

Illinois Public Pensions

A pension management and investment newsletter for Illinois pension funds published by the Illinois Government Finance Officers Association *Winter 2005*

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Illinois Public Pensions

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Using bond swaps to fund pensions and save money

By Jeff Rowitz, Director of Finance, Village of Northbrook and Elizabeth Spencer, Director of Finance, City of Highland Park

Like most municipalities in the area, Northbrook has seen our annual obligation to fund the police and fire pension funds rise dramatically over the last three years. This has been due to poor returns in the stock market combined with increased benefits granted by the state legislature. At the same time, Village revenues (particularly sales and income taxes) have declined due to the national economic problems. As more and more property tax dollars had to be levied for the pension funds, the Village Board became reluctant to raise property taxes for general operations.

The following table shows our tax levy attributed to the pension funds for the last five years:

Fiscal Year	Police Pension	Fire Pension	Total	Percent Change
2000	245,493	328,806	574,299	65.7%
2001	222,101	324,519	546,620	-4.8%
2002	364,346	358,812	723,158	32.3%
2003	598,004	612,923	1,210,927	67.4%
2004	826,392	943,743	1,770,135	46.2%

As shown, the Village's 2003 property tax levy (collected in fiscal year 2004) included \$1,770,135 for the police and fire pension funds. Of this amount, \$1,182,824 was attributed to amortization of our unfunded liability and the remaining \$587,311 was for the normal cost.

We needed to find a way to increase revenues to the General Fund without raising taxes. The initial idea was to "sell" Village bonds directly to our own pension funds. After researching this option we discovered that State law restricts the amount of our bonds that our pen-

sion funds can hold to 10% of their portfolio; but there is no restriction on how much of other municipal bonds can be held. We needed a partner to make this work.

We approached the City of Highland Park and presented an idea where the respective pension funds would buy each other's bonds. We chose Highland Park because they are neighbors, their unfunded pension liability was very similar to ours and they are also an AAA rated community. This was a very good fit.

By issuing 30-year bonds to pay off our April 30, 2004 unfunded liability of \$15.2 million, our annual obligation to the police and fire pension funds has been reduced to the normal cost plus the debt service on the bonds. This is considerably less than we paid under normal amortization.

Northbrook and Highland Park agreed that the amount of the bond issues would be the higher of our unfunded liabilities. Highland Park had unfunded liabilities of \$16.6 million so the bonds were issued in that amount. This created a \$1.4 million overfunding situation for Northbrook, which allows us more flexibility in coming years to smooth out our levy. We issued \$16.6 million in bonds directly to the City of Highland Park and we received a like amount in Highland Park bonds. We will then give these bonds to our pension funds to pay off our unfunded liability.

By issuing the bonds in this manner we were able to structure unconventional debt service in order to increase our cash flow savings. The bonds are structured to amortize 50% of the principal over twenty-nine years with a balloon payment of 50% in year thirty. The balloon payment can be reduced over time by calling in bonds early or we can refinance it at any time. These bonds have open-ended call provisions so we can call any portion we want at any time we want. The interest rate is 4.8%. This was based on the 30-year Treasury rate on October 29th.

As this plan progressed we involved our financial advisor, bond counsel, elected officials, police and fire pension fund boards, fixed income advisors for the pension funds, auditors and our actuary as well as their counter-

parts for Highland Park. As a final review, we also discussed this concept with analysts from Moody's and Standard & Poor's. All of these experts agreed that this plan was legal, allowable and financially sound. To the best of everyone's knowledge, a financing like this has ever been done before, in Illinois or anywhere else.

Northbrook benefits of this bond issue

Both the Village and the pension funds benefit from this transaction. Benefits to the Village include:

1. This transaction will generate cash flow savings that can be re-distributed to the General Fund of \$578,000 for our 2004 tax levy. Annual cash flow savings for the following years will be about \$235,000.
2. Without this bond issue, the total actuarial amortization of this liability over the next thirty years amounts to \$44,964,352. That is the total dollars we would have to pay over the next thirty years to amortize the \$15.2 million liability given current earnings and salary growth assumptions.
3. The total debt service on this bond issue over the next thirty years is \$35,745,114. **That equates to a future dollar savings to the Village of \$9,219,238.** Any bonds we call early will add to that savings.
4. We have locked in our current unfunded liability at a very good rate with the ability to call in bonds in the future if our cash position and interest rate environment warrant.
5. Our pension funds are now \$1.4 million overfunded. The overfunding will give us the ability to increase future year cash flow savings, or it can be held as a hedge against future investment earnings shortfalls. While this slightly reduces our annual savings, this will give us even more flexibility over the next two to four years.

Benefits to our pension funds include:

1. The funds are brought to a fully-funded status well ahead of the 2033 statutory requirement. The Village will have taken a soft obligation and converted it to a

formal debt instrument. Moody's and Standard & Poor's both noted that the Village's willingness to convert the soft obligation to a formal debt instrument would be viewed favorably.

