

DWIGHT ASSET MANAGEMENT COMPANY

AFTER DEFINED BENEFIT PLANS: A LOOK AT FUTURE ASSET ALLOCATION DECISIONS

Years ago, blessed with both a defined benefit plan and 401(k) plan, I was discussing asset allocation decisions with a colleague. Back then, there were fewer investment choices and little in the way of sponsor-provided investment advice. Conversations about how you invested took place less frequently and less openly than they do today. In any case, my colleague Jim made the comment that he viewed our company's defined benefit plan as his fixed income allocation. Therefore, Jim continued, he adjusted his defined contribution plan allocation to reflect a heavier weighting to equities.

I recall being more than a little surprised by these comments. What struck me first was the holistic view Jim had adopted. He had looked at all his assets and developed an overarching asset allocation. At the time, with young children and a modest income, I tended to lump my various savings needs into small buckets, e.g., kids' college money here, down-payment on a house there, and maybe even a few dollars toward retirement over there. Intuitively I might have suspected that such "bucketing" was not expressly efficient. However, it felt right at the time and allowed me to demonstrate to myself that I was slowly making financial progress, whittling away at future college, housing, and retirement needs.

The second source of my surprise was Jim's inclusion of the defined benefit into his decisions. Those of us fortunate enough to have a traditional pension plan often tended to ignore asset allocation decisions. We knew that there would be a future income stream if we vested, but often the details were somewhat vague, and it typically wasn't until one neared retirement that practical interest in the

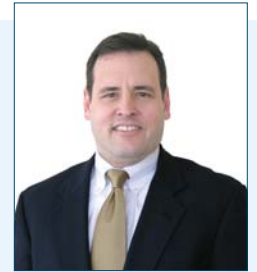
pension plan grew. In fact, at least part of the reason that sponsors are said to be winding down (or choosing not to offer) defined benefit plans is because the perceived benefit was not easy to explain or not readily understandable to some employees. Nonetheless, I came to agree with my colleague that a unified view of my savings made sense and that the defined benefit plan was a good proxy for fixed income. Accordingly, I too increased my defined contribution plan equity allocation.

Today, more and more American workers find themselves without the benefit of the traditional pension plan that, at least some of us, once took for granted.¹ In a new job, I now count myself in this group. Given these changes, it then makes sense to consider what the impact will be on defined contribution plans and to revisit the asset allocation decision.

What will the disappearance of the defined benefit plan mean for defined contribution plans? What changes might employees consider in their asset allocation?

Included in many of the announcements made by plan sponsors who were curtailing long standing pension plans was language that described new and enhanced company contributions to the firm's savings plan. One might reasonably suspect that

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1 According to a Wells Fargo Institutional Trust Services survey (reported in Pension & Investments, September 18, 2006): 14% of employers plan to replace their defined benefit pension plan with a defined contribution plan, 13% plan to freeze their defined benefit plan, and 5% plan to terminate their defined benefit plan within the next 12 months.

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▶ when all was said and done, the company would still come out ahead financially (i.e., realize net savings by freezing or terminating the defined benefit plan). Nonetheless, one sensed a clear intention to provide more generous employer matches. Likewise, it is reasonable to assume that employees may recognize that—absent a pension plan—they should increase their voluntary savings plan contributions. In either case, defined contribution plans (and their investment providers) may experience a potential bonanza of new cash flow if the trend away from defined benefit plans continues.

So whether individuals receive a larger employer match or recognize on their own an increased need to save, how should they invest?

Following Jim’s logic: if the pension plan represented fixed income and it is now gone, employees might now consider reallocating these dollars toward a fixed income vehicle in the defined contribution plan. Stable value seems a logical choice. Let’s consider why.

First we’ll need to consider what stable value is replacing. The answer is a deferred annuity that converts at retirement to a payout annuity. Over the term of employment, the pension benefit grows at a steady rate, factoring in years of accumulated

service and salary. Steady growth in principal balance over time sounds a lot like stable value. An optical difference is that the pension annuity benefit is expressed in terms of a future monthly payment (e.g., \$1,000 per month beginning at age 65 and continuing until death). Of course, the amount allocated in a defined contribution plan to stable value is always seen as a lump sum amount on a benefits statement. An important difference—and the real value of an annuity—is the mortality guarantee. After years of neglect, the benefit of having a payment stream that you cannot outlive, as an annuity provides, is now being rediscovered. Increasing longevity and market volatility are certainly two of the major drivers here. Fortunately, the stable value investor can readily convert his or her balance at retirement into an individual annuity, should they so choose. In doing so, they will effectively recreate the lost pension plan benefit. Loss of a defined benefit plan is not something that any employee will view as a positive development. Once it’s gone, employees should turn their attention to developing a practical replacement strategy.

I have not run this approach by Jim, but I suspect that he would approve. ■

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