

THE AFP® EXECUTIVE INSTITUTE

Strategic Content for Financial Executives

Session: 59

**Defined Benefit Plans in Flux:
New Decisions for CFOs and
Treasurers**

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3:00 p.m. - 4:00 p.m.

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**Defined Benefit Plans in Flux:
New Decisions for CFOs and Treasurers**

For three years now, Fidelity Management Trust has been collecting data on how plan sponsors are responding to various factors affecting defined benefit (DB) plans. The panel will discuss the various pressures DB plan sponsors face and how they are reacting to these demands.

Learning Objectives

- Understand the depth of the pension crisis (Is there a future for DB/cash balance plans?)
- Learn how changes in pension accounting and reform affect asset allocation
- Explain the future role of the Pension Benefit Guaranty Corporation and how it can keep its promises

Pre-requisites

- None

Take Aways

- The 2004 Fidelity/PLANSPONSOR Pension Survey
- Executive Summary of the 2005 Pension Research Study

PLANSPONSOR



Fidelity/Plan Sponsor Research Roundtable Series

2005 Research Report on Corporate Plans The Defined Benefit Dilemma

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Speakers

Charlie Ruffel

Chief Executive Officer, Asset International, Inc.

Charlie is Founder and Chief Executive Officer of Asset International, Inc. He launched Asset International with the original intent of providing better information to investors on the then-nascent business of cross-border investing. This led to the founding of the quarterly *Global Custodian* magazine. An early success, it quickly became the "bible" of the international securities services business and set the stage for an even more ambitious effort: PLANSPONSOR magazine. Publishing *Global Custodian* gave Charlie insight into the growing power of the custody banks' ultimate clients: pension plans. He wanted to publish a magazine that exclusively served their interests and put a premium on objective, practical advice and problem-solving tools. Launched in 1994, PLANSPONSOR quickly established itself as an authoritative and respected voice in the pension community. In keeping with the original vision of creating an integrated information franchise for plan sponsors, Asset International launched sister Web site PLANSPONSOR.com in 1999 and then the Pathfinder provider search and selection service in 2001. These initiatives have transformed the company from a periodical print franchise into an electronic intermediary that delivers information and services to the pension community on a real-time basis. Prior to joining Asset International, Charlie was a financial writer at *Institutional Investor* in New York and *Financial Mail*, in Johannesburg, and an account executive, McCann Erickson Advertising in London.

Charlie earned his M.A. in History from Cambridge University and his M.S. in Journalism from Columbia University.

Alan Kirby

Vice President, Marketing, Fidelity Investments

Alan is Vice President of Marketing at Fidelity Management Trust Company (FMTC). In this role, he manages a team responsible for market research, competitor intelligence, brand management, and marketing communications. Prior to joining Fidelity, Alan was Assistant Vice President of Marketing for Met Life Institutional Asset Management Services. Prior to that, Alan was Director of Investment Communications for New England Investment Company. Alan joined Fidelity in 1997.

Alan earned his Master of Science degree in Investment Management from Boston University. Alan holds NASD Series 7, 6, and 63 licenses.

Agenda

◆ The Funding Status Survey

- Research Methodology
- Demographics

◆ Major Themes

◆ Review of Research Results

- Assets and Liabilities
- The Market
- Cost
- Governmental Action
- Organizational Discord
- Alternatives to the Defined Benefit Plan

