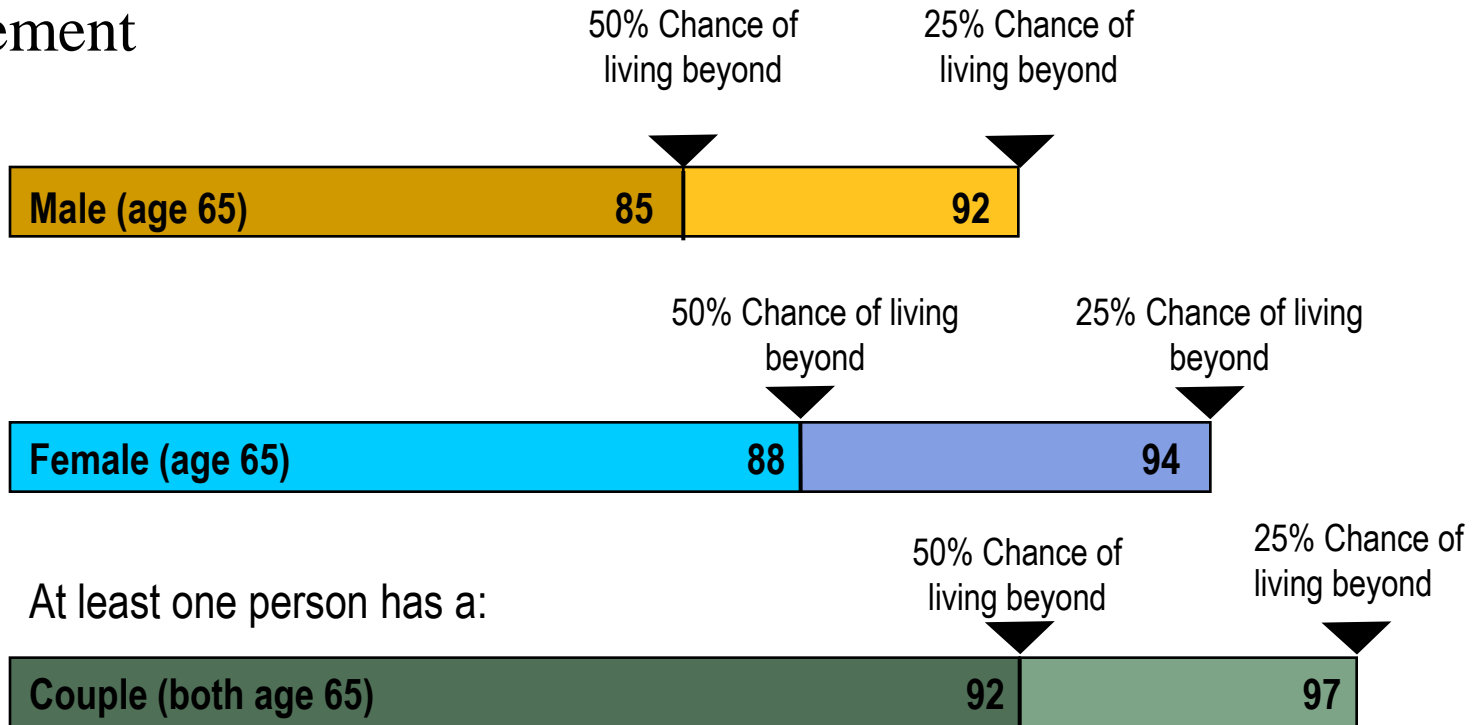


Two Major Components to Planning Retirement Income

- Longevity Risk
- Managing Market Risk

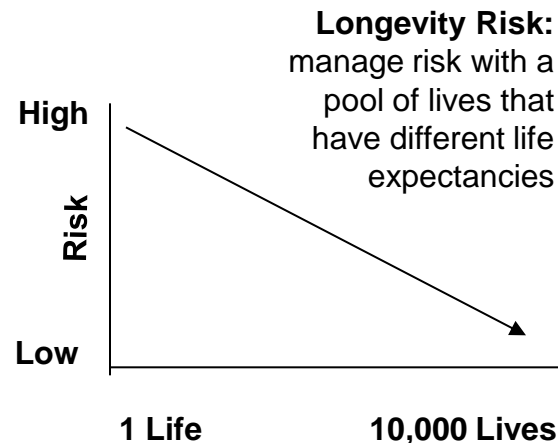
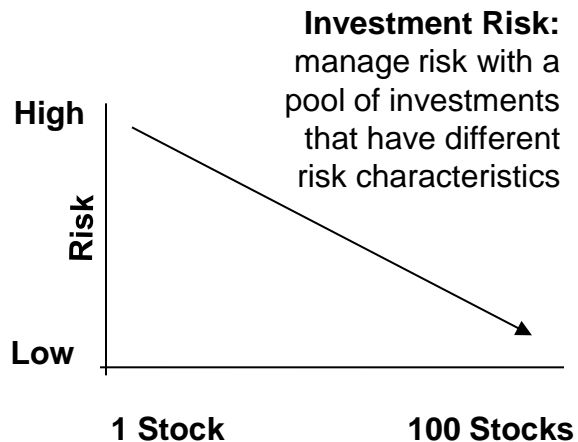
Longevity Risk

