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Fireside Chat

Your Monthly Update from KCS

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2013: A Look Back and New Lessons

“My role in society, or any artist's or poet's role, is to try and express what we all feel. Not to tell people how to feel. Not as a preacher, not as a leader, but as a reflection of us all.” (John Lennon)

As we gaze back on 2013, as we do following any year, we reflect on both the positives and negatives that impact our lives, our families, friends and colleagues, our community, our industry, our country and the world. We wonder why these events occur, why we may or may not have been involved, and whether or not there was anything that we could have done to alter the outcome through our collective experience.

There are more than 31.5 million seconds in a calendar year, and something extraordinary is happening all the time. From events brought on by Mother Nature to those created by man’s own hands, we could pen chapters on what has transpired in 2013. Unfortunately, much of the reported news highlights the pain and anguish that our world’s citizens are enduring.

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For instance, each year seems to reinforce the fact that Mother Nature is in charge, and we continue to marvel at her ferocity, as she unleashes super storms, such as the mile-wide tornado that struck Oklahoma in May that killed 24, or Typhoon Haiyan that hit the Philippines in November impacting / displacing more than 4.3 million people, while taking more than 4,000 lives. We could go in an entirely different direction with this piece and focus on Pop Culture topics, such as the birth of His Royal Highness Prince George or the entertainment industry that always has a plethora of interesting characters and events to discuss. There is always the world of sports, but speaking personally as a Mets, Giants, Rangers and Knicks fan, there isn’t a more depressing topic for me these days. Instead of seeking some input from you as to where the S&P 500, U.S. 10-year Treasury or gold will close next year, we could give you a pop quiz and ask such questions as to “Who is Ben Haggerty? (The answer is at the end of this article).

Despite the myriad directions this piece could travel, we, as asset consultants, will focus our attention on those stories and events that had an impact on the retirement industry and the markets from which we hope to generate returns to support our retirement programs. This article will highlight a few of the major developments that directly impacted

2013: A Look Back and Lessons Learned (cont'd)

participants in the U.S. retirement system, including both defined benefit and defined contribution plans. In the following pages we will focus our attention on Detroit's bankruptcy and the impact that declaration may have on the City's defined benefit participants, both active and retired. In addition, we will review the impact that enhanced fee disclosure rules had on defined contribution sponsors and participants. Finally, we will review the outstanding performance of the U.S. equity market, and its impact on our retirement participants.

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Detroit's Bankruptcy – Unique Event or Opening of the Floodgates?

There was likely no greater event in 2013 than Detroit's Bankruptcy filing that has the potential to impact public defined benefit programs for years to come. On July 18, 2013, the city of Detroit filed for protection under Chapter 9 of the U.S. bankruptcy code. Detroit's bankruptcy filing listed about $18.25 billion worth of debt, with slightly more than half of Detroit's debts ($9.20 billion) representing the unfunded liabilities of the city's retirement benefit plans, one for general employees and the other for police and firefighters, and "other post-employment benefits" (OPEB). The city has about 33,000 workers and retirees who have been promised what human resources records call an "exceptional benefit package" to promote loyalty and reduce turnover.

Furthermore, on September 26, 2013, as reported in the NY Times, Detroit's emergency manager, Kevin Orr, announced that he wants to freeze the city's pension system for public workers in light of mounting evidence it was operated in an unsound manner for many years, contributing to the city's downfall.

Details of the proposed pension freeze were outlined separately in a memo sent to Detroit's pension trustees in mid September. The memo announced that the city's current defined-benefit pension plans would be closed to new members as of Dec. 31. City workers would stop building up their pensions as of that date but would remain entitled to the benefits they had accrued up until then.

This type of pension freeze is legal and fairly common in the private sector. But public employees' unions say that such a freeze would be illegal for their members because of state laws and constitutional provisions that cover government workers. Tina Bassett, a spokeswoman for the general pension trustees, said they opposed the pension freeze and saw it as a sign of bad faith on the part of the emergency manager's legal team.

