POINT OF VIEW
GLOBAL INVESTMENT SOLUTIONS FROM NORTHERN TRUST
Fall/Winter 2009

CHANGES PENDING FOR MMFs
More transparency, risk management are primary goals

DERIVATIVES-BASED INVESTMENT SOLUTIONS
Strategies offer potential to add return, manage risk

THE NEXT PRIORITY FOR DC PLANS
U.S. researcher calls for retirement income focus
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Challenging times can become valuable educational experiences once the dust has settled and people have an opportunity to step back and evaluate the situation. And although the fallout from the recent financial turmoil is still being assessed, some lessons already are clear.

One of the changes likely to occur is that the relationship between institutional investors, consultants and their investment managers will assume new dimensions. In the future, investors will want — even demand — that their managers be more proactive and educational in all aspects of the relationship.

Changes Required
As institutional investors analyze their portfolios and re-examine their asset allocation policies and risk management strategies, they will require that investment managers not only understand their changing needs and objectives, but also have the commitment and resources for delivering appropriate solutions.

To succeed in this new environment, investment managers will need to re-examine their client service organization and structure. For example, a manager might focus on a proactive communication approach with clients. This will ensure they understand and meet their clients’ needs. In addition, managers must maintain the proper technology/systems, processes and other resources to assure clients of how the firm will achieve their objectives.

Structural changes, however, will not be sufficient if an investment manager does not promote the proper culture among its professionals. Managers must reach out proactively to investors and their consultants often, during challenging as well as prosperous times, to provide insight, analysis and reassurance.

Striking the Right Chord
The need for enhanced relationship dynamics was underscored by a client satisfaction survey of more than 4,000 plan sponsors conducted by Chatham Partners, a market research and strategy consulting firm. One of the more surprising findings of the survey was the deterioration in investor confidence in managers’ stability, investment process and personnel.

Chatham examined some of the comments that accompanied the surveys and was able to identify three key elements that investors seek:

- **Reassurance** about the manager’s resources, strength and commitment, as well as the firm’s ability to remain viable during tumultuous times.
- **Confidence** in both the soundness of the manager’s investment process and the manager’s openness and honesty in dealing with difficult issues or negative performance.
- **Trust** that the manager’s investment team has the resources and expertise to implement the investment strategy and that their relationship manager will be proactive in responding to their needs.

Institutional investors understand they may need to adjust the structure of their investment programs from both an investment strategy and risk management perspective. Successful investment managers will recognize the increased expectations placed on them and be able to adjust accordingly.

At Northern Trust, maintaining strong relationships with clients and their consultants is core to our business.

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1 “Rebuilding Client Confidence During an Economic Downturn,” March 2009

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**Building Trusted Relationships**

*Institutional investors deserve proactive, open and educational interaction.*

**By Joanne Hickman**

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**JOANNE HICKMAN**
Global head of consultant relations at Northern Trust
Derivatives-Based Investment Solutions

Customized strategies offer potential to add return, manage risk.

As institutional investors rebuild portfolios in the aftermath of the global credit crisis and ensuing recession, they are increasingly considering, and incorporating, derivatives-based strategies. “We have seen increased usage of credit default swaps, commodity futures and interest-rate swaps to manage risk in investment portfolios,” says Shundrawn A. Thomas, president, Northern Trust Securities, Inc. “Prudent risk management should be the cornerstone of any investment strategy,” Thomas adds, “and used intelligently, derivatives can bring an extra element of risk control to a portfolio.”

Both exchange-traded derivatives, which are settled through a centralized clearinghouse, and over-the-counter (OTC) derivatives can be used to provide institutional investors with the type and level of risk mitigation they desire. “There may be any number of objectives a client may have,” Thomas notes. “They may be trying to protect gains, obtain synthetic market or asset class exposure or adjust the duration of a fixed-income portfolio without selling the underlying securities. Derivative-based strategies can be employed to help meet those objectives.”

There has been explosive growth in both exchange-traded and OTC derivatives as investors seek protection from risks such as inflation, rapidly increasing interest rates or market volatility. The Chicago Board Options Exchange (CBOE) reported that average daily volume of futures contracts traded in August 2009 increased 16% over the volume for August 2008. In the first six months of 2009, the notional amount outstanding of interest-rate derivatives, including interest-rate swaps and cross-currency swaps, grew by 3% to $414.1 trillion, according to the Bank for International Settlements (BIS), the Basel, Switzerland-based clearinghouse for central banks.

Although derivatives are sometimes referred to as alternative investment strategies, that label is a misnomer. “Derivatives strategies are becoming mainstream and are increasingly being used by traditional investors as an effective risk management tool,” Thomas says.

Strategies for the Current Environment

One major benefit of using derivatives is that they enable investors to quickly adjust their portfolios to respond to changes in market conditions. For example, Standard &
Poor's projects that dividends for the S&P 500 may decrease by 13.3% in 2009, the worst decline since World War II.

