



# 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

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- 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

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- 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

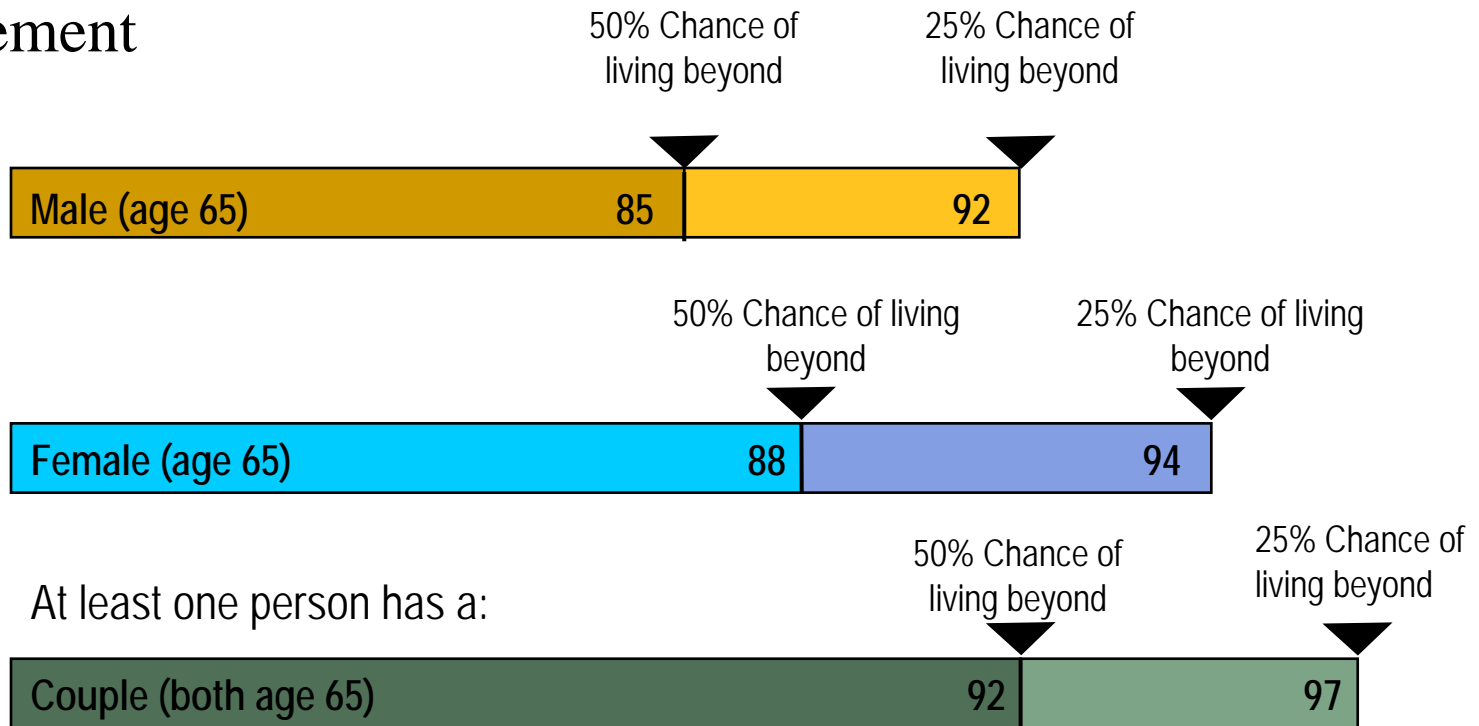
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- Longevity Risk
- Managing Market Risk