However, on December 3rd, the city of Detroit officially became the largest municipality in U.S. history to enter Chapter 9 bankruptcy after U.S. Bankruptcy Judge Steven Rhodes declared it met the specific legal criteria required to receive protection from its creditors. The landmark

Detroit's Bankruptcy – Unique Event or Opening the Floodgates? (cont'd)

ruling ended more than four months of uncertainty over the fate of the case and sets the stage for a fierce clash over how to slash an estimated $18 billion in debt and long-term liabilities.

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The concern that we have is that this ruling will provide negative incentive for struggling cities and states to pursue a similar course with regard to unfunded pension liabilities. As we've discussed in several of our *Fireside Chats*, we firmly support the use of defined benefit plans as the backbone of any retirement program. However, we also believe that there are current practices that need to be reviewed and potentially altered to ensure that future liabilities can be met. Our retirees / beneficiaries are counting on us.

Full Disclosure - Desired Results?

Defined contribution plan sponsors were gifted with additional responsibilities in 2013 as they were impacted by the new fee-disclosure regulations that took effect in August 2012. Under the new regulations, the Department of Labor (DOL) requires that plan- and investment-related fee disclosures be provided to new hires and current employees every quarter (typically as part of their account statements). The information must also be available online, along with a glossary of investment terms. Plan sponsors had to coordinate efforts with investment vendors, Third Party Administrators and their internal HR Departments to ensure compliance.

Was it all worth it? According to findings from the nonprofit Employee Benefits Research Institute's 2013 Retirement Confidence Survey, about half (53 percent) of defined contribution plan participants report having noticed the new fee disclosures, and only 14 percent of those who noticed this information (7 percent of all plan participants) say they have made changes to their investments as a result of the expanded information about fees. Of those few participants who made changes, the most common actions were to move money out of more expensive investments or to withdraw money from the plan.

It appears plan sponsors are still getting used to the reporting rules. Industry groups pressed the Department of Labor (DOL) to clarify its guidance on the deadline to disclose to employees the annual fees they pay for their 401(k) or other defined contribution plans. The participant-level fee-disclosure regulations require plan administrators to "at least annually" provide plan participants and beneficiaries with detailed investment-related information about designated investment options, which includes comparative charts along with written materials. The regulation defines "at least annually thereafter" as at least once in any 12-month period, regardless of whether the plan operates on a calendar or fiscal year.

Full Disclosure – Desired Results? (cont'd)

Plan administrators and service providers had expressed concerns about this timing requirement and its lack of correlation with other annual participant disclosures. Although the regulation allows fee disclosures to be included with other annual benefit notices, the early deadline would have required that it be sent in its own separate mailing, rather than at the end of the year during open enrollment.

"…the DOL said it would consider plan administrators as having satisfied the "at annually thereafter" requirement if they provided a comparative fee chart to employees no later than 18 months after issuing the prior annual fee disclosure."

In Field Assistance Bulletin 2013-02, released earlier this year, the DOL said it would consider plan administrators as having satisfied the "at annually thereafter" requirement if they provided a comparative fee chart to employees no later than 18 months after issuing the prior annual fee disclosure.

Although the bulletin specifically mentioned the comparative chart, many retirement plan professionals believe that the intent was to provide a one-time extension for all of the regulation's annual fee disclosures, and not just for the comparative chart. In a Sept. 18, 2013, comment letter, the ERISA Industry Committee (ERIC), the Plan Sponsor Council of America (PSCA) and the U.S. Chamber of Commerce asked the DOL to confirm that the guidance applies to all of the requirements under the fee-disclosure regulations. With these requirements still in their infancy, we will probably see some additional tweaking as we move into 2014.

U.S. Equities – To Infinity and Beyond!

If Buzz Lightyear were an equity investor, he would be thrilled with the trajectory that U.S. equities followed this year. With the exception of a short timeframe following the original tapering announcement and the concerns that followed, the U.S. stock market enjoyed an exceptional year. Equities, as measured by the S&P 500, are enjoying their best performance year since 1997, while the Dow Jones is experiencing its best year since 1995. The Dow, S&P 500 and Russell 2000 are up 26%, 30% and 37%, respectively through December 30th's market close. No matter how you look at it, the market has enjoyed a banner year.

