The Nationwide Retirement Education Institute℠

America's Retirement

Voice

Volume II, March 2006

Trends in Public Sector Retirement Plans

Nationwide® Retirement Solutions

On Your Side

About the Nationwide Retirement Education Institute Panel of Advisors

Nationwide Retirement Solutions launched the Nationwide Retirement Education Institute (REI or the "Institute") to evaluate the degree of retirement readiness of public sector employees. The Institute's mission is to provide a credible, unbiased forum for thought leadership and research that improves the state of public sector employees' retirement.

Thank you to REI's Panel of Advisors. Their passion and support enhance the lives of both plan sponsors and public employees. The panel's collaborative energy and insight inspired this publication.

Retirement Education Institute Panel of Advisors

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America's Retirement Voice does not reflect the views of individual REI panel members or their firms, but is a compilation of research and findings from viable industry organizations and resources. It is the hope of Nationwide and the REI that *America's Retirement Voice* is both comprehensive and provocative in its presentation of industry-wide research.

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Section 1. Executive summary

Public sector overview

Historically, public sector employees have counted on employer-funded benefits to provide most, if not all, of their retirement income. Today this mindset is changing as there is increasing awareness of employees' personal responsibility for their financial needs, both now and in the future. As a result, there is a renewed effort to promote and enhance the supplemental retirement programs — 457, 403(b) and 401(k) plans — to help employees be financially ready for retirement.

Personal savings is becoming even more important in the private sector since the number of defined benefit plans that are being closed and replaced with 401(k) plans is increasing. Today, pension benefits continue to play an important role in the benefits package provided to state and local government employees. But there is growing concern about their ability to be the single source of retirement income. Continuing budget pressures are causing some public entities to examine alternatives, including:

- Establishing a hybrid or defined contribution plan as an option or alternative to the current defined benefit pension
- Modifying the existing defined benefit plan structure by increasing the retirement age (for full benefit eligibility) or reducing benefit levels for new employees

There are also uncertainties about public employers' ability to continue supporting retiree health care coverage. Employers face significant program costs as well as new accounting rules that begin in 2007. The new rules will require disclosure of long-term retiree health care liabilities on financial statements. Reporting these liabilities could potentially raise entities' borrowing rates. As a result, more state and local government employers are exploring and/or implementing cost-saving measures such as increasing retirees' share of premiums, establishing caps on premiums paid by the employer and imposing additional limits on eligibility requirements.

Due to increasing budget pressures of defined benefit plans and health care, state and local government employees will likely need to save more to meet their retirement needs. This places greater emphasis on supplemental retirement plans in the public sector. As a result, employers are focusing on increasing employee plan participation by simplifying both the enrollment and investment selection processes. An additional priority in both the public and private sectors is to help employees manage their assets and income streams throughout their retirements.

457 participant activity shows positive progress...

Since the first *America's Retirement Voice* report was released in 2004, we have seen several positive trends within public sector supplemental retirement plans, starting with participation rates. In 2003, about 30% of employees, on average, had an account in their employer-sponsored 457 plan. In two years, this participation rate increased more than 4% to about 34% of employees. Other positive trends include:

- Average account balances increased 12% and annual deferral, 8%.
- The difference between the average public and private sector annual deferral is narrowing ($3,800 versus $3,956, respectively).
- Improvements in diversification are dramatic as the percentage of participants investing in three or more asset classes has increased from 19% in 2000 to 39% in 2005.
- Although public sector employees lean towards more conservative investments, the use of asset allocation funds is significantly increasing. This is particularly evident among younger participants (ages 18 to 35) since three in ten are choosing to invest in a lifestyle or lifecycle fund as their single investment choice, up from one in ten in 2003.

Participants investing in three or more asset classes is up 20% from 2003 to 2005.

...Still work to be done

While public employees are making progress with their savings, there are still concerns about their retirement readiness. While participation rates have increased over the last two years, more than 65% of employees are still not taking advantage of their 457 plans.

Participants' conservative approach to asset allocation is also concerning, especially given the fact that the majority of participants have pensions that are conservatively invested.

Overall, the lack of employee involvement in their deferred compensation plans suggests even greater simplification is needed, including "do-it-for-me" services such as managed accounts, asset allocation funds and automatic enrollment and increases.

General attitudes and service preferences

When creating education and service models to meet employees' needs, it's important to understand the attitudes and behaviors behind their financial decisions. Nationwide conducted a comprehensive consumer study of private and public sector employees that compared participants versus non-participants in their employer-sponsored retirement plans. The findings included:

- Only one-quarter of all employees identified that saving for retirement is a priority goal, while four in ten participants (both public and private sector) identified retirement savings as a priority goal.
- Almost half of public sector participants feel they are better prepared for retirement than most people their age, compared to four in ten private sector participants and about one-third of all employees who believe they are better prepared.
- More than half of all workers say they use the Internet for consumer purchases, but less than one in ten use the Internet to research or buy *financial* products or services. Employees who participate in either a 457 or 401(k) plan are slightly more likely than non-participants to use the Internet to research financial products.

More than 80% of participants access the web for customer service.

The research on participant activity within the plans points to the consistent need for educational services to be provided through multiple mediums. Many participants prefer to make investment decisions face-to-face or by phone, but there is also increased use of plan web sites for both information and transactions.

While participants prefer to use multiple mediums to manage their accounts, no single medium dominates (as evidenced by the statistics shared below from Figures 39, 40 and 41 of this report). For simple needs, such as changing an address, participants are more likely to contact a call center or use the plan's web site. For help with more complex questions, such as changing their account's asset allocation, face-to-face help or assistance by phone becomes more important to participants.

- Seven in ten participants prefer personal contact whether by phone or face-to-face.
- Four in ten participants prefer face-to-face contact when completing more complex service transactions, such as changing their account's asset allocation.

Although Internet usage continues to increase each year, most online inquiries are often for informational purposes only (e.g., obtaining account balance information) and less frequently to execute transactions.

- Eight in ten customer service contacts (e.g., obtaining account balance) are handled through the web.
- Only three in ten participants use the web for more complex transactions (e.g., fund exchanges).

The payout phase: retirement income management

For decades, the industry's focus has been on helping employees' accumulate assets. As baby boomers retire, employers and plan administrators are challenged with helping employees shift into the payout phase — managing their assets and generating income throughout their retirement.

The traditional scenario — retiring at age 65 and collecting a pension and Social Security — isn't so simple anymore. Retirement is becoming more complex. Today's workers are planning a longer, more active lifestyle that often includes working into retirement years before entering full retirement. Potential changes to Social Security, Medicare and pension benefits also cause uncertainties.

Providers servicing the public and private sector defined contribution markets are responding to this change with a variety of products and services geared to participants who are near, or in, their retirement years. *Retirement income management* services are being developed to help participants understand their choices (e.g., to rollover or not to rollover) and how to invest and withdraw assets to ensure they last throughout their lifetime.

In regard to products, immediate income annuities are being explored as a desirable feature of employer-sponsored defined contribution plans to provide participants an option to establish a guaranteed level of income for life. Annuities outside of a retirement plan that guarantee principal, income, or both, are additional examples of solutions to help retirees receive adequate and reliable income. Products like these will continue to expand and evolve as the baby boomer generation moves into retirement.

Looking ahead

Over the past few years, retirement has become the "hot topic" for policy makers, regulators and media. In Washington, lawmakers proposed several initiatives during 2005 to enhance employer-sponsored defined contribution plans and encourage workers to save for retirement. Retirement and investment issues are covered daily in magazines, newspapers and on TV, creating a new awareness among workers of the importance of adequately planning for their financial future.

Although there are positive trends occurring within the 457 plans of state and local government employers, more work needs to be done to ensure employees are prepared for their retirement years. The data and analyses within this report can be used by plan sponsors, policy makers and industry supporters to understand today's plans and participants and establish creative solutions to improve public sector employees' retirement readiness.

Section 2. Report purpose and goals

About the Nationwide Retirement Education Institute

Nationwide Retirement Solutions launched the Nationwide Retirement Education Institute (REI or the "Institute") to evaluate the degree of retirement readiness of public sector employees. The Institute's mission is to provide a credible, unbiased forum for thought leadership and research that improves the state of public sector employees' retirement.

Through its research efforts, the Institute provides a forum to:

- Identify trends and issues that are important to the future ability of employees to achieve financial security in, and throughout, retirement
- Present reports and findings to plan sponsors, policy makers and others to help guide the future design and structure of public sector defined contribution plans
- Establish dialogue among industry experts to develop new initiatives and opportunities to enhance the retirement security of employees through their employer-sponsored plans

The Institute is led by a panel of advisors who are selected based on their position and experience in the industry. The panel includes 20 members who represent both practitioners and academicians in the fields of retirement, public policy, investing and aging.

Report objectives

In February 2004, the REI published its first report, entitled "Public Sector Retirement, Yesterday, Today and Tomorrow." This second issue updates the data and research from the first effort to provide a comprehensive picture of the public sector retirement markets, specifically deferred compensation and defined contribution plans.

Considerable research is undertaken on private sector defined contribution plans, but little is conducted on the public sector environment. Although there are many similarities, there also are some key differences, particularly in regard to the continued support of defined benefit plans as the primary source of public employees' retirement income. This report examines and compares public sector defined contribution plans to those within the private sector. It also explores how employees are using and benefiting from the supplemental retirement plans offered by state and local government employers.

Research methods and sources

This second report maintains key historical information, where appropriate, from the original research and provides updated demographics and data when available as of June 30, 2005 or as otherwise noted. Section 457 deferred compensation plans of governmental employers are analyzed extensively based on the internal aggregate data within the Nationwide Retirement Solutions database of more than 7,700 state and local government plans with 1.5 million participants representing $55 billion in total assets.[1] New content has been added to reflect notable industry trends in both the private and public sector marketplace.

The report was prepared from a wide variety of sources. A review of multiple studies gives the confidence of both valid and reliable findings. Because the public sector retirement market is not covered as extensively as the private sector, this report collected information from various sources, weighing the soundness of the research and looking for patterns in the results. The conclusions in this report reflect this approach.

Much of the data on which the conclusions are based is from Nationwide Retirement Solutions, a division of Nationwide Financial dedicated to the public sector. Nationwide has been a market leader in providing 457 retirement plans since these plans began in the mid-1970s and makes significant investments in understanding employee education and product needs by collecting and analyzing data.

