

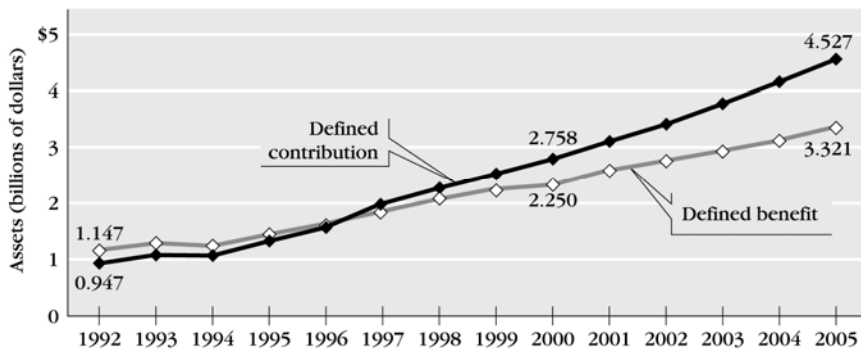
Chapter 8 ~ 12

Supplement

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Growth of DB versus DC, 1992–2005



Source: For 1992-1996, EBRI tabulations based on U.S. Department of Labor, Pension, and Welfare Benefits Administration, *Private Pension Plan Bulletin* (Winter 1999-2000); for 1997-2005, EBRI projections. Asset amounts shown exclude funds held by life insurance companies under allocated group insurance contracts for payment of retirement benefits. These excluded funds make up roughly 10 to 15 percent of total private funds assets. From EBRI, "Research Highlights: Retirement and Health Data," January 2001. Reprinted by permission of Employee Benefit Research Institute, *Research Highlights, Retirement Data*, January 2001.

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Why Employers and Employees Prefer DC Plans

- Employer benefits under DC scheme
 - Avoidance of long-term investment risk and future pension obligations
 - Avoidance of un-funded pension liabilities on balance sheets
- Employee benefits under DC scheme
 - Control over contributions and investment choices
 - Ability to calibrate the amount of their contribution (and deduction)
 - Opportunity for higher returns (and lower returns)
 - DC plans tend to vest earlier than DB plans
 - DC plans are more portable than DB plans
 - In the case of employer bankruptcy, DC plan assets are not subject to creditor claims

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How 401(k) Plans Work

- 401(k) is a section of the Internal Revenue Code governing “cash or deferred arrangements” (CODAs) that are part of a retirement plan
- Contributions are made usually as percent of employees' salary
 - Contributions can be elective, matching, or non-elective
 - Employee currently has \$11,000 pre-tax elective deferral limit (2002)
 - Total limit is \$40,000
 - Employees over age 50 may make “catch-up” contributions each year
 - Anti-discrimination tests may limit overall contributions for some

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How 401(k) Plans Work (cont.)

- Participants choose investments from a retirement menu
 - Plan sponsor designs the investment menu
 - Participants may change their choices from time to time
 - Employee's retirement benefits based on plan contributions and investment performance

Why 401(k) Plans Became So Popular

- Pre-tax deferrals reduce current taxes
- Earnings on contributions grow tax deferred
- Employer usually matches some of employee contribution
- Direct payroll deduction of employee contribution
- Portability in the event of job change
- Participants gain control over retirement benefits

Why Mutual Funds Became Popular

- Services
 - 800# access to account information
 - Voice response units
 - On-line employer access to account information
- Daily valuation and daily prices in the newspaper
- Participant communications
 - Investment education
 - Advice tools
- Broad investment selections
 - Name brand funds
 - Specialized products (e.g., lifestyle funds)

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Mutual Funds and 401(k) Plans

- Assets in 401(k) plans have increased, along with MF share of those assets
- Investment options
 - Employers must offer at least 3 core options to qualify for safe harbor
 - Average number of options available is 10 (1999)
 - Mutual funds are usually standard options
 - Other options include
 - GICS, employer stock, brokerage window, mutual fund window, commingled pools

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Mutual Funds and 401(k) Plans (cont.)

