INVESTMENT MANAGEMENT & CONSULTING GROUP

VIEWPOINTS

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MARKET COMMENTARY FREDRIC W. WILLIAMS

There And Back Again…

Much has been bantered about in the popular press recently about the "lost decade" of investing as the first ten years of the newest millennium drew to a close and it became apparent that many of the domestic equity indices were flat to lower when compared to where they closed out the 1990's. And although this rings true for the most part, the devil, as he is wont, is in the details. The rate of return numbers for the last ten years are in fact dismal for portions of the stock market, but as we've frequently ranted about in this space in the past, we've never believed that prudent long term investors should solely invest in the equity indices – something that would be akin to playing a round of golf with just a driver in the bag. And as it turns out, a peek in the rearview mirror seems to indicate that those who were better diversified amongst assets classes (more clubs to play with) had less volatility (kept the ball in the fairway more) and superior performance (shot better scores).

From a macro standpoint the last two decades suggest some statistical trends that may want to be considered for inclusion in any longer term investment allocation metrics. According to Ibbotson Associates the assumed average annual return from the domestic stock market is in the 10-11% range, although during the period from 1990 through 1999 annual equity performance ranged from a low of 18.21% (S&P 500), to 18.35% (DJIA) and 32.41% (NASDAQ). Even to the untrained eye these were "above average" while to the stat geeks they represented a data sampling several standard deviations above the norm. Although at the time his comments, much like Greenspan's quip about "irrational exuberance", were considered the quaint musings of someone who didn't recognize the "new paradigm", Warren Buffett suggested at the start of this decade that he expected a mean (used as a noun, not an adjective) revision in domestic equity performance during the first ten years of the new century. And surprisingly enough he was spot on as we look back a decade later, given that the annualized total return numbers for the aforementioned indices came in at approximately -2.9%, +1.2% and -6.4% respectively. An argument could be made that the pendulum has a least reverted to the mean, if not migrated toward the other extreme.

But as inferred earlier, not all asset classes, or for that matter all aspect of the equity markets, had such extreme performance swings over the last couple of decades. And for those prudent investors who adhered to conservative asset allocation structures, rather than chasing mediafomented day trading fads, the last ten years haven't been that bad. In fact, for those same folks who had the intestinal fortitude to stick to their diversified portfolios when they lagged the popular indices in the 90's, the last 20 years have been quite good.

Remembering that more than two-thirds of long term portfolio performance is a function of compounding cash flow, it's no surprise to learn that some of the best performing sectors had an income orientation to them. The Dow Jones Utility Average, mentioned frequently in this space, had an annualized return of 7.72% during the 1990's and followed that up with 6.95% during the 2000's. Similarly, the Barcap (formerly Lehman) Intermediate Aggregate Bond Index posted 7.45% and 6.2% returns respectively for the last two decades. Even a traditional balanced mutual fund provided returns 11.5% and 2.7%, according to Morningstar. All of which leads us back to last quarter's comment about favoring the tortoise or the hare, and reinforces, in our opinion, the attractiveness of the lumbering land turtle.

Not that we're fixated on looking out the rear-view mirror to determine our future direction through the investment landscape, but Churchill's comment about learning from history lest you be doomed to repeat it seems apropos at this juncture. Understanding the basis for longer term portfolio performance, recognizing the importance of compounding cash flow and identifying reasonable valuations are all ingredients in the cauldron with politics and economics that forges a plan to deal with the investing future.

As we peer into the ether of the next decade we use history as a reference point and then incorporate the unique circumstances that we find ourselves in after the first ten years of the new century. The challenges of unemployment, housing, credit, along with the deleveraging dynamic that Terry discusses below, all suggest that the economy may have significant headwinds for quite some time. Add to that ballooning deficits, the inevitable tax increases and consumers hunkered down to rebuild their balance sheets and it seems apparent that GDP growth may not be as spectacular as the equity market's march forward has suggested. We're far from naysayers on the prognosis for economic recovery, we just believe that it's going to be far more gradual given the various impediments noted above.

With central banks and governments preparing to exit the various stimulus and support programs used to save the planet over the last 18 months, we feel more comfortable in the tortoise's shell as we navigate what may very well be a modified form of capitalism.

