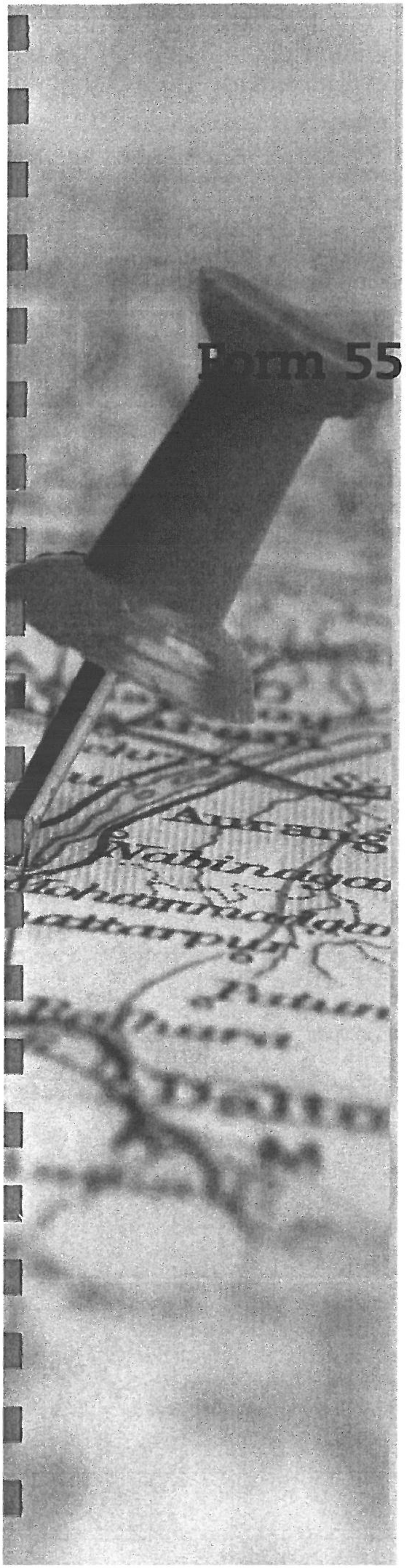
MERCER

MARSH MERCER KROLL
GUY CARPENTER OLIVER WYMAN



Form 5500 roadmap for 403(b) plans

Overview of journey

Beginning with the 2009 plan year, the Department of Labor (DOL) is eliminating the exemption that allowed 403(b) plans to file a very abbreviated Form 5500. Elimination of this exemption means that all 403(b) plans subject to ERISA will also be subject to the same Form 5500 reporting and audit requirements that qualified 401(a) plans must adhere to. Even though the Form 5500 filing deadline seems far off – July 31, 2010, for a calendar year plan – it will take many plan sponsors much time and effort to get ready.

Mercer has prepared this roadmap to help you navigate the route to your plan's filing deadline. With careful planning, you will avoid time-consuming detours and back tracking. Remember that the steps you take in 2009 will lay the foundation for future years' filings. Investing additional time in 2009 will pay off down the road.

Ready to start?

Milestone 1: Plan your route

Whenever you plan a trip to an unfamiliar territory, you first need to get a map and plan your route. For your 2009 Form 5500, that means becoming familiar with the DOL's new reporting and audit requirements for 403(b) plans that are subject to ERISA.

Depending on the number of participants, your plan may be eligible to file the simplified Short Form 5500. In addition to meeting other requirements, the plan must have fewer than 100 participants at the beginning of the plan year to take this route. Short Form filers are not required to have an annual audit of the plan's financial statements.

If your plan has 100 or more participants at the beginning of the plan year, you must file as a "large plan," which includes filing audited financial statements. So, in planning your route, you should begin thinking about who will prepare the financial statements and who will audit them. The auditor must be independent and must have experience with auditing retirement plan financial statements. It's a good idea to make a "short list" now of potential CPA firms that meet these requirements. Remember that the firm you ultimately select will be one of your travel partners for this year's and future years' tours. You will want to spend some time interviewing potential candidates and comparing their proposals.

Milestone 5: Watch out for potential roadblocks

While inventorying plan assets, contracts and service providers, you may discover that you are missing records for former employees. At this stage it is not clear whether the plan sponsor is obligated to include account balances for "missing" participants. This could be a very difficult task for organizations that allowed participants either to select their own service providers under individual contracts or to make "90 – 24" transfers from approved vendors to non-approved vendors. The best advice for now is to exert your best efforts to corral as much plan asset information as possible, starting with payroll records of all vendors who have received contributions, as far back as plan inception, if possible.

Milestone 6: Monitor your vehicle maintenance requirements

Just like the maintenance schedule and warranties for your vehicle, your plan needs policies and processes to ensure proper control and authorization for plan transactions. These internal controls over the plan's reporting process extend to ongoing monitoring of the service providers' transactions and record-keeping processes.

