RETIREMENT Plan Trends

A benefits update Volume 52, Number 10

Companies Adjusting Pension Plan Strategies

Sponsors of both defined benefit and defined contribution retirement plans have been making numerous changes to their investment programs in response to the economic downturn, according to a recent survey conducted by human resources consultancy Watson Wyatt.

The survey, which includes responses from 85 senior-level financial executives from large, U.S.-based companies, showed that more than two-thirds of employers (67%) have made or are planning to make changes in 2009 and 2010 to their defined benefit plan asset allocations. The findings indicated that, by next year, these companies will have decreased their average target equity allocations to 47.8%, or nearly 10 percentage points lower than last year. Results also showed that nearly three-quarters of defined benefit plan sponsors (73%) have hired or fired fund managers since June 2008, with 52% reporting that they have both hired and fired managers.

"This activity is a seismic shift from business as usual," said Carl Hess, global director of investment consulting at Watson Wyatt. "The uptick in activity could be a sign that many funds were caught off guard by the crisis and are now trying to mitigate their risk exposure."

Also In This Issue

- Americans' Views On Social Security Benefits
- Investment Strategies For Retirees

Moreover, researchers noted, the findings suggest that the steps employers are taking to improve their defined benefit plan governance strategies are showing mixed results. According to the survey, less than half of companies (41%) will have implemented cost-cutting strategies by the end of 2009, while just 12% will have established a risk advisory committee. At the same time, however, nearly two-thirds (62%) indicated they have taken a more stringent approach to managing fiduciary risk since June 2008, and 62% said they will have conducted stress tests on their ability to meet future funding requirements by the end of 2009.

"Given the current market, finding solutions to reduce exposure to risk and improve overall investment performance is critical," said Hess. "While some employers may be limited by the steps they can

Furr & Associates
Insurance and Investment Services

5575 Garden Village Way
Suite C-102
Greensboro, NC 27410

(336) 852-4554
(336) 698-3180 *fax*
(877) 273-7755

www.furrandassociates.com

Securities and investment Advisory Services offered through Woodbury Financial Services, Inc. Member FINRA/SIPC, and Registered Investment Advisor, PO Box 64284, St. Paul, MN 55164 (800) 800-2000

When asked about changes made to the investment options of their defined contribution plans, more than half of the employers (56%) said they have already made changes since June 2008 or are planning to do so by the end of 2009.

take, most should be able to find ways to better manage their risks, optimize returns, and improve their overall governance strategies."

When asked about changes made to the investment options of their defined contribution plans, more than half of the employers (56%) said they have already made changes since June 2008 or are planning to do so by the end of 2009. Researchers observed that most of these changes involve adding or eliminating existing investment funds. For example, the poll showed that 45% added new U.S. equity funds to their investment lineup, while 62% dropped an existing equity fund.

In addition, results indicated that 93% of defined contribution plan sponsors offer a default investment option, and of these companies, 71% offer a target date fund. Among those employers that offer target date funds, 20% have already made or plan to make changes to their target date funds, with 11% choosing to apply more conservative strategies, 42% making changes to lower costs, and 32% making changes to build custom strategies.

Americans' Views On Social Security Benefits

Most Americans believe that Social Security benefits provide an important source of income in retirement, and three-quarters said they would be willing to pay higher taxes to preserve Social Security, a study jointly sponsored by the National Academy of Social Insurance (NASI) and the Rockefeller Foundation has found.

The study, "Economic Crisis Fuels Support for Social Security: Americans' Views on Social Security," by Virginia P. Reno and Joni Lavery, is based on survey responses from 1,488 U.S. adults. The survey showed that 88% of people agree that, given the condition of the economy and the stock market, Social Security benefits are more important than ever to ensure that retirees have a dependable income in retirement. This belief, the authors noted, is widely held across all age and income categories. Around 78% of respondents with family incomes over $100,000 a year and 88% of those ages 18–34 agreed with this statement.

When asked if changes should be made to Social Security in light of the economy, two-thirds (66%) agreed that it is more important than ever to strengthen Social Security to make sure that retirees and those with disabilities can count on secure benefits for generations to come. By contrast, 28% said they believe that, given the current economy and the national deficit, Americans should focus on ways to cut taxes and government spending, including programs like Social Security, so people can keep more of their income.

Results further showed that 15% of respondents believe that too much is spent on Social Security, and 45% believe that not enough is spent. The authors observed that those under the age of 65 were more likely than seniors to agree that Social Security spending should be increased. "For Americans under age 65, having enough money for retirement is a key financial concern—more are concerned about having enough money to retire than about paying monthly bills, affording the cost of health care, or losing a job," Reno and Lavery said.

When asked if they trust that Social Security will pay benefits for the next generation, just 44% who are not yet collecting Social Security said they are confident that the program will be available to them when they retire. However, the survey also showed that most want access to Social Security benefits, with 88% saying that they want to know that Social Security will be available to them in retirement if they need it.

The pollsters asked current Social Security beneficiaries how important Social Security is to their monthly income.

Most (93%) said it is important, and nearly three-quarters (72%) told researchers it is extremely important. Moreover, 43% said they would not be able to afford the basics, such as food and shelter, without income from Social Security.

In addition, the survey questioned Americans about their views on Social Security taxes. Nearly nine in ten (87%) said they don't mind paying Social Security taxes because the program provides stability and security to the retired and those with disabilities, and more than three-quarters (76%) said they don't mind paying Social Security taxes because, without the benefits, they would have to support family members in their retirement. A further 72% said they don't object to paying Social Security taxes because they are assured of receiving benefits when they retire, and 77% indicated they would be willing to contribute more to the program to ensure it will continue into the future.