# Longevity Risk

People greatly underestimate the time they will spend in retirement

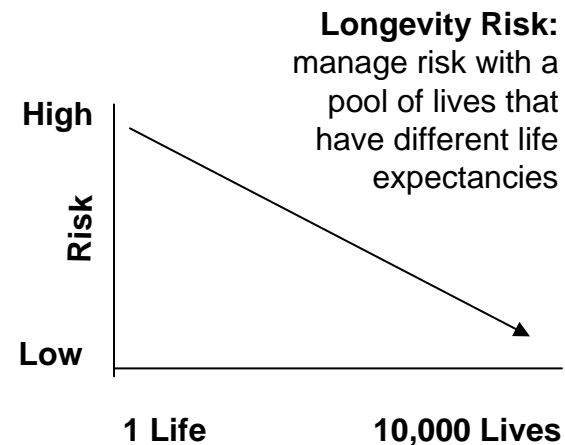
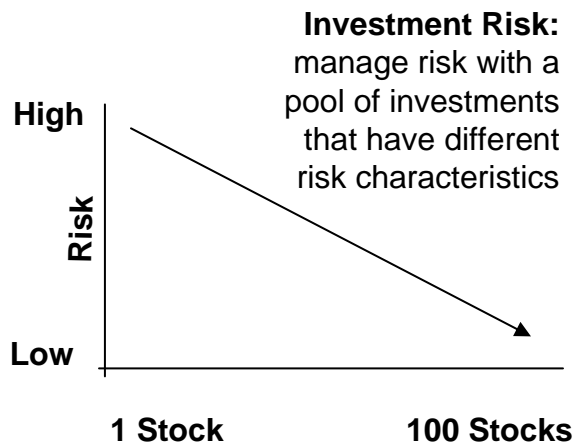


Source: U.S. 2000 Actuarial Male and Female Tables



# 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

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- 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 income<sup>1</sup>
  - 51% *“extremely” or “very” interested in learning more*
  - 36% *“somewhat” interested*
- Those who have purchased income annuities express great satisfaction<sup>2</sup>
  - 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

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## ■ 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

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- 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 “naive 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

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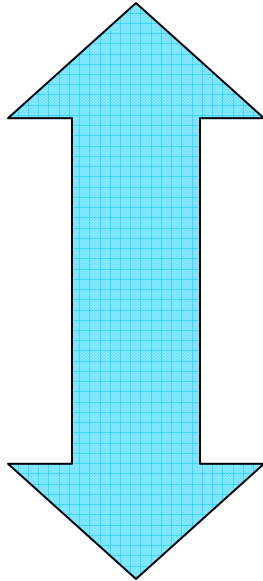
- Inside Track Mentality
- The Water Cooler Theory/Cocktail Party Analytics
- Inertia
- Corporate Culture