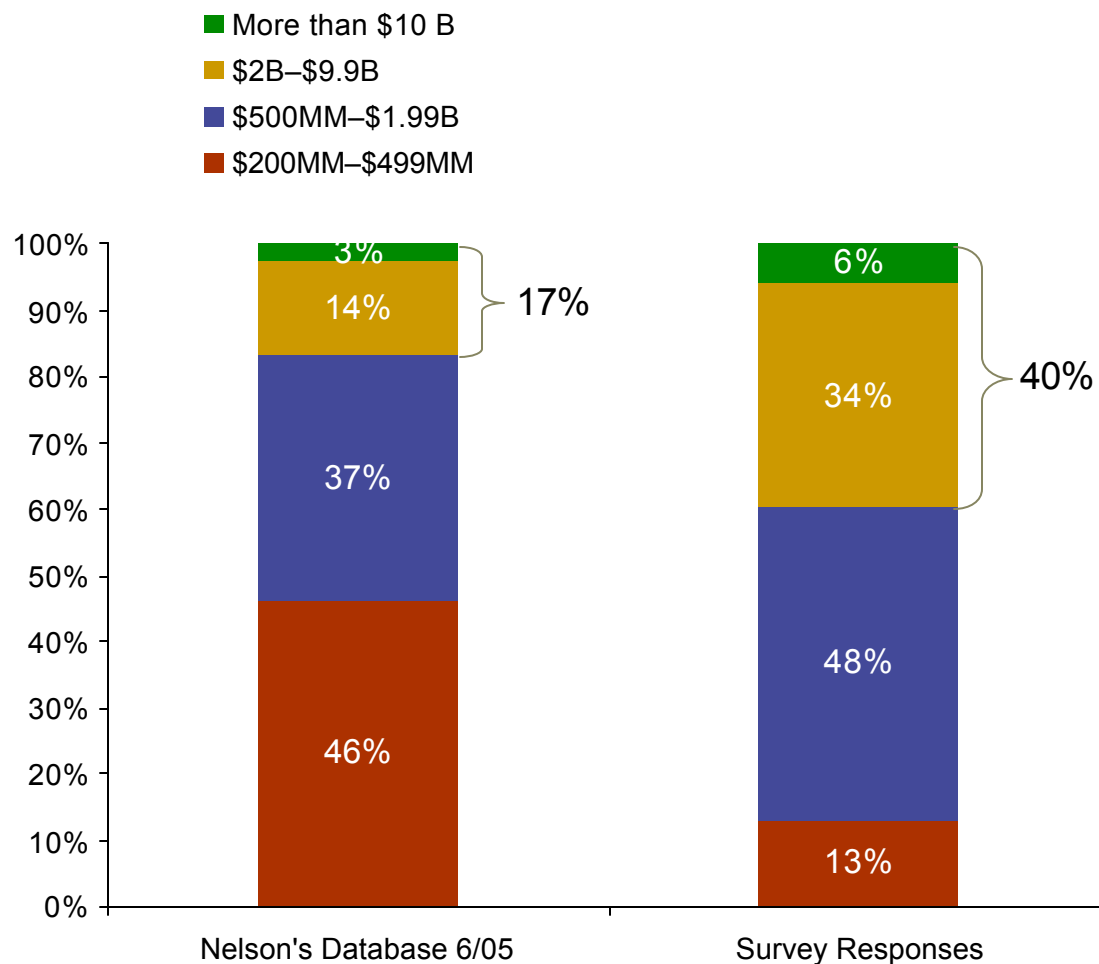
The Market—How they were reached

- ◆ From April 7, 2005 to June 13, 2005, our questionnaire ran to individuals listed as “decision maker” in their profile at www.plansponsor.com. The most common titles held are “Investment Director,” “CFO,” “Trustee,” or “Treasurer.”
- ◆ Surveyed 189 of the largest defined benefit plans
- ◆ Achieved a representative sample of the defined benefit universe

<i>All Defined Benefit Plans</i>	<i>>\$200 million</i>	<i>>\$500 million</i>	<i>>\$2 billion</i>	<i>>\$10 billion</i>
Marketplace: Number of Plans	1,356	730	256	74
Survey: Number of Plans	189	164	83	25
<i>Percentage of Market</i>	<i>13.94%</i>	<i>22.47%</i>	<i>32.42%</i>	<i>33.78%</i>

<i>All Corporate Plans</i>	<i>>\$200 million</i>	<i>>\$500 million</i>	<i>>\$2 billion</i>	<i>>\$10 billion</i>
Marketplace: Number of Plans	649	350	109	17
Survey: Number of Plans	101	88	40	6
<i>Percentage of Market</i>	<i>15.56%</i>	<i>25.14%</i>	<i>36.70%</i>	<i>35.29%</i>

What are the total defined benefit assets for your organization?