2. The pension funds received \$16.6 million dollars in AAA rated municipal bonds at current market rates. This will give the funds \$925,000 per year in principal and interest that can then be invested as they deem appropriate.
3. The bonds are callable at any time, in any amount, at the issuer's option. Therefore, as Highland Park decides to retire any portion of these bonds early the funds will receive additional cash to invest as they see fit.
4. This has impacted the funds' investment allocation. By adding \$16.6 million in fixed income securities, the funds' ratios of fixed income to equities has changed, allowing the funds to allocate more dollars to equities.

The Highland Park perspective

Similar to the Village of Northbrook, the City of Highland Park has experienced dramatic increases in funding requirements for the police and fire pension funds over the past few years, as illustrated in the table below:

	Police Pension	Fire Pension	Total	Percent Increase
2000 Levy	\$ 339,431	693,620	1,033,051	
2001 Levy	401,644	937,170	1,338,814	29.59%
2002 Levy	804,898	857,391	1,662,289	24.16%
2003 Levy	915,748	858,514	1,774,262	6.73%

Losses in equity investments had reduced the City's funding ratio of the pension plans from 99% and 87% at 4/30/2000 to 71% and 77% at 4/30/2003. As a AAA-rated community, the City was concerned about the decline in the funding ratios but had more immediate demands

for any additional property tax dollars. While Northbrook's joint pension bond proposal did not provide an immediate cost savings for the City, there were other advantages to consider.

First, the flexible call provision of the Year 30 principal allows the City the flexibility to level out pension requirements over time. In years when pension fund investments earn high returns, lowering the tax levy requirement, the City will call additional principal. While the City's intent is to have paid the Year 30 principal by the maturity date, we will have avoided the budget constraints of fluctuating pension requirements over the term of the bonds. Second, the pension funds will be fully funded, as the unfunded liability will be replaced with Village of Northbrook pension bonds earning a 4.8% interest rate. As bonds are called by the Village, additional cash will be available for investment by the pension boards.

Currently, both Northbrook and Highland Park have a "AAA" bond rating. Representatives from both municipalities met with staff of Moody's Investors Service to assess the impact of the proposed bond issue on the City's bond rating. Moody's noted that the proposed bond issue is a unique, but viable option for funding pension obligations. They noted that in conducting subsequent rating reviews, this bond issue would be viewed differently than other debt obligations. It was noted that the municipalities' decision to convert a "soft" pension obligation into a formal debt instrument would be viewed favorably, provided the overall debt burden remained reasonable.

There is a risk that either municipality could experience a bond rating downgrade during the 30-year term of the bonds. A rating downgrade would reduce the credit quality of the bonds held by the other municipality. Therefore, the City requested that the two municipalities execute an intergovernmental agreement that states that in the event of a rating downgrade, either issuer would be required to purchase bond insurance for the remaining outstanding bonds to assure that the other municipality continues to hold a AAA-rated investment for the entire term of the bonds.

The City is considering two options regarding the Northbrook bonds. The bonds could be held by the City or transferred to the pension funds. If transferred to the pension funds, the funds would receive millions of dollars in additional investments earning a taxable rate of return. These investments are administered by the pension fund boards and could be sold, potentially for a loss, increasing the pension liability to the City. Should the City desire to transfer the bonds to the pension funds, it will be staff's recommendation that the City enter into written agreements with both pension fund boards agreeing to hold the investments to maturity unless the City Council and the Pension Fund Board mutually agree to sell the bonds.

Completing the plan

The most difficult and time-consuming aspect of this transaction was getting everyone involved to understand and support this plan. We each had to explain the plan and the benefits to elected officials, fire pension board members, police pension board members, credit rating analysts, residents, and other interested members of the community. The most common initial reaction was along the lines of "this is too easy, what am I missing?" Some people initially concluded that this was accounting trickery or "smoke and mirrors." By fully explaining all aspects and answering all questions thoroughly, we were able to show that this was a rare "win-win" situation for both municipal employers and all four pension funds. The bond issues were approved and closed on November 29, 2004. Moody's assigned a AAA rating to both issues and Standard & Poor's also rated the Northbrook bonds AAA.

Social Security Protection Act requires new notices

Section 419(c) of Public Law 108-203, the Social Security Protection Act of 2004, requires State and local government employers to disclose the effect of the Windfall Elimination Provision and the Government Pension Offset to employees hired on or after January 1, 2005, in jobs not covered by Social Security. The law requires newly hired public employees to sign a statement that

they are aware of a possible reduction in their future Social Security benefit entitlement. Form SSA-1945 explains to your new employee the potential effects of two provisions in the Social Security law on workers who also receive a pension based on their work in a job not covered by Social Security:

- The Windfall Elimination Provision affects the amount of Social Security retirement or disability benefits, and
- The Government Pension Offset Provision affects the amount of Social Security benefits received as a spouse or an ex-spouse.

Social Security will not be setting any additional guidelines for the use of this form. To download the form visit <http://www.ssa.gov/form1945/SSA-1945.pdf>

For more information, contact A. Darryl Swain at the Social Security Administration's Chicago Regional Office, 312-575-4239, or at darryl.swain@ssa.gov

Scholarships available through GFOA

Watch the GFOA website, www.gfoa.org for applications to open for scholarships. Scholarships include:

Daniel B. Goldberg Scholarship: \$10,000 awarded to a graduate student who is enrolled in full-time master's study preparing for a career in state and local government finance. This scholarship is funded by the Government Finance Officers Association and the Girard Miller Foundation.