- Mutual funds in 401(k) plans are almost always no-load
- Other services
 - Daily processing (contribution, distribution, loans, etc.)
 - Participant communication (statements, plan choices, telephone, internet, etc.)
 - Services to plan sponsors

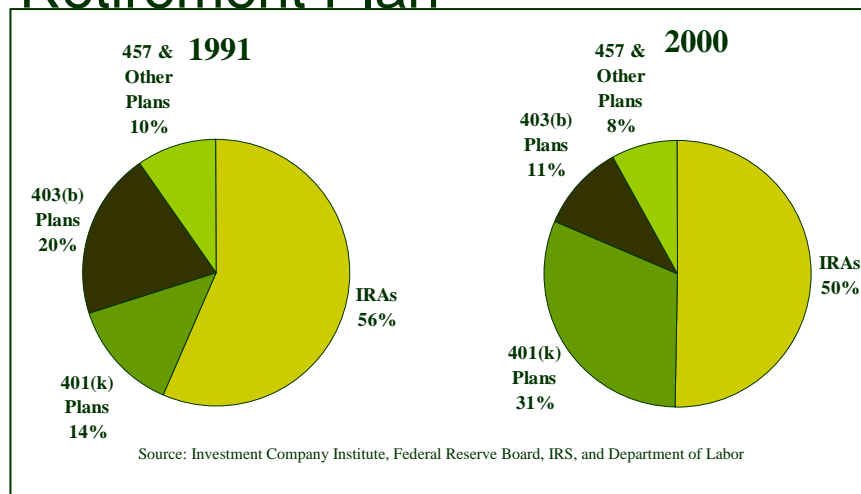
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Mutual Fund Assets by Type of Retirement Plan



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Growth of IRAs and Benefits to Mutual Funds

- Expected to grow from \$2.2 trillion in 1999 to >\$6 trillion in 2010
- Keys to growth are
 - Attracting new investors to contributory IRAs
 - Continuing to attract 401(k) and other DC participants to rollover IRAs
 - Rollover IRA is one established with assets rolled over from an employer-sponsored retirement plan (usually upon leaving)
 - DC distributions rolled to IRAs are projected to reach \$467 billion by 2010
 - Although expected to grow, rollovers can now be “rolled back” to DC plans

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Growth of IRAs and Benefits to Mutual Funds (cont.)

- Reasons that mutual funds dominate the IRA marketplace
 - IRA holders can control their investments through mutual fund selection
 - There is a broad range of investments available under a mutual fund IRA
 - Since IRAs are retail accounts, they benefit from all the retail services available to mutual fund customers
 - Success of mutual funds in 401(k) marketplace has strengthened the attractiveness of mutual funds in the IRA marketplace

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Future of Retirement Plans

- Distribution Planning
 - Current accumulation phase will shift to distribution phase as population ages (as baby boomers really move into retirement)
 - Rollover IRA will become more important
 - Distribution planning for retirees will become more important
 - Fund sponsors must offer tools
 - Fund sponsors must focus on appropriate investment products

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Future of Retirement Plans (cont.)

- Social Security Reform
 - Aging population will stretch/break “pay-as-you-go” system
 - Possible solutions being discussed include
 - Reducing social security benefits for future retirees or raising retirement age
 - Increasing payroll tax for current workers
 - Diverting general tax revenues from other programs to pay for social security
 - Allow some form of investment—part of the trust fund or part of individuals’ accounts—in the stock market
 - Social Security debate raises questions about potential impact on the mutual fund industry

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Case Study: People Who Are Insecure Investors

- I consider myself more of a saver than an investor
- I am not confident I know how to select investment options that meet my goals
- I am very concerned that I won't have enough money to retire
- I don't have a good idea of how much money I will need to retire

Case Study: People Comfortable With Their Investment Situation

- Not concerned I will fall short of retirement assets
- At the rate I am saving I am confident I will have enough money to retire
- I don't need help preparing a financial plan
- I rarely take greater risks for greater return

