

Retirement Report



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More Transparency Required for Retirement Plan Vendors

The Employee Retirement Income Security Act (ERISA) requires plan fiduciaries to act prudently when selecting or monitoring service providers for a retirement plan. Generally, the employer is the fiduciary who hires the third party

administrator, selects the mutual fund companies, and retains other vendors for the plan. As a fiduciary, the employer must act prudently to protect individual participants from excessive or unwarranted fees. But prudent action is no easy task. Fees are complex, fiduciary roles are confusing, and vendors are not always willing to fully disclose how they are paid.

Beginning January 1, 2012, the Department of Labor (DoL) will attempt to make the employer's job easier via new disclosure regulations. However, the disclosure regulation is just the starting point. The employer must still understand fee structures and fiduciary roles and then ask good questions.

Affected Plans. The regulation applies to all retirement plans subject to ERISA such as 401(k), profit sharing, 403(b), money purchase pension, and defined benefit (including cash balance plans). The regulation refers to these plans as "covered plans." Government plans (457b), most church plans, IRAs, SEPs, and SIMPLE IRAs are exempt from the regulation.

Affected Vendors. Generally, all vendors, their affiliates, and subcontractors who provide services to the plan are subject to the rule if they receive \$1,000 or more in either direct or indirect compensation.

Disclosure Content. The new regulation gives the plan vendor a laundry list of required disclosures including:

- **Fiduciary Status.** The vendor must indicate whether or not it assumes the role of a fiduciary to the plan.
 - Is the vendor a trustee?
 - Does it act as an investment manager? If so, in what capacity?
- **Compensation Arrangements.** The vendor must disclose both direct and indirect compensation received.
 - Direct compensation is an amount paid by the plan and deducted from participant balances.
 - Indirect compensation is compensation paid to a vendor from any source other than a plan.

Example: Vendor A charges \$2,000 for administrative services to the plan with \$1 million of assets. In addition, the plan's mutual funds contain revenue sharing provisions (12b-1 fees) which pay the vendor 1% annually. The vendor must disclose the direct fee (\$2,000) and the indirect fee (1% of assets).

In addition, if the vendor shares revenue with a related party, it must disclose that arrangement if it is transaction based (for example, incentives such as commissions or finder's fees) or if the amount is charged directly against participant's investments and reflected in the return (e.g. 12b-1 fees). This aspect of disclosure permits the employer to understand why certain service providers are involved and how they are compensated.

Example: Big Mutual Fund Management Company pays employees of an affiliate, Best Mutual Fund Sellers Co., a 5% incentive for new business. In addition, the mutual funds pay the sales force 1% of plan assets annually in the form of a 12b-1 fee. Both incentives must be disclosed to the employer, the former since it is transaction based; the latter since it reduces the participant's return.

- **Compensation for Record Keeping Services.** Some vendors bring certain mutual funds to the employer and then offer “free” record keeping services including items such as participant quarterly statements, internet access, contribution and distribution services, plan compliance services, etc. In reality, the mutual funds are paying a portion of the fund to the record keeper for these services. This payment reduces the share value of the fund (and the participant’s account) but is not readily apparent to the participant or the plan sponsor. This arrangement creates the perception that the services are free. The regulation addresses this issue by requiring vendors to estimate the costs of record keeping services if they are not explicitly stated. In addition, the vendor must disclose any revenue sharing paid to the record keeper.

- **Investment Fund Disclosure.** This is another area prone to a sales pitch that the plan is “free.” Some vendors provide mutual funds with imbedded revenue sharing that may pay various plan vendors. The regulation attempts to draw attention to this fact. Unless already provided by a record keeper or brokerage firm, a vendor must disclose the following for each investment vehicle in the plan:
 - The amount of compensation assessed directly against the investment such as sales loads, deferred sales charges, redemption fees.
 - The annual ongoing operating expenses (e.g. the expense ratio of the fund).
 - Other ongoing annual fees such as mortality and expense fees, wrap fees, or other charges directly affecting the investment vehicle.

However, this aspect of the disclosure has a shortcoming. A vendor can comply via the mutual fund prospectus which in most cases is not easily understood by the employer.

- **Manner of Receipt of Compensation.** The vendor must disclose how it will receive the fees:
 - Will the plan be billed?
 - Will the fees deducted from participants’ accounts?
 - Will the fees be deducted directly from investments held by the plan?

Practical Considerations. Like many federally mandated disclosures, this new rule is only a tool and not the complete solution. So what should the average prudent employer do? Here are two suggestions:

- **Request a Summary Disclosure Document.** The regulation permits a vendor to meet its disclosure obligation by using a number of different documents. The vendor does not have to make it easy for the employer by assembling all relevant information in one place. Thus, the prudent employer should ask the vendor for a summary disclosure that addresses each of the above issues.
- **Ask Specific Questions About Revenue Sharing.** The prudent employer should ask each vendor whether it receives sales commissions, 12b-1 fees, finder’s fees, sub-transfer agent fees, or other revenue sharing from any mutual fund, insurance company, or other party providing investments to the plan. Most vendors will be able to provide this information within short order. Do not accept an answer that says the fees are immaterial. Remember, the amounts paid to a vendor from a mutual fund or insurance product are generally amounts that reduce the participants’ account.

