

March 6, 2006

*This is the March 2006 monthly Wealth Management newsletter from Hoffman, White & Kaelber Financial Services, LLC. If you do not wish to be included in our circulation, please reply indicating your desire to be removed and we will be happy to oblige. Alternatively, any of your friends or colleagues may receive this on a regular monthly basis by sending their name and email address to info@hwkfs.com. Feel free to forward this to any of your friends who may find it useful. Thanks for your interest and I hope you enjoy the letter.*

## **Are Company Retirement Plans About to Get Better?**

Depending on your vantage point, I guess this question could be debatable. Yet, to me, it certainly seems like things are about to get better! Want to know why?

Maybe in your parents' generation, certainly for your grand-parents' and possibly in your great grand-parents' day, one of the secrets for achieving "the good life" was to work for a big company with a pension plan. Although fewer than half of private sector workers ever had a defined benefit pension, it was one of the few trademark features of the American dream.

Currently, almost all federal employees and a large majority of state and local government employees have defined benefit plans. Yet, in the private sector, only about 20 percent of workers participate in defined benefit pensions, and that number is expected to drop to the vanishing point over the next ten years or so.

A Defined Benefit retirement plan is one in which plan participants (employees) would expect to receive a certain amount of money per month upon retirement determined by a predefined formula. The formula for calculating the promised benefit amount will usually depend on factors such as age at retirement, number of years of service, and the amount of money earned at or within a few years prior to the time of retirement.

Some would say that, offering up a story about defined-benefit pension plans is akin to discussing ancient history. While many remain in existence, for the most part, defined-benefit plans are relics from a bygone era when unions were able to negotiate prized retirement benefits from employers. In the last twenty years, however, 401(k) plans have become the dominant form of employer-sponsored retirement plans.

Unlike a Defined Benefit plan, a Defined Contribution plan only stipulates that the employee and/or the employer shall contribute a certain amount of money per year into a tax deferred savings account for the plan participant (employee). Other than 401(k) plans, additional examples of Defined Contribution plans include 403(b) and 457 programs, profit sharing plans, SIMPLE's, SEP's and IRA's to name a few.

As readers of my newsletters well know, wealth management is the ultimate goal of all that we do at Hoffman, White and Kaelber. Yes, we promote our services; yet, you will find that we always seek to present thought provoking topics that are relevant to our wide audience.

This month's newsletter discusses some of the major challenges retirees face with these retirement plans and how policy-makers in Washington, D.C. are trying to make some positive changes. After that, be sure to look over how well we've performed over the last three years! Yes, at the end of this month we completed a three year track record! Morningstar separate account manager database – here we come!!!

March 6, 2006

## **What's Wrong – What Needs Fixing?**

Citing a February 2006 report by Charles Morris, of The Century Foundation, “The first realization that [Defined Benefit plan] pension promises were not ironclad may have come when the Studebaker Co. folded in 1963 and defaulted on its pension obligations. Congress eventually responded with the Employee Retirement Income Security Act (ERISA) of 1974. ERISA established financing and accounting standards for defined benefit pensions and created the federal Pension Benefit Guarantee Corporation (PBGC) to insure private defined benefit pension commitments.”

The Century Foundation provides top-notch research and expert assessments on public policy matters which it makes available to policymakers, journalists and concerned citizens.

Under ERISA, rather than having to fund current pension benefit payments out of current cash flow, companies having a Defined Benefit plan are required to set aside invested assets to fund their future pension liabilities. Morris’ report continues: “If the actuarially determined present value of pension liabilities exceeds that of pension fund assets, the shortfall is subtracted from the company’s net worth as if it were a debt... As of mid-2005, private companies have amassed \$1.8 trillion in assets to support their defined benefit pension obligations, against future liabilities valued at about \$2.2 trillion [a projected \$700 billion shortfall]... During the 1990s market boom, stock returns were so high that many plans became over-funded, and pension funds actually became an important driver of company earnings. When the markets reversed after 2000, pension fund underperformance hammered plan profits, at the same time as falling operating earnings reduced companies’ ability to increase plan contributions. Just as important...the steady fall in interest rates after 2001 greatly ratcheted up the book value of future pension liabilities.”

To shed some light on the magnitude of this problem and how it has grown, lets turn the clock back approximately eighteen months. In August of 2004, Rep. John Boehner, chairman of the House Education & the Workforce Committee, released the following statement:

“The recent decision by United Airlines to suspend contributions to its under-funded pension plan, at least in the interim during bankruptcy proceedings, is another very visible symptom of a broken defined benefit pension system that needs significant reform. It’s an issue Washington cannot afford to ignore. The retirement security of millions of American workers – and the interest of millions of American taxpayers – is at stake.

