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RETIREMENT REPORT

Second Quarter 2011 Market Review: Volatility Picks Up

U.S. Equity markets were flat for the quarter (with the DJW 5000 Index posting a zero percent return), but not without experiencing a roller coaster ride. The last month of the quarter saw equity markets heading significantly lower and well off their intra-quarter highs, and the last four trading days brought about a dramatic surge to the upside, erasing the quarter's intra-period losses and bringing U.S. equities back to levels they were at only three months ago. International equities posted slightly better results than their U.S. equity counterparts, returning a positive 1.8 percent for the quarter (MSCI EAFE Index), but also showing similar volatility. U.S. fixed income made significant gains, no doubt helped by the spike in equity volatility that was witnessed over the quarter. The broad U.S. fixed income market posted a strong positive 2.3 percent return (Barclays Aggregate Index).

The flight to safety into fixed income was likely encouraged by the relatively high fixed income rates witnessed at the beginning of the quarter (the 10-year Treasury bond yielded 3.45 percent as of April 1, 2011). Coupled with greater equity market volatility, investors had multiple reasons to favor fixed income investments over equities. Fund flows reversed from what was witnessed over the first quarter, with bond mutual funds experiencing inflows, totaling over \$48 billion, and stock mutual funds experiencing outflows, totaling over \$18 billion (Q2 estimates, Investment

Company Institute). Also joining the bond buying party was the Fed, whose QE2 bond buying program ran until June 30, putting additional pressure on yields and likely helping prices (and their returns) rise.

With the Fed's QE2 bond buying program over and longer-term rates/yields lower as a result of the second quarter fixed income rally, conditions are not as favorable for fixed income investors and markets (at least relative to how they were in the second quarter). Equity markets, while finishing mostly flat for the quarter, did hit record highs that have not been seen over the last few years, or in some cases, since the financial crisis. One notable event over the quarter was the Linked-In IPO (initial public offering), which raised concerns of potentially rich equity valuations. To be sure, broad market valuations are still in-line with many long-term norms; however, many concerns remain on the horizon. Volatility may well decide to stick around for awhile.

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DOL Extends Disclosure Deadlines

For some time now you have been reading about additional disclosures that service providers will be required to make to you as fiduciaries (“408(b)(2) disclosures”), as well as additional disclosures that your plan will be required to make to plan participants (“participant disclosures”).

The good news is that your service providers have been gearing up to either meet, or help you meet, these requirements. Many of them are primed to do so already. However the Department of Labor (DOL) recently delayed the effective date for both types of disclosures. The 408(b)(2) disclosures’ (from the service provider to the plan) effective date has been moved from January 1, 2012 to April 1, 2012. In addition, the participant disclosures’ (from the plan to its participants) effective date has been moved (for calendar year plans) to May 31, 2012 (with quarterly disclosures likely provided by August 14, 2012).

Up Close: Changing Market Conditions and Participant Behavior

JPMorgan recently released a white paper titled “Searching for Certainty: Observations and opinions on how changing market conditions are affecting 401(k) plan participant outcomes.” The study, which surveyed 1,000 individuals with 401(k) plans nationwide, reveals a fundamental shift since 2007 largely due to the market conditions of the past several years.

According to the paper participants are focusing on financial issues, but “on a near-term basis.” Half of the respondents indicated their number one financial concern was meeting monthly obligations. A distant second and third were saving for retirement and reducing their mortgage, respectfully.

With regards to company sponsored retirement plans, the study concluded that many participants remain “accidental investors” or rather, participants without actively managing their accounts. According to the study, 45% of

participants never call or visit the provider’s website to monitor their account.

The white paper also discussed the growing trend called the “pensionization” of defined contribution plans. Employees appear to be relying upon employer decisions with their retirement plan. Examples to combat employee inertia include automatic enrollment, automatic deferral escalation, and qualified default investment alternatives (QDIA).

Finally, the report brought back the concept that we often see appear in these type of studies: the goal of using the retirement plan to bridge the gap between what programs such as social security will provide and what the participant will actually need in retirement. Most studies in the past focused on lower income employees, but this study identified an emerging risk for high-income employees due to the fact that they can expect a smaller percentage income replacement from Social Security. As a result, this group must do more to supplement that shortfall. According to JPMorgan, the high-income group (those defined as earning over \$100,000 per year) has the following characteristics:

- Half are “concerned about having enough money to make ends meet.”
- Half of all loans are to high-income employees and they represent half of the value of all loans, despite the fact that the highly compensated group as a whole is typically a fraction of all employees.
- A quarter of high-income employees owe more than \$10,000 in credit card debt, versus only 12% of those making less than \$50,000 per year.

In summary, the passivity of participants is somewhat universal and not limited to any particular income level. Education needs to focus on how decisions today can impact the dollars of tomorrow.

Communication Corner: Staying the Course

It is always helpful to remind participants about the importance of staying diversified and not to panic in times of crises; timing the market or bailing out of the retirement plan altogether is futile in meeting long-term savings goals.

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