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Subject: **RETIREMENT PLANS INDUSTRY OUTLOOK: Part II**

From: CFDD

EXECUTIVE SUMMARY

DC plans are the most successful retirement plan savings vehicle in history, but Americans are clearly not saving enough for retirement. While the U. S. retirement plans market is huge, it has matured and plan formations have peaked. DC plans will continue to play an important role and individual participant assets could continue to grow, but overall asset growth could be limited.

Asset retention is already a problem for retirement plan providers and **declining net inflows could cause non-IRA retirement plan assets to shrink in the years ahead.** Nevertheless, **there will always be pockets of growth and new opportunities.** The opportunities may, however, be limited to well managed specialists with scale, efficiency and marketing savvy.

As the industry moves to wholesale pricing and away from alpha chasing strategies at the plan level, retirement plan margins could shrink. New disclosure rules and litigation could further pressure margins for vendors and advisors.

The number of 401k plans has risen in recent years, but the total number of corporate DC plans decreased to 631,000 at the end of 2005, down from 686,000 at the end of 2002. Similarly, the number DC plan participants peaked in 2000 at 53 million and currently total about 52 million. Many employers who previously sponsored more than one plan have consolidated them into a single plan and there has also been a reduction in the number of DB plan conversions. The consolidation of plans will impact contributions because older DC plans covered virtually all employees while 401k plan participation is about 75%.

On the other hand, the PPA's automatic enrollment arrangements, the need to save, deferred retirements and high quality retirement income products will have a positive impact on contributions. Automatic enrollment may not, however, work for small plans. The general media will never admit it, but employer sponsored plans are by far the most cost effective way to save. A small number of large plan sponsors have recognized this and they are starting to encourage departing participants to leave their assets in the plan. The Paychex types are also still banging out start ups in the small plan market.

ASSETS, NET FLOWS & RETURNS

Based on the latest Federal Reserve flow of funds data, employer sponsored plans - DB, DC, private, public & federal - contained \$10.2 trillion in assets at the end of 2007, up 3% from 2006.

The Fed reported corporate DC plan assets at \$3.5 trillion at year end, up 5.7% from the prior year. They also reported corporate DB plan assets at \$2.35 trillion, down 1.7% from the prior year.

Fueled by rollovers, IRA assets were reported at \$4.2 trillion at the end of 2006, the latest year available, **up 17% from the prior year**. IRAs are fragmented, but collectively they represent **25% of total retirement plan assets**, more than double the level of a few decades ago. The majority of IRA households are covered by employer sponsored plans and while they are eligible to make IRA contributions, few do so.

Total retirement plan assets increased in 2007, but **“net” inflows into corporate DC plans were reported at \$13.2 billion, down 73% from 2006**. Net DB plan **“outflows” totaled \$80.8 billion, almost twice the level reported during 2006**.

As you can see, the decline in “net” contribution levels to corporate sponsored DC plans is in sharp contrast to asset growth. Ignoring broad market investment returns and regulatory changes, **DC plan inflows could be further reduced by the lack of new plans, market volatility and higher costs for food, energy & other basics**. A transitioning economy will also have an impact on employment, contributions, loans and hardship withdrawals.

It is still a few years off, but **increased rollovers from retiring baby boomers could play a major role in the transfer of retirement assets**. It’s also important to note that the aging of the workforce is not a statistical aberration.

The outlook for DB plan asset retention is far more alarming than the reduction in DC plan inflows. Many DB plans have been frozen, closed to new employees and are experiencing increased payouts, including lump sum initiatives for the closed group of older employees. In the face of a public pension plan median return in excess of 7%, the 2007 DB plan outflow was probably the highest on record, but the string of outflows trails over a dozen years.

GROWTH OPPORTUNITIES

Retirement plan providers, TPAs, retirement plan specialists, generalists and B-Ds are all facing different scenarios. TPAs along with individual providers, 403(b) specialists and fee-based advisory practices could continue to grow. Individual retirement plans, individual participant account balances and IRA assets could also continue to grow. However, **the growth outlook for the pool of employer sponsored retirement plan assets is limited.** Consolidation is intensifying and while it will benefit a select group, generalists, less than efficient vendors and B-Ds that fail to adapt are facing serious challenges. To quote Glenn Frey, founding member of the Eagles rock band, *“The Heat Is On, It’s On The Street.”*

In addition to a peak in plan formations, plan turnover has decreased. **A continued correction in the investment markets and the shift to wholesale pricing could make 2008 a transitional year for retirement plan providers.** Providers with efficiency and scale could, however, gain market share from competitors exiting the business.