> *"With less of this support, a continued recovery in equities may have to be driven by earnings growth. In previous cyclical profit rebounds, consumer discretionary companies, such as retailers, and financial services led the way. But these sectors face a tough year ahead as consumers remain mired in debt and banks tackle lingering loan losses from the financial crisis…Consumer discretionary and financial sectors drove past recovers, with average annual earnings growth of 64% and 55% respectively during five rebounds since 1973…This time round these sectors may struggle to generate such strong earnings growth."*
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> *MarketWatch 1/1/2010*

We continue to believe that focusing on dividend production in the equity arena, maintaining a defensive posture with bond allocations, along with diversifying across currencies will provide the preferred income orientation to navigate the somewhat unchartered waters we find ourselves in. Most importantly at this juncture, we think the advent of a new decade should also be the tripping point to re-evaluate the assumptions and expectations you have within your overall investment and financial plan to make sure that what you're doing is going to get you where you want to go.

EQUITY MARKET OVERVIEW — INVESTMENT POLICY COMMITTEE

A Slowing Ascent?

"A recovery on props of an economy on crutches accompanied by a stock market on steroids" — *A. Abelson, Barron's 12/28/09*

The preceding quarter's record book returns were followed by a continued push higher in the domestic equity indices, albeit at a slightly slower pace than the torrid numbers posted in Q3. Both sides of the directional argument for how we got where we are, as well as where we may be headed, have well articulated positions and perspectives as a tumultuous 2009 was put to bed. And regardless as to whether one looked state side or overseas, the rebound from the March lows was impressive given the sentiment that prevailed at the time. As noted above, much has been said about the "lost decade" in the markets, but the last three quarters of 2009, at least when viewed within the abbreviated lens of the last year, have lent credence to certain aspects of "staying the course" when events and outcomes are far from unequivocal.

Although far from flying forward on vapors, the developed worlds bourses slowed a tad from the rocket propelled ascent of the previous two quarters, but still posted respectable numbers for both Q4 and all of 2009. The Dow Jones Industrial Average added a gain of another 7.4% for the quarter, closing the year up 18.8%, while the broader S&P 500 added 5.5%, up 23.5% for the year as a result of the increased exposure to financial sector companies and their meteoric return from the ashes earlier in the year. Even the Dow Jones Utilities Average finally joined the party, moving 5.6% higher in Q4 (7.3% for the year), while the NASDAQ continued on full thrusters, climbing another 6.9% in the quarter to close out 2009 up an impressive 43.9%, although still off 55% from its dot com peak at the start of the decade.

Similar to last quarter, the overseas developed markets did modestly better than their domestic brethren, while the developing world continued its rocket launch sequence started earlier in the year. The fundamental story behind the march of the emerging equity markets continues to be that the developing world represents more than 80% of the globes population, along with the expectation that these export engines will mature into sustainable consumer based economies with expanding middle classes that will drive growth into the future.

London's FTSE 100 added 6.35% in the quarter to close the year up 22.1%, with similar results on the continent as Frankfurt's DAX was up 5.8% (23.8% for the year), and the Paris CAC 40 increased 4.4% (up 22.3% for 2009). Tokyo's Nikkei rebounded from Q3's political and currency head winds to add 4.6% in the quarter and finish the year with a respectable 19% gain.

The developing world saw significant and broad based advances on top of what they'd already posted through the first three quarters of 2009. Using the BRIC countries as a proxy for the majority of the emerging markets, we saw Brazil's Bovespa climb another 18.9% in Q4 to finish the year up 82.7%, Russia's RTS won the home run derby for the quarter and year up 45.6% and 128.6% respectively, while India's Bombay Sensex added only 3.5% for the quarter, but closed 2009 with an increase of 81%, and China's Shanghai Composite rebounded from a weak Q3 to jump 27.4% in the quarter and post none-too-shabby 80% for the year.