Frank L. Greathouse Government Accounting Scholarship: \$3,500 awarded to one or more senior undergraduate students enrolled in full-time study preparing for a career in state and local government finance.

George A. Nielsen Public Investor Scholarship: \$5,000 (may be two awards of \$2,500 each) awarded to an

employee of a local government or other public entity who is enrolled or plans to enroll in an undergraduate or graduate program in public administration, finance, business administration, or related field. The purpose of the Public Investor Scholarship is to support the studies of full- or part-time undergraduate or graduate students with career interests in the efficient and productive investment of public funds.

Minorities in Government Finance Scholarship:

\$5,000 awarded to an upper-division undergraduate or graduate student of public administration, governmental accounting, finance, political science, economics, or business administration (with a specific focus on government or nonprofit management). This GFOA scholarship is funded by Fidelity Investments Tax-Exempt Services Company.

Public Employee Retirement Research and

Administration Scholarship: \$4,000 is available for award to a graduate student in public administration, finance, business administration, or social sciences. This GFOA scholarship is funded by the ICMA Retirement Corporation. The purpose of the Public Employee Retirement Research and Administration Scholarship is to support the studies of a full- or part-time graduate student preparing for a career in the field of public-sector retirement benefits.

The application process usually begins in November with applications due in February for the following year's awards. For more information visit

<http://www.gfoa.org/services/scholarships.shtml>

2004 cases of interest

Coyne v. Milan Police Pension Board, Third District Appellate Court No. 3-03-0066 (April 13, 2004). The village's police pension board erred when it denied plaintiff's application for disability benefits because its decision to accept one doctor's opinion and one report based on one interview was against the manifest weight of the evidence, and Section 3-115 of the Pension Code did not

require unanimity among the three physicians selected by the board.

Village of Stickney v. Board of Trustees of the Police Pension Fund of the Village of Stickney, First District Appellate Court No. 1-03-1111 (March 30, 2004). The village did not have a right, under the Illinois Pension Code, to intervene in a hearing on one of its police officer's application for a duty-related disability pension because the village was not a "party in interest," and the pension board had the power to decide whether to allow a party to intervene.

Alm v. Lincolnshire Police Pension Board, Second District Appellate Court No. 2-03-1174 (Sept. 22, 2004). Plaintiff was entitled to line-of-duty disability benefits because his knee injury occurred while pedaling his patrol bicycle which was an act of duty that involved special risks.

Taddeo v. Board of Trustee of the Illinois Municipal Retirement Fund, First District Appellate Court No. 1-03-2950 (Sept. 27, 2004). Plaintiff was entitled to his pension benefits in relation to his position as township supervisor, because his felony conviction was in relation only to his position as mayor, and there was no nexus between his felony conviction and his position as township supervisor.

City of Rockford v. Unit Six of the Policemen's Benevolent and Protective Association of Illinois, Second District Appellate Court No. 2-03-0774 (July 21, 2004). Whether police officers were entitled to workers' compensation benefits for wages earned from off-duty employment after suffering on-duty injuries was not subject to binding arbitration because, pursuant to the collective agreement between the city and the officers' association, the arbitrator was prohibited from addressing any issue that wasn't part of the agreement, and the issue of workers' compensation benefits was not addressed in the agreement.

General Dynamics Land Systems, Inc. v. Cline, United States Supreme Court No. 02-1080 (Feb. 24, 2004). The Age Discrimination in Employment Act (ADEA), which prohibits discriminatory preference for the young over

the old, does not also prohibit favoring the old over the young because the text, structure, purpose, and history of the ADEA, along with its relationship to other federal statutes, clearly indicated that the ADEA was intended to protect the discrimination against those that were older.

As reported by the Illinois Municipal League in the December 2004, Illinois Municipal Review. For more details, visit <http://www.iml.org> and visit the Legal section.

New firefighter pension benefits bump up unfunded liabilities

Village of Arlington Heights summarizes impact of Public Act 93-0689

In a November 2004 report to the Village of Arlington Heights' Police and Firefighter Pension Fund Presidents, Finance Director and Treasurer Thomas Kuehne noted:

“. . . the Police and Fire Pension benefit increases mandated by the State over the past few years are continuing to put pressure on the Village's General Fund and on local property tax rates. As a home-rule community, the Village could pass on the cost of these pension benefit increases to property tax payers; however, the Village has worked to keep its truth-in-taxation property taxes increase below the five percent. To accomplish this, the Village has had to make up the difference in its General Fund and Capital Project Fund tax levies. Like most municipalities we are still struggling with a lackluster revenue base, and our ability to pay for all Village services is being stretched thin, and the public's willingness to pay higher property taxes is being tested.

While the pension benefit increases are well deserved, the current economic climate may dictate a scenario where continued public safety pension benefit increases may no longer be able to be approved below the political

radar. There isn't a coordinated political outcry yet, but we may be reaching that point, as the cost to continually improve these benefits without the State providing an alternate revenue is proving to be difficult. In the meantime, let's hope the pension fund investment returns improve further, as well as the Village's other revenue sources."