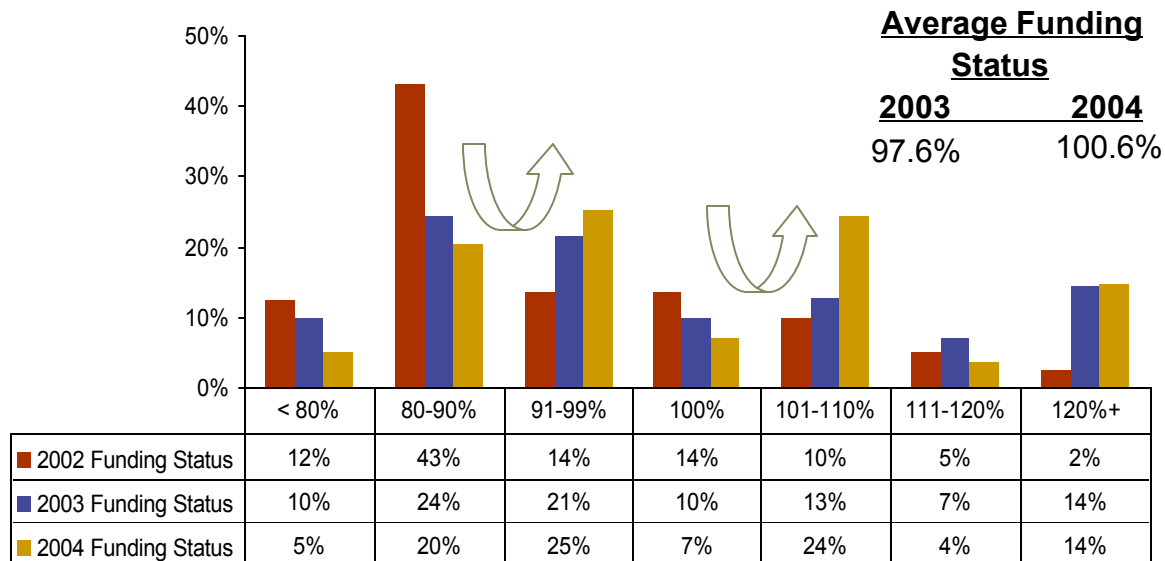


- ◆ The respondent sample is overweighted in large plans
- ◆ 40% of the corporate survey respondents have DB assets that total over \$2 billion compared to 17% for Nelson's universe
- ◆ Plans with \$200-\$499 million represent 13% of the corporate respondents, but 46% of Nelson's universe

Major Themes

- ◆ While still underfunded, plan sponsors are making progress toward closing the funding gap
- ◆ Plan sponsors are protecting plans from a market downturn via portfolio diversification and disciplined rebalancing
- ◆ Though the DB plan is more expensive, it is a superior benefit to the DC plan
- ◆ Regulation has the potential to motivate positive change; however, current legislation is dissatisfactory
- ◆ The pension organization is conflicted: cost versus benefit, management versus employees, balance sheet versus income statement, and early versus late career associates
- ◆ Organizations are still committed to offering the DB plan to their employees

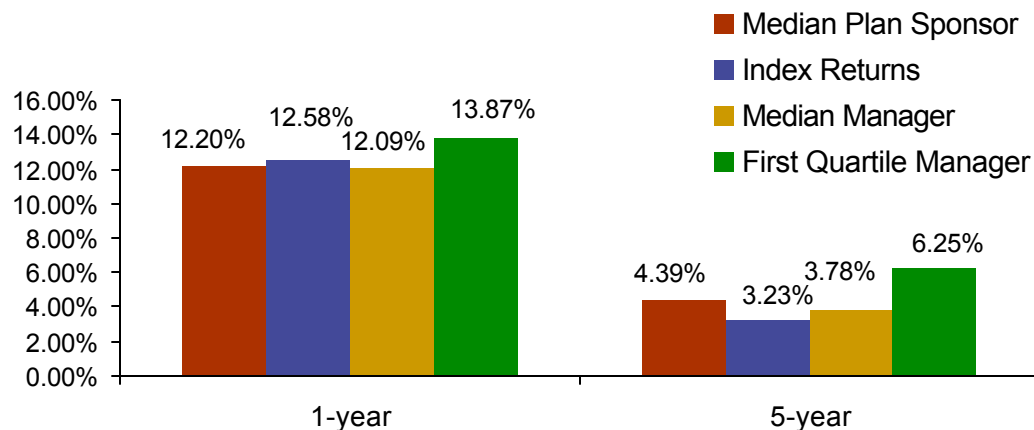
Assets & Liabilities—Key Findings



- Overall, funding levels have improved on an ABO basis; similarly, on a PBO basis, the S&P500 improved from 87% funded in 2003 to 89% funded in 2004

- Mature plans (101%) are better funded than active plans (98%)

Plan Sponsor vs. Index vs. Investment Manager



- Less well funded plans have enlisted expertise

- On a 5-year basis, plan sponsors outperformed the index and demonstrated skill in manager selection

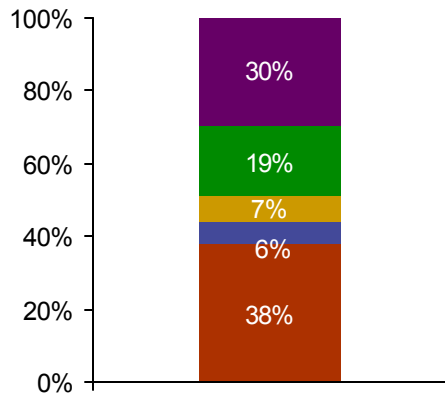
The Market—Key Findings

Average Return Expectations

U.S. Equity	8.17%
Non-U.S. Equity	8.77%
Fixed Income	5.10%
Real Estate	7.15%
VC/PE	10.08%
Hedge Funds	6.69%
Other	4.00%
Total Return	7.37%