# Company Stock Solutions

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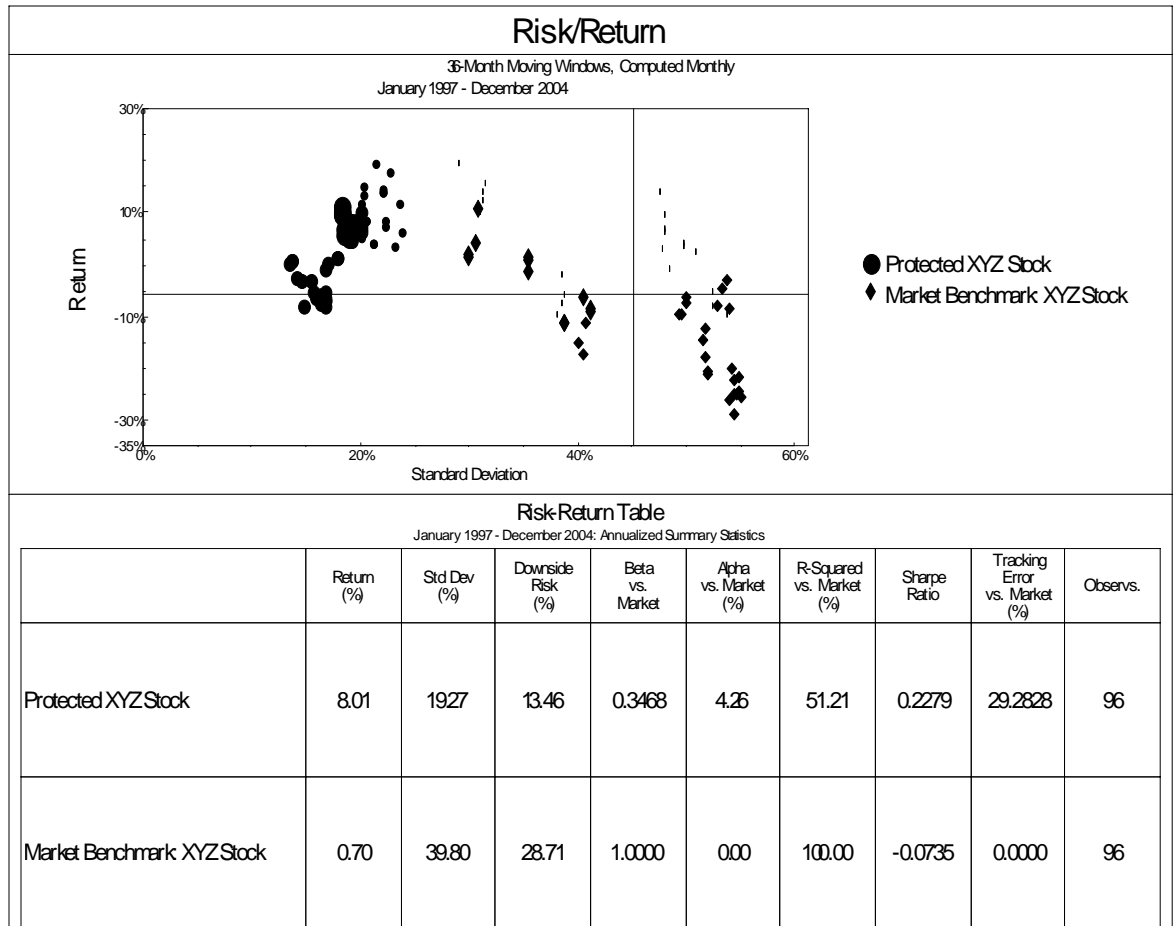
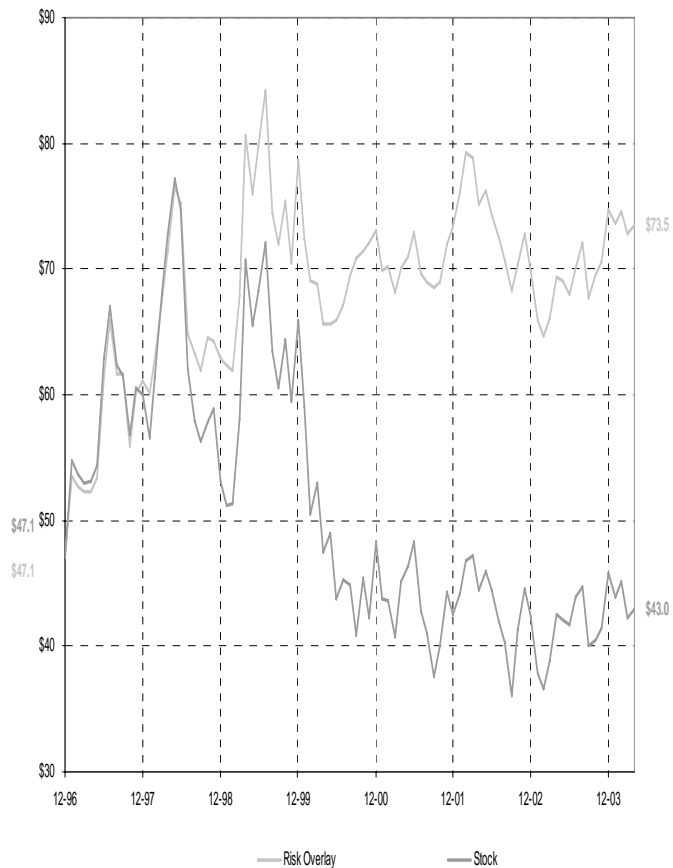
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