Nationwide's data includes current and historical plan analyses, attitudinal and behavioral studies and participant information collected over a span of more than 25 years. These rich data sources have been combined with secondary analyses from both published and unpublished studies to create snapshots, identify trends and develop conclusions about public sector retirement. Unless otherwise noted, all Nationwide data used in this report has been rounded for ease in communication.

1 Nationwide Research, 2005.

Section 3: Public sector retirement plans — demographic examination

Public sector employers — what and how many

The United States retirement market is comprised of both private and public sector employers as retirement plan sponsors. Public sector employers can be divided into three groups:

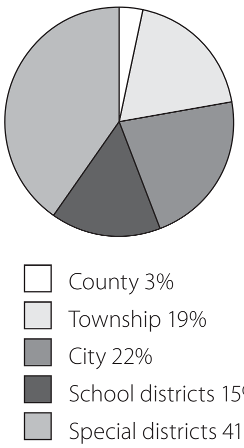
- State and local government
- Educational institutions and non-profit: colleges, universities and non-profits such as hospitals, foundations and other charitable groups
- Federal government

The private sector contains for-profit corporations and multi-employer retirement plans (e.g., Taft-Hartley plans).

Within the public sector, there are almost 88,000* local governments in addition to the 50 states.[2] The breakdown of local governments is as follows:

- County = 3,034
- Township = 16,506
- City = 19,431
- School districts = 13,522
- Special districts = 35,356**

Types of local governments



The 88,000 local government employers contrasts with the private sector employers that collectively total over 17.6 million establishments.[3] Over the past 30 years, while some jurisdictions have been consolidated, the number of county governments has remained relatively constant (3,034), decreasing less than 1% (Figure 1). Township governments have decreased by 3% in the same period, primarily due to jurisdictions being dissolved or folded into nearby municipalities. Municipal (city) governments have increased by 5% as the result of new incorporations.

School districts decreased by 14% due to school district consolidation and reorganization. Also, many "dependent" school districts have been classified as agencies of other state/county/city government units.

[2] U.S. Census Bureau, Statistical Abstracts of the United States 2004-2005, Table 417.

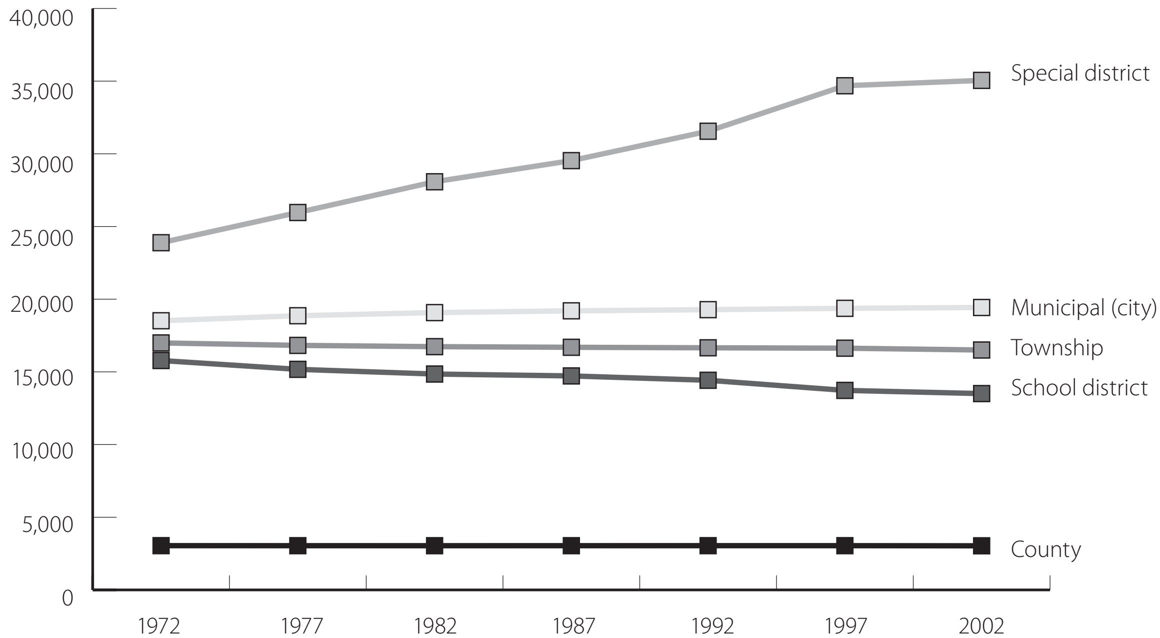
* Includes entities with unknown numbers of employees.

** Includes special districts with no employees as reported by the U.S. Census bureau. These "non-people" special districts hold funds assigned to a specific project such as highway construction. There are approximately 15,000 "non-people" special districts.

[3] U.S. Census Bureau, Statistical Abstracts of the United States 2004-2005, Table 729.

Figure 1: Growth of local government jurisdictions

Only special districts show significant growth at 48% over 30 years.



Source: U.S. Census Bureau, 2002 Census of Governments, July 2002.

Most special districts (91%) have been established to perform a single function. Some examples include: natural resources, fire protection, water supply, housing and community developments. Special districts generally are very small and specialized.

Several employer numbers that originate from the U.S. Census Bureau have not been updated since the 2004 report. As a result, some charts and analysis in this section using U.S. Census Bureau information reflect minor or no changes. Sections that provide a historical perspective remain the same as the original report. Public sector employee information has been updated to reflect the latest U.S. Census Bureau information.

Employees — what and how many

There are approximately 12 million state and local government employees (full and part-time) and another 6.3 million public school district employees.[4] The number of state and local government employees grew by 9.6% from 1997* to 2002, compared to all jobs (total non-farm), which grew at 8% for the same period.[5]

Counties and school district employment led the way with growth rates for 1997 to 2002 of 12.5% and 12.2% respectively. Municipalities followed with employment growth of 7.9% for the same period, followed by States (7.2%), townships (7.2%) and special districts (4.3%).

Compared to private sector employees, government employees are:

- Female — 57% versus 46% of private sector non-farm labor force[6]
- Older — 75% of government workers are over age 35 versus 63% of private sector workers[7]
- Longer tenured and retire younger — Government workers' average tenure with the current employer is 6.9[8] years, a figure almost double that of the private sector. However, public safety employees (police, fire) tend to retire earlier due to stringent job requirements.
- Middle-income earners — State and local government employees have an average annual salary of $41,433.[9] This figure compares to the $39,603 average for private sector full-time wage and salaried workers in the U.S. If total annual compensation[10] is compared, government employees' annual compensation increases to $51,465 versus $47,085 for private industries. A higher proportion of white-collar workers in public versus private sector jobs is likely one of the main reasons for the appearance of higher income within the public sector. An additional factor is the absence of Social Security coverage for some state and local government employees, resulting in a higher annual contribution to their pension benefits that is included in the annual compensation calculation. When compared to 2002, however, the average public sector compensation has decreased by almost 1%.

* The U.S. Census collects and develops statistics on governmental employers and employees every five years. 2002 is the most current year and 1997 the previous information collection year.

4 U.S. Census Bureau, *Statistical Abstracts of the United States 2004-2005,* Table 453.

5 U.S. Department of Labor, Bureau of Labor Statistics, Total Non-Farm Employees, 2005.

6 Employee Benefit Research Institute, *EBRI Issue Brief* No. 274, October 2004.

7 Ibid

8 Bureau of Labor Statistics, Employee Tenure Summary, September 21, 2004.

9 U.S. Census Bureau, *Statistical Abstracts of the United States 2004-2005,* Table 618.

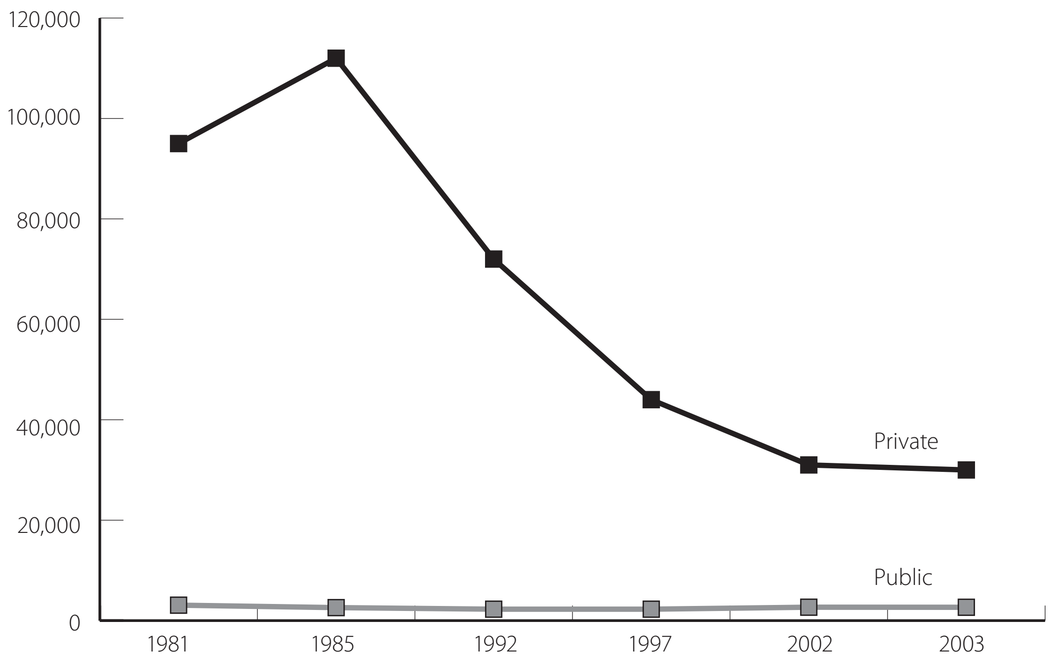
10 Includes in addition to wages and salaries, employer contributions for social insurance, employer contributions to private and welfare fund, directors fees, jury and witness fees, etc.

Defined benefit (DB) pension plans overview

While public sector DB plans continue to be strong, fewer private sector employers are providing this benefit each year. The Department of Labor (DOL) reports the number of private sector DB pension plans dropped to less than 49,000 plans in 2000 (latest data available) from a high of 170,172 plans in 1985. The DOL reports on both private sector DB pension plans covered by the Pension Benefit Guarantee Corporation (PBGC-Insured Plans) and small employer plans not required to have PBGC coverage.