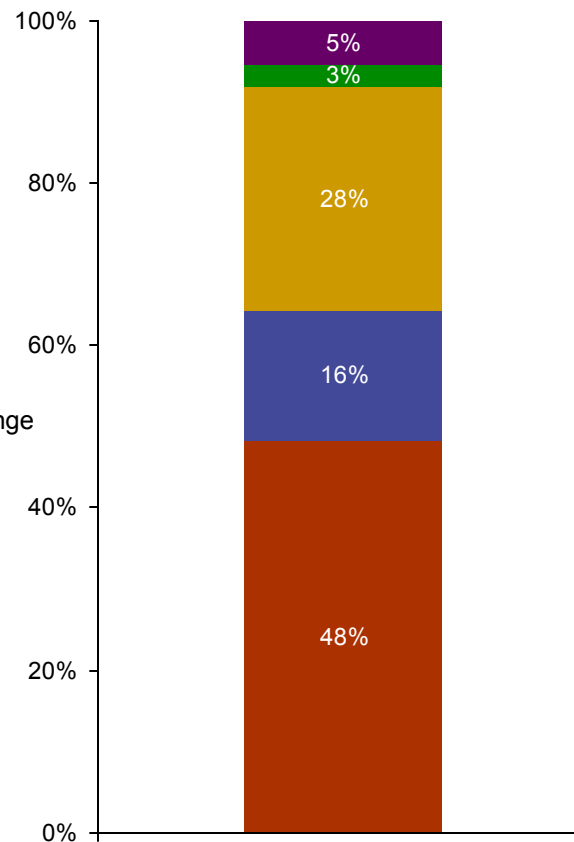
Frequency of Rebalancing

- Monthly and more frequently
- Quarterly
- Semi-Annually
- Annually and less frequently
- Only when our AA strays outside our target range



What is your current asset allocation?

- Alternatives & Other
- Real Estate
- Fixed Income
- Non-U.S. Equity
- Domestic Equity