Michael Leon, managing director, risk management solutions, Northern Trust Securities Inc., says investors concerned about this decline in dividends can potentially boost the yield of their portfolios through the use of equity index options. “By selling covered call options, for example, an investor can generate incremental cash flow without having to sell the underlying assets in the portfolio at depressed market prices,” Leon explains.

Of course, as with all investment strategies, the risk must be weighed against the return. “Risks are strategy dependent,” notes Leon. “Selling covered calls does generate additional yield, but also caps the investor’s upside above the strike price and offers no downside protection. For clients looking to hedge downside risk, there are a number of similar option strategies that can be employed.”

“Derivatives strategies are becoming mainstream and are increasingly being used by traditional investors as an effective risk management tool.”

—Shundrawn Thomas, president, Northern Trust Securities, Inc.
An example of a risk management strategy for both portfolios and single stock concentrations is the zero-premium collar. This strategy allows investors to achieve downside protection by purchasing a put option and offset all or part of this cost by selling an out-of-the-money call option. “In the current economic climate, clients are doing shorter-dated transactions in the three- to six-month range and are accepting more downside risk to gain more upside potential,” Leon says.

**Hedging Interest Rate Risk**

Interest rates currently are at historically low levels, but many institutional investors are wary that rates might start to rise. Gary M. Kramer, of the public and structured finance group at Northern Trust Securities, Inc., has seen an increase in the number of clients using OTC derivative instruments such as interest-rate swaps or interest-rate caps to hedge against potentially rising interest rates.

Consider, for example, a corporation with a long-duration variable-rate loan that is concerned that interest rates will spike. “It may use an interest-rate swap to lock in a fixed funding rate for a period of time,” Kramer says.

“Interest-rate swaps can be customized to the investor’s risk mitigation needs,” explains Kramer. “We look at their specific concerns. Are they worried that interest rates will rise dramatically? Do they need some absolute level of protection at a particular interest rate? While no one knows whether interest rates will rise or fall, any number of risk-mitigation strategies can be deployed to accommodate the client’s desires and concerns — regardless of the interest-rate environment.”
Kramer also has seen investors deploying more complex derivatives strategies designed to hedge against the threat of hyperinflation, with some investors even using inflation as a quasi asset class. He says that most investors, however, are looking to keep their use of derivatives simple. “There’s a lot that can be accomplished with plain-vanilla derivatives,” he adds.

**Listed vs. OTC Derivatives**
The struggles of Wall Street firms last year has heightened investors’ concerns over a number of risks, including counterparty risk. The more common derivative vehicles — futures and options — that trade on formal exchanges have features that help mitigate that risk.

Because exchange-traded, or “listed,” derivatives are settled through a centralized clearinghouse and rely on standardized contracts, the risk that the counterparty will not fulfill their obligation tends to be minimized, explains Leon. By law, the party at risk is required to have funds deposited with the exchange, demonstrating that they can cover any losses. “The central clearing function provides a high level of financial security,” he says. Other benefits of exchange-traded derivatives include a daily mark to market on the options, full price transparency and enhanced liquidity.

OTC derivatives do not share these characteristics, so investors should consider ways of reducing counterparty risk. For example, a third-party intermediary with a strong balance sheet could negotiate the bilateral collateral agreement and use its own financial strength to decrease exposure and limit counterparty risk, Kramer says.

Even with increased regulatory pressures and investor focus on counterparty risk, Kramer expects that the OTC market in general, and interest rate swaps in particular, will remain strong. He notes that OTC derivatives are infinitely customizable. “You can come up with an unlimited number of customized solutions based on the specific needs, objectives and constraints of the client. That makes them a useful risk-control tool in a portfolio.”

**Determining if Derivatives are Appropriate**
While they can meet a wide variety of risk management needs, derivatives are not suitable for every investor. Northern Trust follows a four-step process in helping clients determine if derivatives can help them achieve their investment and risk mitigation goals.

“First, our investment professionals work with clients to identify their objective for wanting to use a derivatives-based strategy,” Thomas explains. “Is the main goal risk mitigation or yield enhancement? Is the client most interested in locking in gains or hedging tail risk? Based on those goals, we analyze the client’s existing portfolio and determine areas of risk.” The third step is to consider the client’s investing time horizon.

Once all aspects of the client’s situation are understood, the fourth step is to advise the client on a customized strategy. “That may or may not include the use of derivatives,” says Thomas. “Our business is to serve clients and provide the best solution,” he adds. “A determination of whether or not a derivatives-based strategy may be appropriate is part of the solution we propose to clients.”

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*Northern Trust Securities, Inc., is a member of the Financial Industry Regulatory Authority (FINRA) and the Securities Investor Protection Corporation (SIPC).*
Global Megatrends

Today, and over the foreseeable future, a series of events — call them global megatrends — will have a profound impact on the world economy. Each issue of Point of View will share insight into these trends and how the institutional investment community is preparing to address them.

