

Retirement Report



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Participant Disclosure Rule—a Nuts-and-Bolts Summary for Employers

Background.

Since April of 2007, the Department of Labor (DoL) has struggled to devise a regulation to outline the plan

information that fiduciaries must provide to participants regarding their retirement accounts. The regulation, referred to as **Rule 404a-5** stems from the DoL's authority to issue regulations interpreting and enforcing the Employee Retirement Income Security Act of 1974 (ERISA). Although the rule has gone through various revisions and delays, the DoL has now finalized it. This article will provide an overview of the rule from an employer's standpoint.

Why Disclose?

The theory behind the disclosure rule is simple. In many plans individual participants control the investment of their account. In order to make sound investment decisions, participants need regular access to information regarding the plan, the investments, and the fees associated with them.

Who Must Disclose?

The rule requires the plan administrator to provide the disclosure. Most plan documents name either the company or a specific appointed committee within a company as the plan administrator. Thus, the disclosure obligation will generally fall on the employer.

Employers can take some consolation for two reasons. First, retirement plan vendors should be ready to provide solutions to the disclosure obligation. Most have been working on computer systems and procedures for quite some time in order to generate the required notice for employer's use. Second, the rule specifically states that the employer, as a fiduciary, may avoid any liability for completeness or accuracy of the disclosure if it **reasonably and in good faith** relies upon information received from retirement plan vendor.

What Must be Disclosed?

The rule requires disclosure via two methods: an annual notice and quarterly statements.

Annual Notice: The annual notice will be given to all eligible plan participants each year and to all newly eligible participants before their first investment election. The annual notice will have two parts. The first addresses general plan information and includes a description of administrative and individual participant expenses. The second part covers detailed investment performance and related fee information. The DoL has provided a model comparative chart for the second part of the notice. Most plan vendors, like Alerus, will likely adopt it for disclosure of investment related information.

The annual notice acts as a **menu** for participants showing them key investment provisions of the plan and the possible fees and charges they may encounter.

Quarterly Statements: At least quarterly, each participant must receive a statement showing the actual dollar amount of fees charged against his/her account and a description of

the services rendered for this fee. If the annual notice is the menu, then to continue the analogy, the quarterly statement is the bill.

Deadline for Disclosure.

Unless the DoL issues yet another delay in implementation, the disclosure requirements will occur in 2012. Generally, the annual statement must first be provided to participants by May 31, 2012. The quarterly statement disclosure must occur by August 14, 2012.

A Communication Challenge.

Employers may face a communication challenge regarding fees. Many employers, especially larger ones, may have negotiated beneficial fee arrangements for their participants. Often they use institutional class mutual funds in the plan with no revenue sharing. In such cases, administration or advisory fees are separately charged (sometimes referred to as a **wrap**) and deducted pro rata from participants' accounts. This wrap fee will show on the participant's quarterly statement. In comparison, a retail mutual fund must only disclose its fees and revenue sharing in its prospectus, which is rarely read by participants. However, since no charges come directly from the participant's account, the quarterly participant statement will have zeros in the fee column. Thus, even if a retail mutual fund has an overall higher cost (i.e. expense ratio), it will appear to the participant to be **free**.

For example, compare the following:

Plan 1. Al has \$100,000 balance in Plan 1. The plan uses Institutional Mutual Fund with an expense ratio of 0.20%. The advisor charges 0.50% (\$500) for its services which is deducted from Al's account. The total cost to Al is 0.70% or \$700 annually consisting of \$200 paid to the mutual fund and \$500 to the advisor. Al's quarterly statement will reflect the advisor fee of \$500 (0.50% X \$100,000) deducted from his account.

Plan 2. Bob has \$100,000 balance in Plan 2. The plan uses Retail Mutual Fund with an expense ratio of 1.20%. Bob's annual investment cost is \$1,200. The mutual fund rebates \$500 of this amount to the advisor for its services. Since the advisor fee is rebated and not taken directly from his account, Bob's statement does not reflect the payment.

In the example, Al's annual investment cost is \$700. Bob's cost is \$1,200. Al is saving \$500 per year in investment fees. Nevertheless, only Al sees the advisor fee. If Al and Bob compare notes, Al is left with the perception that he is paying \$500 while Bob enjoys a **free** plan.

Conclusion.