The Pension Benefit Guaranty Corporation (PBGC), which assumes responsibility for and guarantees retirement benefits should a company falter, is concerned about the pensions of United’s workers and retirees – and rightly so. Unfortunately, it’s become an all too familiar problem. In recent years, the PBGC has become liable for hundreds of pension plans and accumulated an \$11.2 billion deficit. Although the agency has enough resources to pay benefits in the near future, the possibility of a taxpayer bailout of the PBGC could be necessary if the financial condition of the agency continues to deteriorate.”

Now to understand how the problem has grown, lets fast-forward to Charles Morris’ report: “...Analysts at Credit Suisse/First Boston (CSFB) recently published a list of twenty major

March 6, 2006

companies with pension liabilities that equal or exceed the company's market value; the list includes Delta Airlines (which has since declared bankruptcy), with pension obligations 13 times higher than its market value; General Motors, 4.7 times higher; Ford, 2.7 times higher; Lucent, 1.9 times higher; and U.S. Steel, 1.4 times higher. Mounting deficits at the PBGC are creating the potential for a federal bailout on the scale of the 1980s Savings and Loan crisis... More likely, companies will accelerate the process of extracting themselves from their pension obligations. One path is the strategic bankruptcy. Shedding pension obligations has become practically a standardized financial engineering tool in the hands of private equity buyout managers—in steel companies, auto parts companies, and more recently, a string of airline bankruptcies. Collectively, it appears that United, Delta, and Northwestern airlines, and the auto parts maker Delphi will be relieved of some \$32 billion in pension liabilities through the bankruptcy process. The last four companies on that list have not yet officially requested a PBGC takeover, but that seems inevitable.”

So much for Defined Benefit plans. Now, let's take a look at one of the largest economic challenges occurring in the Defined Contribution plan market. The following comes from an August 2002 article from CFO.com entitled:

**“Honey, I Shrunk the 401(k)”**

“That rumbling sound you hear in the distance is the growing chorus of very disgruntled employees who now realize that 401(k) account balances can shrink as well as grow — and who have discovered that they're not very good at managing them, anyway...With the end of the bull market and the implosion of Enron, employees have realized that their hard-earned savings can dwindle, if not disappear, in a 401(k). New studies have shown that 401(k) plans are underperforming the market and coming nowhere near to replacing pre-retirement income for most employees...The problem is exacerbated by employees' general lack of investment knowledge. A recent survey of defined contribution plan participants by John Hancock Financial Services found that 40 percent of respondents say they have little or no investment knowledge. Fifty percent say they don't have time to manage their investments. "Human nature may be the Achilles' heel of the 401(k) system," says survey author Wayne Gates, general director of market research and development at John Hancock...”

“The end result of the shift to 401(k) plans is that employees have considerably less money to retire on today than they had 20 years ago”, according to research conducted by Edward N. Wolff, an economics professor at New York University, and the Economic Policy Institute, a Washington, D.C.-based think tank. A recent study by Wolff shows that retirement wealth (defined benefit and defined contribution benefits plus Social Security benefits) for the median household headed by a person aged 47 to 64 declined by 11 percent from 1983 to 1998 — despite an increase in the Dow Jones Industrial Average of more than 730 percent. “Only households in that age group with more than \$1 million in pre-retirement income saw an increase in total retirement wealth... In addition, the percentage of households approaching retirement that would be unable to replace half of their pre-retirement income rose from 29.9 percent in 1989 to 42.5 percent in 1998”, according to Wolff.

Retiree's can depend on Social Security benefits to take care of them, can't they?

There is a great deal of confusion and concern about the federal Social Security System in relation to Pension Plans. While Social Security has some outward similarity to a Defined

March 6, 2006

Contribution plan it is neither a Defined Benefit nor a Defined Contribution Plan. The monies in the Social Security system are not invested in the economy and do not grow in value with time. In fact, there is no money in an individual's account in Social Security. The only thing of "value" in a Social Security account is an IOU issued by Congress. And, Congress has borrowed this money to spend on other programs. As a result, the payments that an individual makes into Social Security are, in effect, taxes paid to fund welfare payments to the elderly.

Information on the Social Security Administration's web site reflects that, "Social Security's financing problems are long term and are not expected to affect today's retirees and near-retirees, but they are very large and serious. People are living longer, the first baby boomers are nearing retirement, and birth rates are low. The result is that the worker-to-beneficiary ratio has fallen from 16.5-to-1 in 1950 to 3.3-to-1 today. Within 40 years it will be 2-to-1. At this ratio there will not be enough workers to pay scheduled benefits at current tax rates."