Changing Allocation Strategies Of Endowments and Foundations

The market decline and liquidity crisis took a particularly hard toll on many endowments and foundations. During the past decade, endowments and foundations — particularly the larger funds — decreased their allocations to liquid asset classes and increased their commitments to less-liquid investments, such as hedge funds and private equity in an effort to boost overall returns. When the financial downturn hit, however, the opposite happened as many funds were unable to get out of poor-performing investments, dragging down overall portfolio performance. As a result, some endowments and foundations might return to more traditional asset allocation models. And, although most endowments and foundations don’t expect this performance to affect their spending in fiscal year 2009, the outlook for 2010 was less certain.

The Quest for Higher Returns

Between 1998 and 2008, endowments and foundations steadily increased their allocations to alternative investment strategies in an effort to boost overall portfolio performance. This portfolio shift, however, has come at the expense of more liquid investments.

Large Funds’ Performance Starts to Rebound

The recent financial downturn had a significant negative impact on the returns of many endowments and foundations. The performance of large funds, however, started to rebound during the second and third quarters of 2009, according to the Northern Trust Universes, which represents more than 300 large investment plans with combined assets of $390 billion.

To access the full Northern Trust Universes report, go to northerntrust.com/pointofview.

Impact on 2010 Spending Rates Unclear

Almost 45% of endowment executives expect no changes to their funds’ fiscal 2010 spending rates as a result of the decline in investment performance. Still, 17% of executives say they plan to decrease their funds’ spending rates as a result of the economic downturn and decrease in the portfolios’ market values.

<table>
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<tr>
<th>Endowment Assets (as of June 30, 2008)</th>
<th>No Changes Planned</th>
<th>Plan to Increase</th>
<th>Plan to Decrease</th>
<th>Unknown/No Response</th>
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<tr>
<td>Greater Than $1 Billion</td>
<td>35.9%</td>
<td>7.7%</td>
<td>15.4%</td>
<td>41.0%</td>
</tr>
<tr>
<td>&gt; $500 Million to ≤ $1 Trillion</td>
<td>37.5%</td>
<td>7.5%</td>
<td>17.5%</td>
<td>27.5%</td>
</tr>
<tr>
<td>&gt; $100 Million to ≤ $500 Million</td>
<td>40.2%</td>
<td>3.8%</td>
<td>21.2%</td>
<td>34.8%</td>
</tr>
<tr>
<td>&gt; $50 Million to ≤ $100 Million</td>
<td>56.8%</td>
<td>1.2%</td>
<td>16.0%</td>
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</tr>
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<td>&gt; $25 Million to ≤ $50 Million</td>
<td>48.7%</td>
<td>3.8%</td>
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</tr>
<tr>
<td>Less Than or Equal to $25 Million</td>
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<td>All Public Institutions</td>
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<td>2.3%</td>
<td>15.2%</td>
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</tr>
<tr>
<td>All Independent Institutions</td>
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<td>4.3%</td>
<td>17.8%</td>
<td>30.0%</td>
</tr>
<tr>
<td>Full Sample</td>
<td>44.8%</td>
<td>3.7%</td>
<td>17.0%</td>
<td>34.5%</td>
</tr>
</tbody>
</table>

Due to rounding, details may not total 100.0%

Source: “2008 NACUBO-Commonfund Endowment Study Follow-up Survey,” January 2009

A New Roadmap Going Forward

“Endowments and foundations are re-evaluating their investment policies and their approach to overall portfolio management. Rather than classifying investments as ‘traditional’ or ‘alternative,’ these institutions are considering the role each investment strategy plays within the portfolio. These roles include market exposure, risk reduction, return enhancement and inflation hedge.”

—Kieran Browne, senior relationship manager for foundations, endowments and not-for-profit organizations at Northern Trust
The upheaval in the money market fund sector during the past 18 months has prompted a number of proposed regulatory changes in the United States, United Kingdom and Europe. Although designed to enhance the safety and transparency of these investments, the proposed changes also will likely cause institutional investors to rethink their approach to investing in money market funds.

Money market funds have long been considered a bastion of safety, even during times of financial crisis. That changed last September, however, when the net asset value (NAV) of the Reserve Primary Fund fell below $1 per share and the fund couldn’t meet redemption requests.

“The mere fact that a fund ‘broke the buck’ was so unprecedented and such a shock,” says Peter Crane, president and publisher, Crane Data LLC. In retrospect, the problems besetting the Reserve fund shouldn’t have been a surprise, Crane adds. Although money market funds revealed their vulnerability for the first time in a long time, they remained stronger than many asset classes.

“The fact that only one money market fund broke the buck is testament to the durability of the funds themselves and the regulatory structure,” Crane says.

To be sure, if the U.S. Department of the Treasury hadn’t stepped in with its Temporary Guarantee Program for Money Market Funds, or the Federal Reserve Board with its Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF), a full scale panic was a real possibility. The AMLF, for instance, allowed money market funds to borrow against their asset-backed commercial paper to meet redemptions. That instilled confidence in investors and helped avert a run.

Still, the events of last fall were a reminder that money market funds typically are not guaranteed and that investors can lose money. “Investors need to have a good understanding...
of what they are investing in,” says David Rothon, global fixed-income strategist at Northern Trust, London.

Changes on the Horizon
Money market funds represent a large and critical segment of the financial world. According to Crane Data, money market fund assets have grown to about $3.6 trillion at the end of 2009 from about $1.8 trillion at the beginning of this decade.