Employers that are subject to the PBGC coverage must file an annual report on the status of their plans. Current information of this subset of private sector plans shows a steady decline in this number from over 112,000 plans in 1985 to only 30,000 in 2004 (Figure 2).[11] Among small employers not required to have PBGC coverage, a similar decline is evident, with approximately 58,000 plans offered in 1985 dropping to around 19,000 plans as of 2000 (latest data available).

Figure 2: Total number of DB plans subject to PBGC coverage

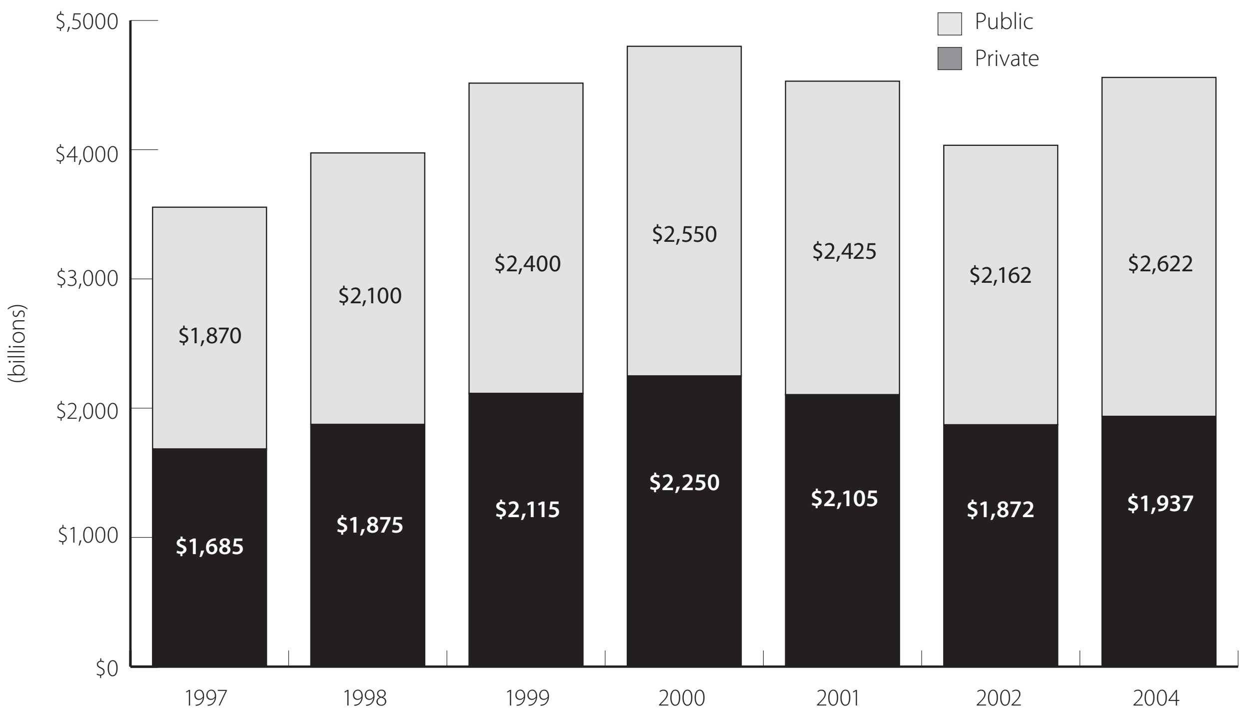


Source: Private: PBGC; Public: U.S. Census Bureau.

Historically the decline in private sector DB plans has been primarily among small employers. Reasons for the decline include legislative and regulatory changes that made the plans more costly and less tax advantageous for these employers. In recent years however, there has also been a decline in larger private sector plans as these larger firms have felt the brunt of global competition and industry restructurings. The termination of airline and steel industry pension plans are recent examples, with potentially more to come in other industries, such as automotive.

[11] Pension Benefit Guarantee Corp., Excludes small employers not subject to PBGC regulations.

Figure 3. Defined benefit plan assets — public & private sector



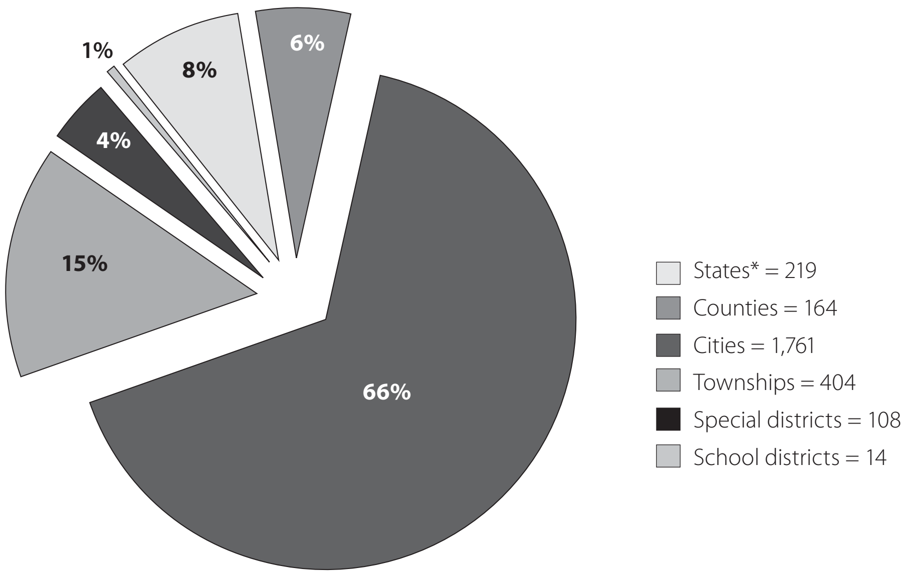
Source: SPARK 2005 Marketplace Update.

The evolution of public sector DB plans

The number of public sector DB plans has changed very little over the past 20 years. While there are far fewer public sector plans compared to the number of private sector plans, their total assets continue to exceed those of private sector employers (Figure 3).

Government defined benefit pension plans existed as early as the late 1800s and expanded significantly following World War II. While not subject to Employee Retirement Income Security Act (ERISA), these plans are subject to Internal Revenue Code provisions and state-level regulations. Over time these plans have evolved into a much more valuable benefit for employees relative to private sector plans, with favorable features including disability and cost-of-living adjustments. Most government DB pension plans are established within large governmental units, mainly states, large cities and counties (Figure 4).

Figure 4: Number of state and local government plans



Source: U.S. Census data, 2001-2002, * NOTE: Many states have multiple plans.

Factors contributing to the development of public sector DB plans include:

- Issues related to competing with private sector employers for skilled workers
- Absence of Social Security coverage prior to the 1950s among state and local government employers
- Strong union presence within public sector, particularly police, fire and school district employees

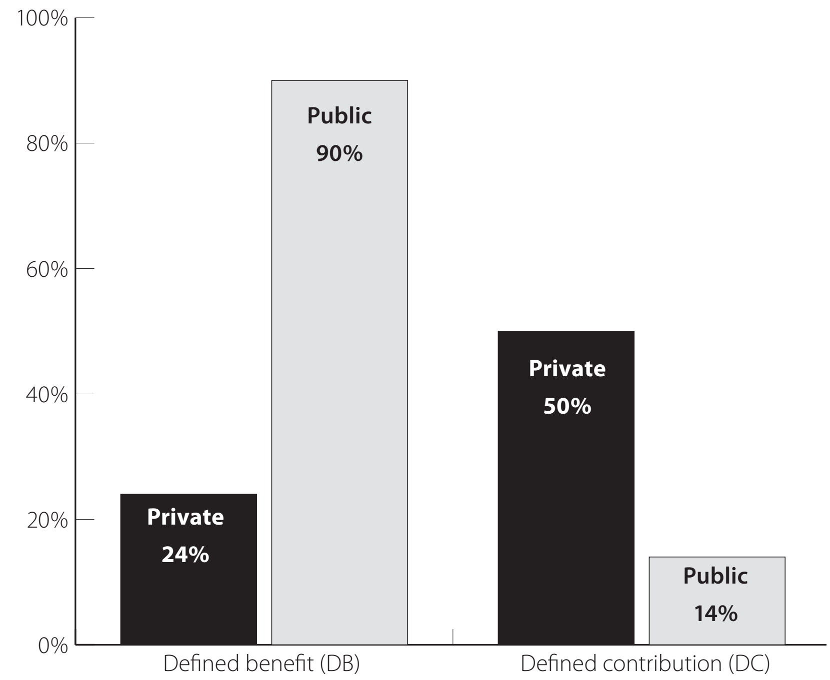
Many state pension plans are multi-employer plans in which the various local governments have elected to participate in the state DB plan. In addition, some states have more than one DB plan serving specific groups (e.g., separate plans for public education employees or state law enforcement personnel).

The 2,670 public sector DB plans:[12]

- Comprise less than 9% of all DB plans in the United States
- Cover approximately 12% of the U.S. workforce
- Hold more than 50% of all DB plan assets in the U.S.

Public sector access to DB retirement plans is far more prevalent compared to private sector employers. Overall, approximately 90% of state and local government employees participate in some type of employer-funded DB plan (Figure 5). In contrast, private sector employees are more likely to have access to employer-funded qualified defined contribution (DC) plans as their primary retirement benefit than public employees.[13] Note however, that public sector access to employer-funded DC plans (not including supplemental plans such as Sections 457, 403(b) and/or 401(k) plans) has increased from 9% in the late 1990s to the currently reported 14%.

Figure 5: Percent of full-time employees participating in plan



Source: EBRI Notes, April 2005, Note: Includes only benefit programs that are partially or wholly paid by the employer.

Although the number of DB plans has decreased overall, it is significant to note that the number of employees participating in private sector DB plan has increased by 2% since 2002. This is attributed to the number of corporate mergers of large plans (plans with 10,000+ employees), which increases the number of participants, while decreasing slightly the number of plans.[14]

[12] *Pensions & Investments,* Volume 33; Number 8, April 18, 2005; Statistical Abstracts 2004-2005; Table 569.

