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Handling Former Employees' Account Balances

The combination of the recent steep stock market decline and workforce reductions have left some employers with an abundance of low-balance plan accounts owned by former employees. These accounts can be costly to maintain and burdensome to administer. What can employers do? Below we answer questions about handling these small accounts.

Can we cash out small accounts? Check your plan's provisions. Under federal law, plans can provide that, if a former employee has not made an affirmative election to receive a distribution of his or her account assets or to roll those assets over to an IRA or another employer's plan, the plan can distribute the account — as long as its balance does not exceed \$5,000. For accounts valued at \$1,000 or less, the plan can simply send the former employee a check for his or her balance. Distributions of more than \$1,000 must be directly transferred to an IRA set up for the former employee. Accounts valued at \$1,000 or less may also be rolled over for administrative convenience.



Do all account assets have to be counted in determining whether mandatory distributions are permitted? No. You only have to include the value of the former employee's non-forfeitable accrued benefit. If the employee was not fully vested in any portion of the account when he or she left your employ, you do not have to count the non-vested portion. In addition, a plan may provide that any amounts that the former employee rolled over to your plan from another employer's plan (and any earnings on those rolled over assets) are to be disregarded in determining an employee's non-forfeitable accrued benefit. Thus, you may be able to cash out and roll over accounts greater than \$5,000. Note that rolled over amounts are included in determining whether a former employee's accrued benefit is greater than \$1,000 for purposes of the automatic rollover requirement. (Continued on Page 3)

Gen X and Gen Y on Retirement Savings Plans

What do younger workers think about saving for retirement? Do they appreciate having a retirement savings plan? The American Savings Education Council and AARP recently surveyed members of Generations X and Y (ages 19 to 39) on personal finances and saving and came up with some answers that may help you attract these employees to your plan and keep them participating.*

Among the findings: 88% of those surveyed consider a retirement savings plan, such as a 401(k) plan, to be an important workplace benefit. A slightly greater proportion (89%) says it's important for an employer to match employee contributions or make other plan contributions on their behalf. Overall, 71% of those eligible to participate contribute to their employers' plans.

Also, 85% of those surveyed think it's a good idea for an employer to voluntarily enroll employees automatically in its retirement savings plan and set up automatic salary deferrals to the plan. ■

* *Preparing For Their Future, A Look at the Financial State of Gen X and Gen Y*, American Savings Education Council and AARP, March 2008



Quotes of the Quarter

“An investor without investment objectives is like a traveler without a destination.”

Ralph Seger

“The key to making money in stocks is not to get scared out of them.”

Peter Lynch

Choosing a Default Investment for Your 401(k) Plan

Traditionally, many 401(k) plans have had a default investment — an investment that is used when employees neglect to make a decision about how to invest their plan accounts. Now, with the trend toward automatic enrollment, government regulators are focusing more attention on the types of investments that plans are using as a default. If you sponsor a 401(k) plan or a similar retirement plan, new guidance from the U.S. Department of Labor (DOL) will be of interest to you.

Liability Relief

When a plan invests an employee’s contributions in a default investment, the employer may be liable for investment losses if the investment doesn’t perform well. But now there’s a *qualified* default investment alternative (QDIA). As long as a plan meets all of the DOL’s requirements, a QDIA provides relief from fiduciary liability (though the employer must still prudently *select* the default investment).

Qualified Investments

In its regulations, the DOL spells out the categories of investments that qualify as QDIAs. They include lifecycle and targeted retirement date funds that take into account an individual’s age or retirement date, as well as funds that take into account the group of employees as a whole, such as balanced funds. Professionally managed accounts that take an individual participant’s characteristics into consideration also qualify.

Stable value and money market funds, which frequently have been used as default investments in the past, can be QDIAs only for the first 120 days after the employee’s first elective contribution. A QDIA generally cannot hold securities issued by the employer.

Other Requirements

To qualify for fiduciary relief, certain requirements must be met. Before investing your employees’ contributions in a QDIA, your plan must give the employees the chance to direct their own investments. And the plan must permit employees to transfer out of the QDIA and into the other investments your plan offers with the same frequency available for the other plan investments (at least quarterly). You also must provide plan participants with certain notices and investment information. ■

Q & A: Why Have a Written Investment Policy Statement?