He further advised the Pension Funds that, as approved in PA 93-0689, "Firefighters will contribute an extra 1% of their wages toward the new benefits, and the additional amount the Village will be required to pay is estimated at \$300,000 per year. This will be payable starting with the 2005 tax levy, and will be in addition to an increase due to annual investment earning underperforming the long-term actuarial assumption of 7.5% earnings." A synopsis of actuarial impacts of PA 93-0689, as prepared in October 2004 by Goldstein & Associates for the Village of Arlington Heights, is shared below:

May 1, 2004 evaluation	without PA 93-0689		with PA 93-0689	
Actuarial Liability for Members Receiving Benefits	\$34,965,849		\$38,124,120	
Actuarial Liability for Inactive Members	\$463,026		\$487,019	
Actuarial Liability for Active Members	\$24,755,440		\$26,417,331	
Total Actuarial Liability	\$60,184,315		\$65,028,470	
Actuarial Value of Assets	\$46,747,334		\$46,747,334	
Unfunded Actuarial Liability	\$13,436,981		\$18,281,136	
Funded Ratio	77.67%		71.89%	
	\$ amount	% of payroll	\$ amount	% of payroll
Employers Share of Normal Cost	\$1,404,548	19.89%	\$1,447,920	20.51%
Annual Amount required to amortize unfunded liability over 40 years subsequent to 7-1-93 as a level % of pay	\$730,247	10.34%	\$993,507	14.07%
Annual Actuarial Requirement	\$2,134,795	30.24%	\$2,441,427	34.58%

Financial markets commentary

By Mark F. Toledo, CFA

Risk management

Volatility of returns represents the most widely used definition of risk. Traditional risk management efforts focus on maximizing the expected return for a level of volatility or minimizing volatility for a targeted return through asset class diversification. This process provides a useful means for identifying the probability of attaining long-term financial goals if the investor has the fortitude to stay with a long-term investment plan.

The most damaging risk that investors face results from changing a “long-term” plan as a result of intermediate term results. This risk manifests itself in the possibility of buying near a cyclical peak or selling at a cyclical low. Many investors have succumbed to this phenomenon over the past five years. For example, during the first quarter of 2000 mutual fund investors deposited \$140 billion into equity funds, just as the stock market was peaking and entering an extended decline. Mutual fund investors then withdrew \$72 billion from equity funds in the third quarter of 2002, during a bear market low.¹ The risk of making a change to a long-term investment plan at the wrong time cannot be under-estimated.

This commentary will review traditional risk management through effective diversification and then explore other measures of risk to minimize the potential of making a change in investment policy at the wrong time.

Effective diversification

The foundation for traditional risk management is the combination of asset classes in a portfolio that do not move in the same direction at the same time. As a result, the total portfolio will dominate the individual securities in terms of optimizing the risk reward tradeoff. Table 1 shows risk return plots for Treasury Bills (T-bill), Large Cap Core (LCC), Large Cap Value (LCV) Small Cap Value (SCV), Small Cap Core (SCC), International Value

(IV), International Small (IS), Real Estate (RE) and a Globally Diversified Equity Portfolio (GDEP) for the period January 1973 through December 2003.²

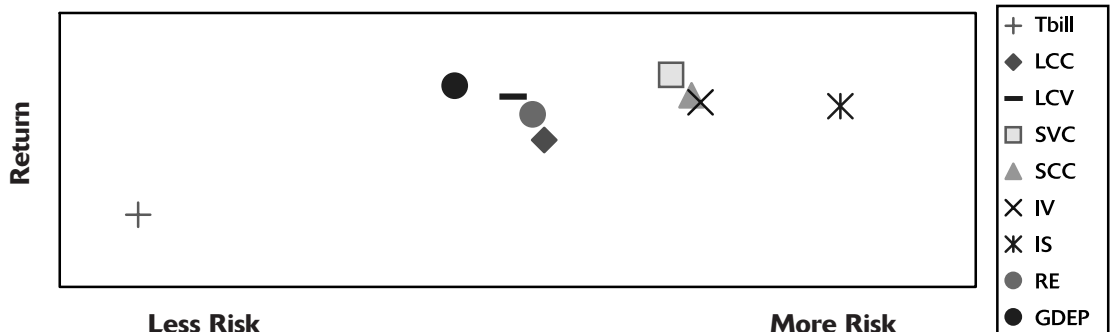
Table 1 below shows that Treasury Bills produced the lowest annualized return and volatility of returns over this time period. Small Cap Value stocks produced the highest return and International Small Cap equities generated the most risk. The Globally Diversified Equity Portfolio plot shows the results achieved by combining the seven equity styles in a portfolio.³ This portfolio does not produce either the highest return or the lowest risk. However, the portfolio does present the best set of risk reward characteristics by presenting the lowest level of risk for the expected return.