[13] McDonnell, Ken, Benefit Cost Comparisons Between State and Local Governments and Private Sector Employers. *EBRI Notes,* October 2002, Figure 7, p. 7.

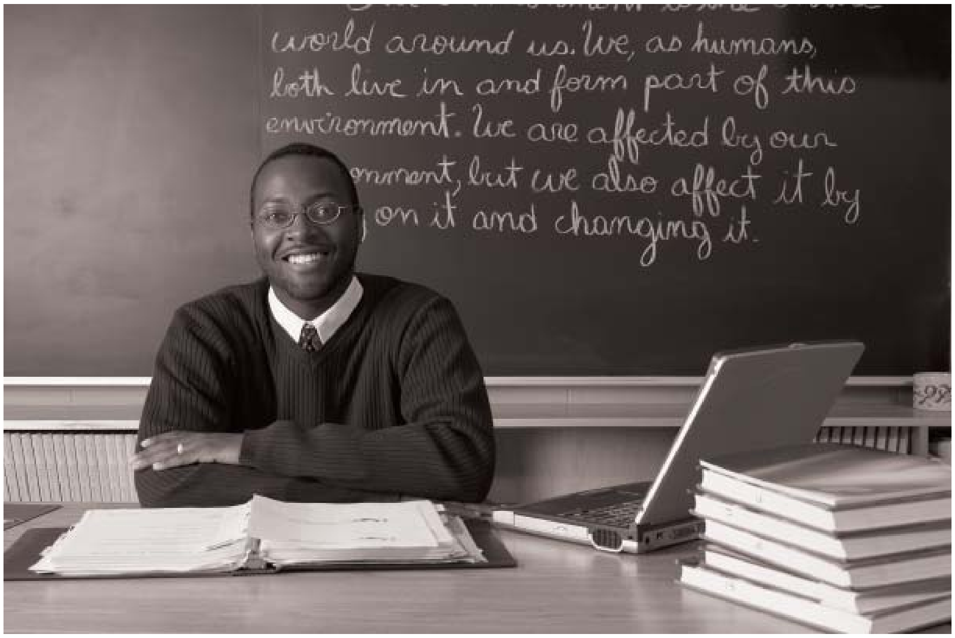
[14] National Association of State Retirement Administrators; *Myths and Misperceptions of Defined Benefit and Defined Contribution Plans;* November 2002, Updated February 2005.

Public sector DC plans — voluntary employee-funded plans

Unlike the employer-funded 401(a) DC plans, voluntary DC plans in the public sector are considered supplemental retirement benefits and are generally funded through employee deferrals from income. These plans include Sections 457(b), 403(b) and 401(k) plans. In the few instances where match programs exist, they essentially are supplemental contributions in small amounts and were established to encourage voluntary contributions to 457, 401(k) or 403(b) plans.

Legislation created Section 457 plans in the mid-1970s, although some state and local governments established similar deferred compensation arrangements prior to this based on private letter rulings. State and local governments as well as public university and school district employers are eligible to offer these plans. Section 403(b) plans (or tax-sheltered annuities) are more frequently offered by universities and school districts in lieu of, or in addition to, 457 plans. Section 401(k) plans are offered by government employers who adopted this plan type on or before May 1986.

Supplemental 457 DC plans grew because they allowed employers to compete more effectively with the private sector for qualified employees — without having to fund the plans. The employer-funded match plans arose in the 1990s to enhance public sector retirement benefits and encourage more employee involvement in their supplemental plans.



Most state and local governments offer 457 plans as a supplemental retirement benefit.

Marketplace overview — employee-funded public sector 457 plans

Market leaders

An overview of the marketplace shows that six financial institutions continue to administer the vast majority of 457 plan assets. With little new plan growth and since most state and local government employers already offer one or more 457 plans, it is a highly competitive marketplace. It is estimated that six financial services companies (CitiStreet, Great-West Life, Hartford, ICMA-RC, ING and Nationwide Retirement Solutions) manage the administration of approximately 80 to 90% of all 457 plan assets. All of these companies have a long history in the 457 market. Unlike the private sector 401(k) market, public sector employers often contract with multiple providers to offer more than one 457 plan to their employees.

Limited new plan growth

The governmental 457 plan market is estimated to include 31,450 plans.[15] These voluntary plans grew quickly during the 1980s. Most, if not all, large and mid-size cities and counties and all 50 states already have a plan in place. A notable number of small government jurisdictions use their state's 457 plan rather than set up their own plan. Ohio, New York and Wisconsin are a few examples of this shared approach. Remaining new plan formation is limited primarily to small special districts (e.g., water districts) and some small townships.

The majority of 457 plan participants and assets continue to be concentrated in a few large plans (Figure 6). It is estimated that these large and mega size plans account for:[16]

- Less than 1% of all 457 plans
- 59% of all participants
- 70% of the total 457 plan assets

Figure 6: 457 Statistics by plan size

Plan size (assets)	Avg. # participants	% of all 457 participants	% of all 457 assets	% of all 457 plans
Mega ($1 billion+)	79,164	43%	54%	<1%
Large ($100 million–$1 billion)	10,244	16%	16%	<1%
Medium ($5 million–$100 million)	608	24%	21%	7%
Small (<$5 million)	33	17%	9%	93%

Source: Nationwide research, 2005.

[15] "The Section 457 Retirement Plan Market, Spectrem Group, December 2000.

[16] Nationwide Research, 2005.

Multiple providers — "less is more"

Unlike the private sector where a single provider administers a 401(k) plan, many public sector plan sponsors allow employees a choice by offering more than one 457 provider. Past research by NRS among mid-size, large, and mega plans has estimated this multiple plan activity to be as high as 60% of all plans (data is unavailable for small plans, defined as 457 assets with less than $5 million). The current trend is to consolidate to one or two providers that offer multiple investment choices to eligible employees.

- Among larger plans, generally a single provider administers the 457 plan, similar to the private sector. Recent competitive bidding situations suggest that larger plans with multiple providers are either moving to a single provider or, if they have several providers, looking to reduce the overall number of providers that are used.[17]
- 403(b) plans, which are available to public and private college/university, K-12 school personnel, hospitals and other types of non-profits, have typically included a wide array of providers. Recently however, the trend appears to be going towards more consolidation with fewer offerings. This is resulting from new proposed regulations which call for a single plan document and more employer oversight.[18]

The trend to consolidate to fewer plan providers is occurring as employers recognize that too much choice leads to confusion and inaction. Also, it results in additional oversight from the employer as the fiduciary, to monitor all providers and ensure participants are being offered suitable choices for their long-term retirement investments.

Participants in both private and public plans average a 7.9% contribution rate.

Sector differences — 457 versus 401(k)

Examining 457 plans of governmental employers in more detail helps to identify how they compare to their more well-known counterpart, 401(k) plans (Figure 7). These plans have a few notable differences since they evolved to service their respective constituents (public and private sector employees).

When specific participant data is reviewed, however, some distinctions emerge:

- Participation rates differ widely, due to various factors such as differences in the availability of an employer matching contribution, prevalence of a DB pension plan among public sector employees and access to alternate voluntary plans (e.g., 403(b) in the case of public education employees).
- Public employees that participate in their employer plan are slightly older and earn less compared to private sector 401(k) participants.
- The average contribution rate for public sector participants is 7.9% and matches the private sector rate.

[17] Nationwide Research, 2005.

[18] Institutional Investor, June 2005.

Figure 7: Comparison of selected 401(k) and 457 plan statistics

Private Sector 401(k)[19]	Measurement	Public Sector 457[20]
42	Average age of participant	48
$58,130	Average annual salary of participant	$48,100
70%	Average % of workers participating in plan	34%
2.9%[21]	Average match %	<1%
7.9%*	Average % of pay contributed to plan	7.9%*
$69,000	Average total balance in plan	$29,900*
14	Average number of funds available in plan	39
4.2	Average number of funds held by participant**	3.1
70%	% Assets in equity investments	57%
17%	% Participants who made a trade (last 12 months)	14%

* Estimate constructed by Nationwide using Hewitt and Census Bureau data, 2005.
**Actual funds — not to be confused with asset classes.

Other noteworthy public to private sector differences are:

- Most long-term government employees will receive a significant portion of their retirement income from their DB pension plan (the 457 plan serving as a supplemental plan). Sixty-four percent of private sector employers indicated that their 401(k) plan is their primary retirement vehicle offered to employees in 2005, up from fifty-five percent in 2004.
- Public participants have been shown to be more conservative and less active investors in their retirement investment plans than private sector participants.[22]
- Matching is much more prevalent in the private sector with employer matching contributions averaging 2.9% of employee earnings, compared to the public sector which is generally less than 1%.

[19] "How Well are Employees Saving and Investing in 401(k) Plans: 2005 Hewitt Universe Benchmarks."

[20] Nationwide 457 plan data on plans and participants unless otherwise noted.

[21] *48th Annual Survey of Profit Sharing and 401(k) Plans,* Reflecting 2004 Plan Experience; Profit Sharing/401(k) Council of America, 2005.

[22] "How Well are Employees Saving and Investing in 401(k) Plans: 2005 Hewitt Universe Benchmarks.

Section 4. Participant activity in 457 deferred compensation plans

Industry participation rate

The good news about employee participation in supplemental 457 deferred compensation plans is that it is going up. The bad news is that it is still too low. In 2003, the average participation rate was estimated to be 30% and in 2005, it has increased to 34%.

It is important to recognize that determining the actual participation rates in government 457 plans is difficult because of the varied structure and the potential for employers to offer more than one supplemental deferred compensation plan to their employees. Because employees may be offered multiple 457 plans as well as 403(b) and/or 401(k) plans, they actually may be double counted in the total number of eligible employees. This inflates the total population that is eligible to participate and reduces the reported average participation rates.

Plan participation — how can it be improved?

There is little doubt within public and private sector retirement plans that an employer match has a tremendous impact on motivating employees to participate in the 457 or 401(k) plan. Funding a match continues to be a challenge for many public sector employers as their priority is continued funding of the primary defined benefit plan.

While few public employers offer a match program, some have developed alternate approaches to enhance participation without using a match. A variety of best practice tactics used with supplemental 457, 401(k) and/or 403(b) defined contribution plans have emerged and can increase participation rates from 50% to 70%. Some of these tactics are described below.