SITUATION: We have a 401(k) plan that allows our employees to direct the investment of their own plan account assets. We comply with all of the pension law’s Section 404(c) requirements so that our liability for investment decisions made by participants is limited. However, we don’t have a written investment policy statement. A colleague of mine says we should.

QUESTION: Why should we have a written investment policy statement?

ANSWER: Although a written policy is not required, it would provide your company with a critical measure of fiduciary liability protection if the plan’s investment choices or their performance were challenged.

DISCUSSION: A written investment policy statement is documentary evidence that a carefully considered investment policy exists. A policy statement provides the employer and other plan fiduciaries that are responsible for plan investments with investment management guidelines. It also provides a process for making broad investment management decisions, setting investment goals, and communicating the policy to employees. Without a prudent investment policy, an employer could be found liable for fiduciary shortcomings, including poor investment results.

(Continued on page 3)





**Quotes of
the Quarter**

"In the business world, the rearview mirror is always clearer than the windshield."

Warren Buffett

"An investment in knowledge always pays the best interest."

Benjamin Franklin

Handling Former Employees' Account Balances Cont'd

What are the fiduciary requirements for rolling over a small account?

To fulfill your fiduciary duties as a plan sponsor, the following requirements must be met:

- The rollover must be a direct transfer to an IRA set up in the former employee's name.
- The IRA provider must be a state or federally regulated financial institution, such as an FDIC-insured bank or savings association or an FCUA-insured credit union, an insurance company whose products are protected by a state guarantee association, or a mutual fund company.
- You must have a written agreement with the IRA provider that addresses appropriate account investments and fees.
- The IRA provider cannot charge higher fees than would be charged for a comparable rollover IRA.

(Other fiduciary responsibilities apply.)

How should the rollover IRA be invested?

The investments chosen for the IRA must be designed to preserve principal and provide a reasonable rate of return and liquidity. Examples include money market mutual funds, interest-bearing savings accounts, certificates of deposit, and stable-value products.

What, if any, disclosures are required? Before you cash out an account, you must notify the former employee in writing, either separately or as part of a rollover notice, that, unless the employee makes an affirmative election to receive a distribution of his or her account assets or roll them over to another account, the distribution will be paid to an IRA. As long as you send the notice to the former employee's last known mailing address, the notice requirement generally will be considered satisfied. In addition, you must include a description of the plan's automatic rollover provisions for mandatory distributions in the plan's summary plan description (SPD) or summary of material modifications (SMM). ■

Why Have a Written Investment Policy Statement? Cont'd

While the specific needs of each individual plan and sponsor determine what should be included in an investment policy statement, these statements generally include:



- The plan's investment goals.
- Roles and responsibilities of those involved with plan investments.
- Considerations and guidelines used in selecting and replacing investments and investment managers.
- Procedures for monitoring investment performance, directions as to how managers should report performance, and a review schedule.
- A statement deferring to the plan document's provisions if a conflict arises.
- A description of how participants may control their plan account investments, the manner and frequency of investment performance reporting, and what educational materials will be provided to help participants make informed investment decisions.

Once you have established an investment policy, you, as the employer, or the company's benefits committee should review it regularly and revise it as needed. ■

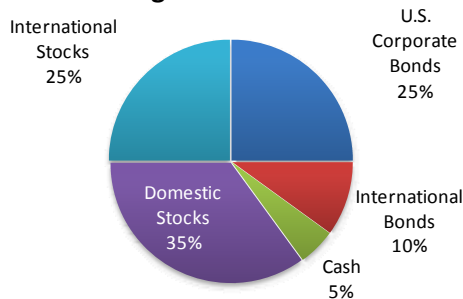
Diversification STILL Does a Portfolio Good