“The money market sector has proven to be important to a well-functioning financial system,” says Peter Yi, director of money markets at Northern Trust. “It’s the grease that allows the wheels of financial system to turn. That’s why the credit freeze within this sector was one catalyst to a broader credit crunch,” he notes.

In the United States, Rule 2a-7 of the Investment Company Act of 1940 governs money market funds. The rule was amended in the 1990s and worked effectively for about a decade, but faltered under the recent market turmoil, says Bradford Adams, senior product manager, Northern Trust. In fact, the Reserve Primary Fund actually was operating within 2a-7 when it ran into trouble. “That highlighted the fact that 2a-7 was inadequate for the challenges money market funds faced,” Adams says.

To remedy this, the U.S. Securities and Exchange Commission (SEC) is considering changes to the regulations,
“The money market sector has proven to be important to a well-functioning financial sector. It’s the grease that allows the financial system wheel to turn.”

–Peter Yi, director of money markets, Northern Trust

and has received proposals from several groups, including the Investment Company Institute (ICI).

The main objective of any regulatory changes would be to manage systemic risk. Currently, about 40 million investors hold registered money market products. When significant redemptions occur, the liquidity in the system is unable to accommodate them, which means sales take place into a distressed market. The proposals are intended to mitigate that.

“In general, we’re looking at the proposals with optimism,” Yi says. “They’re ultimately good for the industry and will strengthen it.”

This convention is an accident of history, Adams says. When the money market fund sector exploded in the 1970s and 1980s, the primary risk was interest-rate risk because rates were rising. That’s changed, and regulators today are more concerned with funds’ exposures to securities that will be held for longer periods of time, which increases risk.

Another proposal would cap the weighted average life maturity (WALM) of a portfolio at 120 days; no current regulation limits this. The WALM indicates when a security becomes liquid and pays off. This change would limit funds’ ability to invest in long-term floating-rate securities.

Several other proposals focus on liquidity, Adams notes. One requires institutional money market funds to maintain at least 10% of their holdings in securities that mature within one day and 30% in securities that mature within one week. The current version of Rule 2a-7 contains no liquidity requirements.

The ICI is proposing a slightly different version of this change. The group suggests that funds keep 5% of their portfolio in securities that mature within one day and 20% in securities with maturities of up to a week.

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A Closer Look at the Proposals
Several of the proposed changes concern the maturities of the securities within money market funds. One would reduce the weighted average maturity (WAM) of a fund’s portfolio from 90 to 60 days. By convention, WAM measures a note with a floating rate to the date of the next interest-rate reset. So, a floating-rate note whose interest rate changes each month is considered to have a WAM of one month, not the time to the final maturity, which could be as much as a year longer.

Either of these changes would slightly shorten most funds’ overall maturities, Crane says. They also might prompt fund managers to focus more on securities that are easily sellable.

Another potential change concerns what are sometimes referred to as “second-tier securities,” or securities rated A2/P2 by Moody’s. Currently, under Rule 2a-7, funds can invest up to 5% of their assets in these securities. Under the proposed changes, money market funds would be restricted to only A1/P1, or the highest quality, securities.
PROPOSED CHANGES IN U.K., EUROPE

Some modifications to money market fund regulations also are likely in the United Kingdom and Europe, says David Rothon, a London-based global fixed-income strategist at Northern Trust, London. He says the Institutional Money Market Funds Association (IMMFA), a trade association representing the European triple-A rated money market funds industry, has formulated several proposals.

IMMFA, working with the European Fund and Asset Management Association (EFAMA) developed some common definitions of money market funds, which hadn’t existed in Europe.

Several other proposals are similar to or the same as those being discussed in the United States. One is a liquidity policy. Funds would have to hold at least 5% of their assets in securities that mature within one day, and 20% in investments that mature within one week. Another proposal would allow a fund to offer a portion of its holdings rather than cash to an investor who wants to redeem his or her holdings. Yet another proposal would require more disclosure of the percent of the fund’s assets held by the top 10% of shareholders, as well as the holdings within the fund.

All of these make up a “code of practice” to which funds would have to adhere. Existing funds, however, would be grandfathered in over a period of time, Rothon says.

Another potential change, if enacted, would require funds to contribute a small amount – perhaps five basis points – to a pool that would be used to offset any future losses.

Together, the proposed changes highlight a trend toward greater transparency and product integrity. “In the future, a fund that takes on more risk will be distinguished from a safer fund with lower return,” Rothon says. “The days of dialing up the risk on a AAA-rated fund in order to boost yield are over. The goal of the proposals is to make sure that 2a-7 or IMMFA funds provide the seal of quality investors expect from a money market fund.”
This proposal has a good chance of moving forward, Adams says. “It’s important to note, however, that such a change wouldn’t have prevented the Reserve Primary Fund from breaking the buck. Lehman was an A-rated issuer until the day it filed for bankruptcy,” Adams says. “Allowing funds to invest in A2/P2 securities enables them to diversify away from financial sector issuers, which account for more than half of A1/P1 securities. An argument can be made for continuing to allow A2/P2 securities in money market funds because it tends to help diversification more than it lowers credit quality,” he adds.