The survey findings also indicated that most Americans object to proposals that would reduce Social Security benefits. When asked which of three possible options they would choose in order to protect the Social Security program's ability to pay out benefits for decades to come, 11% selected reducing benefits for workers, 31% said raising the retirement age, and 46% said raising taxes on workers.

When asked if they support various proposals for raising revenue for Social Security, 83% indicated they are in favor of lifting the Social Security tax cap so all workers pay the same payroll tax, regardless of income. A further 70% said they support dedicating the estate tax solely to Social Security, and 69% support adding a 5% tax on families earning over $250,000 and individuals earning more than $125,000. Additionally, 58% said they favor increasing the Social Security tax rate for workers by 1% starting in 2020 and by another 1% in 2050.

Around 90% of respondents agreed that it is at least somewhat important for Congress to make adjustments in the next two years to keep Social Security financially solvent and to guarantee income for recipients, and 70% said it is very important that lawmakers take action soon. The authors noted that this belief extends across party lines, with 98% of Democrats, 87% of Independents, and 85% of Republicans agreeing on the need for improvements to the Social Security program.

Investment Strategies for Retirees

While many retirees prefer to hold their money in safe investments, such as money market accounts and certificates of deposit, retired households seeking a secure and dependable income over time should consider investing in a portfolio of bonds and, in some cases, equities, according to a report by the Center for Retirement Research at Boston College.

The issue brief, "The Case for Investing in Bonds During Retirement," was written by economist Anthony Webb. The report cited research showing that retired households exhibit a strong preference for holding safe investments. For example, 86% of households nearing retirement were found to have bank accounts, while only 33% owned stocks directly and only 7% owned bonds directly. Furthermore, the desire for short-term investments was shown to increase with age.

An analysis of the investment options available to retirees, Webb said, "highlights the trade-off that households must make between a guaranteed return of capital and a guaranteed return on capital—they cannot have both at the same time." Short-term deposits, he pointed out, provide a guaranteed return of capital, but offer no guarantees as to the return the household will receive on its capital. On the other

Nearly nine in ten (87%) said they don't mind paying Social Security taxes because the program provides stability and security to the retired and those with disabilities.

hand, a portfolio of Treasury bonds of appropriate maturities provides a guaranteed return on capital, but with the return of capital guaranteed only at maturity.

While short-term deposits assure investors the full repayment of the investment on maturity, savers still face reinvestment risk, the report said. In other words, the investor has no guarantee that he or she will be able to reinvest the proceeds of a certificate of deposit at the same rate of interest. In addition, the investor has no protection against the effects of inflation.

By comparison, Webb noted, a purchaser of a long-term bond receives a fixed income for an extended period and the repayment of principal at the end of that period. Treasury bond holders face only inflation risk, whereas default by the borrower is an additional risk associated with corporate bonds. However, selling the bond before maturity may result in a market price that is greater or less than the original investment.

An alternative to traditional bonds, Webb said, may come in the form of Treasury Inflation-Protected Securities (TIPS), or bonds with interest payments and eventual repayment of capital that is linked to the Consumer Price Index. While constant maturity Treasury bonds have been shown to produce almost the same yield as TIPS, Webb observed that "a risk-averse investor may prefer the TIPS because it protects him against unexpectedly high inflation."

Even though many investors prefer cash and short-term deposits because the market value of bonds can fluctuate, Webb warned that the standard of living of these households is at risk if short-term interest rates fall. "In contrast," he noted, "changes in interest rates and bond prices may have no effect on the standard of living of a household investing in bonds."

If an investor preparing for retirement knew in advance when he wanted to access his capital, he could assemble and manage a bond portfolio with income payments and returns of capital on maturity that precisely matched his consumption needs, Webb asserted. But in reality, he acknowledged, most investors lack the knowledge and patience to create such a portfolio. However, he added, a retiree may want to consider investing in a mutual fund or exchange traded fund that invests in bonds with an average duration equal to the investor's life expectancy and that also rebalances the portfolio over time from long-dated to shorter maturity bonds.

Moreover, Webb said, retirees with sufficient income from Social Security, which has investment income characteristics similar to those of TIPS, and from defined benefit pension plans, which serve as reasonable substitutes for nominal bonds, may be in a position to take greater risks with their portfolios, investing larger proportions of their financial assets in stocks than other households. Between 1926 and 2007, the report noted, equities yielded an annual average return of 7.1%, compared with 2.2% for corporate bonds and 0.6% for short-term deposits.

In conclusion, Webb cited research showing that investors preparing for retirement have a clear preference for short-term deposits over bonds, and this preference may be attributed to "myopic loss aversion," or a greater sensitivity to losses than to gains. To overcome this aversion, Webb advised, investors "need to learn to focus less on the market value of their investments and more on the consumption they can support."

While short-term deposits assure investors the full repayment of the investment on maturity, savers still face reinvestment risk, the report said.

The information contained in this newsletter is for general use, and while we believe all information to be reliable and accurate, it is important to remember individual situations may be entirely different. The information provided is not written or intended as tax or legal advice and may not be relied on for purposes of avoiding any Federal tax penalties. Individuals are encouraged to seek advice from their own tax or legal counsel. This newsletter is written and published by Liberty Publishing, Inc., Beverly, MA. Copyright © 2009 Liberty Publishing, Inc. All rights reserved.