Each of the major indexes have either achieved all-time high levels or multi-year peaks, in the case of the NASDAQ index. In fact, the WSJ reported (12/31/13) that the Dow had achieved 51 new highs last year. According to S&P Dow Jones Indices, the S&P 500 is now up 125% for the 5-years ending November 30, 2013, which would include the market returns for the final 3 1/2 months of the great recession. It is amazing how quickly the recession has become just another a blip on the radar screen of institutional investors.

What has this exceptional year done for our pension plans and defined contribution participants, and what will 2014 bring? Just once, I, Russ Kamp, wish that I could leave well enough alone and accept things for what they appear to be and enjoy the fruits of what this market has provided. Life would be so much more relaxing. But, alas, I can't.

U.S. Equities – To Infinity and Beyond! (cont'd)

The exceptional return within equities this year has obviously had a positive impact on funding ratios, as most plans will have exceeded their 7.5% to 8.5% ROA, while long-term interest rates also rose reducing the present value of a plan's liabilities. The combination of the two helped to significantly improve funded ratios that had plummeted in the 2007-2012 period as rates fell and equity markets were basically flat.

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However, the average plan sponsor and DC participant have reduced their exposure to traditional equities. As we reported in the June Fireside Chat, individual participants had reduced their equity exposure by more than 10% following the crash, while also sitting on considerable GIC / stable value /money market balances. In addition, institutional plans (including Endowments & Foundations) had dramatically increased their exposure to alternative investments which, by their very nature, are not designed to keep pace with the equity markets (both rising and falling), and in keeping with this expectation – haven't! So, the negative psychological impact from the great recession has caused investors to be lighter in their exposure to traditional equities than they were at the end of 2007.

Furthermore, as we witnessed during the first decade of the 21st century, and again most notably in 2011, there remains a mismatch between assets and plan liabilities. The performance of equities in 2013 is likely to have sponsors of DB plans maintaining this mismatch, as opposed to using the liability side of the equation to dictate the appropriate asset allocation. It is common wisdom among market participants today that interest rates have to rise, and as such, why lock in liabilities at these interest rate levels. However, we question that common wisdom, and remain focused on the market forces that might lead us in a different direction. Furthermore, we are always frightened of what might be when everyone believes that something is inevitable.

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Although 2013 proved to be an exceptional year, only about 4.5% of the performance of the S&P 500 is earnings-driven while the balance of the return was achieved through multiple expansion, according to Factset. Year-over-year earnings growth for the S&P 500 constituents has been on a negative trajectory for a while, and although multiples for the next 12 months are "only" at 15.4 times, some of the stimulus for the exceptional returns has been removed from the market, particularly the fiscal deficit, which is down from $1.3 trillion to less than $800 billion at this time. We are not anticipating an immediate sell-off in U.S. equities, but we certainly don't expect performance in 2014 to be anywhere close to that which we witnessed this year.

On to 2014

In many ways, 2013 was an exceptional year for the U.S. retirement industry. As such, there were so many subjects that we could have discussed. We hope that you appreciate our focus on issues that impact our industry and the participants for whom we are responsible. We remain committed to preserving defined benefit plans as the primary source of retirement income, while favoring the use of defined contribution plans as secondary sources of support, which was their original intent. Unfortunately, our crystal ball remains as cloudy as anyone else's, and trying to "forecast" a one-year return is usually folly. However, for fun (and pride, not prize), we'd be interested in receiving your expectations for the S&P 500, U.S. 10-year Treasury rate, and gold in 2014. We'll share our thoughts with you, and we'll monitor the results throughout the year.

So, who is Ben Haggerty? He is none other than Macklemore, who along with producer Ryan Lewis, released the song "Thrift Shop" in 2012, which reached number 1 on the U.S. Billboard Hot 100 chart in 2013, selling more than 2.2 million copies. Their second single, "Can't Hold Us" also peaked at #1 of the Billboard Hot 100 Chart, making Macklemore and Ryan Lewis the first duo in the chart's history to have their first two singles both reach number 1. You can thank KCS Partner, Dave Murray, for the pop culture education.

May 2014 be your best year yet, filled with family, friends, prosperity, and importantly, good health. With regard to the latter, a very good friend and mentor of mine is suffering through ALS, and his courageous battle has been an inspiration to those of us who have the pleasure to know him. We take so many things for granted on a day-to-day basis. Your health can't be one of them. Be well!

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