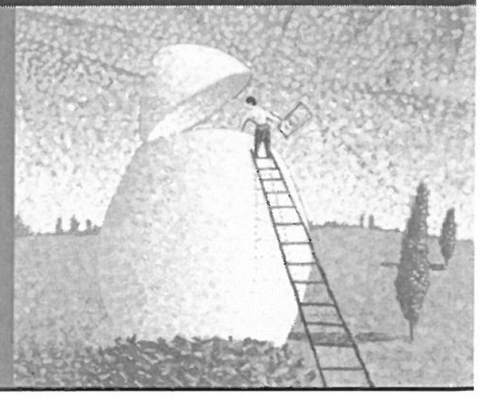
CALLAN INVESTMENTS INSTITUTE

DC Observer

FOURTH QUARTER 2009



THE DC LEGAL AND REGULATORY ENVIRONMENT: WHAT IT MEANS TO PLAN SPONSORS

This year may shape up to be significant on the legal and regulatory front for defined contribution (DC) plans. Key areas that continue to draw scrutiny from legislators, regulators and in some cases, litigators, include: DC plan fees, target date funds, investment advice and lifetime income solutions. Following is an update of recent activity on these fronts, along with a summary of what it could ultimately mean to DC plan sponsors.

Fee Lawsuits

There have been more than a dozen 401(k) fee lawsuits filed since 2006. Allegations generally fall into three categories: 1) Failure by plan sponsors to discharge fiduciary obligations, such as: not properly establishing and/or monitoring plan fee structures, use of misleading benchmarks and improper use of master trust arrangements. 2) Failure to properly and adequately disclose fees to participants, such as: not disclosing revenue sharing or cash holdings in company stock funds. 3) Unreasonable fees such as: using retail mutual fund vs. institutional share classes and structures, fees for company stock fund management, fees paid to affiliate providers, and fees paid for active management—for "shadow index funds."

These cases have resulted in a wide variety of outcomes. Several notable ones include:

Hecker et al. v. Deere & Co.

This lawsuit was dismissed by the U.S. Court of Appeals for the Seventh Circuit, which ruled there was no ERISA fiduciary duty to affirmatively disclose revenue sharing as long as total expenses were transparent. It also found that 401(k) fiduciaries do not have to "scour the market to find and offer the cheapest possible fund." The plaintiffs had alleged that "Deere violated its fiduciary duty under ERISA by providing investment options that required the payment of excessive fees and costs and by failing adequately to disclose the fee structure to plan participants."

Among the most controversial findings: the court said that the fiduciaries discharged their duties by offering a broad range of funds as investment options with a wide range of expense ratios. Some industry observers interpreted that there might be a certain "safe harbor" in offering a self-directed brokerage account as a result of this finding. The Department of Labor (DOL) then petitioned the U.S. Court of the Seventh Circuit, arguing that ERISA fiduciaries are always potentially liable for selecting 401(k) plan investment options. In turn, the court explained that it did not mean that any plan fiduciary could "insulate itself from liability by the simple expedient of including a very large number of investment alternatives."

In January 2010, the Supreme Court recently rejected a review of the dismissal of the case.

IN THIS ISSUE

The *DC Observer is* a quarterly newsletter that offers Callan's observations and opinions on a variety of topics pertaining to the defined contribution industry. Each issue is updated with the latest Callan DC Index™ returns.

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About the Callan Investments Institute

The Callan Investments Institute, established in 1980, is a source of continuing education for those in the institutional investment community. The Institute conducts conferences and workshops and provides published research, surveys and newsletters. The Institute strives to present the most timely and relevant research and education available so our clients and our associates stay abreast of important trends in the investments industry.

About Callan Associates

Founded in 1973, Callan Associates Inc. is one of the largest independently owned investment consulting firms in the country. Headquartered in San Francisco, Calif., the firm provides research, education, decision support and advice to a broad array of institutional investors through five distinct lines of business: Fund Sponsor Consulting, Independent Adviser Group, Institutional Consulting Group, Callan Investments Institute and the Trust Advisory Group. Callan employs more than 170 people and maintains four regional offices located in Denver, Chicago, Atlanta and Florham Park, N.J.