Effective controls serve several purposes:

- To reduce risk of asset loss
- To ensure that plan information is complete and accurate
- To guarantee reliable financial statements
- To make sure that the plan complies with all relevant laws and regulations

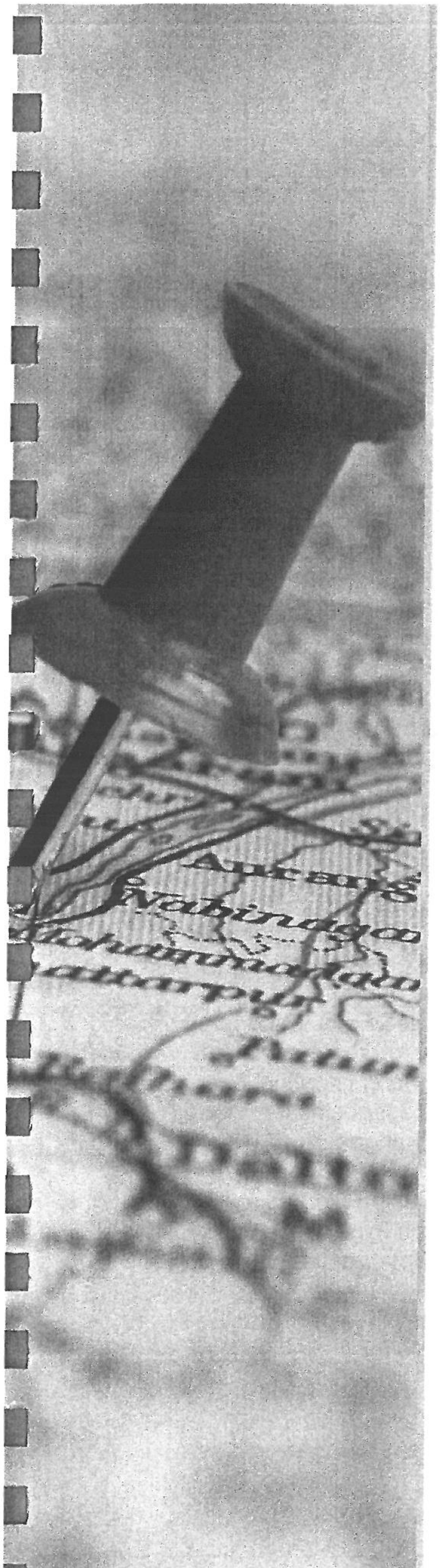
Your mechanic (aka, auditor) is required to inform you of certain deficiencies in internal controls over the plan's financial reporting, if he finds any during the audit.

Milestone 7: Check your insurance policies

Before starting your trip, you will also want to check that your insurance policies and vehicle registration are up to date. In other words, be sure that your plan has a current, written plan document that satisfies the new 403(b) regulations. The plan document should include the following provisions:

- Eligibility
- Contribution limits
- Benefits
- Distribution options
- Information about the approved annuity contracts and/or custodial agreements

The IRS has extended the deadline for satisfying the written plan requirements to December 31, 2009. In addition, 403(b) plans that are subject to ERISA must provide an up-to-date summary plan description (SPD) to all newly eligible employees. The plan should also have a written investment policy governing the authorized investments and outline who is authorized to make or approve investment transactions.



MERCER

MARSH MERCER KROLL
GUY CARPENTER OLIVER WYMAN

Finally, review whether the plan is in compliance with IRS and DOL rules relating to salary deferrals, universal availability, nondiscrimination and coverage, limit monitoring, rollover and contract exchange restrictions, and distribution rules. Mercer's consultants are able to help you with this analysis and assist with correcting any deficiencies. Our experts are proficient in drafting plan documents and SPDs, performing nondiscrimination tests, reviewing administrative procedures and forms, and working with your vendors and auditor.

Milestone 8: Start your engines!

Now that you have charted your course and tuned up your plan-reporting vehicle, you are ready to start your journey.

There are many Form 5500 filing details not mentioned here, including:

- Form 5500 and attachments must be filed in an electronic format through the DOL's EFAST system.
- A summary annual report containing pertinent financial information from Form 5500 must be distributed to participants and beneficiaries no more than two months after the Form 5500 filing deadline.

For help along the way, remember that you have several resources:

- Visit the DOL's Employee Benefit Security Administration website at **http://www.dol.gov/ebsa**
- Call the DOL's EFAST helpline at 866-463-3278
- Contact your local Mercer office

Mercer has a dedicated team of consultants who work exclusively with nonprofit employers. They have extensive experience with Form 5500 preparation and audit requirements and can assist you with any aspect of the Form 5500 journey. Your local Mercer contact will be happy to make the introductions – call us at any point along your route for roadside assistance!