-Patrick J. Morrell, CIMA®

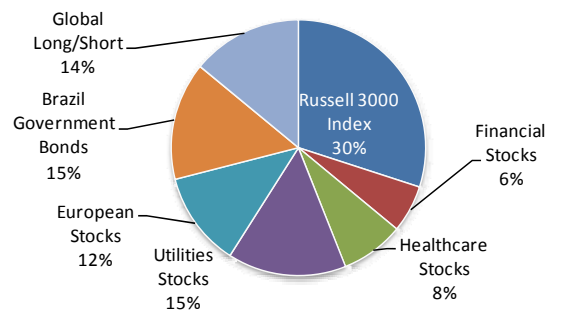
Don't put all of your eggs in one basket seems like an easy task but the past two years have left many investors with the proverbial *egg on their face*. It was Dr. Harry Markowitz who developed the concept of Modern Portfolio Theory (MPT) in the late 1950's. He went on to win the *Nobel Memorial Prize in Economic Sciences* in 1990 based on his research and development of MPT. The Theory focused on three main factors: risk, return and correlation. MPT proposes how rational investors will use diversification to optimize their portfolios and generate the maximum potential return given a specific level of risk using a combination of investment asset classes. The cornerstone of MPT is the correlation of underlying assets used to build a portfolio. If the portfolio's underlying investments are highly correlated then the portfolio is not adequately diversified. The theory of MPT, among others, has been called into question by investment professionals over the past year. The increased correlation among asset classes over a short period of time argues against the need for asset class diversification. Nonetheless, it's too presumptive to say that asset class diversification doesn't work; investors simply need to rebalance their thoughts about how to diversify.

Diversifying an investment portfolio using a variety of uncorrelated asset classes is still standard practice in the investment industry. The recent market decline has called that practice into question, most notably within the Pension Industry. Asset allocation and portfolio construction can be developed using two main investment philosophies: strategic asset allocation and tactical asset allocation. **Strategic asset allocation** is long-term in nature. A portfolio is built and managed using a long-term view of the investment markets. The portfolio allocation can be modified but generally remains consistent over long periods of time. Changes are usually made to the portfolio after a full market cycle or as the long-term views of the investor change. Furthermore, changes to the allocation are not drastic but rather subtle, by adjusting the target weighting to each asset class to be more conservative or aggressive. In contrast, **tactical asset allocation** is more short-term in nature. The portfolio construction process uses short-term views of the market, generally 3-, 6- and 12-month periods, to form investment themes. The investor uses these themes to select which asset classes or stock sectors to use and how to weight each of the underlying investment components. Tactical strategies can be changed as often as necessary in trying to add incremental alpha to the portfolio over short-term periods of time. Tactical strategies require more active portfolio management and a thorough understanding of the markets.

Strategic Asset Allocation



Tactical Asset Allocation



The Pension Industry and qualified accounts should be more strategic in nature. These types of accounts hold a longer time horizon than a general non-qualified account such as an individual brokerage account. Further, the money invested within qualified accounts is not

Quotes of the Quarter

“Financial literacy is an issue that should command our attention because many Americans are not adequately organizing finances for their education, healthcare and retirement.”

Ron Lewis

“You make most of your money in a bear market, you just don't realize it at the time”

Shelby Davis



“You get recessions, you have stock market declines. If you don't understand that's going to happen, then you're not ready, you won't do well in the markets.”

Peter Lynch

“The price pattern reminds you that every movement of importance is but a repetition of similar price movements, that just as soon as you can familiarize yourself with the actions of the past, you will be able to anticipate and act correctly and profitably upon forthcoming movements.”

Jesse Livermore

readily available to investors, meaning an investor can afford to take a long-term view of the market. Be that as it may, strategic asset allocation strategies have come under scrutiny due to the increased correlation within the investment markets over the past two years.

The media, investment professionals and critics alike claim that the recent market conditions, coupled with globalization, require an investor to take more control over their portfolio. The common cry of “asset allocation is dead” really translates to investors taking a more short-term view of the markets and managing portfolios. This approach to portfolio building is short-sighted and dangerous to the long-term performance of the portfolio.

Asset class correlation has certainly increased between particular securities over the short-term but any major market event will cause correlation to increase throughout a short timeframe. For example equities, both domestic and foreign, suffered dramatic losses as the global equities markets crashed in phases over the past two years. The heavy losses amongst equities have caused the correlation among equity asset classes to rise to a higher level than we've historically seen. The extreme short-term market fluctuations have made many asset classes move in tandem, but this is not characteristic of the relationship among securities over longer periods of time. Table 1 depicts the correlation among asset classes over the past 50 years. All of the asset classes show low to moderate correlation but still the movement within each of the asset classes cannot thoroughly be explained by the others. The two most highly correlated asset classes are U.S. Stocks and Foreign Stocks, though even the correlation between those asset classes remains moderate.