People greatly underestimate the time they will spend in retirement



Pooling Lives to Manage Longevity Risk

Like mutual funds with stocks that have different risk characteristics (i.e., a diversified portfolio), insurance companies manage risk and can offer lifetime income because of the large number of individuals who buy annuities.





Market Acceptance of Annuities

- In the 2004 Merrill Lynch Retirement Survey, 66% of all individuals would prefer an annuity income stream instead of their defined contribution plan
- High level of interest in guaranteed lifetime income¹
 - *51% "extremely" or "very" interested in learning more*
 - *36% "somewhat" interested*
- Those who have purchased income annuities express great satisfaction²
 - *60% consider it a "good" financial decision*
 - *Another 22% consider it "one of the best" financial decisions they've ever made*

Source: 1. Nationwide Survey, 2001;

2: ACLI Survey of Immediate Annuity Owners, 2003



A Deferred Fixed Annuity Embedded in a 401k Plan: Benefits to Employee & Employer

■ **Key Benefits to the Employee:**

- **Security:** Each dollar saved *today* buys guaranteed income for *tomorrow and beyond*
- **Dependability:** Income immune to equity market downturns
- **Innovation:** There is no other product like it on the market today
- **Control:** Individual decides the amount/frequency of contributions as well as when benefit starts
- **Choice:** Wide range of pay-out options to meet varying needs
- **Access:** Provisions for withdrawals or liquidation before retirement income payments begin*
- **Ease:** Participants contribute via payroll deduction

■ **Key Benefits to the Employer:**

- Easily added as an investment option to 401(k) plans at no cost to the employer
- Empowers employees to create their own personal pension plan
- A way to provide employees with a lifetime income benefit, without the cost and liability associated with a defined benefit plan
- May differentiate retirement plan and help recruit talent

* Taxes and penalties may apply to withdrawals made prior to age 59 1/2 and may be subject to plan level restrictions.

*Hypothetical, for illustrative purposes only.



Managing Market Risk: The Importance of Advice

- Millions of dollars spent on communications programs to educate and train employees to make informed financial decisions has not changed the inertia and poor investment management within defined contribution plans.
- In a 2001 research paper Thaler & Bernatzi proved that people engage in “naïve diversification”
- In the Merrill Lynch 2004 Retirement Survey:
 - 58% of those surveyed believed that some portion of 401k plans are guaranteed by law, and
 - The average annual rate of return expected in retirement is approximately 20%
- Company stock concentration levels represent 43% of average assets among plans with 5,000 employees or more.



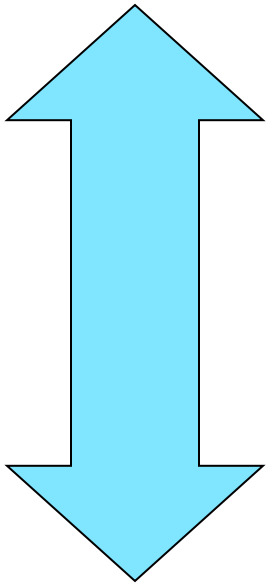
Participant Behavior and Stock

- Inside Track Mentality
- The Water Cooler Theory/Cocktail Party Analytics
- Inertia
- Corporate Culture