> *"All of which shows that there's nothing like a sunny attitude on the part of doughty investors and, lest we forget, trillions and trillions of dollars showered down like confetti on their financial sectors by central bankers wearing Santa Claus suits, to goose markets beyond even a raging bull's wildest dreams.*
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> *Our heart (yes, Virginia, we have one) leaps up when we drool over these extravagant performances. What tempers our enthusiasm is -- as an old, wise and perceptive man once pointed out to us -- no tree grows to the sky. That the markets seem to be determined to belie that remarkable observation is evident in their price/earnings multiples, which have risen apace. On the S&P, for example, the multiple is now 25, a lofty perch not reached in some seven years.*
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> *There's this, too: Just as governments giveth, so do they taketh away. And, frankly, never have governments in modern memory given in such quantities, a generosity all the more impressive since many didn't have that much to give to start with. So they compensated for that unfortunate lack by printing bundles more of the paper of the realm.*
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> *"But for countries, just as for humble folk like us, no imprudent deed, regardless of how altruistic its inspiration, goes unpunished. We have no reason to believe that this time is different."* *A. Abelson, Barron's 1/4/10*

As we voiced last quarter, we don't question that there will be a recovery from the dark days of late 2008-early 2009, or that the recession may very well be over. And we're firm believers in the impact that the monetary and fiscal stimulus showered on the global economies by the central banks had in stifling the world's free fall. We're just concerned about the staying power of all this activity once the excess liquidity starts to be reined back in, as it inevitably must at some point. The economy may chug along at lower GDP rates with higher unemployment levels for quite some time, and that appears to be out of sync with a market rebound that has pushed numerous valuation measurements to *at least* their long term averages. It would therefore appear that the equity indices have priced in a pretty rosy view of what the next year is going to look like from a profitability standpoint – and that's an assumption we feel may have some considerable air underneath it. Not that we don't believe there are opportunities, because there are. We just believe that the focus needs to be on income producing total return sectors that have lagged the indices and can provide the more sustainable returns that we think will be the norm going forward.

The Fed Flat Lines…

After a year of aggressively cutting rates as part of a monetary policy to stem our economy's decline in 2008, 2009 was a year where the F.O.M.C. sat on its hands as far as the Fed funds rate was concerned – primarily due to the fact that they couldn't reduce the range any lower than the 0.0% to 0.25% that it had been set at since the December 2008 meeting. Although quiet on the short end of the yield curve, the Fed was far from inactive as it continued its quantitative easing policy via massive open market purchases of Treasuries and mortgage-backed securities.

Following the credit market carnage of 2008, sovereign intervention on a global scale helped partially resuscitate the world's bond markets.

> *"Help from the U.S. government gave credit markets a huge boost as many asset classes rebounded from sharp declines in 2008.*
> *Prices of corporate bonds, mortgage-backed securities and leveraged loans soared back to levels unseen since before Lehman Brothers collapsed in September 2008, as investors gained confidence throughout the year that the worst of the credit crisis had passed.*
> *Investors poured cash they had on the sidelines into riskier assets, causing a once-in-a-lifetime opportunity for returns of 50% or more in some categories, including "junk" bonds and leveraged loans.*
> *The new year is unlikely to bring results of the same magnitude, as the government winds down its many support programs, pulls out of the mortgage-backed-securities market and codifies regulatory changes to the financial system."* *WSJ 1/4/10*

The flight-to-safety mantra that was the hallmark of 2008 turned into the run-for-risk trade as the central bank-suppressed short end of the yield curve forced investors out of low yielding money market funds and Treasuries in the quest for higher returns. This dynamic created mirror image annual rates of return for the various bond market asset classes – last year's biggest winners became this year's biggest losers, and vise versa.

The 10-year Treasury note hit a closing low yield of just 2.078% in December of 2008 as the dollar-centric run to quality pushed prices higher, resulting in nearly a 20% total return. As investors left the safe have of government bonds the 10 year yield climbed to 3.91% on 12/31/09, providing a *loss* of 9.3% for the year. Conversely, high-yield corporates last year saw declines of nearly 25%, but this year were beneficiaries of the migration out the risk spectrum and realized total returns that exceed 55% for 2009.

Like last quarter, spreads continued to contract as the U.S. Government's record setting $2.1 trillion in debt issuance pushed longer date Treasury yields up and the demand for higher yielding investment grade corporates pulled yields lower for that asset class. The Federal Reserve and Treasury were also involved from a quantitative easing standpoint as purchasers of mortgage backed securities and as backers (via the FDIC) of more than $300 billion in debt issued by banks and other financial institutions.