Cross-selling opportunities also exist and certain providers, including Schwab & Fidelity, appear to be pricing for outflows by factoring in cross-selling opportunities in their recordkeeping quotes.

Retirement plan specialists with an institutional/fee model and excess capacity are gaining market share by replacing traditional broker-sold products in the mid-market. Non-specialized RIAs could also gain market share by teaming with TPAs and replacing generalists in the small plan market. BOR changes have become a major trend and a large percentage of the 100,000 plus generalists with one plan under management could be replaced in the coming decade.

The retirement plan B-D consolidators are on a roll, but faced with expensive distribution, **the major wirehouses must offer value beyond brand to keep what they have.** They must also address the changing retirement plan market dynamics, including 408(b) (2) requirements, and some are starting to do that. Influenced by the McDonald Investments team, UBS appears to be ahead of the curve and Oppenheimer & Co., Inc. seems to be particularly open-minded about the RIA model. The fiduciary dam has been breached and the other majors are no doubt working on more competitive approaches to the retirement plans business.

Contrastingly, **major growth opportunities are still available in the 403(b) market.** Many 403(b) sponsors are getting help for the first time and they are starting to recognize the complexities and liability associated with these plans. **The TPA channel, retirement income vehicles, target date funds, managed accounts and terminal funding also offer opportunities for growth,** but the major opportunities are at the individual wealth management level.

Pursuing plan and participant level business at the same time is somewhat conflicted. As a result, retirement plan specialists need to think through their business model. Unlike retirement plan assets, **the individual wealth management business is growing**. It is also less complicated, more appreciated and alternative strategies with higher margins are in demand, particularly in the small plan market. On the other hand, if more departing participants leave their assets in the plan, advisors will have to adjust their model.

As the industry becomes more institutional, retirement plan specialists may be able to distinguish themselves far easier than wealth management specialists, but we all need to adapt. **Mature markets demand the best from service providers and knowledge is only power if it is used properly**. As a result, the industry would be wise to revisit core offerings, assets, growth, margins, liability, scale and the costs/complexities associated with various business lines.

LEGISLATIVE WILDCARD

Speculating on future legislation may not be prudent, but there appears to be some talk about allowing plan sponsors to access the investment options of the Federal Thrift plan. The options include a suite of collective trusts consisting of low cost, index-based asset allocation portfolios. There is also some discussion about allowing individuals to invest in these vehicles via an IRA vehicle that is integrated with the 1040 tax return.

Bureaucrats and industry critics are generally a decade behind the market and have no clue about the challenges facing providers today. Nevertheless, a stroke of the pen could wreak havoc on the industry, drive billable costs through the roof and force more providers to exit the low margin business. Coverage will probably be the next area of focus, but **legislative developments should be monitored closely**.

INDUSTRY OVERVIEW

Provider

The year 2008 will be a transitional year for retirement plan providers. The challenging trends discussed at last year's conference are gaining momentum and margins remain under pressure. In short, **more vendors that lack profitable scale, i.e., new technology, could exit the business before year end**. Some of the blocks of could offer a buying opportunity, but most of the business is over priced and under margined.

Margin pressure is emanating from numerous areas, including a transitioning economy, a challenging investment market, reduced plan turnover, litigation and increased liability. Negative coverage by the mainstream media is also playing a role.

Individual plans can always be overpriced, but the media and others are attempting to fix a collective retirement plans problem that doesn't exist. **The media should be talking about the higher costs associated with saving outside employer sponsored plans** rather than discouraging participation in the nation's most successful retirement savings vehicle.

New plan formations have peaked, but last year was an average year for the efficiently managed providers. **Industry service has improved and this has reduced plan turnover**, a major problem for vendors.