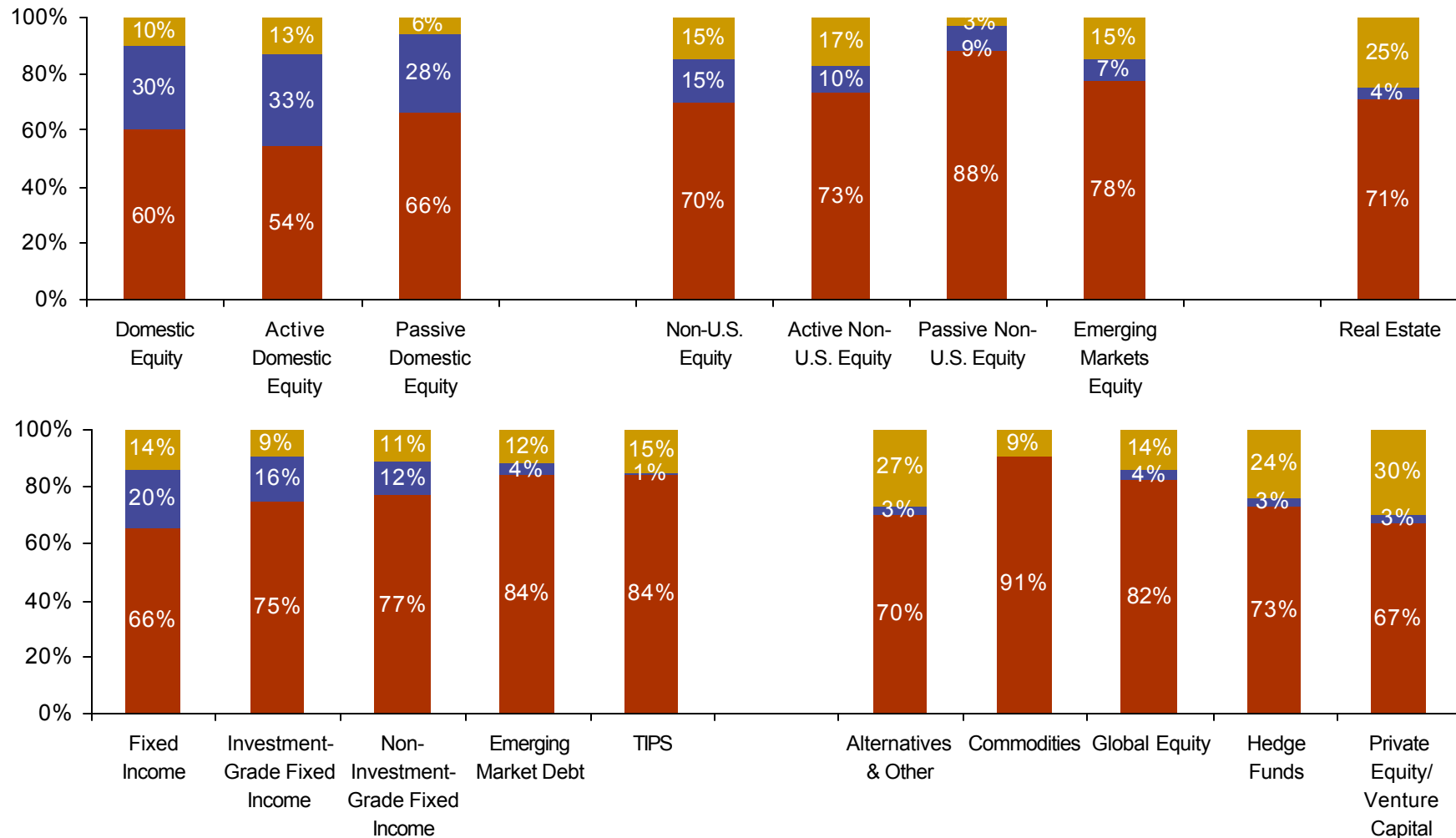


- ◆ Although not expecting a market downturn, plan sponsors' most frequently cited defenses are diversification and rebalancing
- ◆ 65% rebalance back to a target range versus 25% who rebalance back to target
- ◆ Rebalancing to a target range on no less than a quarterly basis enhanced performance
- ◆ Style-specific domestic equity allocations contributed to above- median performance

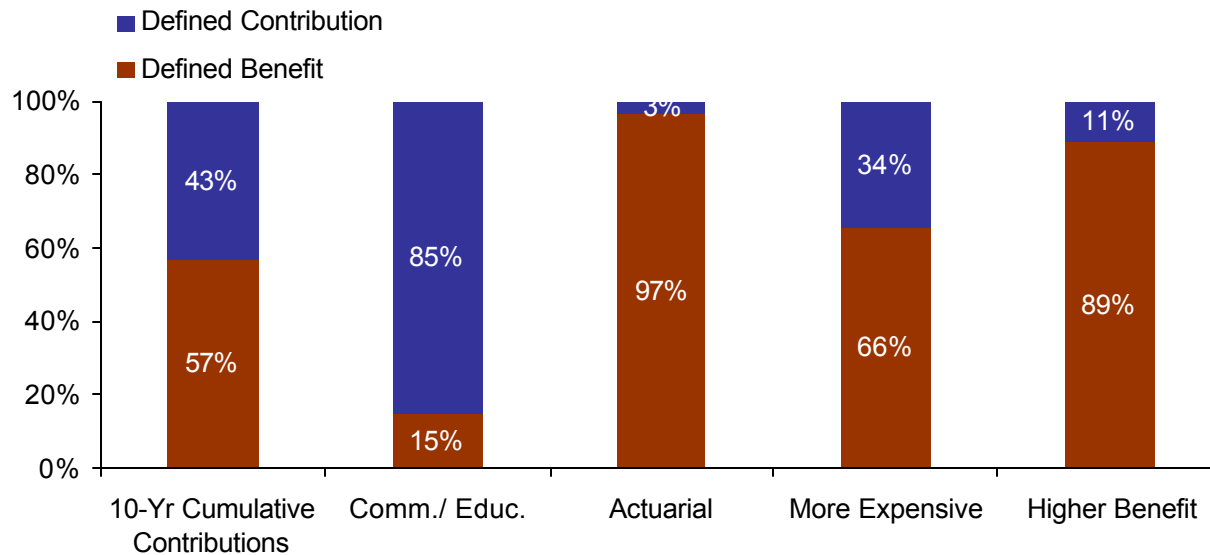
The Market—Key Findings

Expected Asset Allocation Changes Over the Next 12 Months

■ % Increase
■ % Decrease
■ % Do Nothing



Cost—Key Findings



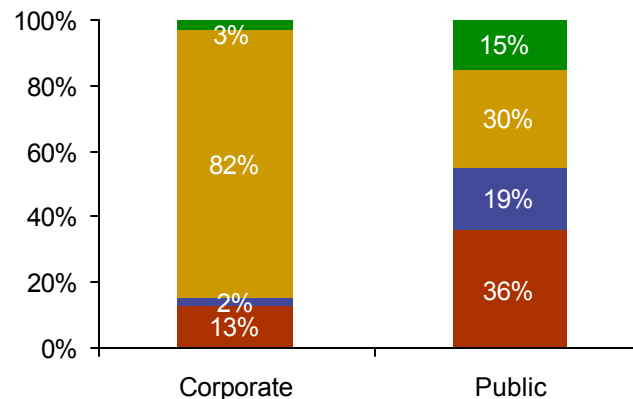
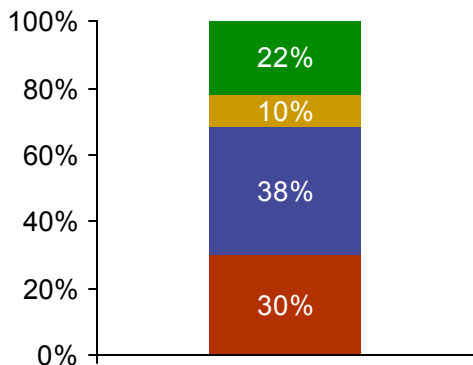
- ◆ DB is a superior benefit to DC and more expensive
- ◆ Contributions are slightly higher for DB
 - Communications costs are more expensive for DC
 - Actuarial costs are more expensive for DB

What is your contribution policy?