The Debate Continues
Several of the proposals have generated more controversy. One proposal would allow funds to suspend redemptions if their asset values fell below 0.995; that is, if they broke the buck. “Some funds outside the United States already allow this,” says Steve Everett, director, balance sheet and operating assets, Northern Trust. “Some industry experts question whether funds actually can withhold money from investors, even though doing so limits the likelihood of selling into a declining market,” he notes.

Another proposal that’s generated controversy is the recommendation to move from fixed to floating share prices. “There’s an intellectual appeal to a variable net asset value,” Adams says. “It’s difficult to create a fund that always remains at a $1 per-share price without severely restricting investment choices. The pressure to continue operating at $1 per share, even when liquidity was poor and security valuations were under duress,

“The days of dialing up the risk on a AAA-rated fund in order to boost yield are over. The goal of the proposals is to make sure that 2a-7 or IMMFA funds provide the seal of quality investors expect from a money market fund.”

—David Rothon, global fixed-income strategist, Northern Trust
contributed to the stress that money market funds faced during the past year.”

However, this change would create a host of other concerns. As a starting point, money market funds currently are classified as cash in most companies’ balance sheets, Everett says. If a move to a floating NAV is enacted, they would have to be classified as short-term investments. In addition, such a shift would create gains and losses on every trade, creating a tremendous amount of accounting work. “Money market funds are used by investors who trade frequently. Every day, cash flows in and out of the account,” Adams explains. “Daily gains and losses would have to be recorded, each of which could have tax implications for the investor.”

It’s unlikely that this proposal will make it through, as most people think the system works well as it is. Almost all of the comment letters received on the SEC website regarding the idea were opposed to it, Crane says. “No support has materialized for this.”

“It’s widely believed that if money market funds moved to a variable NAV, they would begin to look like ultra-short bond funds,” Yi adds. “This could potentially introduce more volatility to a sector that has always been considered a safe ground for principal preservation.”

Some changes, however, likely will move forward, in part because regulators want to take action. In addition, some updating of money market fund regulation is in order, given that the current regulations are a decade or so old. The SEC has indicated that it would like to have the proposals out by the end of the year, although that could roll into 2010, Crane says.

Yi notes Northern Trust already operates within this framework, focusing first on principal preservation, then liquidity and then yield while also emphasizing credit research and risk management. “Where we will see real benefits from these proposals is by continuing to be a leader within a stronger and more stable industry,” he says.

Steps Investors Can Take

Going forward, investors will want to consider several aspects of a money market fund before investing in it. First, assess the strength of the fund organization, along with its investment process and governance. “People may complain about yield, but they want a solid brand and provider,” Crane says.

To determine this, investors need to focus on the process a company uses to evaluate investments and assess risk. “Until recently, some investors paid little attention to this, treating money market funds like commodities with a sole focus on yield,” Everett says. “Higher rates usually indicate a greater level of risk. It’s important that investors understand that yield is a good thing, but it also can be a red flag,” he adds.

Investors also should review the maturities of the investments in the fund. The shorter the maturities, the greater the ability of the fund to accommodate redemptions.

Investors also might want to consider the level of resources dedicated to credit analysis, he says. Someone other than the portfolio manager should assemble the universe of securities from which the portfolio manager chooses, thus separating credit and investment decisions. “This helps to prevent a portfolio manager from boosting return simply by selecting a lower-quality security with a higher yield,” Everett explains. “Especially for cash, where you want safety, you need good governance.”
The size and composition of the fund also deserves attention. Larger funds, for example, often offer more investor and issuer diversification, so a single investor or holding will have less of an impact on fund management, Yi notes. Investors also should review the maturities of the investments in the fund. “The shorter the maturities, the greater the ability of the fund to accommodate redemptions,” Yi adds.

“Investors also should verify that the fund has the technical tools to readily evaluate its holdings and risks to make informed decisions. Its systems should provide frequent and robust reports,” Yi says. “In addition, a fund should be able to adopt any proposals that are enacted without wavering in its overall investment philosophy and process,” he adds. “The fund family should have the resources to support more stringent reporting requirements that promote greater transparency and disclosures.”

The money market fund also should be a core element of the parent firm’s business, Everett says. In the past, some money fund parents have simply wound down funds that ran into trouble, rather than provide support. Similarly, strong parent companies also are key, as they are more likely to have the resources to support the fund if necessary.

Changing Perspectives
Institutional investors might want to re-evaluate their approach to their cash portfolios, Adams notes. For example, an investor might want to segment the cash portfolio, identifying the portion that needs to stay very liquid versus the amount that can be invested for longer periods. “There will be an array of products across the risk spectrum that provides investors some liquidity and return,” Adams says.