Like providers, advisors must justify their fees. Fees have been under pressure, but **advisors can justify higher fees if they can demonstrate the value added**. As specialists replace non-specialists with their value proposition, Broker of Record (BOR) turnover has intensified. Broker turnover does not benefit providers, but the savvy providers are holding their own in the "BOR war." Some have also plugged the hole in the rollover bucket with their own initiatives and many are developing strategies for the RIA market.

Guaranteed income products are a bright spot. Advisors may not yet be onboard, but sponsors and participants are seeking the insurance. The products could change the market, but gains in market share may be limited to providers with competitive bundled programs that include guaranteed options. We are less optimistic about individual retail products and unbundled guaranteed products offered to retirement plans on an investment only basis.

Major changes are ahead. The industry is already heavily regulated, but fees, disclosure, auto enrollment, QDIAs, litigation, court rulings and legislation will remain in the headlines. Court rulings will shape the industry and **coverage will probably be the next area of legislative focus**. In terms of knowledge and fiduciary conduct, the professional bar has been raised.

The financial landscape is becoming increasingly complicated, the workforce is aging and needs are changing. On a positive note, **sponsors need expert support and individuals need advisor solutions** more than ever.

Sponsor & Participant

Sponsors are taking their fiduciary role more seriously. Competitive pressures will require employers to offer savings plans, but litigation is a disincentive for them to offer self directed plans. Litigation could also raise costs and eventually reduce benefits.

The new direction of ERISA litigation will force plan fiduciaries to become more cognizant of their role, plan documents, policies, fee arrangements, procedures, disclosure, process, documentation and liability insurance. Litigation will also **increase the demand for qualified retirement plan specialists**.

To increase participation, more sponsors are opting for automatic enrollment, but **market volatility could generate complaints from participants defaulted into equity heavy target date funds.** Automatic enrollment features are a positive for some groups, but they will not solve the savings shortfall. These features may benefit compliance and offer fiduciary protection, but they also increase the cost of matching contributions and the number of orphaned accounts.

Over 70% of companies with at least 1,000 employees still offer at least one DB plan, but almost 25% of those firms plan to freeze, reduce benefits or terminate their DB plans. This is not good news for participants, but **there has been a spike in business for advisors specializing in terminal funding.**

A deteriorating investment climate will no doubt revive the critics, but the nation's DC plan system has been a major success. Nevertheless, **education remains essential because the majority of Americans are not saving enough.** The average contribution, even with the employer match, is about ten percent, far below the 15-25 percent required to supplement social security.

Surveys indicate that 60% of the workforce lives from paycheck to paycheck and half the population is not covered by an employer sponsored plan. Moreover, employers are trimming retiree health benefits and Medicare covers only about half of healthcare expenses.

Observers have been worried about Social Security long before the current challenges, but the threat to Medicare's solvency is far more severe. In their once-a-year analysis, trustees of the Social Security trust fund noted that unless something is done, the resources would be depleted by 2041. The reserves in the Medicare trust fund are, however, expected to be depleted by 2019. If you are looking for a classical example of "*Nero Fiddles While Rome Burns*," look no further. Healthcare needs compete with investment dollars, but it's time for retirement plan advisors to discuss healthcare needs with their participant clients.

Home equity, retirement savings plans, Social Security, Medicare and a stable economy are the cornerstones of retirement. Home equity is the largest component of net worth for the average person and while home prices increased significantly during the early part of the decade, **equity withdrawals to finance consumption reduced home equity to a record low at the end of 2007.**

Home prices and the equity market have declined in recent months while mortgage delinquencies, foreclosures, heating bills and food costs have soared. The Fed has pushed short- term rates lower, but credit standards and long term mortgage rates, particularly jumbos, have actually increased.

Social Security currently provides only minimal benefits, but 40% of retirees are totally dependent on this safety net. The baby-boom generation is much bigger than succeeding generations and the Census Bureau estimates that **the ratio of retirees to those in the work force will rise to 36% in 2030, up from 21% in 2005.** Unless taxes are raised, the increased ratio may result in a reduction in benefits.

