

# RETIREMENT Plan Trends



A benefits update

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## Hybrid Defined Benefit/401(k) Plan Debuts In 2010

Starting in 2010, companies with 500 or fewer employees have the option of sponsoring a tax-advantaged “DB(k)” retirement plan, a hybrid of a defined benefit plan and 401(k) plan. This new plan type could prove attractive to companies that want to provide employees with both a traditional pension plan and a defined contribution plan, but wish to minimize the administrative burdens involved with sponsoring two plans.

The new combined defined benefit/401(k) plan, or DB(k), was established by the Pension Protection Act of 2006 and is available for plan years starting after December 31, 2009. The plan assets are governed by a single trust and single plan document, but there is separate accounting for the DB and 401(k) components of the trust. Generally, defined benefit rules apply to the defined benefit component of the plan, and defined

contribution rules apply to the 401(k) component of the plan. Any employer with 2 to 500 employees may implement a DB(k) plan.

In a DB(k) plan, the defined benefit must be equal to 1% of final average pay for each year of the participant’s service, up to 20 years. Thus, plan sponsors will be required to create a pension fund large enough to pay each participant up to

20% of his or her average annual salary during the last few years of employment. Alternatively, plan sponsors can use an age-weighted cash balance method for determining benefits. These benefits are paid out to retirees in monthly checks, as is typical of a defined benefit plan. An employee’s accrued defined benefits are vested after three years of employment with the company.

The 401(k) component of the plan must have an automatic enrollment feature. Under the new plan, employees automatically contribute 4% of their earnings to the 401(k) portion of the plan, unless they opt out. The plan sponsor is required to match at least 50% of the employee’s 401(k) contributions, with a maximum match of 2% of pay. Employer matches vest immediately, and the distributions from these accounts must comply with the rules governing defined contribution

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*Using a measure of the variability of returns by their standard deviation, the authors found that, from 1949 to 2008, the average real rate of return on stocks was 7.2%, and the standard deviation of annual returns was 18.2%.*

plans. Because the DB(k) sets limits for employee salary deferrals and employer matches, these new plans are not subject to the nondiscrimination or top-heavy testing imposed on 401(k) plans.

The DB(k) was developed to give employers the option of providing their workers with guaranteed defined benefits and 401(k) savings in a single plan, without the complex regulatory requirements and administrative tasks involved in operating two separate plans. Assuming the design requirements are met, plan sponsors only have to file one document for the plan and one tax form each year, Form 5500, Annual Return/Report of Employee Benefit Plan.

The new DB(k) plan is established under Section 414(x) of the Internal Revenue Code, where it is referred to as an “eligible combined plan.” More information about DB(k) plans is provided in the Internal Revenue Service (IRS) Notice 2009-71.

## Stock Investment Risks May Be Linked To Investor Behavior

While variations in economic conditions and corporate profits affect the stability of stock prices, the ways in which investors react to this volatility can also lead to distortions in stock values, according to a study published by the Center for Retirement Research at Boston College.

The issue brief, “Why Are Stocks So Risky?” was written by economist Richard W. Kopcke and research associate Dan Muldoon. In the study, the authors analyzed the risk in stocks, both as a reflection of the growth of economic activity and corporate earnings, and as a reflection of the way investors value those earnings.

After examining the historical record, the authors acknowledge that stocks are risky investments, as real returns are highly volatile not just over short holding

periods, but also over periods longer than a decade. Using a measure of the variability of returns by their standard deviation, the authors found that, from 1949 to 2008, the average real rate of return on stocks was 7.2%, and the standard deviation of annual returns was 18.2%. The gap between the annual return on stocks and bonds has averaged 3.8 percentage points since 1972, and 5 percentage points since 1949. In an effort to dilute this risk, the authors noted, some investors have turned to buy-and-hold investment strategies, hoping that the low and high outcomes will eventually “average out.”

The analysis showed that, over long periods of 40 years or more, earnings tend to track the gross domestic product (GDP). Over shorter periods, however, stock prices are affected by economic booms and busts, as companies’ earnings push the average rate of appreciation of equity far from its historical average. Meanwhile, the ratio of market values to earnings was found to be even more volatile than the ratio of earnings to GDP. Sometimes valuations surge when earnings increase temporarily with the adoption of new technologies or products, but then collapse as shareholders recognize the connection between companies’ capacity to generate profits and GDP.

If earnings and valuation ratios always equaled their long-run averages, the authors asserted, the total value of stocks would move in lockstep with GDP. However, economic cycles can result in large variations in earnings, which contribute to the volatility of stock prices. Significant fluctuations in valuation ratios, as stock prices become substantially unhinged from companies’ ability to generate earnings, can exacerbate the problem.

“Shareholders’ reactions to economic conditions and to recent trends in stock prices create most of the volatility in the returns on equity,” the authors asserted. “Although stock prices vary substantially in response to cycles in business activity and earnings, these factors account for a small share of the risk in stocks over holding periods as long as 10 years or more.”

Despite these shareholder-driven distortions, because the long-term risk associated with stocks has been limited, the authors concluded that, “with intergenerational programs for sharing risk, equity retains considerable promise for helping savers meet their objectives for building wealth for retirement.”