- **Hold face-to-face meetings with employees about the benefits of participation.** One of the most affective approaches to encourage participation is personal meetings with employees, either one-on-one or in group workshops, to educate them about the benefits of their deferred compensation plan.
- **Establish an employer identity and image for the program.** Employers that take an active role in supporting and promoting the plan achieve higher participation rates. This includes branding the plan as the employer's (and not just an outsourced company plan name) to make this more visible as part of the employees' overall benefits package. Having a single access point through the employer web site (Intranet) for all benefits, including the deferred compensation program, can help brand this as the employer's plan.
- **Create plan sponsor advocacy.** Employers that place more emphasis on the plan and take ownership of its success tend to have higher participation rates. This includes discussing the deferred compensation program along with all other employer benefits in orientation programs for new hires, holding annual conferences or benefits fairs for HR/benefits staff and employees that provide education about retirement planning and the benefits of the 457 plan, and so forth.
- **Establish peer support to promote the program.** Using retirees or other peer networks (e.g., firefighters) to talk with employees (particularly new employees) about the plan has been shown to have a positive influence on participation rates. Another approach is to establish networking opportunities for employees to talk with peers during routine staff meetings about the benefits of saving for retirement.

The Saver's Credit can provide a federal tax advantage to low- to mid-income public and private sector employees.

- **Simplify the plan.** Providing a pre-filled enrollment form with certain default investment choices (e.g., lifestyle, lifecycle, asset allocation fund) and minimum deferral amount, can help ease the complications of enrolling in the plan and generate higher participation. Also, providing an uncomplicated investment line-up that includes asset allocation type funds (to allow participants to make a single choice) can positively influence participation.
- **Simplify plan education.** Simplified education that focuses on the basic decision items (deciding to enroll, how much to invest) are positive factors in increasing participation. Providing education on debt management and how to find dollars to invest for retirement adds tremendous value in achieving higher participation rates, as well as providing multi-language materials (Spanish language).
- **Promote Saver's Credit advantages.** Many public employees can take advantage of the Saver's Credit for their federal income taxes. Providing more communication to employees about this credit (such as directly through the employer, unions or employee groups) can have a positive impact on participation of low- to middle- income workers.

Participant activity

This section provides details on participant activity including account balances, deferral rates and asset allocation. The data is analyzed by age and gender and compared to private sector 401(k) plans when appropriate. A more comprehensive analysis of asset allocation funds (lifestyle and lifecycle funds) is also provided to determine how these are being used to enhance participant diversification and provide a simplified investment approach.

Account balances

Highest participant account balances are in largest plans, whether public or private

A comparison of the 457 and 401(k) plans of small to large public and private sector employers shows that the average participant account balance increases with employer size (Figure 8). Private sector participant balances are greater than public sector regardless of plan size, although the greatest difference is in the smallest employers with less than 50 employees (42%) and the least difference with mid-size employers with 250 to 999 employees (24%).

The greater average account balance in private sector employers is likely attributed to the fact that 401(k) plans are often the primary source for retirement income while 457 plans are considered supplemental benefits. Other reasons for this variance may include:

- High prevalence of employer matching contributions within private sector employer plans
- Salary differences and management support of the plans

Figure 8: Average participant account balance by plan size

Selected plan size (number of participants)	Public sector	Private sector	% difference
5–49	$17,849	$30,882	42%
50–249	$21,981	$31,212	30%
250–999	$24,701	$32,299	24%
1,000–4,999	$23,865	$36,545	35%
5,000 +	$35,049	$55,214	37%

Sources: Public: Nationwide Research, 2005, Private: SPARK 2005 Marketplace Update.

When the public sector plans are reviewed, participant account balances in the largest plans (5,000+ participants), which represent state and larger city or county employers, are significantly greater than participants in smaller plans. This likely can be attributed to the following:

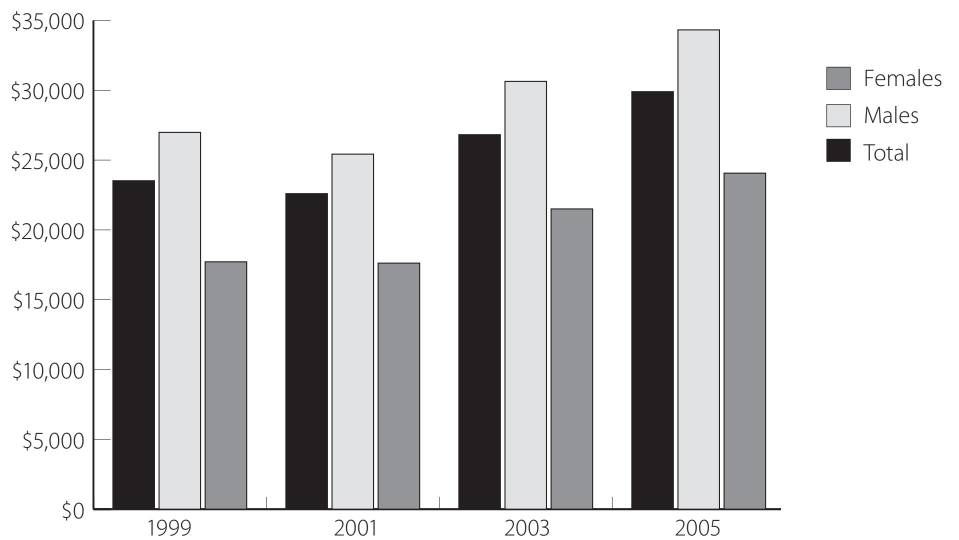
- Participants' longevity in the 457 plan as many states and local governments started their plans in the late 1970s
- Larger employers typically devote staff and budget to promote the 457 plan
- Larger employers often provide more enhanced, high-touch participant services and education

Account balances by gender — males have greater balances than females

Overall participant account balances continue to rebound from the market decline in 2001, when the average balance decreased by 4% from 1999 to 2001. In 2005, the average is just under $30,000 compared to $26,820 in 2003 (Figure 9).

There continues to be disparity between male and female participants, with the average male participant having a balance in 2005 of $34,324 versus $24,063 for female participants, a difference of $10,261. This is the largest dollar amount spread since 1999 when the male to female difference was $9,178. However, as a percentage, the difference in 2005 is less than in previous years (30% difference in 2005 versus 34% in 1999) and the annual increases are relatively equal as a percentage of the total, at 11% from 2003 to 2005 for both male and female participants.

Figure 9: Average 457 participant account balances



Source: Nationwide research, 2005; 2005 data through 6/2005.

Account balances by age — upward trend

On average, account balances have increased over the past two years in every age group except the youngest (Figure 10). This growth can be attributed to new deferrals as well as moderate investment gains. In regard to the youngest age category, 18 to 25 year olds, the average account balance decreased by approximately $200 between 2003 and 2005. This decrease can likely be attributed to new enrollments that lower the average account balance, as:

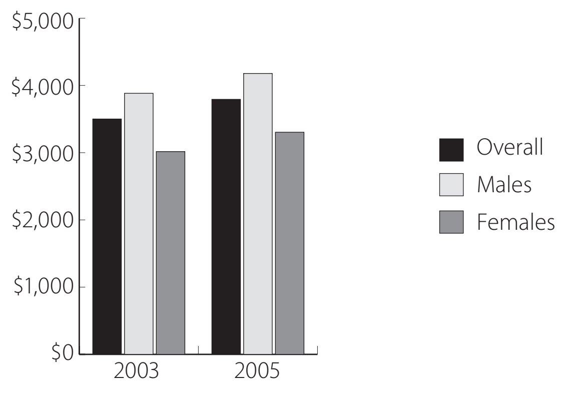
- 13% of the total participants in the 18 to 25 age group enrolled in 2005
- Only 1% to 4% of the total participants in all other age groups enrolled in 2005

Figure 10: Average participant account balance by age range (public sector)

Age range	1999 average account balance	2001 average account balance	2003 average account balance	2005 average account balance
18-25	$1,834	$1,671	$2,404	$2,209
26-35	$7,909	$6,602	$8,491	$8,909
36-45	$17,303	$14,659	$17,639	$19,429
46-55	$30,317	$27,379	$30,894	$32,851
56-65	$42,938	$41,854	$45,641	$48,857
65+	$48,893	$51,993	$55,551	$58,689

Source: Nationwide Research, 2005.

Figure 11: Average deferral amounts per year



Source: Nationwide Research, 2005. 2005 Annualized-may be slightly overstated.

Participant deferrals

Average deferrals — upward trend for both genders

The average participant deferral into the 457 plan has increased each year. Over the past two years, the average deferral increased by 8%, from $3,500 in 2003 to almost $3,800 in 2005. This trend has likely been influenced by continued education about the need to invest for retirement, increases in maximum deferral limits, the addition of the age 50 catch-up provision in 2002 and improvements in market conditions. The private sector average deferral was slightly higher at $3,956 for year-end 2004.[23]

Both the average male and female deferral amounts increased $300 from 2003 to 2005, with the average male deferral at just under $4,200 and the average female deferral at $3,300. As a percentage, however, the increase in female annual deferrals from 2003 to 2005 is 9.5% compared to only a 7.6% increase in the average male deferral for this same period.

Deferrals by age — all ages increased from 2003 to 2005

Average annual deferral amounts are increasing in all age groups with the most dramatic change in the youngest participants — ages 18 to 25 (Figure 12). Over the past two years, several education and marketing campaigns have been targeted at raising awareness of employees to join their 457 plan and increase deferrals. This encouraging trend indicates that educational efforts are making a difference.

Figure 12: Average deferral by age

Age range	2003 average deferral	2005* average deferral	% increase 2003 to 2005
18-25	$1,216	$1,459	20%
26-35	$2,099	$2,293	9%
36-45	$2,783	$3,052	10%
46-55	$3,708	$4,274	15%
56-65	$5,078	$5,730	13%
65+	$6,124	$7,156	17%

Source: Nationwide Research, 2005; 2005 amount annualized from 6/2005 data and may be slightly overstated.