Case Study: Confident About Their Investments

- I am more concerned with investing than with saving
- I am willing to take higher risks to get higher returns
- I am confident about my selection of investment options

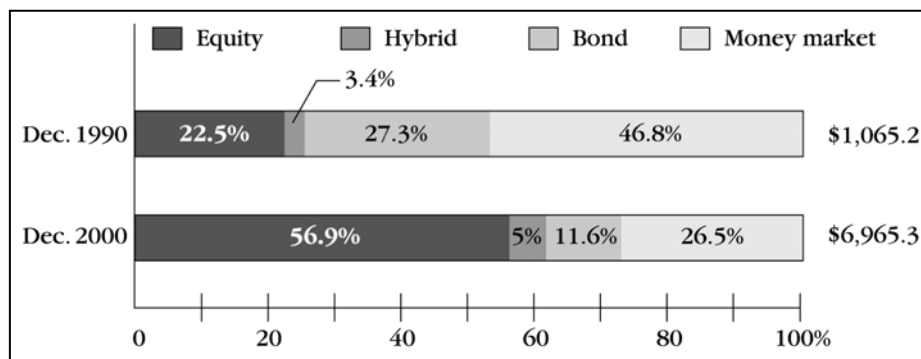
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Structure of Fund Industry: Asset Composition



Source: Investment Company Institute (ICI)

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Structure of Fund Industry: Industry Concentration Over Past Decade

Largest mutual fund complexes by assets, 1990 versus 2000

1990 Rank	Fund Group	Assets (\$B)	Asset Share	2000 Rank	Fund Group	Assets (\$B)	Asset Share
1	Fidelity Investments	108.3	10.2%	1	Fidelity Investments	822.9	11.8%
2	Merrill Lynch	90.5	8.5%	2	Vanguard Group	563.8	8.1%
3	Shearson/IDS	75.2	7.0%	3	Capital Research (American Funds)	359.8	5.2%
4	Dreyfus Corp.	57.4	5.4%	4	Putnam Funds	264.7	3.8%
5	Vanguard Group	56.6	5.3%	5	MSDW/Van Kampen	226.8	3.3%
6	Franklin	44.8	4.2%	6	Janus/Berger	206.3	3.0%
7	Federated	44.0	4.1%	7	AMVESCAP PLC (AIM/INVESCO)	205.5	3.0%
8	Dean Witter	40.2	3.8%	8	Merrill Lynch	184.9	2.7%
9	Kemper	37.1	3.5%	9	Franklin Templeton	172.9	2.5%
10	Capital Research (American Funds)	34.0	3.2%	10	Salomon Smith Barney/Citi/Shearson	169.6	2.4%
Subtotal - Top 10:		588.1	55.1%			3,177.3	45.6%
Total - Top 25:		812.9	76.2%			4,945.4	71.0%

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Mergers and Acquisitions Involving Fund Sponsors

- M&A activity increased throughout the 1990s
 - Trend coincided with stock market rise and general growth in financial services
 - 144 publicly reported M&A transactions analyzed in a Merrill Lynch study
- 3 main M&A categories analyzed in study include
 - U.S. domestic transactions
 - Cross-border transactions
 - Foreign transactions (not discussed in the chapter)

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Mergers and Acquisitions Involving Fund Sponsors (cont.)

- General M&A trends during the 1990s
 - Early 1990s
 - Transactions among U.S. financial firms were main focus
 - Intraindustry activity focused on fund sponsors being acquired
 - Later in decade
 - Fund sponsors began to become intraindustry acquirers
 - Pace of cross-border transactions increased
 - Acquirers paid higher and higher prices in anticipation of continued strong growth of revenues and assets

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The Case for Mergers in the Industry

- Economic factors—economies of scale
 - Overall asset size
 - Lower cost to buy than build
 - Reduction of overlapping costs
- Business factors
 - Product line extensions
 - Distribution expansion
 - Diversification

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The Case for Mergers in the Industry (cont.)

- Legal factors
 - Change in control terminates the advisor contract
 - Acquisition does not guarantee contract renewal
 - Need seller's assistance to obtain required approvals

Who Are Institutional Investors?