Tables 1 & 2 display the correlation among 6 distinct asset classes. Each numbered row represents a unique asset class. To determine an assets correlation to another, move vertically or horizontally to match up the two numbers in question within the table. If the table cell reads “1.00” then the assets are perfectly correlated, meaning the assets move in tandem. A negative numeral displays negative correlation, meaning that the returns among asset classes move in opposite directions; if one asset is positive the other must be negative. A positive correlation (example: 0.20) represents a direct relationship, albeit weak, between the two asset classes. The movement of one asset classes does not necessarily explain the movement of another. The higher the numeral in the cell, the stronger the relationship between the two asset classes.

Correlation: Last 50 Years						
July 1959 - June 2009						
	(1)	(2)	(3)	(4)	(5)	(6)
1) Broad U.S. Stocks	1.00					
2) U.S. Large Cap Stocks	0.98	1.00				
3) Broad Foreign Stocks	0.57	0.57	1.00			
4) Global Government Bonds	0.21	0.21	0.46	1.00		
5) U.S. High Grade Bonds	0.22	0.22	0.20	0.50	1.00	
6) U.S. 10-year Treasuries	0.16	0.17	0.08	0.51	0.70	1.00

Table 1, Source: Zephyr Associates

Now looking at Table 2, correlation among asset classes over the past two years, there is a dramatic increase in the relationship among securities most notably between U.S. and Foreign Stocks. Nevertheless, the relationship between stocks and bonds still remains low, even in times of extreme market volatility. Table 2 in fact suggests that strategic asset allocation isn't necessarily the best method of portfolio construction due to the heightened relationship among asset classes.



An all-stock portfolio using both U.S. and Foreign Securities would provide little downside protection due to the high correlation among asset classes. Yet, Table 1 suggests that the two asset classes show moderate correlation. This comparison of correlation over two time periods represents the disparity of strategic and tactical asset allocation.

Correlation: Last 2 Years						
July 2007 - June 2009						
	(1)	(2)	(3)	(4)	(5)	(6)
1) Broad U.S. Stocks	1.00					
2) U.S. Large Cap Stocks	0.98	1.00				
3) Broad Foreign Stocks	0.92	0.92	1.00			
4) Global Government Bonds	0.62	0.58	0.66	1.00		
5) U.S. High Grade Bonds	0.29	0.25	0.35	0.56	1.00	
6) U.S. 10-year Treasuries	-0.10	-0.11	-0.08	0.35	0.75	1.00

Table 2, Source: Zephyr Associates

Tactical asset allocation would call for an investor to make short-term decisions about a portfolio but that's only using a short-term view of the investment markets. Strategic investors should be looking at asset classes over a full market cycle, as correlations tend to relax throughout extended periods of time. In order to construct a portfolio for a long-term investor, choose a mix of stocks and bonds that suit your flavor for risk. After the broad asset allocation has been determined, diversify within each of those two main categories. Hold a portion of your equity portfolio in both domestic and foreign stocks creating diversification among investment products. On the bond side, hold a variety of products that vary in credit quality and duration, spreading your fixed income investments along the yield curve. An investor may also allocate a portion of their assets to real estate and commodity-based securities, as these types of investments tends to have low correlation to stocks and bonds over long periods of time. Using these methods of strategic asset allocation typically provide better portfolio diversification over the length of your time horizon. Although it may seem like a good idea to try and add alpha to your portfolio, over a short market cycle it requires an a great deal of attention, knowledge and skill to be successful. It may seem like strategic asset allocation is no longer an effective method for building portfolios but an investor simply needs to rebalance their view on portfolio construction. Strategic asset allocation works over an extended period of time; it just doesn't seem like it works when reviewing asset allocation during short time market fluctuations. ■

The Retirement Advisor

A Newsletter for Retirement Plan Sponsors

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