Conclusion. DoL regulations will require vendors to provide greater fee and service disclosure beginning in 2012. However, the prudent employer will still be challenged to see the entire fee picture. That said, the employer should request a summary of the vendor’s disclosure information and follow up with key questions regarding revenue sharing. These two simple steps will provide the employer with better information to make the important decision regarding the hiring and retention of plan vendors.

At Alerus Retirement Solutions, we believe that this disclosure requirement is a step in the right direction for plan sponsors and our industry. We offer our services at a competitive price and welcome greater disclosure by our competition. Feel free to contact us if you have questions regarding fees or other complex plan issues.

Investment Update



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Stocks: Look Past Japan and the Middle East

Stocks began the year strong, with the major averages hitting recovery highs in mid-February. But, when an earthquake followed by a tsunami hit Japan causing massive damage to life and property and to all six nuclear reactors at the power plant in Fukushima, global stocks fell. The

Nikkei dropped over 15% in just two days. As the Japanese authorities regained control over the reactors and it became clear that the nuclear damage was contained, investors returned to risk assets. The Dow Jones Industrial Average rose 6.4% in the first quarter of 2011. The broader Standard and Poor's 500-stock index rose 5.4% and the Russell 2000-index of small company stocks did the best, up 7.6% for the quarter.

Political turmoil began in Tunisia, spread to Egypt and then across many countries in North Africa and the Middle East. Investors worried about the impact of these movements on the supply of oil. Oil prices surged almost 17% in the first quarter ending at over \$106/barrel. Energy stocks were the best performers in the quarter, up 16.3%. Exxon and Chevron, two of the largest companies in the Dow rose 15.1% and 17.7% respectively. Investors also favored industrial stocks levered to the global cyclical recovery. The Industrial sector was up 8.3% with stocks such as Caterpillar, Alcoa, and Boeing rising 18.9%, 14.7%, and 13.3% respectively. The laggard sectors were utilities, consumer staples, and financials.

International stock markets faced several headwinds during the first quarter of 2011. Soaring energy and food prices caused a surge in inflation in emerging markets forcing central banks in China, India, and Brazil to either raise interest rates or curtail bank lending. China was up 4.7% for the quarter, Brazil dropped 0.1%, while India's stock market fell 7.1%. As political turmoil spread in the Middle East and North Africa, investors fled those markets. Egypt was down 23%, Kuwait fell 10.1%, and Oman dropped 9.9%. In Asia, the earthquake and tsunami caused the Japanese stocks to fall 5.3%. And finally in Europe the rising inflation forced the European Central Bank to declare that they would raise interest rates in 2011. The Euro climbed on this news to over \$1.40/Euro but the German stock market rose only 1.6% for the quarter.

Bonds: Stuck in Neutral

As stocks and oil hit new highs, the bond market offered investors a total return of 0.4% for the first quarter of 2011. Corporate bonds outperformed U.S. government securities. The 10-Year Treasury began the year with a yield of 3.29%, reached a high of 3.7%, and ended the quarter at 3.45%. Because of the yield spread offered by corporate bonds, these securities were able to offer better returns. Investment grade corporate bonds returned 0.9 while high-yield bonds of lower rated companies did the best, up 3.9% for the quarter.

Commodities: It Was All About Oil

As the political turmoil spread from Tunisia to Egypt and now to Libya, investors began to price in the possibility that oil supplies could be cut off to the rest of the world. Oil prices which were relatively stable in 2010 shot up 16.7% in just three months of 2011, settling at over \$106/barrel. However, the Dow Jones-UBS Commodities Index that tracks nineteen commodities rose just 4.4% for the first quarter of 2011. Investors worried that high oil prices, China's desire to slow bank lending,

and supply disruptions due to the earthquake in Japan would hurt demand for industrial metals and some of the agricultural commodities. Palladium prices fell 4.4%, wheat was down 3.9%, and gold rose just 1.3% for the quarter.

2011 Outlook: Prefer Risk Assets While Keeping an Eye on Oil

With the global recovery moving into the mid-cycle and the spreading crisis in the Middle East and North Africa, oil prices have spiked from around \$90/barrel in 2010 to \$108/barrel. Should oil prices continue to rise towards its past peak of \$140/barrel, it has the potential to derail the global economic recovery. Until that happens we continue to prefer stocks to bonds and cash.

The U.S. economy grew at about a 3% pace in the 4th quarter of 2010. Recently, job growth has also accelerated to about 200,000/month. However, unemployment continues to be high at around 9% and inflation is below the Fed's targets. We expect the Federal Reserve will be on hold until 2012. In this environment of above-trend growth, low inflation, and Fed support, we recommend an overweight position in equities. Within equities the economically sensitive sectors such as technology, energy, and financials should outperform. We also favor stocks of large multinational U.S. companies such as McDonalds, IBM, Oracle, Proctor & Gamble, United Technologies, DuPont, and Boeing. These companies have excellent balance sheets, access to credit markets, growth in emerging markets, and reasonable valuations. We expect these companies to outperform most other financial

assets over the next five to seven years.

The Fed policy to be on hold in 2011 should provide an anchor for short-term rates. As economic growth begins to accelerate in the second half of 2011, long-term rates should drift higher. We expect the 10-year note to yield between 3.5% and 4.0% by the end of the year. This drift to higher rates should limit fixed-income returns to low single digits for 2011. Within the fixed income categories we would be overweight in riskier sectors such as high-yield and asset-backed securities and underweight in government debt.

Sources: Wall Street Journal, Bank of America Merrill Lynch, Goldman Sachs

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