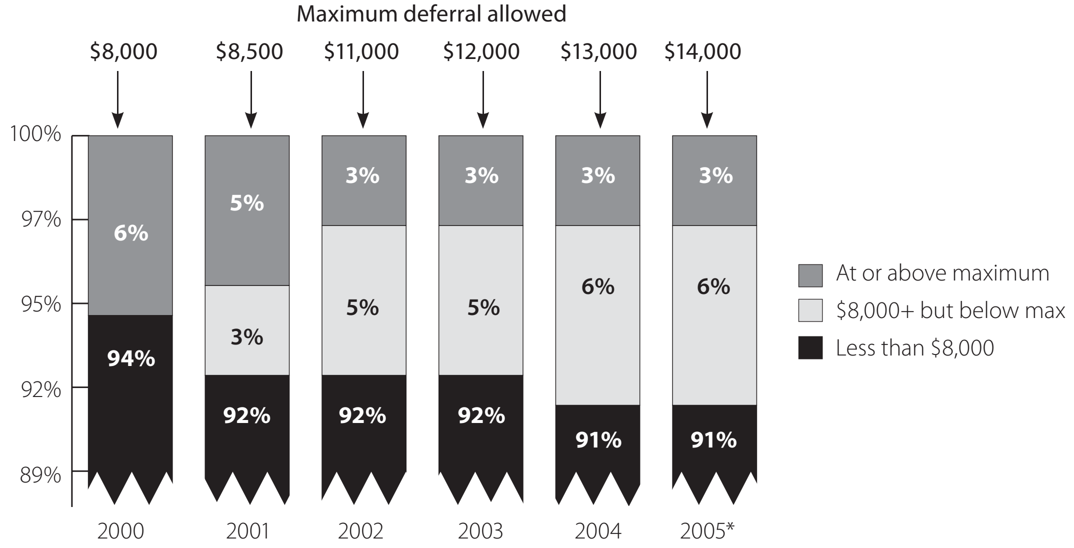
[23] Hewitt 2005 Universe Benchmarks: How Well Are Employees Saving and Investing in 401(k) Plans.

Other research conducted by Nationwide on participant attitudes and behaviors supports the trend towards increasing deferrals. The percentage of participants who reported they had increased their deferrals in the past year was between 40% and 73%. In addition, the participants who reported they were extremely likely or very likely to increase their deferrals in the coming year ranged from 23% to 37%.[24]

Participants deferring the maximum amount — proportion who max out holds steady

A review of participants contributing the maximum deferral amount shows another positive trend. (Figure 13). In spite of continued increases each year to the maximum deferral amount allowed to 457 plans, the percentage of participants who are contributing at or above the maximum held steady at 3% in 2005. In fact this percentage has held steady since 2002 when the maximum deferral (as a result of Economic Growth and Tax Relief Reconciliation Act, EGTRRA) jumped from $8,500 to $11,000. Although there are still more than 90% of participants who continue to defer less than the previous $8,000 annual limit, the percentage deferring more than $8,000 but less than the annual maximum continues to slowly climb.

Figure 13: Percent of maximum-deferring participants by year



Source: Nationwide research, 2005; 2005 amount annualized from 6/2005 data.

*Amounts above the maximum are due to "catch-up" provisions, which allow participants over age 50 or within 3 years of retirement to contribute more than the maximum amount in order to "catch-up" their accounts.

[24] 2005 Public Employee Plan Participant Satisfaction Surveys, Nationwide, September 2005.

Asset diversification — account balance

Participants are moving slowly towards more diversification

One of the main concerns that employers have expressed over the past few years is in regard to how participants invest their assets. Investment decisions are complicated and research shows that the trend is for participants to look for a more "do it for me" approach to their investments, such as with lifestyle and lifecycle funds and/or managed accounts. This year's data suggests that public sector participants are increasing the allocation of their investments among the various types of investments that are made available, with more using a pre-mixed approach (lifestyle/lifecycle funds).

Standard asset classes[25] that are typically included in 457 plans from which participants select include:

-Balanced	-Bonds
-Fixed/cash	-International
-Large cap	-Mid cap
-Small cap	-Asset allocation (defined as lifestyle or lifecycle funds)

Considering the total asset size (more than $34 billion) of the 457 plans reviewed, small shifts in asset allocation over the past two years are notable. It appears that participants often redirect deferrals to a more diversified asset allocation approach before they move existing balances. For this reason it is important to examine both total assets and deferral allocations to identify participant trends in diversification.

When examining total assets, there is an increase in the percentage of assets in the small and mid cap stock funds, international funds and asset allocation funds. Figures 14 and 15 illustrate the diversification of the total asset base in 2001 and 2005.

The most notable shift is decreased assets in the large cap stock funds and increased assets in the small, mid cap, international and asset allocation funds. The shift to asset allocation investment funds (lifestyle or lifecycle funds) from 1% of the assets in 2001 to 3% in 2005 seems like a small advance, but is an important trend that will be discussed in more detail later in this report.

The fixed/cash asset levels have remained somewhat constant as a percentage of assets, both 40% in 2001 and 2005. Fixed/cash asset levels were not significantly impacted by monies moved out of the large cap asset class

[25] Asset or fund classes are categories of investments based on company capitalization, geography, guarantees, investment philosophies or a combination thereof.

into other asset classes which kept constant the proportion of assets in the fixed category. This stability has not always been so, as in 1999 fixed/cash represented only 36% of total participant assets while in 2003 fixed/cash rose to 45% of total participant assets (1999 and 2003 percentages are not shown in Figures 14 and 15).

This change in fixed/cash levels is likely the result of both market losses in equity classes (raising the proportion of assets in the fixed category without any real movement of participant assets) and participants moving to a conservative investment approach during the more volatile years by transferring balances into this asset class.

Figure 14:
2001 Participant assets by class

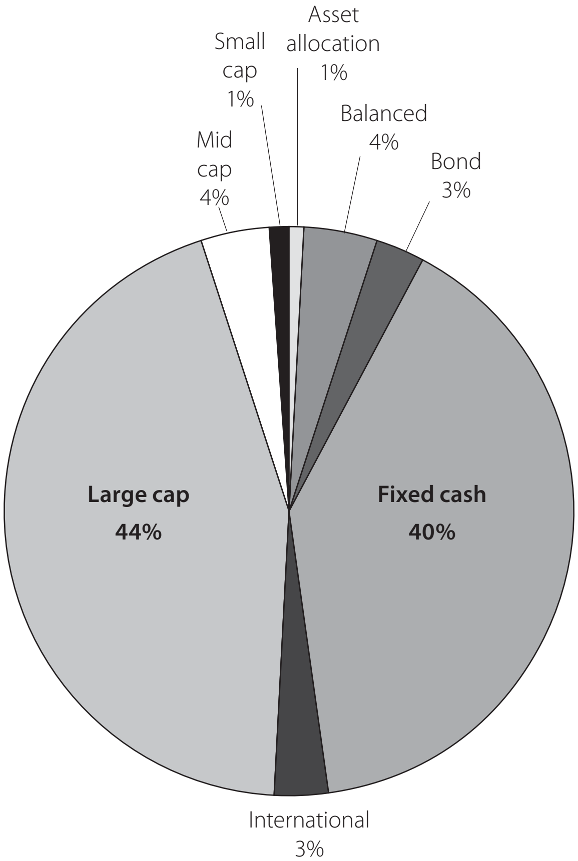
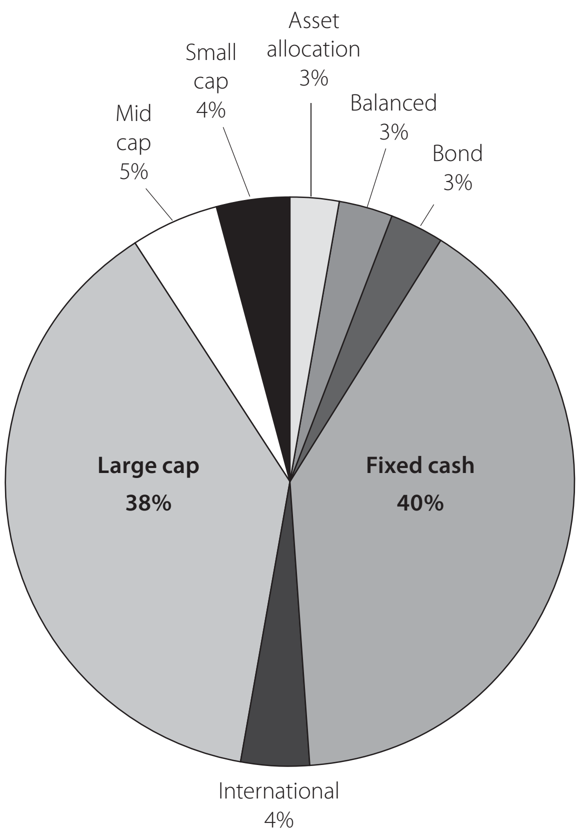


Figure 15:
2005 Participant assets by class



Source: Nationwide Research, 2005. Classes with less than 1% are not shown.

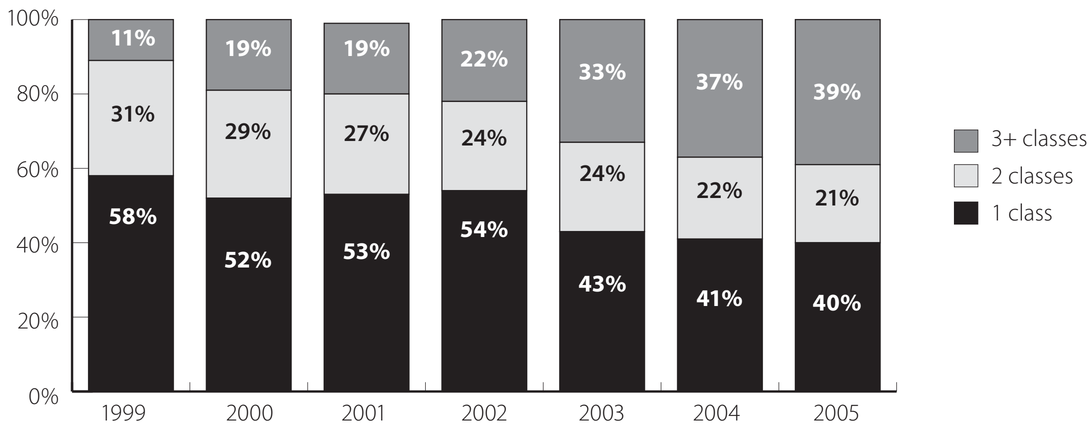
One important measure of diversification is determining the number of different asset classes a participant has within their 457 portfolio. A diversified portfolio is generally considered to hold three or more asset classes. A single investment in an asset allocation fund, by its design, is considered to be well diversified and contain more than three asset classes.