- Mutual funds
- Pension funds
- Bank trust departments
- Insurance companies
- Endowments of universities and foundations

Institutional Ownership by Size of Company

TABLE 11.1

Institutional investor concentration of ownership in the largest 1,000 U.S. corporations by bracket, 1990-3Q 1999

Top Corporations	Average Institutional Holdings		
	1990	1995	3Q 1999
1-50	50.1%	52.9%	58.2%
51-100	59.2	61.8	56.6
101-250	54.7	58.4	62.5
251-500	51.1	59.0	60.2
501-750	47.5	59.4	57.4
751-1000	44.6	52.5	52.3

Source: The Conference Board, "Institutional Investment Report." Calculated from the Brancato Report (1990-1995) and Thompson Financial (1999) databases. Reprinted by permission of The Conference Board.

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Some Differences Between Investors

	Mutual Fund	Corporate Insurgent	Venture Capitalist
Motivation?	Diversify portfolio	Acquire company	Hold large positions
Goal?	Not seeking control	Seeking control	Seeking management participation
Holdings assets?	Need liquid positions	May hold or sell positions	May hold illiquid
How paid?	On % of assets managed	On company profits or sale of company assets	Base fee plus 20% profit participation

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Voting Procedures for Mutual Funds

- Government agencies
 - SEC: No formal rule on proxy voting for mutual funds
 - DOL: Extensive set of letters and interpretations on proxy voting for ERISA fiduciaries
- Independent directors
 - Typically have reviewed/approved a set of voting guidelines used by the investment adviser to the funds
 - Investment adviser provides directors with annual summary report of fund votes

Voting Procedures for Mutual Funds (cont.)

- Investment adviser
 - Adviser may form a special group dedicated to evaluating proxy votes or may use a third-party vendor
 - Most proxies involve routine votes; non-routine votes handled by board guidelines or adviser's officials

Types of Shareholder Activism

- Goals of various groups seeking to implement corporate governance
 - Governance structure of company is improved
 - Price of company's stock goes up
 - For green or socially responsible funds company improves its environmental approach or achieves targeted policies

Benefits of Activism by Level

- Higher benefit/most likely to lead to higher stock price
 - Mergers
 - Tender offers
- Lower benefit/least likely to lead to higher stock price
 - Many procedural changes in corporate governance
 - Example: appointing an outside chairperson separate from the CEO
- In the middle: long-term benefits to shareholders
 - Restructuring executive compensation
 - Electing a majority of independent directors

Cost of Strategies

- Higher cost strategies
 - Categories
 - Tender offers
 - Proxy fights
 - Director nominations
 - Legal issues
 - May require filing extensive documents with the SEC
 - Exposure to potential lawsuits
- Lower cost strategies
 - Categories
 - Shareholder resolutions
 - Letters to outside directors
 - Informal discussions with management
 - Legal issues
 - Company must include shareholder resolutions, along with supporting statements in its proxy statement sent to all shareholders
 - Shareholder must file form 13D with the SEC if deemed to be acting in concert with other shareholders holding 5% or more of company's voting stock

General Guidelines for Choosing Strategies

- Generally use low-cost strategies because it is difficult to predict benefits of activism
- If activist on an issue not involving stock price, use only lowest cost strategies
- If activist on an issue involving stock price, use higher cost strategies only in exceptional circumstances

Size of Global Equity Markets

Market Capitalization, in \$ Billions

	U.S.	Japan	U.K	Total Developed	Total Emerging	World
1980	1,448	380	205	2,552	186	2,738
1984	1,863	667	243	3,296	146	3,442
1988	2,794	3,907	771	9,240	489	9,728
1992	4,485	2,399	927	9,922	913	10,835
1996	8,484	3,089	1,740	17,933	2,226	20,159
2000	15,104	3,157	2,577	29,521	2,740	32,260

Source: SIA 2001 Securities Industry Fact Book

Increasing Importance of Global Sector versus Local Market