Company Stock Solutions

Minimum

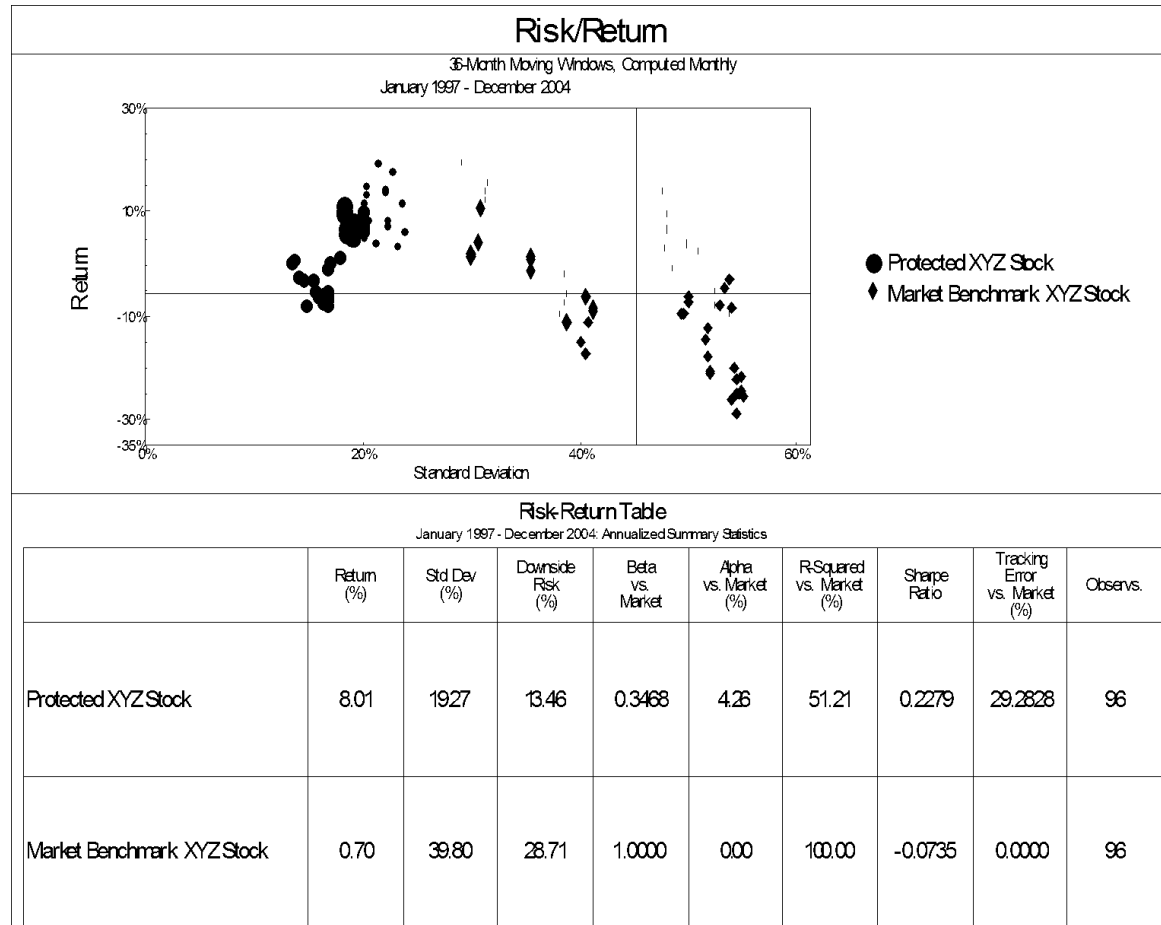
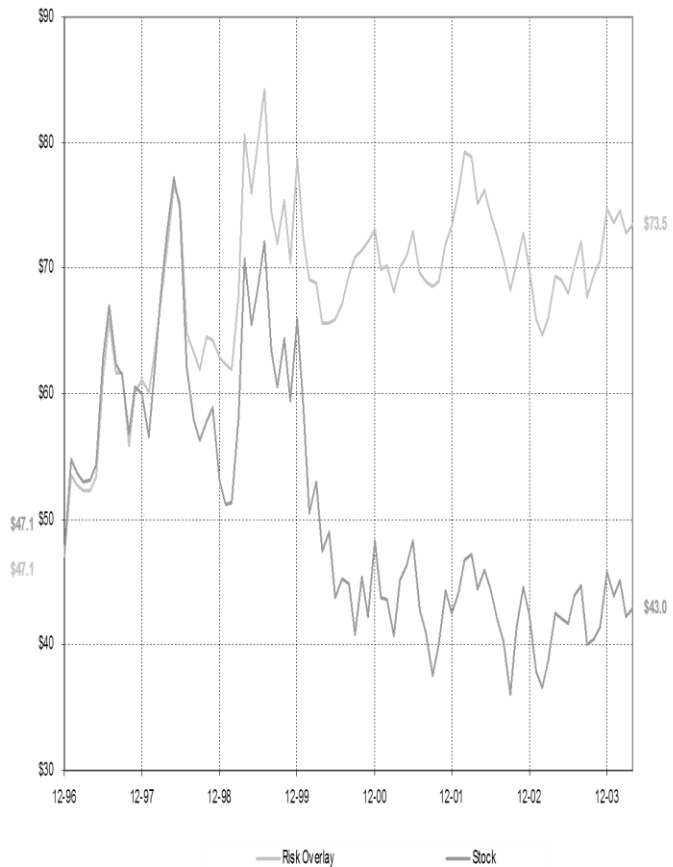