Impressively, when 457 assets are examined, the percent of participants investing in three or more classes has grown from 19% in 2000 to 39% in 2005 (Figure 16). There are two significant factors that have attributed to this significant trend:

- Increase to the number of 457 plans that are offering lifestyle and/or lifecycle funds to provide employees with a single diversified choice that automatically places them in three or more asset classes
- Increased emphasis on education to inform participants about the reason for diversification and asset allocation and its importance in reducing volatility to achieve greater returns

Although this is a significant improvement, more work needs to be done in the public sector to be in-line with private sector 401(k) plans. In 2004, data from private sector plans showed a more diversified participant base, with 68% invested in three or more asset classes,[26] compared to 39% of public sector participants in 2005.

Figure 16: Percent of participants by number of asset classes*



Source: Nationwide Research, 2005.
*Asset allocation funds automatically included as three or more asset classes.

[26] "How Well are Employees Saving and Investing in 401(k) Plans: 2005", Hewitt Universe Benchmarks.

Another way to measure diversification is by looking at the asset allocation by participant age. Figure 17 shows that almost five in ten younger employees (those under age 35) are investing in three or more asset classes, with less than two in ten older participants (age 66 and up) choosing this investment approach. This indicates that education is working. It is more difficult to reach older participants who have been in the plan for several years than younger workers who are starting their career and their retirement investment portfolios. Additional reasons for this disparity may be:

- Older participants are less inclined to make major shifts when they are so close to retirement age
- As participants get closer to retirement, the historical trend has been to move into safer, more conservative investments to avoid market risks when dollars may begin to be liquidated for retirement income
- Younger employees are more likely to invest in asset allocation funds (lifestyle/lifecycle)

Figure 17: Diversification by age group — 2001, 2003 and 2005

Percent of assets invested in three or more asset classes*

Age group	2001	2003	2005
18-25	9%	30%	45%
26-35	21%	40%	49%
36-45	22%	35%	43%
46-55	24%	34%	40%
56-65	23%	30%	33%
66+	14%	16%	17%

Source: Nationwide research, 2005.
*Asset allocation funds automatically included as 3 or more asset classes.

Asset allocation funds — younger investors see advantages

Except for the youngest age category (18 to 25 year olds), there has been an increase in the total assets that participants have invested in fixed options and a reduction in equities (Figures 18 and 19). This change is more pronounced at older ages. Investment returns are likely a significant factor in this statistic.

The percentage of assets held in asset allocation funds (lifestyle and lifecycle) increases in all age groups, except the oldest (66 and older). This is particularly true in the youngest participant category (ages 18 to 25) with almost 20% of their total assets being invested in these funds.

Figure 18: Asset allocation by age — 2001

Percent of assets by age range	Equities	Fixed	Bonds	Balanced	Asset allocation
18-25	43%	44%	2%	2%	9%
26-35	79%	14%	1%	2%	4%
36-45	71%	22%	2%	3%	2%
46-55	60%	32%	2%	3%	2%
56-65	49%	43%	3%	4%	1%
66+	33%	59%	4%	4%	1%

Source: Nationwide research, 2005.

Figure 19: Asset allocation by age — 2005

Percent of assets by age range	Equities	Fixed	Bonds	Balanced	Asset allocation
18-25	46%	28%	4%	2%	19%
26-35	70%	15%	3%	2%	9%
36-45	67%	23%	3%	3%	5%
46-55	54%	36%	3%	3%	4%
56-65	43%	48%	3%	4%	2%
66+	30%	63%	3%	3%	1%

Source: Nationwide Research, 2005.

Asset diversification — males and females are similar

Gender does not appear to be a significant factor for how account balances are allocated among the various asset classes (Figure 20). The overall trend away from equities exhibited from 2001 to 2005 is similar in both males and females. However, females tend to be slightly more conservative than males.

Figure 20: Asset allocation by gender — 2001 and 2005

2001	Male	Female	2005	Male	Female
Equities	54%	51%	Equities	51%	48%
Fixed	39%	41%	Fixed	39%	42%
Bonds	2%	3%	Bonds	3%	3%
Balanced	3%	4%	Balanced	3%	4%
Asset allocation	2%	1%	Asset Allocation	4%	3%

Source: Nationwide research, 2005.

Asset diversification — are public sector participants too conservative?

A comparison was made of 457 participants' 2005 asset allocations to a standard Ibbotson[27] model for a moderate aggressive portfolio (Figure 21). With the prevalence of defined benefit pension plans within the public sector, it is often suggested that 457 participants should be more aggressively investing their supplemental retirement assets.

An argument can be made that the pension assets should be considered an investment in a fixed/cash asset class for purposes of diversification in the supplemental account, since the primary benefit provides guaranteed income. With this in mind, the analysis below indicates that current 457 participants' assets are more conservative and less diversified than the model. Although assets are invested in all asset classes, there is not enough in each to provide "true" diversification. It is encouraging to note that there has been some improvement from 2003 to 2005. Figure 21 illustrates the gaps by asset class.

[27] Ibbotson Associates is an independent financial research department that publishes recommended asset allocation models for public use.

Figure 21: Asset diversification
457 Plan participants versus Ibbotson moderate aggressive model

Class	2003 assets by class	Ibbotson moderate aggressive	Difference + or -	2005 assets by class	Ibbotson moderate aggressive	Difference + or -
Fixed	41%	5%	+36	39%	5%	+34
Bond	3%	15%	-12	3%	15%	-12
Large cap	40%	35%	+5	37%	35%	+2
Mid cap	4%	15%	-11	5%	15%	-10
Small cap	2%	5%	-3	4%	5%	-1
International	3%	25%	-22	4%	25%	-21
Others *	6%	N/A	N/A	7%	N/A	N/A

Sources: Nationwide Research, 2005, Ibbotson Associates independent financial research.
*Other remaining classes include: Asset allocation, Balanced and Self-Directed Brokerage Option; Ibbotson does not offer corresponding asset classes.

Change in assets — investment performance versus new contributions

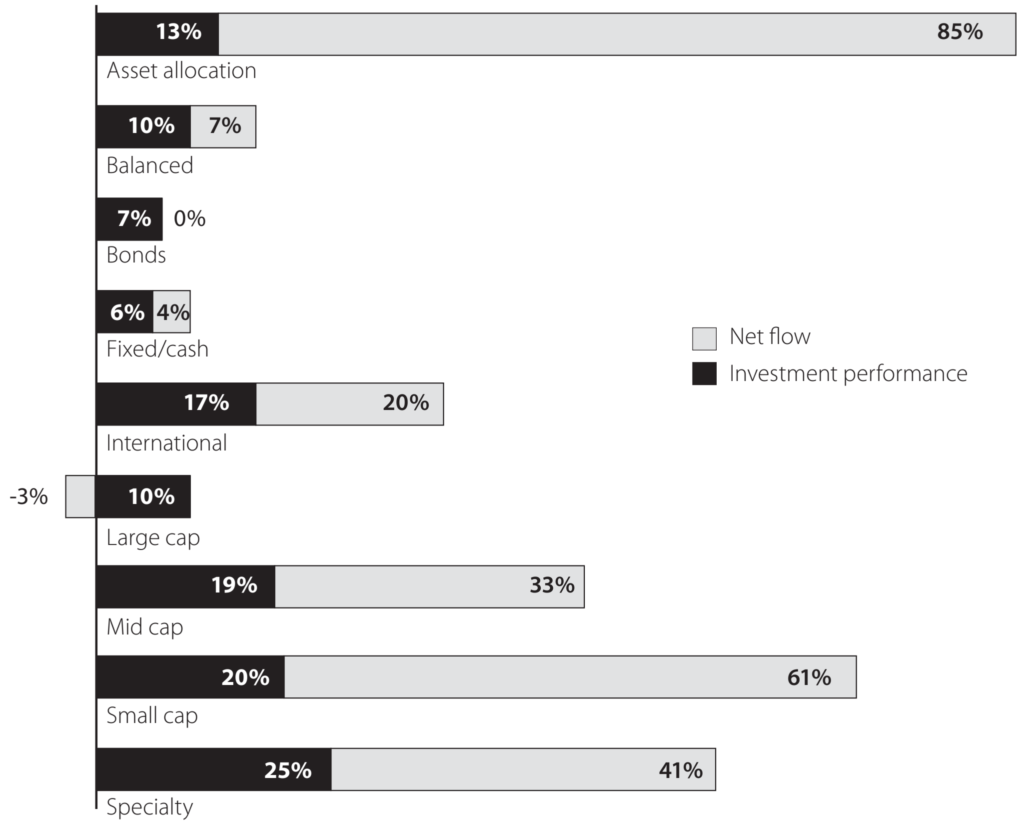
New research in this year's report examines the effect of investment performance on the asset allocation changes that have occurred over the past two years. This information is intended to provide an understanding of participant actions versus changes to the allocations that have occurred because of investment performance.

Figure 22 illustrates the change in assets from 2003 to mid-2005, segmented by investment performance and net flow of assets, as follows:

- Investment performance represents the change in the level of assets that has resulted from the gains or losses due to investment performance
- Net flow represents all money going into and out of the asset class that is not attributed to investment returns (e.g. deferrals, exchanges, withdrawals)

This analysis shows that asset allocation funds had the largest percentage gain during this 18-month period with a total increase of 98%. Eighty-five percent of this growth was from new contributions while the remaining 13% increase resulted from investment performance. Small cap had the next largest gain as a result of new contributions (61%) and saw a 20% gain from investment performance. Large-cap investments actually had a negative net flow of 3%, with more dollars being transferred out than contributed during this period, while experiencing a 10% gain from investment performance.

Figure 22: Changes in assets for the period from 12-31-03 to 6-30-05



Source: Nationwide Research: 2005.