To determine which will provide the best fit, investors will need a solid understanding of the securities, Rothon adds. “There’s no substitute for doing it yourself. You want to lift the bonnet and understand where the risks lie.”
Wealth accumulation has been the focus of defined contribution (DC) plan sponsors and participants worldwide. But as more people reach retirement age, it’s time to put more emphasis on asset distribution and retirement income. That’s the view of one of the top researchers on retirement income in the United States, Jeffrey R. Brown, finance professor and director of the Center for Business and Public Policy in the College of Business at the University of Illinois at Urbana-Champaign.

Dr. Brown recently published a white paper on retirement income solutions in which he says annuities that provide guaranteed income for life ought to play a central role in the portfolio of most retirees. Susan C. Czochara, senior product manager in the DC Solutions Group at Northern Trust, spoke with Dr. Brown about his research, the current state of DC plans in the United States and how to make secure lifetime retirement income a priority.

Susan Czochara: There has been a great deal of focus on asset accumulation within defined contribution plans, but there has not been a focus on the distribution of those assets. Why have policy makers and plan sponsors been slower to address this issue?

Jeffrey Brown: Let’s put this in historical context. The growth of 401(k) plans during the last two decades has, to a large extent, been an accidental development. The 401(k) was never really designed to serve as a retirement security vehicle. Rather, the 401(k) is focused almost exclusively on wealth accumulation. So all the infrastructure that has grown up around the 401(k) system focuses on investment issues such as portfolio allocation. Even the way we communicate with employees about their 401(k) — by reporting account balances — focuses on the 401(k) as an investment vehicle.

It’s only in the last few years — because of the baby boomers moving into retirement and the turbulent economic times — that the weaknesses of the 401(k) system as a source of retirement income have been exposed. And now participants, plan sponsors, policymakers and financial services providers have started focusing on the fact that accumulating wealth is only the first half of successful retirement planning. The second half requires that individuals have successful strategies for converting wealth into retirement income.

Plan sponsors have been caught between a rock and a hard place. We have a regulatory system that has historically discouraged plan sponsors from offering retirement income options within 401(k) plans. In the United States, for example, required minimum distribution rules set a minimum rate at which people must dispose of their assets. But we have no rules preventing them from squandering assets too quickly.

Up until fairly recently, U.S. regulations included the “safest annuity available” provision. That scared a lot of plan sponsors away from including income options in their plans. Essentially, plan sponsors who were successful at getting...
participants to take a lump sum at retirement were considered to have met their responsibilities and faced no more fiduciary risk. But if a plan sponsor wanted to provide participants with options for converting their account into guaranteed lifetime income, the plan sponsor was now subject to potential fiduciary risk through their choice of annuity provider. I think we have this backwards.

Fortunately, those rules have been relaxed. But the perception of fiduciary risk still serves as a disincentive for plan sponsors to provide an income option. Policy change will be required to change that environment.

**Susan Czochara:** Although the policy isn’t there yet to support a shift to provide retirement income, have you seen interest from plan sponsors?

**Jeffrey Brown:** Plan sponsors are increasingly interested in providing guaranteed income options. But most plan sponsors do not want to be the first mover. They want proven, safe approaches that will work for their employees without exposing themselves to unnecessary risks. To move ahead, we’ll need some action from Washington, D.C., just as we needed some encouragement to move to automatic enrollment in the accumulation phase of plans.

**Susan Czochara:** You mentioned how auto-enrollment has helped reduce participant inertia. Do you think having a retirement income solution as part of either a target date

**Jeffrey Brown:** The plan sponsor plays a more important role with in-plan annuities, and if there is one thing we’ve learned from all the behavioral research done during the past decade in the pension world, it is that the plan sponsor and plan design really matters. Employees take cues from how a plan sponsor designs and structures the options in the plan. For example, everybody knows automatic enrollment has had an enormous effect on participation. But we also have learned the menu of investment options can influence investment behavior in ways we might not expect. It may be that consumers view employers as implicitly endorsing certain options, or maybe it’s just inertia on the part of individuals. But whatever the reason, we know that plan sponsor choices matter.

I would like to see income options integrated in the plans from the beginning, during the wealth accumulation phase. Having said that, I am open to alternative approaches, and we have witnessed terrific innovation in this area. If plan sponsors view out-of-plan options as either more cost effective, or as a way to limit their fiduciary or regulatory risk, then that’s fine. But regardless of the approach, I’d like to see these options clearly communicated from the beginning and I’d like to see employers educate their employees about the importance of lifetime income.

**Susan Czochara:** We have seen a lot of product development from investment and insurance providers. Some are trying to include an option within a plan and some are going with a roll-over solution. What are the advantages or disadvantages of each?

“It’s only the last few years — because of the baby boomers moving into retirement and the turbulent economic times — that the weaknesses of the 401(k) system as a source of income have been exposed.”

- Dr. Jeffrey Brown
**Jeffrey Brown:** I think so. We know default, or automatic, mechanisms work. They work in every other part of the retirement savings process, whether it’s to boost participation, to increase contribution rates or to influence portfolio decisions. There’s no reason to think when it comes to the payout decision that consumers will not be subject to the same forces.