## Improvements In 401(k) Plan Design May Help Enhance Savings

While the economy has dealt a blow to the retirement savings accounts of many workers, innovations in retirement plan design, especially the introduction of automated features, are helping employees save more effectively over time, according to a report released by benefits consultancy Hewitt Associates.

The study, “Trends and Experience in 401(k) Plans,” is based on the results of a biennial survey conducted in 2009. The survey questioned more than 300 large employers about key aspects of the design of their 401(k) plans, including investments, plan expenses, education, communication, and plan success.

More than two-thirds of respondents (67%) said a 401(k) plan is the primary retirement savings plan offered to employees. Researchers noted that this figure has leveled off in recent years, after rising for more than a decade. In addition, 23% said they are shifting away from defined benefit retirement plans, and 21% indicated they are moving away from retiree medical benefits. To help compensate for these changes, 17% said they are increasing their 401(k) matching contributions, and 15% reported raising non-matching contributions. However, in response to market conditions, 17% of plan sponsors said they have decreased, temporarily suspended, or eliminated their matching contributions.

The findings also indicated that employers are encouraging more employees to participate in retirement plans. The 2009 survey showed that 74% of the employers surveyed do not have any service requirements for participating in a 401(k) plan, up from 61% in 2007. In addition, 56% do not have service requirements for employer matching contributions, up from 44% in 2007. Participation in retirement plans appears to have risen, at least partly because of automatic enrollment programs. Results showed that an average of 81% of eligible employees participate in their employers’ 401(k) plans, up from 78% in 2007 and 75% in 2005. More than half of the employers surveyed reported having retirement plan participation rates of more than 90%, representing an increase of almost 10% from 2007.

When asked about their adoption of automatic features, 58% of the employers said they now automatically enroll participants in their 401(k) plans, up from 34% in 2007. In addition, 44% of employers have added an automatic contribution escalation feature to their plans, up from 35% in 2007, and 47% offer automatic rebalancing, up from 42% in 2007.

The poll showed that investment defaults under automatic enrollment have shifted to diversified investment options, with 69% of plans now defaulting participants into a target date fund, up from 50% in 2007. By contrast, only 5% of plans default participants into money market or stable value funds, down from 17% in 2007. In addition, 35% of plan sponsors set their default contribution rates at 4% or higher, up slightly from two years ago, and 40% of employers currently use contribution escalation in conjunction with automatic enrollment, up from just 28% in 2007.

Nearly all the companies reported that they contribute employer money to their plans, with nearly two-thirds indicating that they provide a fixed employer matching contribution. Results showed that the most common type of fixed match, reported by more than one-quarter of respondents (27%), is a dollar-for-dollar



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match up to a certain percentage of pay, usually 6%. The second most common fixed match formula, reported by 23% of respondents, is 50 cents on the dollar up to a specified percentage of pay, again usually 6%. Just 17% of the companies said they invest the employer matching contribution exclusively in company stock, down from 24% in 2007 and 36% in 2005.

The survey also asked employers about the investment options offered to defined contribution plan participants. Nearly all employers (90%) reported that they have a written investment policy statement, up from 83% in 2007 and 78% in 2005. When asked what criteria they use in selecting funds, 59% of employers ranked fees/expense ratio as one of the most important factors. Other important factors cited by respondents included fund objective and style consistency (48%) and historical investment performance (47%). Researchers observed that, in 2007, historical performance was the top-ranked factor.

When asked to identify the types of funds their plans offer, 78% of respondents said they offer target date portfolios, up from 58% in 2007 and 28% in 2005. While the median number of investment options has risen in recent years—to 20 in 2009 from 17 in 2007—researchers attributed this increase to the adoption of target date portfolios. The median number of funds offered has risen only slightly, from 11 in 2007 to 12 in 2009.

Responses to questions about 401(k) asset allocation revealed that a large portion of assets remain invested in stable value (26%), large-cap U.S. equity (19%), and employer stock (16%) funds. However, results of the 2009 survey showed that allocation to fixed income funds increased significantly from 2007, primarily due to the intervening downturn in the markets.

As was shown in previous surveys, the vast majority of plan sponsors in 2009 (90%) said they provide investment education to their employees, with nearly all indicating that they use written materials for communicating investment concepts. More than three-quarters (76%) said they believe these materials are at least somewhat effective. By contrast, of the 86% of respondents that reported using on-site investment seminars or workshops, just 46% said they believe they are effective.

To supplement in-house financial education programs, half of the employers said they offer outside investment advisory services to employees, up from 40% in 2007 and 37% in 2005. Moreover, 9% said they plan to add this service in the next 12 months. Of those respondents indicating that they do not offer outside investment advice, most said the main barriers to doing so were fiduciary concerns (62%) and cost issues (20%).

In response to recent scrutiny of retirement plan expenses by the government and the media, the survey found that growing numbers of plan sponsors are attempting to calculate the total cost of maintaining their company's 401(k) plan. A full 84% said they have calculated the cost, up from 60% in 2007 and 29% in 2001. Of those respondents who said they have not yet assessed the total plan cost, complexity is cited as the leading reason. Nearly three-quarters (74%) indicated they have made efforts to reduce plan expenses, up from 54% in 2007. When asked to identify these efforts, 66% said they have negotiated a reduction in fees with their current service provider, 51% said they have swapped out funds for lower-cost alternatives, and 18% said they are working with fund managers to develop alternative pricing structures.



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