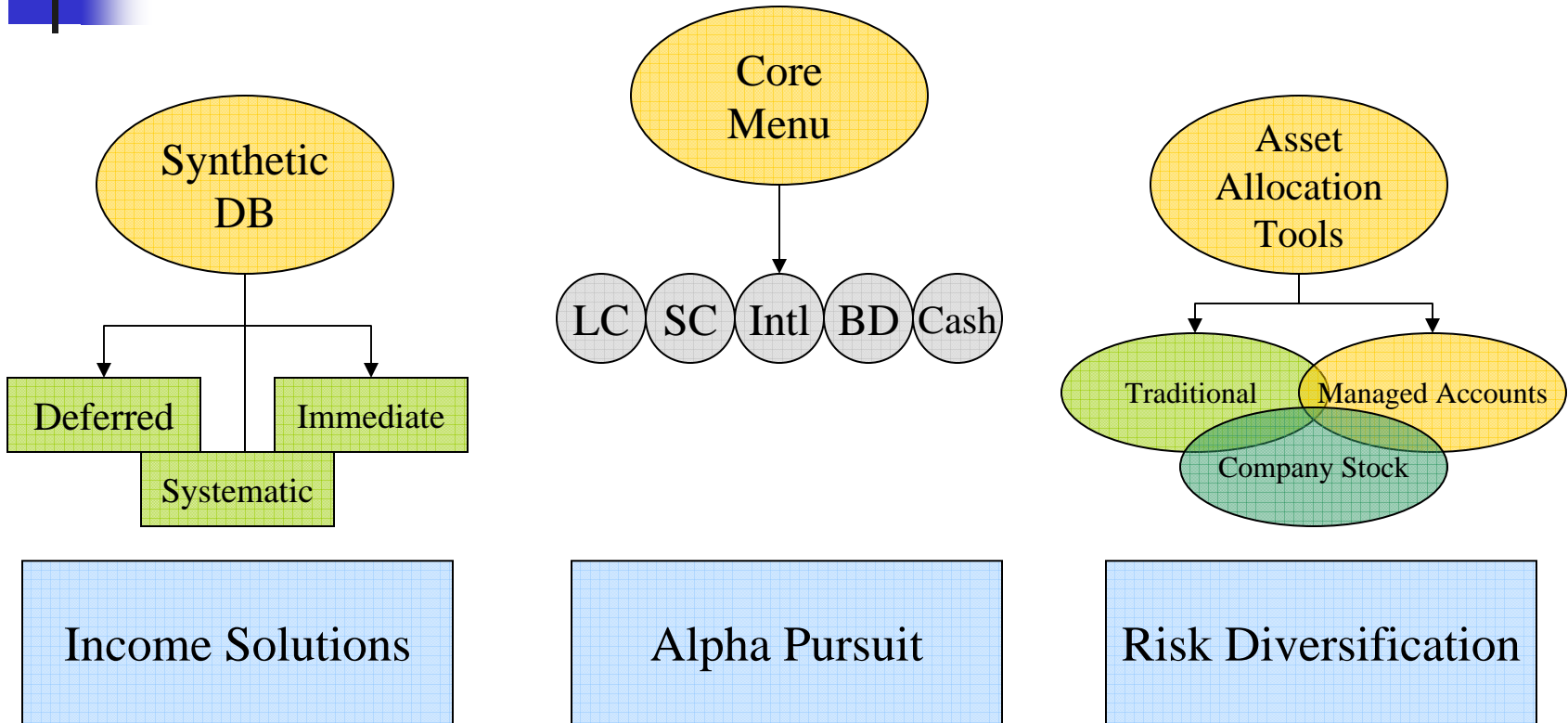
Innovative

- 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?

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Thank You!