Spano et al. v. Boeing Co.

In 2007, the Boeing Employee Benefits Investment Committee was added as a defendant to the existing fee lawsuit. Named in the original lawsuit were the Boeing Company, the plan sponsor, the Employee Benefit Plans Committee and the plan administrator. Additional charges were also alleged in the amended complaint, which followed the discovery process by plaintiffs' lawyers. These charges included: failure to consider additional sources of compensation such as securities lending earnings, failure to shift early enough to separate accounts and use of active versus passive funds. The case is ongoing.

George et al. v. Kraft Foods Global, Inc.

A federal judge dismissed a lawsuit on Jan. 27, 2010 against the Kraft Foods Global Inc. Thrift Plan. This class-action lawsuit alleged that the defendants breached their fiduciary duties in how they operated and administered their 401(k) plan under ERISA.

Plaintiffs' specific allegations included: 1) the plan maintained excessive cash in the unitized Altria and Kraft stock funds leading to excessive transaction costs; 2) fees paid to the recordkeeper (Hewitt Associates) were unreasonable, excessive and inadequately monitored; 3) the float or earnings received on plan account uninvested cash balances was not monitored or accounted for—leading to payment of excessive fees and expenses to State Street, the plan's trustee.

Following is a summary of the ruling by U.S. District Court Judge Sidney I. Schenkier of the North District of Illinois.

Company stock: An email trail demonstrated that Kraft used a reasoned decision-making process with respect to the company stock funds and balanced competing interests under conditions of uncertainty, per ERISA's requirements. Further, the defendants did not breach their fiduciary duty since the plan held at least seven other non-company stock investment funds. In the absence of evidence that these funds were unsound or reckless, the choice of funds and its disclosures allowed participants to make informed decisions.

Fee payment to the recordkeeper: The fees charged by its recordkeeper (Hewitt) were inline with the industry. The court said that ERISA does not require fiduciaries to "scour the market" to find the "cheapest possible" fund or service provider. Furthermore, there was no triable issue as to whether the defendants used a reasonable decision-making process in their contracts with Hewitt. The defendants and their consultant regularly reviewed and renegotiated their fees with Hewitt—utilizing standard industry methods (including fee database comparisons)—to determine the reasonableness of the recordkeeper's fees. The court also dismissed the plaintiffs' contention that the RFP process was the exclusive legitimate means of determining the reasonableness of recordkeepers' fees.

The float: The disclosure that State Street retained the float in the fee schedules—and conducted at least one meeting on this topic—demonstrated that the defendants properly allowed and adequately monitored the float. The court said there was no evidence that the retention of the float resulted in excessive fees to State Street.

Congressional Actions

Congressional actions include bills addressing DC fee transparency, a focus on potential target date fund conflicts of interest and encouragement for use of annuities.

The House Committee on Education and Labor's 401(k) Fair Disclosure and Pension Security Act of 2009 – Rep. George Miller (D-CA)

This bill seeks to amend ERISA to prohibit a 401(k) plan sponsor from contracting plan services without receiving fee, service and other disclosure information from the provider.

It requires 401(k) plan service providers to reveal to plan sponsors the "total expected annual charges for services," broken into four categories: administration and recordkeeping, transaction-based fees, investment management fees and other fees. It also requires disclosure to plan sponsors of revenue sharing and revenue from cross-selling (e.g., rollovers). Detailed participant fee and investment characteristics disclosure is required, including dollar amount fee disclosure. Finally, in one of the more controversial aspects of the bill, it requires employers who desire 404(c) protection to provide at least one "low cost market-based index fund option."

Defined Contribution Plan Fee Transparency Act of 2009 – Rep. Richard Neal (D-MA)

This bill seeks to impose a penalty tax on DC plan providers for failing to furnish the plan administrator with disclosures of plan fees and expenses. It requires that administration and investment fees be disclosed separately. (It does allow fees to be presented as dollar amounts or as a percent of assets; estimates can be used.) It also requires disclosure if there are different share classes or provider benefits from the plan using proprietary funds. There is also participant fee disclosure in the bill, including the presence of revenue sharing. The bill was referred to the House Ways and Means Committee on June 9, 2009.