The service industries are still expanding, but the job market has started to weaken. **Retirement plan participant withdrawals for emergencies have increased and an unexpected drop in account values would require many participants to defer retirement.** In short, the leveraged consumption party is over and the dislocations will take time to work through the system.

TPA

The TPA market is growing and consolidating. The decision to build, buy, maintain a recordkeeping service infrastructure, rent, outsource or sell the business is complicated. All firms must determine how they are going to compete and survive, but TPA decisions will no doubt be based on the owners' view of their business, strengths and resources.

TPA capabilities vary widely and include Administrative Consultants, TPA/Recordkeepers and Recordkeeping Platforms. To add value and generate revenue, more TPAs are offering investment services. Nevertheless, non-producing **TPAs are a natural fit for advisors and RIAs in the small plan market.**

As noted many times, most RIAs don't service the retirement plans market, but they are positioned for growth. **By partnering with a local TPA, non-specialists could leverage the new commission disclosure rules, participate in BOR consolidation and replace less than competitive products in the small plan market.**

Joint TPA/RIA proposals can increase credibility as well as profitability and broaden exposure. In addition to accommodating more complex plan design and fee transparency, TPAs are often more willing to work with ERISA Accounts and accommodate non-traditional investments like collective trusts.

To gain market share, TPAs must find a niche, develop referrals, sell their strengths and like advisors, demonstrate their value. TPAs would also be wise to provide leads, increase communication with their advisor partners – particularly when there is a problem – and assume a more active role in the sales process. In addition to partnering with RIAs, TPAs must develop and execute a viable marketing plan along with a strategy to capture rollovers.

Advisor

As sponsors increasingly acknowledge their fiduciary role, retirement plans specialists with additional capacity are gaining momentum in the mid-market. **Most of the broker-sold products above the small plan market will be replaced by RIAs and this is a major opportunity for advisors capable of differentiating their practice and communicating their value.**

Non-specialized RIAs also have an opportunity to partner with other specialists, particularly TPAs, and gain market share in the small plan market. TPAs are gaining market share and the 403(b) market also offers major opportunities.

Observers have predicted it for years, but **the new 403(b) regulations along with the PPA have generated major opportunities for advisors in the relationship driven Not-for-Profit Markets.** The opportunities extend to the Higher Education space, i.e., Think Tanks, K-12 and Healthcare. The opportunities to add major value in this segment are very real. In addition to institutionalizing plan management, some of the products currently in use are far less than competitive and lack service. New providers are entering the 403(b) market, but others are leaving, including those that can't deliver on the mandated compliance.

Low margins and somewhat generic products are helping retirement plan specialists and vendors with strong relationships win business. These advisors may be able to obtain more competitive proposals and bring business to the table, but vendors often pressure them to become strategic partners. The partnerships make economic sense, but they also dilute independence. Advisors are human and responsive vendors that respect the advisor's client relationships certainly have an edge. On the other hand, arrogant providers could feel the sting of the whip.

The trade media serving advisors have become more retirement plans savvy, but they continue to talk about the retirement plan opportunities available to non-specialized RIAs without addressing the huge learning curve.

As assets cycle from accumulation to distribution, the trade also notes the individual wealth management opportunities available through retirement plans. However, they never mention the fiduciary conflict that exists when advisors solicit business at the plan and participant level. Retirement plan advisors considering participant business that goes beyond education should think about the conflict before pursuing it and read the DOL's largely ignored AO 2005-23.

Independent RIAs pursuing business at the plan & participant level should consider servicing the business on a fee only basis and establish a separate corporation to service participants. If participant level business is pursued, the RIA should obtain a written acknowledgement of the potential conflict from the plan committee. The committee could also limit the services and/or require participants to sign a non-product endorsing agreement.

The DOL opinion is also being ignored by provider trust departments. Vendors are targeting rollovers with aggressive initiatives and they are ahead of advisors. Major assets are poised to move and **advisors interested in individual wealth management business should get their programs in motion now.**

Managing Change, Growth & The Practice

To manage the changes ahead and continue growing, advisors must adapt, increase professionalism, remain product current, operate with a higher fiduciary standard, avoid conflict and operate with full disclosure.