Outside of these aforementioned credit market confines, little of the bond market stimulus has been able to make its way from Wall Street to Main Street, as the securitized market has yet to see much activity. This more consumer and small business oriented arena, covering everything from vehicles to credit cards, leases and lines of credit has yet to recover to its pre-crash levels.

> *"But overall, these markets are still shrunken compared with pre-crisis levels. Demand for new credit is lower as consumers retrench and wrestle with a still-struggling housing market. Issuance of asset-backed debt last year was 23% lower than 2008, according to Dealogic, and there have been nearly no new securities issued and backed by nonconforming mortgages."* *WSJ 1/4/10*

The central question at this point is when (not if) the stimulus liquidity will start to be withdrawn and what the economic world will look like at that point in time. Although banks have benefited from an artificially steepened yield curve (to borrow at lower rates and lend at higher ones), the short end of the yield curve will likely rise first as the stimulus punch bowl is removed. This, as well as resulting increases along the rest of the yield curve, could represent significant headwinds for any nascent recovery.

Although the inflation and deflation camps will continue to debate their respective positions, we feel that the end game will be represented by higher interest rates over the next 3 to 5 years. Whether it's influenced by relative currency issues or the absence of buys for our continued debt issuance, we see higher rates as the eventual inevitable consequence.

Additionally, the mixed economic data doesn't seem to support an organically expanding economy absent the existence of subsidized interest rates and stimulus gizmos. From the one-off impact of cash for clunkers on auto sales, to the recent plunge in pending home sales in the face of the loss of the tax credit, 10% unemployment and businesses still in credit-induced bunker mode seems to suggest that any inflationary pressure will be evidenced on the cost-push, rather than the demand-pull, side of the equation.

From an asset management standpoint we still see long term value in the fixed income foundation that prudent portfolios should be built upon. With the compounding of cash flow such a significant factor in consistent long term rates of return, we see this asset class as being both strategic and tactical. We therefore will continue to keep our maturities in the short to intermediate range, maintain a laddered structure to spread our interest rate risk, as well as add to our inflation protected and floating rate allocations both domestically and abroad.

WEALTH MANAGEMENT UPDATE

Planning Issues to Watch in 2010 TRACY W. ROGERS & TRAVIS SPENCER

Recent years have seen a flurry of legislation impacting retirement plans. Here are some of the more significant changes that take effect in 2010.

Non-spouse rollovers must be permitted

The Pension Protection Act of 2006 allowed, for the first time, non-spouse beneficiaries to make a direct rollover of inherited funds from an employer plan to an IRA. While the provision seemed fairly straightforward at the time, confusion arose as to whether plans were actually required to allow these rollovers. Congress addressed this in the Worker, Retiree, and Employer Recovery Act of 2008--beginning in 2010, employer plans must let non-spouse beneficiaries make a direct rollover to an IRA if they so choose. The new law also clarified that prior to 2010 employer plans could, but were not required to, allow the rollovers.

IRA conversions for (almost) everyone

Beginning in 2010, if you own a traditional IRA, you'll be able to convert it to a Roth IRA. The income limits and marital status requirements that previously applied to Roth conversions were repealed by the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA). In addition, if you convert a traditional IRA to a Roth IRA in 2010, you'll be able to report half the income on your 2011 tax return and half on your 2012 return. Or, if it's to your benefit, you can instead elect to include the entire amount in income on your 2010 return. It's up to you.

If you inherit a traditional IRA from your spouse, and you elect to treat that IRA as your own, you'll also be able to convert the inherited IRA to a Roth IRA in 2010, regardless of your income or marital status. Non-spouse beneficiaries, however, still can't convert an inherited traditional IRA to a Roth. Note that the income limits for contributing to a Roth IRA haven't changed for 2010. If your income is high enough, your ability to make regular contributions to a Roth IRA in 2010 may be limited, or even eliminated. You'll have to aggregate all your traditional IRAs when calculating the tax effect of the conversion.