Consulting. Outsourcing. Investments.

July 2009

Improving Target Date Lifecycle Funds

Target Date Lifecycle Funds, also known as Target Horizon Lifecycle Funds, were conceived as a single-investment solution for less sophisticated members of participant-directed retirement programs such as 401(k), 403(b) and 457 plans. They are multi–asset class funds that adjust their asset allocation as time progresses toward a target date, generally an identified year such as 2015 or 2030. The adjustment to the asset allocation has come to be known as a glide path and can be thought of as a reduction in the allocation to higher-return/higher-risk assets (and a corresponding increase in lower-return/lower-risk assets) as the target date approaches. This adjustment is presumed to correspond to the changing risk tolerance of notional participants as they approach retirement. The glide path will approach an all lower-return/lower-risk allocation at some point on or after the target date.

Target Date Lifecycle Funds have seen dramatic growth in recent years, with currently more than $200bn invested and estimates of growth to $1tn in the next five years.[1] This growth has been fueled by target date funds' widespread inclusion in plans, for several reasons. One is to address a growing belief that most members of participant-directed plans have been making poor choices within the critical area of asset allocation. The second is to provide an investment fund alternative for participants who are uncomfortable making asset allocation decisions. Many plan sponsors have seen participants investing too conservatively to create sufficient wealth to sustain an acceptable post-retirement lifestyle; suffering crippling losses by chasing returns; or investing significant amounts in whatever asset classes are currently hot and not reacting when the market psychology changes.

Target Date Lifecycle Funds have also benefited from their designation as a Qualified Default Investment Alternative (QDIA) in the Pension Protection Act of 2006, making them attractive as a default options in participant-directed plans.

Asset allocation is among the most important decisions for any investor. Studies have indicated that the asset allocation decision is responsible for 85% – 95% of

---

[1] Source: Prudential: Strengthening Target-Date Funds with Guarantees to Enhance Retirement Security, May 2009

total investment performance, with manager or fund selection contributing only 5% – 15% of return.[2]

Target Date Lifecycle Funds can be viewed as having a three-phase hierarchy of investment decisions, each with different considerations.

1. Glide Path Construction
   Changing the allocation over time between higher-return/higher-risk and lower-return/lower-risk assets. The description of the rate of change and point when the fund is predominately or exclusively invested in lower-return/lower-risk assets – is referred to as the glide path. The glide path is unique to each vendor and is based on fundamental views about the nature of risk, the tolerance for risk at given ages, and an implied cumulative wealth-generation requirement. The glide path, being based on fundamental beliefs, typically changes infrequently at any given vendor.

2. Portfolio Structuring
   A portfolio structuring process takes place when allocating the higher-return/higher-risk and lower-return/lower-risk portions to broad asset classes. This process depends on assumptions regarding the expected returns, risks and correlations of the broad asset classes. The objective is to develop an efficient portfolio (maximum return for a given level of risk or the minimum risk for a given level of return) at any given point in time. The portfolio structure will change as the fund rolls down the glide path and as assumptions for return, risk and correlations change.

3. Implementation/Vehicles
   Finally, individual investment vehicles are implemented in each asset class; typically these vehicles are mutual funds provided by the lifecycle fund vendor. An advantage of the lifecycle funds is often the inclusion of mutual funds representing asset classes (such as emerging markets or even regional emerging markets) that are not available in the plan's core investment option array, thereby providing a higher level of efficiency to a portfolio relative to what participants could obtain on their own.

Phase 3, the implementation of individual mandates, is usually via mutual or commingled funds that provide a narrow slice of the asset spectrum and/or a specific investment style. This is usually the easiest part of the target date fund management process.

---

[2] Source: Gary P. Brinson, L. Randolph Hood, and Gilbert L. Beebower: Determinants of Portfolio Performance, 1986

There are many sound approaches to the portfolio structuring process, phase 2, including mean-variance optimization using forecasts for returns, risk, and correlation and more sophisticated approaches such as the evolving factor-analysis models that recognize that correlations depend on common factor risks such as the availability and price of credit, the availability and price of energy, consumer confidence, and government intervention – all on a global basis. Phase 2 will typically generate a portfolio of passive and active mandates chosen and sized to produce an efficient portfolio.

Phase 1, the changing allocation from high expected return/high expected risk to low expected return/low expected risk as the target date approaches, is both the most difficult and the highest-impact decision. In the earliest history of target date funds, the risk allocation approached or reached cash or near-cash risk levels at the target date, typically defined as the expected retirement date. This was based on the beliefs that a) people entering retirement had little or no current income to replace lost assets, b) the risk of market losses should be eliminated from the portfolio, and c) it was highly likely that people would withdraw funds at a faster rate than they had anticipated.