It’s time we start thinking about how to design and put together an auto-annuitization mechanism as the default option for withdrawals. It’s admittedly a bit trickier to implement than auto-enrollment because of concerns about defaulting someone into a product that is difficult to get out of. However, my work in this area, as well as that of others, suggests that there are ways to design auto-annuitization policies that achieve the desired retirement security goals while preserving flexibility and choice for participants.

**Susan Czochra:** How do you think policymakers might be able to help plan sponsors support these income solutions for their participants?

**Jeffrey Brown:** The Qualified Default Investment Alternative and auto-enrollment models provide some direction. Those took place over a decade when regulation helped ease the path by clarifying that employers weren’t going to get into trouble if they experimented. So companies did. Then we were able to collect data, and show a positive effect. Then plan sponsors, financial services providers and policymakers got interested in expanding the idea more broadly. They ultimately passed the U.S. Pension Protection Act that paved the way to take the successful models mainstream. We need something similar here. But we’ll have to provide incentives and/or eliminate the disincentives that stand in the way of plan sponsors being willing to move forward.
Susan Czochara: Washington is focused on healthcare reform right now, but will we see new regulations coming from the Department of Labor and U.S. Congress? And when do you think it might happen?

Jeffrey Brown: There’s a lot of interest in this topic. Policymakers understand we don’t have an optimal retirement system. They understand that the lack of income options is one of the most critical issues. Having said that, Congress is in the middle of healthcare reform, and they have climate change on their agenda. There are plenty of major foreign policy challenges on our plate, and we aren’t out of the woods on the macroeconomic issues either. So, I cannot say where exactly retirement income lies on the list of priorities, but I do know that there are a lot of key staffers in the administration and in Congress working on these issues.

Susan Czochara: How can plan sponsors begin to address some of the gaps in retirement income within their plans?

Jeffrey Brown: First, most plans don’t offer any guaranteed income options. You can’t have a conversation with participants if you’re not even offering an option, whether it’s in-plan or out-of-plan. I would love to see plan sponsors take the important step of at least making some

“If you reach age 62 or age 65 with a lump sum of wealth, you’ve only solved half of the problem. You have to turn that wealth into a sustainable income stream.”

- Dr. Jeffrey Brown
type of option available. Second, I'd like to see employee communication about retirement focus on income security and not just on saving enough money for some magical retirement date. If you reach age 62 or age 65 with a lump sum of wealth, you’ve only solved half of the problem. You have to turn that wealth into a sustainable income stream. Those conversations are just not happening.

Susan Czochara: So if plan sponsors start having conversations with their participants, what should sponsors be saying?

Jeffrey Brown: Research shows that if you talk to people in an investment framework where the conversation focuses on account balances, rates of return and the like, then annuities and other retirement income products do not look attractive. If, instead, you provide the same information but frame the conversation as being about having sufficient income that is guaranteed to last for life, then annuities look like extremely attractive forms of insurance. Even during the accumulation phase, sponsors should be focusing on how much monthly income a person will have in retirement, rather than on an account balance. A lot of plan participants think they are doing really well when they have accumulated $100,000, but then are shocked when they discover that this might provide only $500 in monthly income if they buy an annuity, or even less if they don’t. We have to help people understand that retirement saving is about providing a secure source of income for the rest of their lives, not simply retiring with a large account balance.

Susan Czochara: Changing the framework of how participants think makes a lot of sense. It’s our hope that everyone will begin to recognize the difference between wealth accumulation and retirement income. As we look to the next generation of our target date solution, we plan to explore the inclusion of a retirement income component. We agree that there are significant benefits of bundling the income component within the target date strategy for both the plan sponsor and their participants.
Most DC Plan Sponsors Aim for Savings, Not Income

The majority of plan sponsors around the globe say their defined contribution (DC) plans are designed as vehicles for accumulating retirement savings rather than for providing adequate retirement income.

The “Mercer 2009 Global DC Survey” found 55% of DC plan sponsors act as a “facilitator” to building retirement savings, compared with 27% of plan sponsors that have a “paternalistic” objective of securing sufficient retirement income.

The June online survey, which received 1,500 responses from plan sponsors in 33 countries, also found 72% of respondents offer 15 or fewer investment options. The most popular options were balanced funds, 61%; lifecycle funds, including target date, target risk and lifestyling, 57%; and fixed interest gilt/bond funds, 51%.

Automatic features — such as enrollment, contribution escalation and rebalancing — were used by about one-third of the respondents.

For more information, including an executive summary of survey findings, visit mercer.com/globalDCsurvey.

Financial Turmoil Shifts Priorities

The recent financial crisis and ensuing credit crunch has U.K. plan sponsors focused more on matching investment performance to liabilities rather than on increasing longevity risk, according to a new survey.

“The Pensions Pulse Survey” from Lucida, a London-based insurer, found 43% of respondents cited matching performance to liabilities as their top concern, compared with 28% for increasing longevity risk.

In addition, 68% of the respondents to the 2009 survey stated they needed additional funding to manage their plans more effectively, versus 42% for the inaugural survey the previous year.