Risk resulting from underperforming the S&P 500

The potential for changing the long-term targets for the equity style allocations of a portfolio at the wrong time presents a risk for investors. For example, equity mutual fund investors deposited over 90% of the \$140 billion invested in equity funds into growth style funds and withdrew \$40 billion from value funds during the first quarter of 2000, just as the growth style was entering a period of under-performance and value a period of superior performance.⁴ This hazardous behavior resulted from the loss of patience with the under-performance of value funds relative to the S&P 500 during 1998 and 1999.

The first step in managing this risk is to recognize that to “outperform” the S&P 500 you must construct a portfolio that is different than the index. Hopefully, the “dif-

Table 1
Traditional
Risk
Management

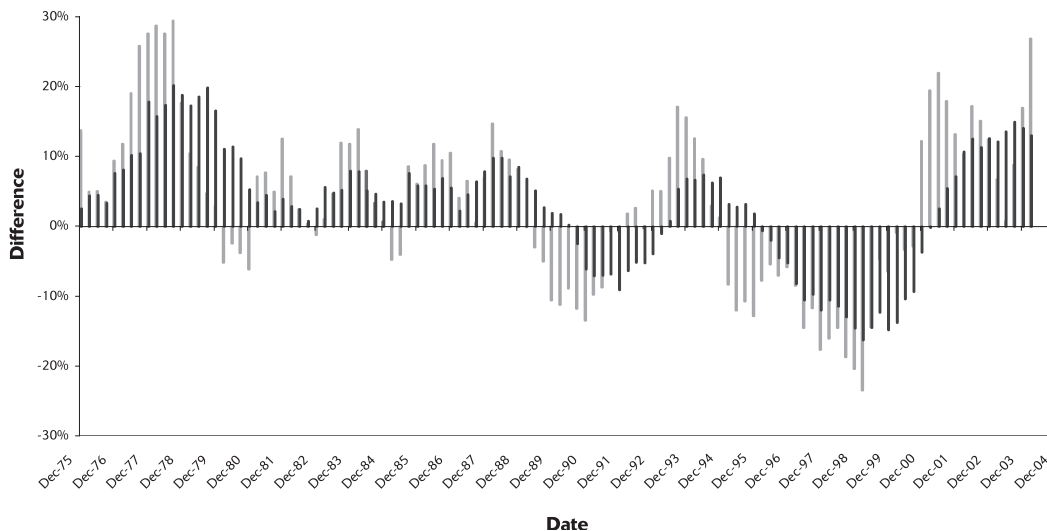


ference” means that the portfolio will produce annual results that outperform over the long-term, but may have a high probability of periodically under-performing on an intermediate term basis (one to three years). For example, Table 2 shows the one and three year difference in annualized total returns for the Globally Diversified Equity Portfolio and the S&P 500. The lighter grey bars represent the one-year and the darker grey bars represent the three-year difference.

The annualized return for the Globally Diversified Equity Portfolio during the January 1973 to December 2003 timeframe was 14.8% versus 11.1% for the S&P 500. However, in order to realize this superior return, an investor needed the fortitude to stay with the asset allocation during one and three year periods of significant under-performance relative to the S&P 500. The worst one-year under-performance occurred during the twelve months ending March 1999. The light grey bar for this date shows that the Globally Diversified Equity Portfolio underperformed the S&P 500 by 23%. Additionally, the dark grey bar shows an under-performance relative to the S&P of 16% for the three years ending March 1999.

Small capitalization, foreign, real estate and value-oriented equity styles offer diversification and enhanced return potential for portfolios because these segments of the equity universe often operate in a cycle that is not highly correlated with the S&P 500. As a result, the Globally Diversified Equity Portfolio will perform sub-

Table 2
One-Year &
Three-Year
Difference



stantially different than the S&P 500 over intermediate time frames. Investors must acknowledge this risk and be willing to accept it so that they do not join the crowd and sell value style funds during periods like early 2000 to load up on the S&P 500.

Risk of capital loss

Table 3 shows that in addition to offering superior returns with less volatility, the Globally Diversified Equity Portfolio also reduced the risk of capital loss during the January 1973 to December 2003 time period. The lowest annual return for this effectively diversified portfolio and the S&P 500 occurred from October 1973 through September 1974 when the portfolio's annual return of -33.6% was modestly less than the S&P 500's return of -38.9%. The benefits of effective diversification were more apparent during the worst three-year period from April 2000 through March 2003, when the annualized total return for the Globally Diversified Equity Portfolio was -5.0% versus -16.2% for the S&P.

Table 3 Risk & return statistics Jan 1973 to Dec 2003⁵

	Annualized Return	Standard Deviation	Lowest 1-Year Return	Lowest 3-Year Return
GDEP	14.8	14.6	-33.6 (10/73-9/74)	-5.0 (4/00-3/03)
S&P 500	11.1	15.9	-38.9 (10/73-9/74)	-16.2 (4/00-3/03)

⁵ *Source: Dimensional Fund Advisors, Inc.*

To further reduce the risk of capital loss we can add high quality intermediate term bonds to the portfolio. Bonds provide steady, reliable streams of income, and reduce both volatility and capital loss risk. The highest quality bonds perform best in times of severe stress, allowing investors to view the opportunity costs of holding bonds as an insurance premium that enhances the ability of the portfolio to survive traumatic periods.