If overfunded:

- Contributions are dictated by company health.
- We contribute the same amount every year.
- We contribute to hit our target funded level.
- We contribute the minimum each year.

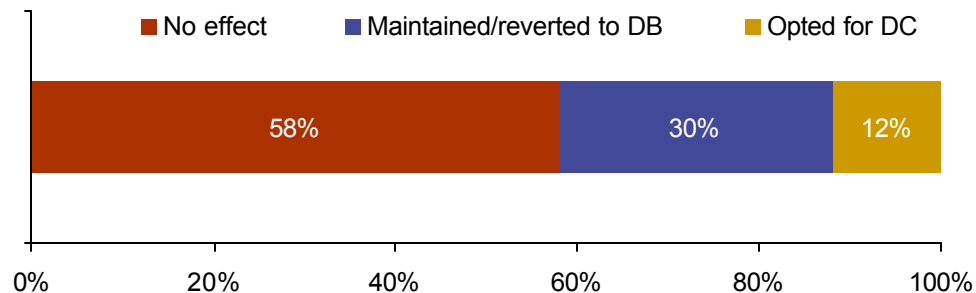
- We will improve benefits
- Contributions holiday or lower contributions
- Both of the above
- None of the above



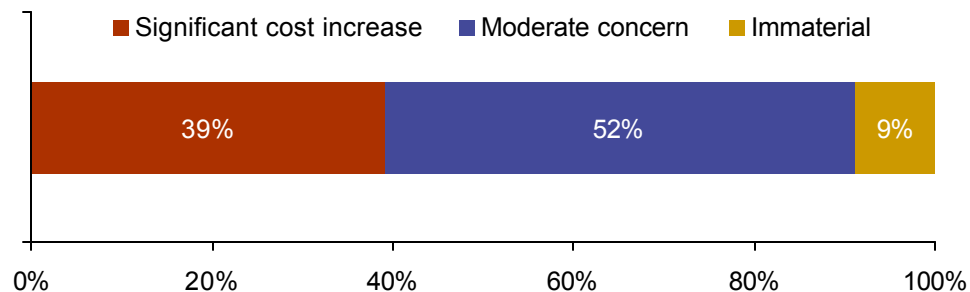
- ◆ Contribution policy is mixed with 38% contributing to hit their funding target and 30% contributing the minimum
- ◆ If overfunded, corporate plans will skip contributions

Governmental Action—Key Findings

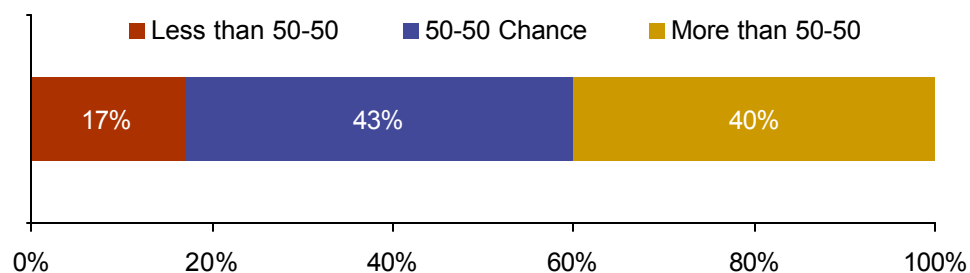
Effect of uncertainty of cash balance?



View of increased PBGC premiums?



How likely is mark-to-market?



◆ Governmental Inaction:

- Cash balance
- Permanent replacement for 30-year Treasury

◆ Preferred replacements: AA Corporate (65%), yield curve (20%), and no change (11%)