A copy of the survey can be obtained at lucidaplc.com/knowledge-centre.
U.S. DB Plans Could Get Contribution Relief

A drop in funded status among U.S. defined benefit (DB) plans could result in significant increases in employer contributions unless companies receive relief from regulatory requirements, according to an analysis from Watson Wyatt.

The funded status of U.S. DB plans is projected to fall to 93.8% in 2009, compared with 96.4% in 2008. Recent regulatory and legislative measures provided some funding relief to DB sponsors for 2009, but required contributions for 2010 and 2011 remain large.

The Watson Wyatt analysis notes that without the guidance from the Internal Revenue Service issued in September, funded status for DB plans would have fallen to about 78% in 2010. As a result, employer contributions would spike to about $121 billion in 2010 and $145 billion in 2011. Other measures could push contributions even higher.

Although the recent IRS guidance eases funding requirements through 2010, the contribution levels for 2011 would remain at about $147 billion. Three legislative funding relief proposals would ease contribution requirements through 2011. Watson Wyatt notes this relief would free up financial resources for other corporate purposes, including jobs and investment in plant and equipment.

More information, including a summary of the legislative relief proposals, is available at watsonwyatt.com.

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U.K. Plans Focus on Return

U.K. solutions providers increasingly are recommending target return strategies as the default option for defined contribution plans. The strategies include absolute return targets as well as inflation or interest rate relative targets.

The “2009 PensionDCisions DC Default Provider Survey” also found the majority of respondents, 69%, use default solutions with dynamic or tactical assets allocations or active management, compared with 31% employing fixed asset allocations.

For more survey results, go to pensionDCisions.com.

Investment Fund Options Hold Steady

The average number of investment options in U.S. profit-sharing and 401(k) plans has plateaued at 18, according to a survey from the Profit Sharing/401(k) Council of America (PSCA).

The “52nd Annual Survey of Profit Sharing and 401(k) Plans,” released in September, covers 908 plans with more than $600 billion in assets and 7.4 million participants.

The survey also found the average sponsor contribution was 4.1% of payroll, the same as in 2007. About 1% of respondents indicated they had suspended their employer match of participant contributions.

Other findings from the PSCA survey include:

• The typical plan had 60% of its assets invested in equities, down 5% from the previous year. The most common investments were actively managed domestic equity funds, 23.1% of assets; stable value funds, 13.7%; and target date funds, 8.4%.

• More than eight out of 10 eligible employees, 82.7%, have 401(k) balances, up from 81.9% in 2007. Pre-tax deferrals averaged 5.5% of pay for non-highly compensated workers and 6.6% of pay for highly compensated employees.

• The number of plans permitting Roth 401(k) contributions grew to 36.7% from 30.3% in 2007. Of those eligible to make Roth 401(k) contributions, 15.6% are doing so.

For more information, visit psca.org.
Northern Trust
Attn: Global Institutional Marketing, B-9
50 South La Salle Street
Chicago, Illinois 60603

ADDRESS SERVICE REQUESTED

LOCATIONS

Abu Dhabi
Al Bateen Center
Building C6
1st Floor
Abu Dhabi
United Arab Emirates
+9712 697 3621

Amsterdam
World Trade Centre, H-Toren
Zuidplein 36
1077 XV Amsterdam
Netherlands
+310 20 799 7994

Bangalore
2nd Floor, RMZ Ecospace,
Campus 1C
Sarjapur Outer Ring Road
Bellandur Village, Varthur Hobli
Bangalore
India 560037
+91 80 40178500

Beijing
Yintai Center
Tower C, Unit 2106
No. 2 Jianguomenwai Avenue
Chaoyang District,
Beijing 100022
China
+8610 8513 5300

Chicago
50 South La Salle Street
Chicago, Illinois 60603
United States
+877 651 9156

Dublin
George’s Court
54-62 Townsend Street
Dublin 2
Ireland
+353 1 542 2000

Guernsey
Trafalgar Court
Les Banques St. Peter Port
Guernsey GY1 3DA
+44 14 8174 5000

Hong Kong
Suite 703-4 One Pacific Place
88 Queensway
Hong Kong
+852 2918 9884

Jersey
26 Church Street
St. Helier
Jersey JE4 9F
+44 15 3483 2832

Limerick
Hamilton House 2
National Technology Park
Plassey, Limerick
Ireland
+353 1 542 2389

London
50 Bank Street
Canary Wharf
London E14 5NT
United Kingdom
+44 20 7982 2000

Luxembourg
2 rue Albert Borschette
L-1246 Luxembourg
Grand-Duche de Luxembourg
L-1246 LU
+352 27 62 72 1

Melbourne
Level 47
80 Collins Street
Melbourne, Victoria
Australia 3000
+61 3 9947 9300

New York
65 East 55th Street
24th Floor
New York, New York 10022
United States
+212 339 7474

Singapore
One George Street
#12-06
Singapore 049145
+65 6 437 6666

Stamford
300 Atlantic Street, Suite 400
Stamford, Connecticut 06901
United States
+203 351 8700

Stockholm
Master Samuelsgatan 60
8th Floor
111 21
Stockholm
Sweden
+0046 8 5051 6483

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