Table 4 on page 8 shows the risk reduction effect of adding higher allocations to high quality intermediate term bonds.

Table 4 shows that by increasing the bond allocation from 0% to 40%, the lowest annual return rises from -33.6% to -18.1%. Additionally, the lowest annualized three-year return rises from -5.0% to -0.1%. The reduction in the annualized return from 14.8% to 12.6% represents the insurance premium paid for the partial protection against loss of capital.

Table 4 Balanced strategies for Jan 1973 to Dec 2003⁶

Stock allocation	100%	80%	60%	40%	20%	0%
Bond allocation	0%	20%	40%	60%	80%	100%
Annualized Return	14.8	13.8	12.6	11.4	10.0	8.6
Standard Deviation	14.6	11.7	8.9	6.2	3.8	2.6
Lowest Annual Return	-33.6	-26.2	-18.1	-9.4	-1.2	-1.1
	(10/73-9/74)	(10/73-9/74)	(10/73-9/74)	(10/73-9/74)	(2/94-1/95)	(1/94-12/94)
Lowest Annualized 3-Year Return	-5.0	-2.5	-0.1	2.2	4.5	4.1
	(4/00-3/03)	(4/00-3/03)	(4/00-3/03)	(4/00-3/03)	(4/00-3/03)	(1/92-12/94)

This insurance premium would be very valuable if it prevented an investor from joining the crowd of mutual fund investors that were selling common stocks in the third quarter of 2002 as the general equity market was reaching a bear market low. However, the cost for this protection must be recognized. The reduction in the annualized return from 14.8% to 12.6% over the full 31 year time frame represented in Table 4 means that the ending value for a \$1 million portfolio with no cash flows would drop from \$72.1 million to \$39.6 million.

Conclusion

Effective diversification through asset allocation should be the first risk management tool employed for a portfolio. The asset allocation process exemplifies the importance of combining art and science in portfolio construction, as neither informed judgment nor quantitative analysis alone produce consistent successful results. In the long run, sticking to your asset allocation plan is more important than picking the “right” one.

The most costly risk results from succumbing to emotional responses to intermediate term investment results. The assessment of this risk requires qualitative judgments about potential behavioral responses to future financial conditions. As evident by the last five-years, the risks of under-performing the S&P 500 and capital loss can be interrelated and accompanied by other risk, such as reduced employment income and health setbacks. As a result, every investor should have a reserve portfolio of intermediate term fixed income securities to meet potential spending needs over a two to five year time horizon. The reserve portfolio reduces the probability of a “forced” sale of equities in the latter stages of a bear market.

The hardest work in investing is emotional, not intellectual. Providing rational advice in an emotional environment is the most important risk reduction service that an investment advisor provides to clients.

Notes

¹ Source: Bianco Research, LLC and Investment Company Institute

² Source: Dimensional Funds Advisors, Inc.

³ Globally Diversified Equity Portfolio consists of 20% large cap core, 20% large cap value, 10% small cap core, 10% small cap value, 15% international value, 15% international small and 10% real estate.

⁴ Source: Investment Company Institute

⁵ Source: Dimensional Fund Advisors, Inc.

⁶ Source: Dimensional Fund Advisors, Inc., Matrix 2004, p 61

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Survey finds conflicting attitudes toward health benefits

Employer efforts to warn employees about the impact of rising health care costs are falling on skeptical ears, according to a Towers Perrin survey.

Sixty-nine percent of executives and managers at more than 120 major U.S. companies said they've begun educating employees about the business impact of rising health care costs, and 70% believe they do an effective job at it. But only 34% of the 1,000 employees surveyed agreed that rising health care costs have implications for the success of their companies, while 43% disagree.

What's more, just about half (53%) of employees said they believe what their companies say about rising health care costs.

"The major disconnect is that employers have focused on employer cost and employees are focusing on their own self-interest and therefore the employer communications either don't address the employee interests or create skepticism," says Rich Ostuw, principal with Towers Perrin.

Just 28% of employees surveyed felt it was appropriate for employers to ask them to absorb further health cost increases, a sharp drop from 46% last year. Yet employees said they were open to changing their health care behavior if it's in their interest. Employer-provided resources they said they valued most include health-related Web sites and independent nurse lines.

*From June 15, 2004 Connect newsletter produced by Employee Benefit News(c) 2004 Thomson Media, One State Street Plaza, 25th Floor, New York, NY 10004;
www.BenefitNews.com*

Baby boomers retirement woes catch attention of Congressional Budget Office

The approaching retirement of the baby-boom generation has become a public concern—partly because of the budgetary pressures that will develop when baby boomers collect Social Security and Medicare benefits, but also because of claims that boomers are not accumulating enough private savings to finance their retirement. However, there is no widely accepted standard of

what constitutes “enough” savings, mainly because retirement preparations are largely a matter of personal choice. Recent studies apply a range of different standards and provide a more complete picture of boomers’ finances.

Compared with their parents at the same age, baby boomers typically have higher income, are preparing for retirement at largely the same pace, and have accumulated more private wealth. On the whole, boomers are on track to have higher income in retirement than their parents and appear much less likely to live in poverty after they retire.