It is anticipated that the Miller and Neal bills may be combined. The prospects are uncertain for passage of any plan fee disclosure legislation, especially if pending DOL defined contribution fee disclosure regulations satisfy the requirements of the proponents of this DC fee legislation.

Retirement Income Security Needs Lifetime Pay Act of 2009 – Rep. Earl Pomeroy (D-ND)

This bill would promote the use of annuities among retirees by excluding a portion of lifetime annuity payments from taxable income. It also excludes longevity insurance in IRS calculations of employee benefits.

Lifetime Income Disclosure Act

In December 2009, U.S. Senators Jeff Bingaman (D-NM), Johnny Isakson (R-GA) and Herb Kohl (D-WI) introduced the Lifetime Income Disclosure Act, which would require plan sponsors to provide the annuity equivalent of the total benefits accrued with respect to a participant or beneficiary.

Department of Labor Initiatives and Other Governmental Actions

DC Fees

The DOL is expected to release ERISA 408(b)(2) service provider DC fee disclosure regulations in final form in June 2010, defining the specific information that must be disclosed by service providers when they enter into plan service arrangements about the compensation they will receive and possible conflicts of interest that may affect their provision of services.

The DOL is expected to issue final participant fee disclosure regulations in July or August 2010, which will impose certain disclosure obligations on plan fiduciaries of all participant-directed individual account plans. Currently, the DOL is conducting focus groups to determine appropriate forms of disclosure. However, the trend is toward requiring "unbundled" fee disclosure (disclosure of revenue sharing).

Annuities

There have been a number of initiatives by the DOL and other government entities seeking to make annuities more attractive for retirees and DC plan sponsors.

Interpretive Bulletin 95-1 amended ERISA to eliminate the safest available annuity requirement for DC plans. Further, the 2006 Pension Protection Act established a fiduciary safe harbor for the selection of annuity providers by DC plan sponsors. However, requirements were fairly broad and potentially difficult to adhere to—such as requiring fiduciaries to engage in an objective, thorough and analytical selection process, and that fiduciaries appropriately consider information sufficient to assess the ability of the annuity provider to make all future payments under the annuity contract. This has undermined the attractiveness of the safe harbor.

The DOL allowed for variable annuities in the final Qualified Default Investment Alternative (QDIA) regulation—leading some within the industry to believe that lifetime income solutions are feasible as QDIAs.

More recently, the Employee Benefits Security Administration (EBSA) and the Department of the Treasury published a request for information asking for comments from plan sponsors and others in the industry in an effort to encourage use of retirement income solutions (including annuities) in DC plans.

Finally, there are initiatives by Mark Iwry, Senior Advisor to the Treasury Secretary, to encourage utilization of annuities by retirees, including a proposal for automatic trial-income strategies (annuity defaults) for retirees and phased or incremental acquisition of deferred annuities.

Target Date Funds

In June 2009, the Securities and Exchange Commission (SEC) and DOL held a joint hearing to explore issues facing investors in target date funds, such as portfolio composition, risk and disclosure. One conclusion from the hearing was that the DOL should provide more specific guidance to plan fiduciaries who are responsible for selecting and monitoring these funds as a prudent investment alternative in a DC plan.

EBSA also recommended that the DOL should develop participant education materials and illustrations to enhance awareness of the values and risks associated with these funds. EBSA and the SEC are coordinating and evaluating what steps should be taken to address the differences and risks associated with target date funds, specifically for those funds used as default options and directed at less financially-sophisticated participants.

However, the DOL has expressed no interest in revisiting the appropriateness of the use of target date fund as QDIAs, or rethinking the inclusion of stable value as a QDIA.

Investment Advice

On Feb. 26, 2010, EBSA issued proposed DC regulations governing the provision of investment advice to participants.

The new regulations replace the final advice regulations that were issued just over a year ago, which were subsequently withdrawn amidst concerns that they did not adequately safeguard DC participants against conflicts of interest.