Rule 404a-5 will provide plan participants with greater fee disclosure beginning this year. Added fee disclosure will be good for plan participants, but will create another compliance burden for employers. In addition, employers who use institutional class funds may be challenged to convey the true value to employees. At Alerus Retirement Solutions, we are prepared to assist you with implementing the new disclosure rules. In addition, we're ready to provide you and your employees with educational opportunities to better understand this important company benefit. Feel free to contact us if you should have any questions.



Investment Update



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Stocks: Macro-Economic Worries Triumph Over Strong Earnings

In 2011 earnings of the 500 companies represented in the Standard and Poor's 500-stock index increased over 15%.

However, the price of the Standard and Poor's 500-stock index was unchanged for the year. The P/E multiple (or the price investors are willing to pay for a dollar of earnings) dropped from 15 to 13. The median P/E multiple for the Standard and Poor's 500-stock index has been around 15. Investors became more risk-averse as the

year wore on when European politicians appeared to be unable to contain the sovereign debt crisis from spreading from peripheral countries such as Greece and Ireland to core countries like Spain and Italy. The debt ceiling debate in the United States, and a slowdown in the Chinese economy did not help.

Although the Standard and Poor's 500-stock index was flat for 2011, it was achieved only with significant volatility in stock prices during the year. The year began with optimism as stocks rose over 8% through spring. However, the European Union's debt summit in the summer failed to impress investors. This was followed by a debate over whether to raise the debt ceiling in the U.S. and a subsequent downgrade of U.S. debt by Standard and Poor's. In the fall, the European debt crisis appeared to spread to Italy as the 10-year sovereign Italian bond rose to an unsustainable 7% yield. Investors sold risk assets and at one point in October, stocks were down almost 13% for the year before rallying in the fourth quarter to end the year unchanged. Daily volatility was also significantly higher as stocks moved up or down by 2% on 35 days in 2011 compared to zero in 2005 and 2 days in 2006. Investors appeared to care more about daily headlines out of Europe, China, or the United States, rather than fundamentals of individual companies. In 2011, there were 69 days when 90% of stocks moved in the same direction which was more than the combined total for 2008 and 2009.

Higher volatility is a reflection of higher investor uncertainty about the future. In this environment investors chose safety and bought large, high quality, blue-chip dividend yielding stocks. The Dow Jones Industrial Average rose 5.5% in 2011. On the other hand, the Russell 2000 index of riskier smaller company stocks fell 5.5%. Within the Dow Jones Industrial Average, McDonalds, IBM and

Pfizer rose 31%, 25%, and 24% while Bank of America and Alcoa fell 58% and 44%, respectively. A similar theme played out within sectors. The high dividend yielding utility and pharmaceutical stocks were up 14% and 15%, respectively. Riskier financial and materials sectors were down 14% and 16%.

European stocks, in the eye of the storm, dropped by double-digits across most markets. The Stoxx Europe 600-index fell 11% in 2011. Countries most affected by the sovereign debt crisis—Greece, Portugal, and Italy—fared the worst, down 52%, 28%, and 25% respectively. The core countries of Germany and France also experienced steep stock market losses, falling 15% and 17%. Investors feared that Germany and France would have to bail out the rest of the Eurozone. UK, which is part of the EU but not part of the single currency, fared better—falling 5.5%. Outside Europe, few if any markets, offered investors positive stock market returns. Policy makers in China had to contend with soaring inflation and a bubble in property markets. The Shanghai Composite fell 21.7% in 2011. Australia, facing its own housing bubble and being tied to exports to China, fell 14.5%. Emerging markets in Latin America and Asia felt the slowdown in Europe and China; Brazil, Hong Kong, and Taiwan were down 18%, 20%, and 21%, respectively. India, facing high inflation, political corruption, and slowing growth was down 25%.

Bonds: Long U.S. Treasuries Offer Best Returns of Any Asset Class

Global investors concerned about macroeconomic uncertainties in Europe and China sought the safety of U.S. Treasuries. Slow economic growth, low inflation, and the Federal Reserve's stated objective to keep short-term rates at these low levels offered the perfect environment for bonds and U.S. Treasuries. Long-term Treasuries offered investors a return of almost 29% in 2011. The 10-Year Treasury which began the year yielding 3.29%, ended 2011 at 1.88%. The overall Treasury market offered solid returns of 9.8% as did other long-duration government bonds, such as TIPS up 14% and the much maligned municipal bonds up 11%. The overall bond market also offered healthy returns of 7.8% in 2011. Falling yields and strong corporate balance sheets helped investment-grade corporate bonds deliver an 8.4% return. High-yield bonds offered by smaller, riskier companies were up only 5.7%.