Within that overall picture, however, about a quarter of baby-boomer households have so far failed to accumulate significant savings. They appear likely to depend entirely on government benefits in retirement. At the other end of the spectrum, at least half of the households are expected to maintain their working-age standard of living during retirement (under the assumption that current laws governing federal benefit programs do not change). For the remaining quarter of boomer households, the evidence is mixed: under midrange assumptions about saving, rates of return, and retirement age, they appear set to experience moderate declines in their living standard during retirement, which could be offset by modestly increasing saving and by working for a few more years. For many boomers, a relevant issue is the degree to which they could be affected by—and plan for—any future changes in federal retirement benefits.

Concerns about boomers’ retirement

Baby boomers—people born between 1946 and 1964—make up one of the largest and most prosperous generations in U.S. history. As a group, boomers have enjoyed higher income during their working years than any preceding generation, and they have been accumulating substantial savings, in part to provide for their retirement. As they move out of the workforce and into retirement over the next 25 years, boomers will begin to draw on those savings, collect private pensions, and become eligible for benefits from government programs such as Social Security and Medicare.

That impending wave of retirements has become a source of concern for two reasons. First, the population of retirees will grow much more quickly than the tax-paying workforce, at a time when average benefits per retiree are expected to continue rising. Those developments will place severe and mounting budgetary pressures on the federal government.¹ Second, some researchers have questioned whether many boomers are accumulating enough wealth to pay for an adequate retirement. Not only could inadequate saving leave boomers poorly prepared, but it could compound the government's budgetary problems by limiting the growth of investment, productivity, and wages (which drive federal revenues).

The Congressional Budget Office (CBO) recently reviewed the research that has been conducted over the past decade on the retirement prospects of aging Americans.² That review reveals a mixed picture of boomers' futures. Because retirement preparations are largely a matter of personal choice, there is no widely accepted standard of what constitutes an adequate or appropriate level of retirement income or consumption. In the absence of a single standard, researchers have used a number of different measures to assess the adequacy of retirement preparations; the application of a variety of measures produces a variety of conclusions.

Prospects compared with their parents'

Some studies have compared boomers' finances with those of preceding generations; others compare them with the official poverty level. Those studies conclude that, on the whole, boomers will almost certainly be better off in retirement than their parents and much less likely to live in poverty.

Baby boomers have benefited greatly from productivity growth, rising real (inflation-adjusted) wages, and the increasing participation of women in the labor force. Although the benefits of prosperity have been distributed unevenly, boomers generally have higher per capita income than their parents did at the same age, are preparing for retirement at largely the same pace as their parents, and have accumulated more wealth. Boomer families have roughly the same wealth-to-

income ratio that families of the same age nearly 20 years earlier had. See Table 1. Those observations suggest that boomers' saving behavior is much the same as that of their parents—and, furthermore, that baby boomers are not the source of the long-term decline in the overall personal saving rate in the United States.⁵

Prospects compared with current standards

Most studies of retirement preparation use a standard derived from economic theory suggesting that people will generally try to maintain roughly the same level of well-being throughout their lifetime. According to that standard, boomers are making adequate preparations for retirement if they are on track to accumulate enough resources during their working years to continue their working-age standard of living when they retire. That standard is relative because it depends on how much income people can expect to have over their lifetime. However, if the standard roughly matches how people actually behave, it may measure whether they are making sufficient preparations to meet their own perceived needs.

Taken together, the studies that apply such a standard suggest that roughly half of boomer households are on track to accumulate enough wealth to maintain their current standard of living if the heads of those households retire when they now plan to. At the other end of

Table: Ratios of Family Wealth to Income, by Age of the Head of Household

Median family wealth to median family income			
	1983	1992	2001
Ages 35 to 44	1.5	1.2	1.5
Ages 45 to 54	2.2	1.9	2.4
Median family wealth to average family income			
	1983	1992	2001
Ages 35 to 44	2.7	2.9	3.4
Ages 45 to 54	5.2	4.7	5.2

Source: Congressional Budget Office using tabulations from Federal Reserve Board, Survey of Consumer Finances.

Note: These measures of family income include most kinds of before-tax income; the measures of family wealth include most kinds of private wealth (net of liabilities) but do not include expected Social Security and Medicare benefits.

the spectrum, perhaps a quarter of the households—many of them low-income households with low-skilled workers—have accumulated very few assets thus far and are likely to find themselves largely dependent on government benefits in retirement. For some of those low-income households, Social Security benefits will be sufficient to let them maintain their working-age consumption (because Social Security benefits replace a larger share of previous earnings for low-income households than for high-income ones). Nevertheless, other households in the low-saving group could face a decline in their standard of living in retirement.