As with the prior regulations, the newly proposed regulations provide two ways of offering investment advice: through an adviser and through a computer model. While the proposed regulations substantially resemble the withdrawn regulations, there are some important differences.

1) **Adviser-provided advice:** The proposed regulations make it impermissible for both an individual employee providing advice and the company employing that individual to receive payments that vary based on the investments selected by the participant (level-fee requirement). This is a broader prohibition than in the previous advice regulations.

2) **Computer-based advice:** The proposed regulations prohibit computer model-generated advice from inappropriately favoring investments offered by the advice provider or inappropriately favoring investments that generate greater income for the adviser. The proposed regulations would also prohibit computer-generated advice from distinguishing among investment options within a single asset class on the basis of factors that "cannot confidently be expected to persist in the future."

The preamble goes on to cite certain examples: "While some differences between investment options within a single asset class, such as differences in fees and expenses or management style, are likely to persist in the future and therefore constitute appropriate criteria for asset allocation, other differences, such as differences in historical performance, are less likely to persist and therefore less likely to constitute appropriate criteria for asset allocation." Callan notes that such an approach would favor index funds over actively-managed funds.

The DOL has asked for written comments by May 5, 2010.

Legal and Regulatory Trends and Outlook Conclusions

The DC legal and regulatory environment continues to evolve. Several themes can be derived from recent lawsuits and regulatory/legislative (recent or pending) actions that apply to investment fund selection within DC plans:

1) **Upcoming DOL regulations and/or legislation may require greater disclosure** to participants of embedded fees such as revenue sharing. As such, plan sponsors should understand and be comfortable with the way that administrative fees are paid across the plan, and the extent to which some funds may pay greater administrative fees than others when revenue sharing is used.

2) **For large plans, documentation of the consideration of separate accounts and collective trusts relative to the use of mutual funds within the plan is warranted** given the direction that fee lawsuits are taking.

3) **It is essential to thoroughly document the selection, monitoring and evaluation of target date funds** within the plan. This is important even when the proprietary target date funds of the recordkeeper are being used.

4) **Plan sponsors will want to watch closely** in coming months as investment advice regulations are finalized, with the goal of ensuring that advice provided within the plan meets the new regulatory standards.

5) **Annuities as they relate to DC plans may gain traction eventually**—but that will depend very heavily on the safe harbors and incentives that are put into place by regulators for plan sponsors involving everything from annuity selection to counterparty risk to portability.

A clear theme throughout the legal and regulatory events cited here is the importance of a thorough, prudent and well-documented process in 401(k) plan management.

DC INSIGHTS LAUNCHES

In light of the active legal, regulatory and legislative DC environment, Callan recently launched an online news service called *DC Insights*. Subscribers receive periodic emails alerting them to important legal, regulatory, legislative and other developments within the defined contribution industry. All *DC Insights* are archived on www.callan.com. To subscribe, send an email to dcinsights@callan.com. Please provide your name, organization and email address.

CALLAN DC INDEX™

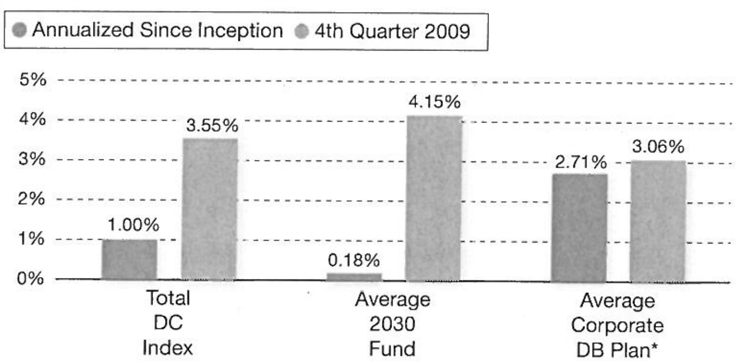
Investment Performance

Defined contribution plan investors made solid gains in 2009. The average DC plan rose 22.22% for the year according to the Callan DC Index (+3.55% for the fourth quarter), significantly offsetting the 28.5% decline in 2008.