Commodities: First Some All-Time Highs, Then the Fall

In the beginning of 2011, solid global growth, easy monetary policy, and tight supplies caused commodity prices to rise almost 9%. Copper, cotton, and corn prices hit all-time highs. Street protests in the Arab-world, along with a civil war in Libya, propelled crude oil prices higher—by 25% to \$114/barrel. In the summer

of 2011, faltering U.S. growth, spreading European debt crisis, and a slowdown in the Chinese economy caused a steep sell-off in commodity prices. The Dow-Jones UBS commodity index fell 13% for the year.

Agricultural commodities such as cotton, sugar, and wheat, which reached record prices in 2010 because of drought in many parts of the world, cooled off and fell by more than double-digits. Copper prices fell more than 30% as China began to slow down its economy to contain inflation and cool a property bubble. Excess supply and a mild winter drove natural gas prices down by 31%. However, crude oil prices ended the year up 8.5% due to tight supplies and a war of words between the U.S. and Iran.

Currencies: Investors Seek Shelter in the Dollar and Yen

The “risk-on,” “risk-off” trade was also the major theme in the currency markets. The dollar sold off in the beginning of the year as ECB tightened monetary policy to combat inflation from high oil prices. The Euro hit a high of \$1.49/Euro. However, as investors began focusing on the European debt crisis and the potential for a recession and banking crisis in Europe, the Euro sold off ending the year below \$1.3/Euro. The dollar ended the year about 3% higher than the Euro and the U.S. Dollar Index rose about 1.5% against a basket of currencies. The Euro crisis also affected emerging market currencies. Despite healthy balance sheets and economic growth in emerging markets, investors sought the relative safety of the U.S. dollar. The dollar rose 12% against the Brazilian real and 5.6% against the South Korean won. The Japanese economy has been beset with problems—low growth, low interest rates, and deteriorating demographics. Despite all these issues the yen has been strong and strengthened 5.5% against the dollar in 2011. The yen’s strength is derived from its export-oriented corporations that repatriate foreign profits.

2012 Outlook: Stay Defensive

We enter 2012 with signs that the U.S. economy rebounded in the 4th quarter of 2011. Unemployment fell from a high of 10.1% to 8.7%, the economy was creating about 125,000 jobs every month, and manufacturing and services indices suggested continued expansion. But this good news could be short-lived because this year the U.S. economy faces some headwinds—fiscal drag from cuts in local and state government spending and a fading federal stimulus, policy uncertainty in the face of presidential and

congressional elections in 2012, and finally, the potential for a recession in Europe. In Europe the ECB and EU leaders have taken steps toward improving bank funding and moving closer to fiscal integration. We anticipate the austerity measures being implemented in many European countries will result in a mild recession in the first half of 2012. China is slowing down and countries like Australia, Japan, and Brazil that rely on exports will find it difficult to decouple from the rest of the world. There is a good chance that the global economy will slow down in the first half of 2012 and recommend a defensive asset allocation posture.

Despite a not so rosy scenario for the global economy, there are many investment opportunities available to the alert investor. The Federal Reserve has said it will hold interest rates at these low levels through 2014. This should provide an anchor for short-term rates. We believe that the developed economies in Europe and the U.S. will continue to deleverage for the next few years and fixed income should continue to offer solid returns until central banks are ready to raise rates. With interest rates at historically low levels and housing prices down 30-35% from their peak, the next couple of years will be an excellent time to buy a new home or trade up to a more expensive home. Real short-term interest rates are negative in the developed world and we anticipate central banks to continue to print money to support their local economies. Gold as an alternative to currency debasement should continue to do well. And finally, investors should allocate a portion of their portfolios to commodities, and in particular, oil or energy stocks to hedge against political unrest in the Middle East.

For investors with a long-term horizon, over five to seven years, the sell off last year has produced outstanding opportunities in many areas of global equities. We have long favored stocks of large high-quality 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 believe this sell-off has also created outstanding values in emerging market and European stocks. However, we believe international stock values may continue to fall until the market sees a viable solution to the Euro debt crisis.

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

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