Employer plan conversions for everyone

Beginning in 2008, employees and beneficiaries were permitted for the first time to essentially "convert" employer plan distributions by rolling the funds over to a Roth IRA. This was allowed, however, only if the payee satisfied the income and marital status limits that applied to traditional IRA conversions. The elimination of those restrictions by TIPRA, described above, also applies to distributions from employer plans--so beginning in 2010, anyone who receives an eligible distribution of non-Roth funds from an employer plan can roll those funds over to a Roth IRA, regardless of income or marital status. This applies even to non-spouse beneficiaries--but only if the transfer to the IRA is done in a direct rollover.

Here comes the DB(k) Plan ...

Beginning in 2010, "small employers" (those that generally employ at least 2 and no more than 500 employees) can adopt a DB(k) plan--a single plan that incorporates both a 401(k) plan and a defined benefit plan (including a cash balance plan). A single trust is used, but there is separate accounting for the defined benefit and 401(k) portions of the plan. The plan must meet certain benefit, contribution, vesting, and nondiscrimination requirements. In return, the plan will be exempt from top-heavy rules and certain 401(k) testing. Because the DB(k) plan is one plan instead of two, it is expected that the plan will be simpler to administer and less costly than maintaining two separate plans. This, in turn, may provide an incentive for employers to begin offering defined benefit plans to their employees in addition to 401(k) plans. Whether this proves to be the case, however, remains to be seen.

Contribution Limits and Catch Up Contributions

The IRS has issued the cost-of-living adjustments for 2010 that affect employee benefit plans. Most 2010 limits applicable to 401k and other plans will remain at their 2009 levels.

Maximum Deferral and Threshold Limits for 2009 and 2010		
Limit	**2010**	**2009**
Elective Deferral Maximum for 401(k) Plans and 403(b) Plans	$16,500	$16,500
Elective Deferral Maximum for 457 Plans	16,500	16,500
Catch-Up Limit (Age 50 and Older) for 401(k), 403(b), and 457 Plans	5,500	5,500
Traditional & Roth IRA Contribution Limit	5,000	5,000
IRA Catch-Up Limit (Age 50 and Older)	1,000	1,000
Simple IRA Contribution Limit	11,500	11,500
Simple IRA Catch-Up Limit (Age 50 or Older)	2,500	2,500
Coverdell ESA Contribution Limit	2,000	2,000

The 2010 Estate Tax Quandary

In 2001 Congress passed the current estate-tax law, which gradually phased out the tax through 2009 and repealed it for 2010. However, in 2011 the current law is set to expire and estate-tax levels that applied years earlier are scheduled to go back into effect. The House of Representatives passed a bill in late November that would eliminate the 2010 repeal and permanently keep the estate tax at levels that were in effect in 2009. But the Senate has not yet voted on estate-tax legislation and there is debate about the constitutionality of any bill passed later in the year that be retroactive to January 1st of 2010.

In 2001, estates were exempt from paying tax on their first $675,000 of value; they owed a tax of up to 55 percent on amounts above that level. By 2009, heirs could exempt $3.5-million from taxes ($7-million for couples), with amounts above that taxed at 45 percent. While current law repeals the estate tax for 2010, estate-tax levels for 2011 would carry an exemption of $1-million and a top tax rate of 55 percent.

Although many estate attorneys have had this dilemma on their planning radar for a while, we would recommend scheduling a review of your present documents and strategy with counsel to assure their effectiveness in this current environment.

Life Without Debt?

"Will this rescue plan work? It will buy time for balance sheets to be repaired. But it has an essential flaw. It tries to maintain the status quo. Hank Paulson designed the plan to get the economy to "fund expansion." We cannot afford what we have. The plan should really be to shrink the economy back to a sane level."

Inside The Markets ~ October, 2008

"Business. It's quite simple. It's other people's money."

~ Alexander Dumas

Leverage is the life blood of a modern economy. As Dumas put it so succinctly, if you want to get rich, you have to use other people's money. As we emerge from this most recent recession, the economy faces a lack of capital to borrow to fund expansion. In financial jargon, this is an absence of leverage. For better or worse, our economy functions on credit.