The Callan DC Index started the year with a 5.22% annualized decline since its 2006 inception. However, after gaining ground throughout much of 2009, the Index ended the year with an annualized gain of 1%. This puts the Index ahead of the average 2030 target date fund, which has only advanced 0.18% on an annualized basis between 2006 and 2009.[1] Although the average 2030 target date fund has outperformed the average DC plan during the market rally due to a heavier weighting in equities (80% in equities compared to 63% for the Index), it sustained far greater damage during the market collapse, putting it behind the Index for the period dating back to the beginning of 2006.

Still, the Index has significantly underperformed the average corporate defined benefit plan since inception by: 1.71% on an annualized basis.[2]

Investment Performance



*Performance is gross of fees.

ABOUT THE CALLAN DC INDEX

The Callan DC Index is an equally weighted index tracking the cash flows and performance of approximately 70 plans, representing more than 800,000 defined contribution participants and nearly $60 billion in assets. The purpose of the Callan DC Index is to:

- Understand the asset allocation of defined contribution plans
- Track defined contribution fund flows
- Measure the performance of defined contribution plans

The Index was officially launched with second quarter 2007 data, but includes results dating back to its inception in January 2006. It is updated quarterly and reflects 401(k) plans as well as other types of defined contribution plans.

For more in-depth coverage, please see the *Callan DC Index Performance Summary & Analysis* or go to www.callan.com.

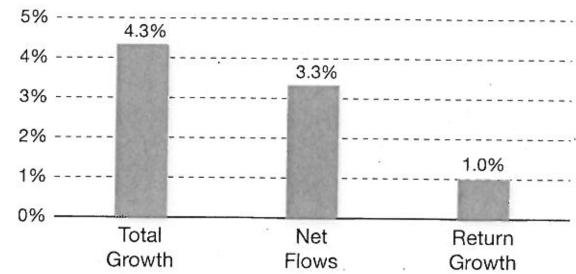
1 We compare the Index to a 2030 target date fund because this is the target date fund that roughly matches the time to retirement of the average DC participant.

2 This performance edge is partly attributable to the fact that corporate DB plans' returns are gross of fees, as opposed to the Index's returns which are net of fees.

Asset Growth

The Index's recent strong performance means that DC participants are in the black for the first time since the third quarter of 2008. Going into 2009, the value of DC Index assets had shrunk by 2.16% on an annualized basis since inception—despite an annualized contribution rate by plan sponsors and participants of 3.06% during that same period. However, by the end of 2009, balances of participants in the Index experienced a growth rate of 4.34%. While this is good news, it remains that much of this increase (3.33%) comes from contributions, with only 1% attributable to actual total return.

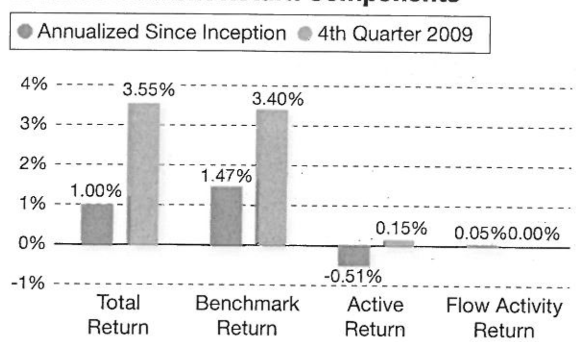
Growth Sources (Annualized Since Inception)



Active Management's Impact

Active management added about 3% to the Index's return for 2009 (over a comparable mix of passive investments). This somewhat—but not quite—reverses the damage done by active management in 2008, which reduced the Index's performance by 3.5%. Traditionally, active funds are expected to outperform during down markets, as such funds typically hold cash positions. However, the benefit of whatever cash was held in active funds during the market decline was decimated by many active managers' aggressive positioning relative to their benchmarks. Conversely, in the market rally, such positioning benefited active managers, allowing them to surpass benchmark gains. Indeed, active return was positive within the Index every quarter in 2009, with the strongest active gains coming in the year's first half, during the initial recovery.