The DOL's proposed 408(b) (2) regulations on disclosure, including services & compensation, conflicts of interest and ongoing fee disclosure are very important. Unlike the new form 5500, the burden of proving compliance is on service providers, including advisors and B-Ds.

The complexity of ERISA regulation is greater than ever and now poses an almost insurmountable barrier for generalists. Prohibited transactions, litigation, excise tax, fallout from inadequate E&O coverage, permanent removal from the plan and injunctions against future engagements are all real threats for those that fail to comply with the new rules.

The perfect storm has emerged. **Increased & broadened litigation, legislation, regulation, court rulings and a challenging investment/economic climate will increase the demand for competent specialists and drive generalists out of the retirement plans market.**

Advisors must **practice risk management** by ensuring that their E&O coverage is adequate for their specific practice, including investments and fiduciary services. Advisors should also seek contractual insulation and avoid sponsors without adequate insurance along with those that don't take their fiduciary responsibilities seriously.

A growing number of advisors are dissatisfied with their firms. Rather than moving quickly, advisors should **evaluate the business umbrella** before changing firms. Dual registration has been booming, but at some point, advisors will have to make a choice between fees or commissions.

To reduce compliance and administrative burdens, advisors contemplating the independent path should consider **partnering with other like minded RIAs**. In addition to economies, partnering could enhance brand and broaden the menu of specialized services. Prices have softened and compatible acquisitions could also be a path to growth for some advisory practices.

In addition to identifying profitable growth trends and new opportunities, advisors must **develop a business plan while professionalizing their practice**. In reality, advisors need plans for growing, managing and transitioning their business.

Technology, compliance and staffing must all be embraced. Advisor practices are scale type businesses, but given the growing diversity of plan sponsor needs, non-team practices are facing an uphill battle. Service is essential to success and the practice must **create a fertile work environment that develops and integrates the various team members**.

Specialization is the order of the day and in addition to identifying the targeted market, **the business plan should include a well executed marketing component**. The plan should include brand development, differentiation, concise communications and a formalized referral process. A strong, consistent and integrated message should also be delivered through multiple channels, including clients and non-clients.

Brand is essential, but advisors need to define who they are, what makes them unique, how they differ and why clients choose them before it can be developed. Brand is not a logo or an ad. Brand is about positioning, credibility and the creation of a positive association that sticks.

Mutual fund companies have reduced advertising spending in the last year, but they have allocated more funds to internet advertising, trade-to-trade advertising, trade publications and events. Like vendors, advisors will have to find their own marketing “sweet spot.” Using the office, referrals, centers of influence, vendors, telemarketing, e-mails, Webinars, seminars, post cards, direct mail, newsletters, surveys, the firm’s website and advertising should all be considered. Using one medium is generally less effective, but regardless of the approach, **the message should be consistent and continuous.**

Satisfied clients are always the best source of new business and referrals, but **the referral machine should include the firm, vendors and centers of influence.** In addition to leveraging satisfied clients, the ultimate sales force, advisors should forge and **leverage alliance partnerships.** Advisors should be prepared for a challenging investment market, a transitioning economy and increased competition. As a result, a dedicated team member responsible for **ongoing business development is now a necessity.** Indeed, business development is now comparable to a healthy lifestyle, i.e., **it’s what you do everyday that counts.**

The sales process has become consultative and clients are getting smarter. Competition is also intensifying and advisors would be wise to **revisit their sales model.** In order to steal market share from competitors, advisors must be at the top of their game.

Developing Wealth Management Business

Advisors and team members focusing on the higher margin and more appreciated individual wealth management business should **pursue the business with flexibility.** In addition to customized services, they should **target wealthier clients** and assume a more holistic approach, including accumulation, distribution, estate planning and healthcare. In addition to investment management, accounting, legal, trust and insurance services could also be offered.

Offering a broader menu of products and services may be smart, but **service should be positioned as a differentiator.** Like the practice, **each team member should focus on what they are good at.**

Retirement income services could be far more demanding and labor intensive than asset management type business. As a result, advisors should not be hesitant to adjust their pricing and/or use a client specific approach to pricing their services. As always, advisors should **avoid needlessly complex solutions along with problematic and unprofitable clients.**

“The only real security is the ability to adapt, change & grow.”

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