Normally, recessions end as credit becomes easier and leverage increases spending power - both corporate and consumer. We are in a much different position in 2010 because this latest recession was caused by the deflation of the real estate bubble fueled by excessive borrowing and irrational lending standards. We cannot grow our way out of this slump.

It has been 16 months since we first heard of TARP funds and financial stimulus packages. Sixteen months since Lehman Brothers filed for bankruptcy protection. Although there is a different administration in the White House, the financial industry is still governed by the same players. Most troubling of all, the world still depends on the U.S. consumer to refloat the global economy. But the consumer is showing signs of not wanting to go back into hock. This is a double-edged sword.

Total consumer debt has declined for the first time on 60 years. The economy may be on the way to "shrinking back to a sane level." The good news is we move toward an economy with stronger fundamentals away from a debt-fueled expansion that collapses in a sea of bankruptcies, cost-cutting, lay-offs and precipitous declines in employment. Savings rates increase. Personal balance sheets become more sustainable.

The bad news is that without domestic consumption, there is very little real growth. The American consumer is the largest factor in the global economy, spending an amount worth roughly double the combined economies of China and India. In a world without leverage (like today), capital expenditures are delayed, job growth disappears and earnings are slashed. The assets that we all borrowed against (real estate, 401k plans) lose value and no longer function as our personal ATMs.

Those of us who were involved 20 years ago may remember a somewhat similar situation when the junk bond market collapsed in 1989, ending the great LBO boom. The collapse was triggered when Michael Milken was indicted on 98 counts of racketeering and securities fraud. Milken's firm, Drexel Burnham, then defaulted on a $100 million loan and filed for Chapter 11 bankruptcy protection on February 13, 1990.

Without Drexel and Milken, the leveraged debt markets shut down. Eventually LBOs returned, but it took 17 years before Kohlberg Kravis Roberts & Co. could top the largest buyout ever - $31 billion for RJR Nabisco in 1989 - with its $33 billion deal for HCA in 2006. Milken, a polarizing figure in the history of finance, was sentenced to ten years in prison and permanently barred from the securities industry. His sentence was later reduced for cooperating with investigators and good behavior and he served less than two years.

The problem was not just how much we bought; it was how we paid for it. For more than a decade, the U.S. economy has been caught in a cycle that saw consumers buying underpriced products from Asia using borrowed money or funds taken out of savings. If there is one valuable lesson we should take from the last recession it is that Americans must align their spending closer to income growth — and to rely much less on debt to finance their lifestyle. This change in behavior not only makes good sense, the future prosperity of the country depends on it.

RETIREMENT & FIDUCIARY CONSULTING UPDATE — STEPHEN L. EDDY

Fee Transparency

Fee transparency. It's a hot topic in Washington these days as it relates to the retirement plan market. When all the rhetoric is cast aside, it boils down to a simple concept: plan sponsors and plan participants have the right to know how much they are paying to whom for services rendered to their retirement plans, AND how much revenue the service providers are taking from the plans (these are two different concepts, as we'll see).

Congress is pushing for full disclosure of the fees, supported in their quest by plan participants, plan sponsors, independent fiduciaries, independent fee-based advisors and consultants (including yours truly). Naturally, the industry (led by the insurance companies, the mutual fund companies and the service providers) is pushing back. It's what happens any time a cash cow gets legislatively threatened.

The reason that this is an issue is that even after some long overdue fee disclosure and reporting simplification mandates directed at the mutual fund industry in the last decade, many fees associated with retirement plans remain "hidden". They are deducted directly from plan assets, so there is no easy trail of canceled checks to follow. Terms like "12b-1 fee", "Sub-TA fee" and "CDSC" are thrown around, yet few outside the industry understand what they represent.

In many instances, the plan sponsor simply has no idea how much the plan is paying for services. In many instances, the plan sponsor thinks there is no cost. And in many instances, the plan sponsor is paying well over 1.5% in "all-in" costs, when more competitive, less expensive options exist in the market place. To put this in perspective, consider these facts:

- Retirement plan fees are generated from a numerous variety of sources including: investment management, administration, recordkeeping, custody, asset operations, financial advice, consulting, plan audits, and legal expenses.
- They are billed or charged in multiple ways: asset-based, person-based, transaction-based, hourly or flat.
- In addition to the usual ongoing expenses, there are start-up fees, one-time fees and termination fees.