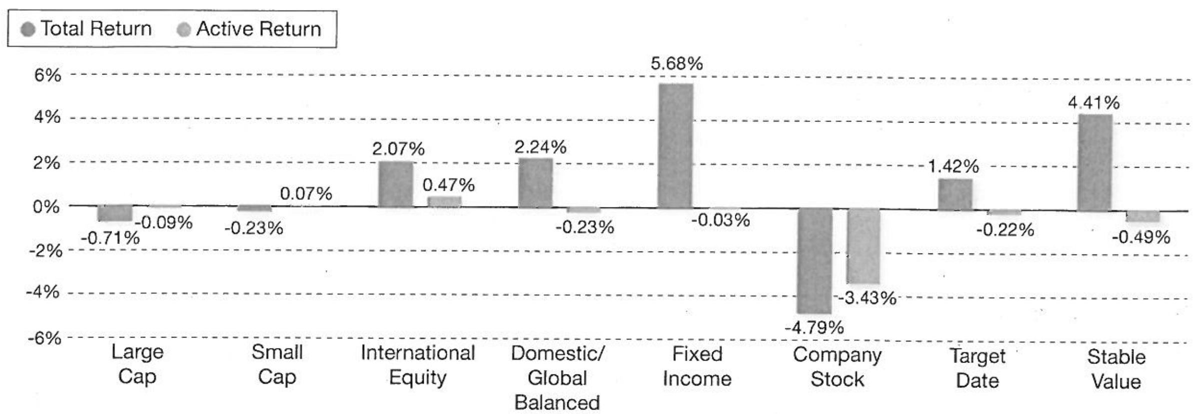
Total Investment Return Components



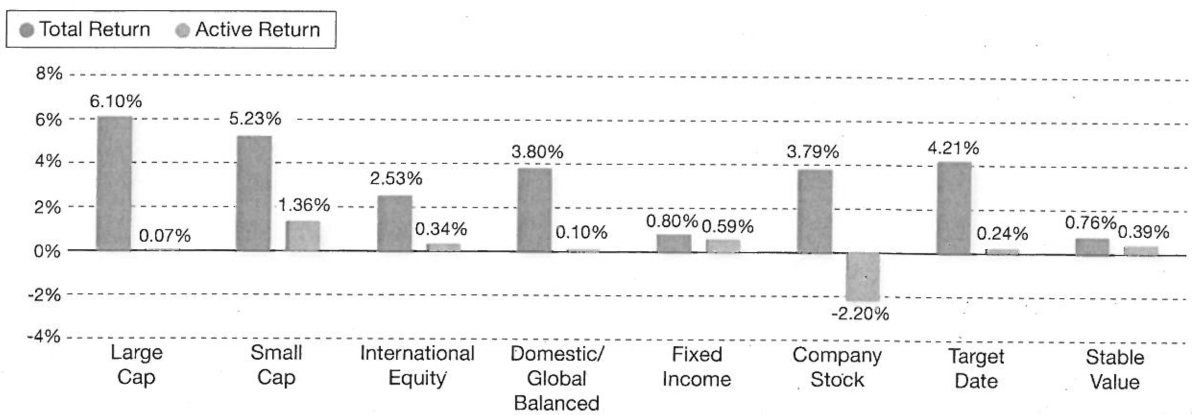
Moreover, most asset classes added value from an active return perspective during the year. Company stock made an enormous comeback from 2008, adding 11.59% to its benchmark (S&P 500). Among diversified investment funds, domestic small/mid cap stocks offered the greatest active management boost (+6.77%) for the year.

Still, since the Index's inception, the only asset class to add material active return in the fourth quarter is international equity (+0.47% on an annualized basis), and overall active return remains disappointing at -0.51% annually.

Asset Class Total Return and Value-Added of Active Management (12/31/09 Annualized Since Inception)



Asset Class Total Return and Value-Added of Active Management (Fourth Quarter 2009)



Cash Flows

Throughout much of the 2009 market rally activity, as measured by fund flows within the Index, was above average, as participants sought to increase their exposure to risky assets. In the fourth quarter, money continued to flow into most equity funds and out of capital preservation vehicles such as stable value and money market funds. However, the pace of turnover[3] for the quarter declined to 0.57% (below the historical average of 0.76%).