For the remaining quarter of boomer households, the evidence is more mixed. Studies that use relatively optimistic assumptions about how much wealth those households will be able to accumulate before retirement—and that use broad measures of how much wealth they have—conclude that they are reasonably well prepared. For instance, if those households are projected to earn fairly high returns on their savings, to work until they qualify for full Social Security benefits, and to draw on their housing equity to finance some of their consumption in retirement, most of them should be able to maintain their current living standard. Conversely, studies that apply more-pessimistic assumptions or that use more-restrictive measures of wealth conclude that members of those households may face significant shortfalls: if they earn relatively low returns on their savings, retire before age 62, and never choose to draw on their housing equity, they may experience a significant decline in consumption during retirement. Under a midrange set of assumptions, many of those households appear likely to face relatively modest shortfalls that could be offset by increasing saving and by working for a few more years.

The effects of delaying retirement

For households facing shortfalls in their retirement savings, relatively small changes in behavior can have surprisingly large effects. Because people who retire at 62 can expect to live another 20 years, each year they postpone retirement reduces their need for retirement savings by about 5 percent. An extra year of work also

increases their Social Security benefits by several percent. Taken together, those effects lessen the total amount that people need to save, and the additional year gives them time to save more and earn returns on the assets they have already accumulated. As a result, households can make up for earlier shortfalls in retirement savings with surprisingly modest changes in behavior.

The role of Social Security

Nearly all of the studies that CBO reviewed assume that Social Security and other government benefits will be paid as prescribed by current law. However, budgetary pressures could result in lower benefit levels for some recipients in the future. Because baby boomers in the lowest quarter of the income distribution are likely to depend on government benefits for nearly all of their income in retirement, their current prospects depend heavily on the future of Social Security.

Furthermore, people's saving behavior is influenced by their expectations about future benefits. To the extent that baby boomers believe they will receive all of the government benefits to which they would be entitled under current law, that expectation may induce them to work or save less than they would otherwise. Conversely, to the extent that they recognize the looming difficulties in funding those programs, they may increase their saving or retire at a later age than they had originally planned.

Notes

- ¹. For more details, see Congressional Budget Office, *The Long-Term Budget Outlook* (December 2003), *A 125-Year Picture of the Federal Government's Share of the Economy, 1950 to 2075*, Long-Range Fiscal Policy Brief No. 1 (June 14, 2002; revised July 3, 2002), and *The Looming Budgetary Impact of Society's Aging*, Long-Range Fiscal Policy Brief No. 2 (July 3, 2002).
- ². See Congressional Budget Office, *Baby Boomers' Retirement Prospects: An Overview* (November 2003).
- ³. The causes of that decline are not fully understood.

Some evidence suggests that it may be related to an increasing propensity to consume on the part of older people, combined with the government's redistribution of income to those older people. For more details, see Jagadeesh Gokhale, Laurence J. Kotlikoff, and John Sabelhaus, "Understanding the Postwar Decline in U.S. Saving: A Cohort Analysis," *Brookings Papers on Economic Activity*, no. 1 (1996), pp. 315-407.

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Questions for investment managers

For the purpose of this questionnaire, soft dollars or soft commissions include any third-party or broker services you receive in addition to execution, whether these arrangements are explicit or implicit.

1. Where you are not using execution, only brokerage, please list other services that you buy or benefits that you receive from a broker (such as research and access to IPOs). Please explain how you evaluate the benefit these generate for us relative to the cost.
2. If you use both external research and in-house research explain what distinguished the former, for which we pay an additional charge, from the latter, which is covered by your management fee, and how you decide which to use.
3. Please provide any policy document you have on the firm's use of soft dollar arrangements.
4. Last year, what percentage of transactions in listed securities involved the use of soft dollars? What was the average commission paid, in cents per share, on trades involving the use of soft dollars versus trades involving executions only?

5. What were the total commission dollars paid for your portfolio last year? Of these, can you provide an estimate of the amount that could be attributed to non-execution services?
6. Have you evaluated the execution quality of soft dollar brokers versus execution-only brokers? If so, can you provide us with the result or the conclusions?
7. If you wish to make a case for soft commission arrangements, explain how our interests are better served by the broker providing you with services rather than by securing lower trading costs for us.

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The IRS can help contact missing participants or beneficiaries

With appropriate safeguards to protect the privacy rights of each tax-paying citizen, the IRS affords employers an opportunity to try and contact their former employees.

Known as the **Letter-Forwarding Program**, the service offers assistance to individuals who have retained the social security numbers of the persons they wish to contact, but whose address or whereabouts currently are unknown to the inquirer. For humanitarian purposes (which includes financial entitlement) the IRS will search its database for a recent address and forward the inquirer's letter to the missing person. Revenue Procedure 94-22 provides instructions and information on the IRS' use of the letter-forwarding program.

For more information, visit
<http://www.irs.gov/retirement/article/0,,id=110106,00.html>

Retirement plan quality: An issue around the world

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Dublin, Ireland—September 15, 2004: Mercer today welcomed the changes announced by the Government for pensions for public sector employees, but cautions over the expected costs.

A key change will be the introduction of a facility to retire early. Currently, public servants can retire from age 60 without a reduction factor being applied to their benefits. However, retirement before age 60 is not facilitated. The new provision will facilitate early retirement from age 50 with a reduction factor applied to achieve a cost neutral effect.

Minimum retirement age for new entrants to the public sector had been raised from age 60 to age 65.

From <http://www.mercerhr.com>

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