Over time, the philosophy changed as there was a recognition that people tended to live many years or even decades after retirement and that post-retirement portfolios should have an equity component to permit continuing growth and a modest hedge against inflation. As that philosophy was adopted, the glide paths extended to the extent that many vendors have relatively high allocations to equity well into the retirement period. While more aggressive strategies have been adopted, such strategies have tended to ignore the liquidity needs of participants in retirement.

While that higher allocation to higher-return/higher-risk assets could generate a very adverse result over a short period, there was a belief that the long-term return advantage of equity over low-return/low-risk assets would make up for losses during interim periods. Statistics were cited that showed that historically, equity outperformed cash over virtually any 10-year period.[3]

This extended glide path philosophy has been adopted to one degree or another by virtually all vendors of Target Date Lifecycle Funds. The recent market environment, with extreme losses in virtually all of the high-return/high-risk asset classes coupled with the extended glide path, has resulted in severe losses in many near-date target date funds just when many leading-edge baby-boomers are nearing retirement.

---

[3] Source: Vanguard: Target-date funds: A solid foundation for retirement investors, May 2009

While much concern about this issue has been articulated by government, plan sponsors, and investment professionals, a strong defense has come from the vendors with the extended glide path philosophy.

Mercer believes that a key factor has not been considered in the development of the phase 1 glide path decision. Average target date fund investors have started saving too late, contributed too little, perhaps borrowed from the plan in the intervening years, and made poor investment decisions prior to the use of the target date funds, and for these and other reasons, have entered retirement with insufficient assets to retain the lifestyle to which they have become accustomed.

Typical participants attempt to maintain their previous lifestyle by drawing down their asset balance far more rapidly than is "actuarially sound" or that is considered in the vendors' glide path assumption. Participants earning a preretirement $50,000 annual income who retire with an asset balance of $100,000 and may receive $20,000 in Social Security but attempt to maintain the lifestyle available with a $50,000 per year income will deplete their asset balance in little more than three years.

This short period in which the asset balance can be totally depleted because of an unsustainable "burn rate" makes these participants much more sensitive to short-term market volatility than previously thought as reflected by the simplistic assumptions based on mortality. Those assumptions are based on a totally unrealistic behavioral model. Participants are just not willing to suffer the reduction in lifestyle that an actuarially sound withdrawal rate from their low asset balance would require while they are still young (at heart) and healthy.

JPMorgan has some behavioral data that illustrate the problem. Pre-retirement, 15% of participants over the age of 59½ withdraw, on average, 25% of their assets. The average participant withdraws over 20% per year at or soon after retirement.[4]

Two other factors further negatively impact participants. Employers are now often contributing less to the 401(k) plan in a match, which further exacerbates a root problem – low balances when participants are moving into their retirement years. The mathematics of investment return also contributes to the problem. The large early withdrawals reduce the asset base that any improved returns from a subsequent rebound are applied. Even a high subsequent return, applied to few dollars, generates only a little wealth.

---

[4] Source: JPMorgan Asset Management, Target Date Fund Research, Insights: Ready! Fire! *Aim*? March 2007

It seems clear to Mercer that the trend in glide path development (the assumption that the long-term-return advantage of equity over cash will provide a sufficient increment of wealth to compensate for short-term volatility) ignores critical asset balance and behavioral factors and thus is misguided. Participants typically deplete their accounts so rapidly that long-term advantages are meaningless.

There are a couple of obvious approaches to deal with these issues. First, realistic assumptions need to be made about participant behavior. Education about actuarially sound burn rates should be assumed to be effective only for more sophisticated participants, who probably don't need it. The reality that most participants will consume their account balances at an unsustainable rate requires a dramatic shortening of the glide path, not back to the former state of little or no equity at retirement, but approaching that point in five years and not 15 years.

There also needs to be a range of return/risk funds to accommodate different participant needs. These could be low-, moderate-, and high-risk funds for each target date. Participants with access to defined benefit plans or high asset balances have very different return/risk profiles than participants with no defined benefit plans and typical asset balances. Education should focus on selecting the appropriate risk category and not just selecting the fund with the target date closest to the proposed retirement date.

Target Date Lifecycle Funds are a powerful tool for participants with limited knowledge about or comfort with making investment decisions, but an enhanced recognition of the real-world behavior of participants is needed. Target Date Lifecycle Funds could serve real-world participants far more effectively.

About the author

Terry Dennison is a worldwide partner in Mercer's Los Angeles office. He is the US director of consulting and coordinates the development and dissemination of Mercer's intellectual capital. Terry is a member of the US investment consulting leadership team.

In his 36-year career in the investment industry, Terry has had the opportunity to develop a broad and deep knowledge of all aspects of investment management. His investment consulting clients include a number of large and middle-market private and public sector clients. Terry has a BA and an MBA from the University of Wisconsin – Madison, and is a Certified Public Accountant.

Important notices