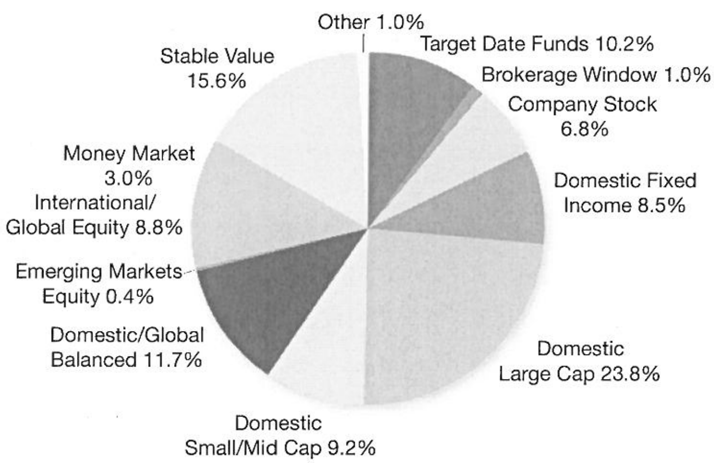
Nearly 5% of money flowed out of stable value funds in 2009, compared to inflows of nearly 17% in 2008. Target date funds were a major recipient of inflows during the fourth quarter. Indeed, target date funds have seen inflows every quarter since the Index's inception—including throughout the market collapse. This reflects the popularity of target date funds as a default investment option and the stickiness of defaulted monies.

3 Total Index "turnover" measures the percentage of total invested assets (transfers only, excluding contributions and withdrawals) that moved between asset classes.

Net Cash Flow Analysis Fourth Quarter 2009

Asset Class	Flows as % of Total Net Flows	Flows as % of Asset Class Market Value	Flows as % of Total Index Market Value
Alternatives/Other	-1.11%	-3.19%	-0.01%
Brokerage Window	-6.17%	-3.41%	-0.04%
Company Stock	-16.75%	-1.41%	-0.10%
Domestic Fixed	14.10%	1.40%	0.12%
Domestic Large Cap	-13.35%	-0.33%	-0.08%
Domestic Small/Mid Cap	1.13%	0.11%	0.01%
Domestic/Global Balanced	-8.29%	-0.41%	-0.05%
Emerging Markets Equity	0.72%	1.72%	0.01%
Global Equity	0.28%	0.31%	0.00%
High Yield Fixed	0.19%	1.38%	0.00%
International Equity	18.54%	1.97%	0.16%
International/Global Fixed	0.83%	10.54%	0.01%
Money Market	-6.11%	-1.11%	-0.04%
Real Estate	0.26%	1.15%	0.00%
Real Return/TIPS	1.18%	3.24%	0.01%
Specialty Equity/Sector	-0.12%	-1.16%	0.00%
Stable Value	-48.11%	-1.70%	-0.28%
Target Date	60.25%	5.30%	0.51%
Total Turnover			**0.57%**

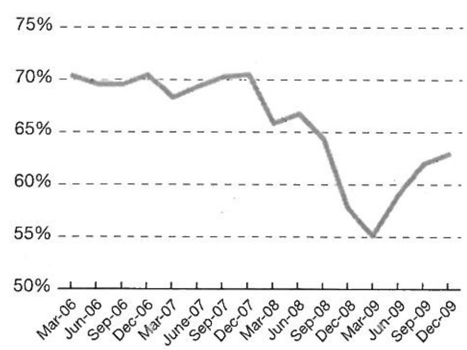
Callan DC Index Asset Allocation as of December 31, 2009



Asset Allocation

Target date funds account for more than 10% of DC assets and are represented in 75% of DC plans. For plans with target date funds, target date assets average 19% of the total. Stable value funds account for 16% of assets, down from more than 18% going into 2009. Despite positive flows and the market rally, the Index's equity exposure has not returned to pre-market collapse levels. The average plan has about 63% in equities, down from a high of 70.5% in December 2007.

Average Total Equity Exposure



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