Innovative

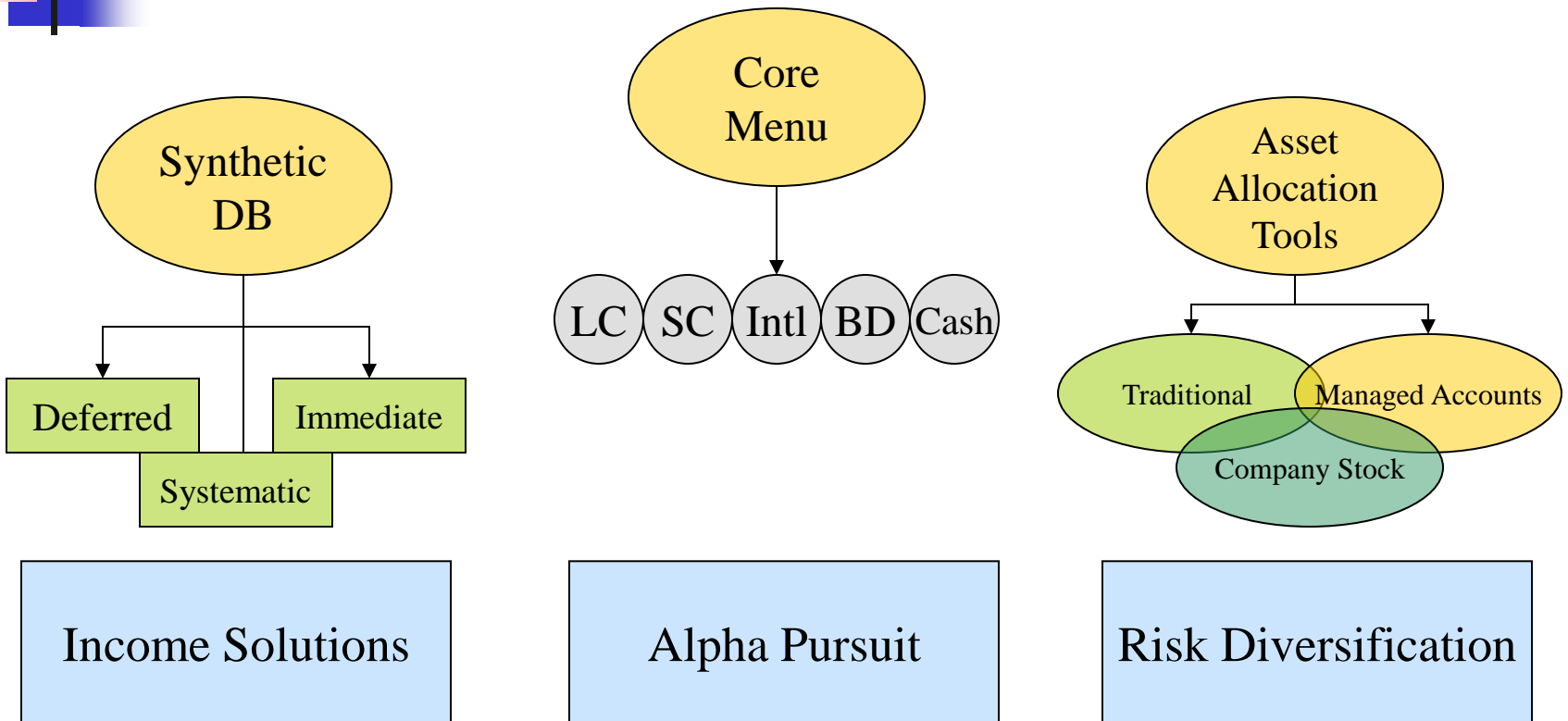
- Managing Fiduciary and Participant Behavioral Risk
 - *Plan or DOL Imposed Liquidity Thresholds*
 - *Plan Imposed Concentration*

- Plan Sponsor Directed
 - *Treated as an individual asset category*
 - *QPAM Oversight*
 - *Managed Stock Position*
 - *Investment Policy Statement*
 - *Hedging or Selling*

Stock Solution Example



Conclusions





Questions?

Thank You!