The result of all of these fees (besides confusion) and creative ways to collect them:

1. **INVESTMENT-RELATED EXPENSES ACCOUNT FOR UPWARDS OF 80-90% OF RETIREMENT PLAN FEES.**
2. **PARTICIPANTS UNKNOWINGLY PAY 85% OF THE PLAN COSTS.**
3. **"ALL-IN" PLAN COSTS FOR PLANS BETWEEN $0 and $10,000,000 CAN BE HIGHER THAN 2.3% OF ASSETS, AND OVER HALF COST MORE THAN 1.2% –** *ICI study, June 2009*

Why is this important? Consider that the higher the expense, the lower your return. Just a 25 basis point lower return on your $100,000 retirement plan balance over 10 years yields $5,000 less. Over 20 years this figure is $20,000 less. That is real money. And the only reason for the lower balances is the expense difference between share classes of the SAME mutual fund. This has nothing to do with - repeat nothing to do with – fund performance.

How is this possible? In this first part of a two part series (start holding your breath for the April newsletter!), I'll examine retirement plan fees from two angles – "all-in" cost (April), and the primary driver of retirement plan expenses: the mutual fund. Simply put, the mutual fund is the industry's "sun" around which all of the other fee category "planets" orbit. Following is a quick summary of mutual fund expenses:

<u>Mutual Fund Expenses</u>
According to the most recent prospectus, the American Funds Growth Fund of America investment management fee is an extremely attractive and reasonable .27%, or 27 basis points. At last glance, American Funds had **<u>18 different share classes</u>** for its funds. Morningstar shows expenses of the 18 funds ranging from .33% to 1.47%. IF EACH SHARE CLASS HAS EXACTLY THE SAME INVESTMENTS, AND EXACTLY THE SAME INVESTMENT MANAGEMENT FEE, WHY THE HUGE DIFFERENCE IN EXPENSES?

To understand this, we need to break down the way mutual fund expenses operate. There are three basic costs to a mutual fund:

1. ***Investment management costs*** *– the aforementioned fee representing how much the investment manager at the fund family (i.e. Vanguard, American, Fidelity, Oppenheimer, etc.) charges*

The investment management fee is the simplest, most straightforward cost. It is what the money manager charges to invest the assets. These costs typically range from .06% (six basis points) for some index funds to nearly 1.50% (one hundred fifty basis points) for some of the more esoteric emerging market, sector or specialty funds.

2. ***Distribution costs*** *– how much commission to pay to brokers who sold the funds; they come in two flavors: direct and indirect*

Direct costs:

- Front end sales loads - the 5.75% charge on most retail funds (invest a dollar, have 94.25 cents working for you).
- 12b-1 fees - the latter are the insidious but legally allowed fees that are deducted from performance to pay brokers a "trail" or continual payment for having sold the funds (the gift that keeps on giving). 12b-1 fees range from .25% to 1.00%.

Indirect costs:

- Finder's fee – also known as commission – the up to 1% of plan asset total, paid by the platform (John Hancock, American Funds, Great West, etc.) to the broker who sold the plan. For a $2.5 million dollar plan, this amount can be as high as $25,000, paid to your broker. This cost, while not coming directly out of plan assets, is factored into such things as contract surrender charges, fee minimums and even what interest rate you can get for your stable value fund.

3. ***Operational costs*** - *how much the fund pays for legal, advertising and accounting services*

These costs include trading costs for the fund, some marketing and audit costs, and are also the home to the rather opaque sub-transfer agency fee (or "Sub-TA fee"). The Sub-TA fee allows the fund to make payments to any vendor that provides sub-accounting services for the fund. This includes third party administrators and others who provide participant-level accounting for the plans. You may not be aware of these payments to providers for your plan (which can be as high as 10 basis points) because they are lumped under operational expenses, and not usually disclosed.

Between the investment management fee, the front-end sales load, the 12b-1 fee, the finder's fee, and the sub-TA fee, you can see how all of this accumulates pretty quickly. What the plan sponsor and plan participant needs to know is that there is a choice. Next quarter: "All-in" costs. Bet you can't wait.