### **So, What's Washington, D.C. Doing About All This?**

In 2005, with Social Security reform having gone nowhere early in the year, pension plan reform quickly took center stage on Capital Hill. It might have seemed that defined benefit plan issues dominated the legislative agenda, but defined contribution issues started gaining traction as pension reform moved through the House and the Senate. The result of this focus produced both the Pension Security and Transparency Act (PSTA, S.1783), approved by the Senate on November 16<sup>th</sup> and the Pension Protection Act (PPA, H.R.2830), approved by the House on December 15<sup>th</sup>. As you might expect, the House and Senate bills differ significantly and further negotiations are required.

But, before we move on, it is important to know that these Acts are considered "bills" at this time. A bill is a legislative proposal before Congress. A bill must be passed by both the House and Senate and then be signed by the President before it becomes law.

As posted on the Senate's Democratic Policy Committee website, PSTA S.1783 was summarized as follows: "The Pension Security and Transparency Act of 2005, would strengthen the funding requirements for single-employer defined benefit pension plans, create new rules for multiemployer plans, provide the airline industry and financially troubled plans special provisions to avoid plan terminations, enhance financial disclosure requirements for pension sponsors, expand retirement savings options for employees working for firms facing bankruptcy or corporate scandals, provide workers access to investment education tools and independent investment advice, and address concerns relating to women, spouses, survivors, and older workers."

And Rep. John Boehner (R-OH) posted on AssetBuilding.org, a project of the New America Foundation, the following about PPA H.R. 2830: "This comprehensive pension reform bill from the Republican leadership is based on some of the Bush Administration's proposals. The bill would provide real-time information for workers on the health of their pensions; a structure for identifying troubled multi-employer pension plan with a system of benchmarks to move them towards better health; and would allow employers to provide all workers with access to investment advice as employee benefit. In addition, the bill will raise employers' premiums who participate in PBGC to cover rising costs. With regards to the new structure the bill proposes to gauge pension health based on how well funded it is, pension plans

March 6, 2006

funded at 65 to 80 percent receive a "yellow" or warning status and must adopt a program to improve within ten years. If they fall below 65 percent funded, they would be at "red" status and face additional benchmarks."

### **Concluding Thoughts**

After looking over the details of both of the bills discussed above, a couple of things seem fairly clear about the direction of pension reform. First, both bills seem to be encouraging an orderly dismantling of the defined benefit plan system and, at the same time, discouraging large plan sponsors from extracting themselves from their pension obligations through a strategic bankruptcy process. Second, it would seem that 401(k) and similar plans (defined contribution plans) are being favored for use as the primary retirement plan vehicle and there seems to be a big push for defined contribution plan sponsors to engage qualified investment advisors for the benefit of their employees.

As the push for engaging qualified investment advisors evolves, it wouldn't surprise me if plan sponsors began migrating from offering participants investment choices to hiring an investment manager to invest plan funds. This type of arrangement would certainly make the most sense, from a cost benefit perspective, for all parties involved.

### **Hoffman, White & Kaelber Financial Services Investment Performance Update**

Consumer confidence declined in February, and the housing market appeared to be slowing a bit, according to end of month reports that led some economists to suggest slower growth ahead. In its consumer confidence report, the Conference Board said its index of consumer sentiment fell in February to 101.7 from 106.8 in January. Also, the National Association of Realtors said existing home sales dipped 2.8% last month to an annual rate of 6.56 million. The inventory of unsold homes rose to a 5.3-month supply.

Regarding the other side of the globe, the International Monetary Fund will likely revise its forecast of 2.0% growth for Japan in 2006 "significantly" upwards when it issues its semi-annual report in April, a senior IMF official said recently. David Burton, director for the IMF's Asia and Pacific department, told reporters that given the recent performance in the world's second-largest economy, a new forecast would be "quite a bit higher than 2.0%".

We were very pleased to finish the month of February on a positive note. It's hard to believe that it's been three years since we started. For the month ended February 28, 2006, our one-month performance is up 0.27%, our rolling twelve month return is up 11.75%, and our three year average annualized return is up 10.18%. Our since inception risk profile remains very conservative at +/- 5.52% (+/- 3.82% for the last 12 months) and our Sharpe Ratio (reward for risk taken) is an enviable 1.47 (2.13 for the last 12 months). For more performance information, please see our web site for details.

**Is a comfortable retirement or preservation of wealth important to you?  
Want better long-term results from your investments?  
Choose Us As Your Investment Manager!  
Research us on the web at [www.hwkfs.com](http://www.hwkfs.com)**