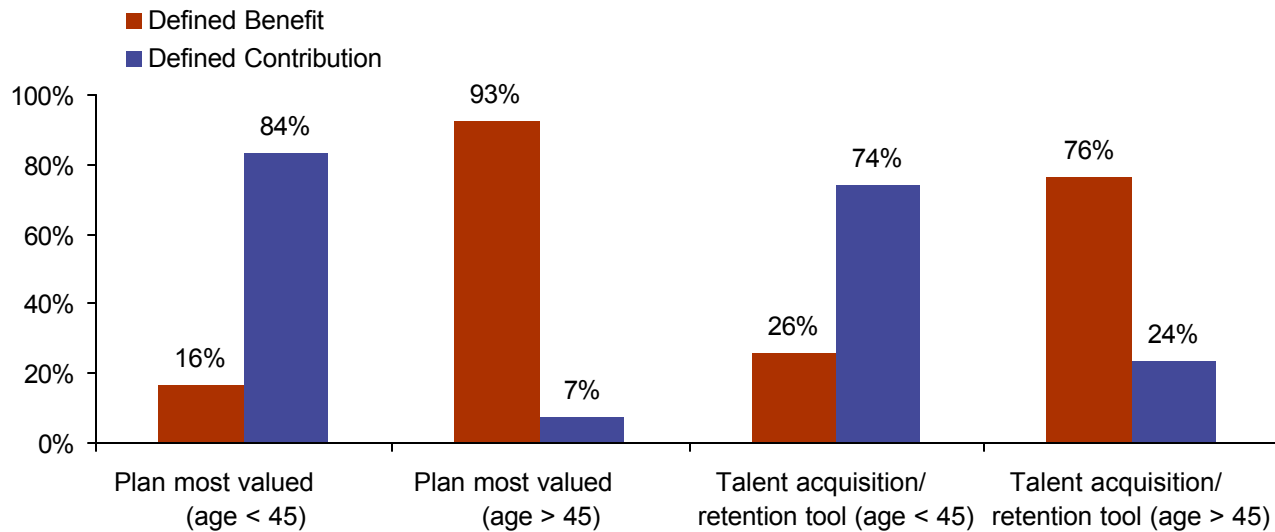
◆ Governmental Action

- Increase PBGC premiums
- Mark-to-Market

◆ Plan sponsors would increase funding if contributions to an overfunded plan were deductible and if they could withdraw pension surplus

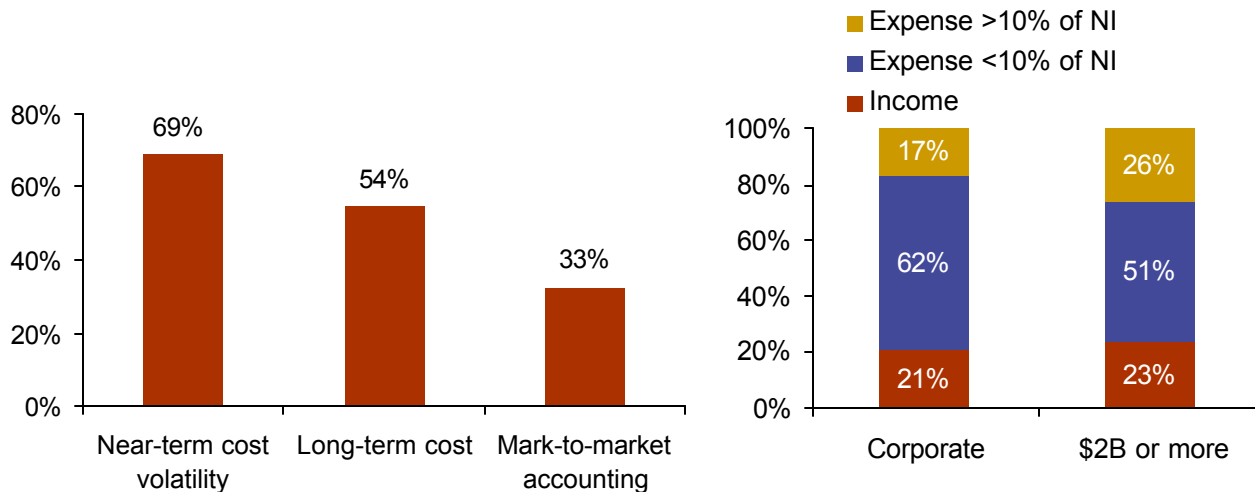
Organizational Discord—Key Findings

“Early” versus “Late” Career Associates



◆ Plans believe younger associates value a DC benefit more than DB, therefore the DC plan is a better recruitment and retention tool; they believe the opposite of their employees over 45 years of age

What concerns senior management? Pension income or expense?



◆ Near-term pension cost volatility is the major concern to senior management

◆ One quarter of large plans posted pension expense greater than 10% of net income

What is the biggest misunderstanding about your pension plan and who holds this belief?

Corporate

“The lack of the company—and peers—to promote what a fantastic benefit this is.”

“No surprises should ever occur with regard to funding and/or pension cost—a belief held by our CFO and organization.”

“Outside analysts/credit agencies don’t have a clear understanding of our liability/risk because of all the different and complicated accounting rules.”

“How it works. Most everyone.”

Public

“The belief that our retirement benefits are rich; this is trumpeted in the media.”

“That it is a serious burden to taxpayers, when in fact our employees have paid additional contributions for every benefit enhancement. Uninformed taxpayers hold this belief...politicians exploit it.”

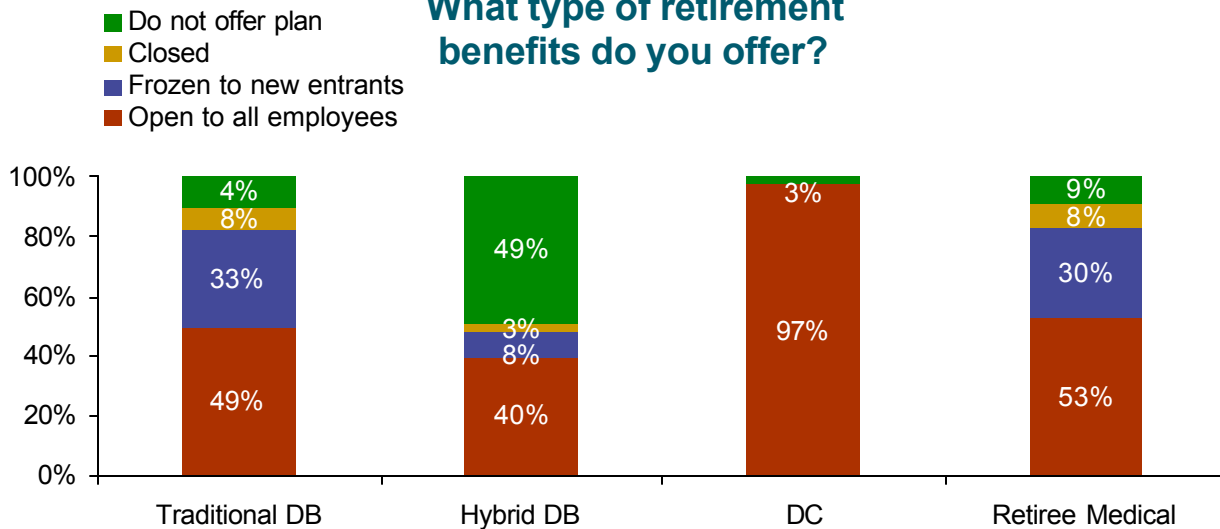
“The biggest misunderstanding may well be the State of California and Legislators who want to take control and regulate our County sponsored employee retirement system. Our system is over 100% funded and managed very well.”

“That the assets belong to the taxpayers when they are really held in trust for the members and beneficiaries of the system.”

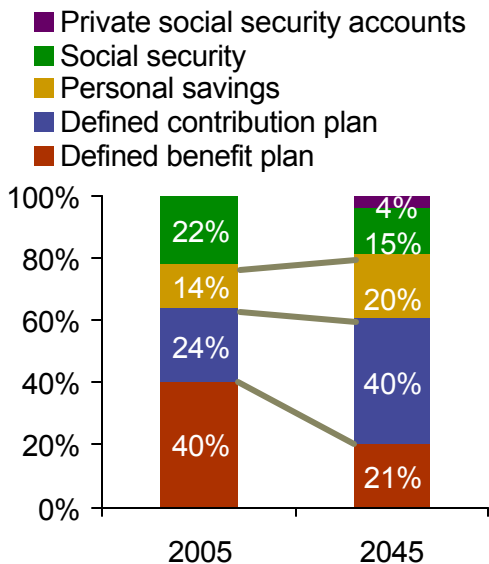
“That there is this big pot of money that the state should be able to tap into for all sorts of mischief.”

Alternatives to DB—Key Findings

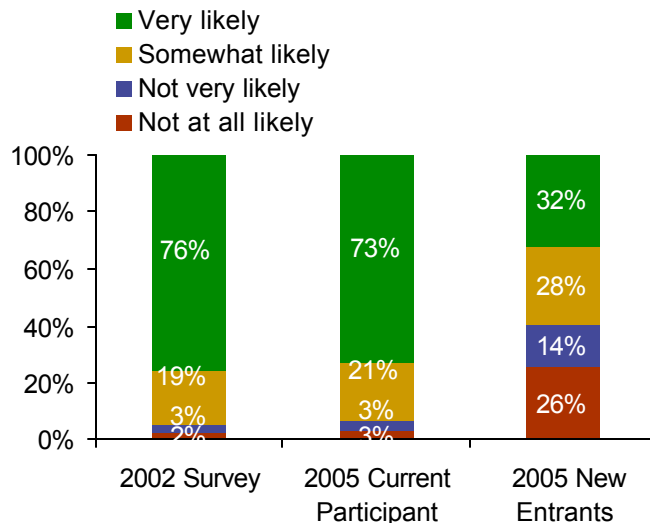
What type of retirement benefits do you offer?



Sources of Retirement Income



How likely are you to offer DB plan in next 5-10 years?



- ◆ Corporations have led the transition to hybrid plans
- ◆ 97% offer a DC plan; 83% are supplemental to an open DB plan
- ◆ Future retirees will rely more heavily on personal savings and DC plans
- ◆ If organizations switch to DC, 67% believe the average retirement age would increase
- ◆ Over the next 5-10 years, most believe they will offer DB for current employees and 60% believe they are at least somewhat likely to offer the plan to new entrants

Reality Check

Major Themes

Myth

Reality

- ◆ While still underfunded, plan sponsors are making progress toward closing the funding gap
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- ◆ Organizations are still committed to offering the DB plan to their employees