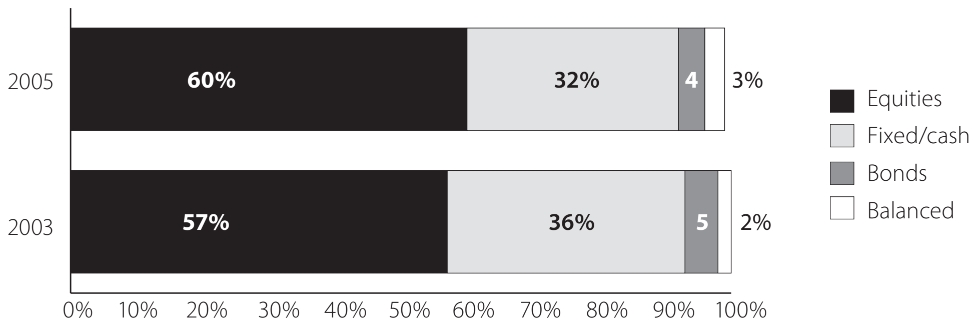
Asset diversification — deferrals

Deferrals demonstrate more aggressive investment behaviors

When comparing total assets to current deferrals, the deferral allocations are slightly more aggressively invested than represented by the total portfolios. For example, the 2005 percentage of fixed/cash assets within a participant portfolio is 40%, bonds are 3%, balanced funds are 3% and equity investments are 54%. On the other hand, deferral allocations in 2005 are 32% in fixed/cash, 4% in bonds, 3% in balanced and 60% in equity investments. This indicates that public sector participants may be less conservative than their total portfolio allocations suggest.

Deferral percentages to large cap funds are decreasing, but are still 35% of all new deferral dollars in 2005. Overall, equity fund deferrals decreased from 72% in 1999 to 57% in 2003 and seem to have stabilized with 60% in 2005 (Figure 23). Fixed fund deferrals have decreased from 36% in 2003 to 32% in 2005. These shifts are likely responses to the equity market rebounding and continued education efforts around the value of diversification.

Figure 23: Percent of deferral allocation by class

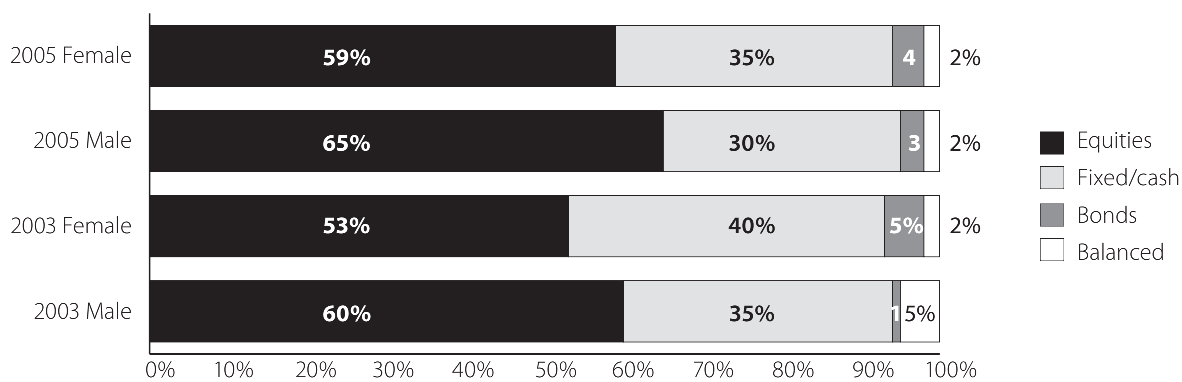


Source: Nationwide Research, 2005.

Asset allocation of deferrals by gender — overall becoming more aggressive

There are slight differences in deferral allocations within male and female participant accounts. Generally, females tend to be somewhat more conservative, as illustrated by a higher percentage of deferrals going to fixed/cash investments in both 2003 and 2005. We are seeing an increase in deferrals for both genders into equity asset classes in 2005 (Figure 24).

Figure 24: Deferral allocation by gender and asset class — 2003 & 2005



Source: Nationwide Research, 2005.

Diversification — number of investment options used in portfolio increases

A different way to look at asset allocation and diversification is to review the number of funds that a participant uses within their 457 account portfolio. Over the past seven years, the number of selected funds has gone from an average of 2.9 funds in 1999, to 3.3 in 2003 and dropping down to 3.1 in 2005. In comparison, the average 401(k) private sector participant is invested in 4.2 funds as of 2004 year-end.

Looking at participants that enrolled during 2005, the number of funds in which they invest is dramatically different than participants who have been in the plan for one year or more, with 69% of new enrollees investing in only one fund. This includes those selecting a single lifestyle or lifecycle fund. The average number of funds held by new participants (those enrolled in 2005) is 2.5 funds compared to 3.1 for all participants in 2005.

More participants are using lifestyle or lifecycle funds as their only investment choice in a 457 plan. The increased use of these options is likely occurring because:

- In 2001, approximately 44% of 457 deferred compensation plans offered asset allocation funds to participants as fund options. This increased to more than 51% in 2003 and in 2005 an estimated 57% of plans offered asset allocation funds.
- Participant education focuses on how asset allocation funds can help diversify a participant's portfolio.
- Participants look for a simple approach to investing.

The increased use of asset allocation funds, such as lifestyle or lifecycle mutual funds, is also occurring in private sector plans. In 2005, about 63% of 401(k) plans reported offering at least one asset allocation fund. This is up from 35% in 2001 and 19% in 1997. There are also more asset allocation funds for plan sponsors to choose from, as new lifestyle and lifecycle funds are being launched by financial service companies at a rapid pace.[28]

[28] *Wall Street Journal* article: "Age Old Question for Investors — Retirement Plans' Offerings Seek to Simplify Choices, But Are Often Confusing," by Kaja Whitehouse Dow Jones Newswires; July 11, 2005.

Figure 25: Participant fund ownership

	Participants' average number of funds — 2003	Participants' average number of funds — 2005	% of participants using asset allocation — 2003	% of participants using asset allocation — 2005
New enrollees	2.3	2.5	23.5%	26.3%
Existing participants	3.3	3.1	8.8%	12.5%

Source: Nationwide Research, 2005.

New enrollees are more consistently selecting asset allocation funds, representing approximately one-fourth of that group in 2003 and increasing by about 10% to reach 26.3% in 2005. When examining total participants, they are also increasing their use of asset allocation funds, with 8.8% of participants in 2003 compared to 12.5% participants in 2005. Although current participants' use of asset allocation funds is not as prevalent as new enrollees, the increase over the past two years is an encouraging trend in improving asset diversification.

Asset allocation fund examination

Single fund diversification by gender

To better understand how asset allocation funds are being used in 457 plans, an additional analysis was undertaken to review participant accounts with a single investment option. This analysis showed that, based on those only investing in one fund, a majority selected a fixed option. However, there is a positive trend to select an asset allocation fund (lifestyle or lifecycle) as the single investment choice, particularly among participants under age 35.

An analysis by gender was conducted for those participants whose accounts were invested in only one fund (34% of all participants in 2005). As shown in Figures 26 and 27, more than 60% of single fund portfolios, both male and female participants, were held in fixed fund options in both 2001 and 2005. Asset allocation funds have experienced the largest increase, more than doubling from 5% in 2001 to 13% in 2005 for both genders. Those investing in large cap equity funds as their single investment choice dropped from 26% to 13% for males and 25% to 14% for females between 2001 and 2005. Single fund ownership in all other asset classes remained small (5% or less) for both genders.

Figure 26: Single fund option participants/gender — 2001

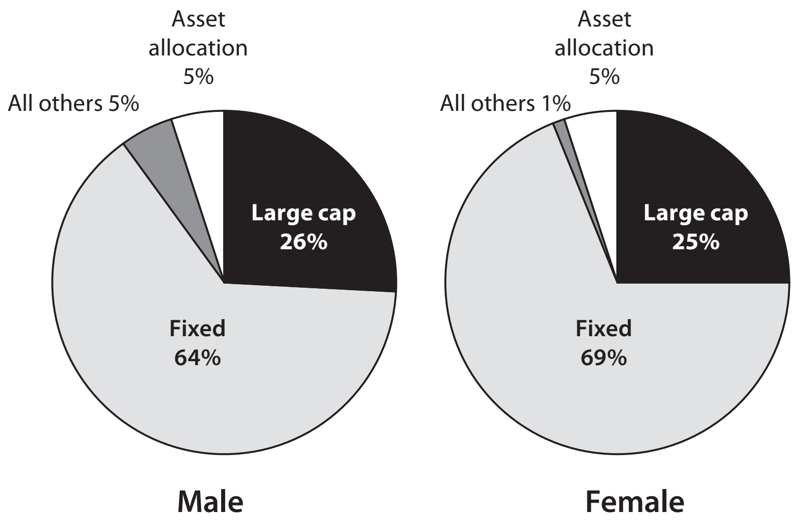
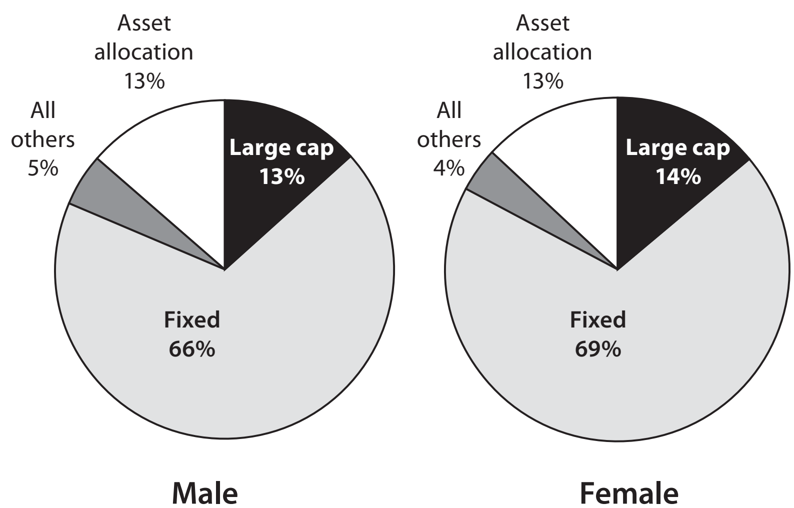


Figure 27: Single fund option participants/gender — 2005



Source: Nationwide Research, 2005.

Single fund diversification by age — total assets

The use of a single investment option for the participants' total asset allocation was also examined by participant age (Figures 28 and 29). This review demonstrates that younger participants (age 18 to 35) have increased their use of asset allocation funds as a single investment from 10% in 2001 to 30% in 2005. Fixed funds continue to have the highest percentage of participants selecting this as their single investment choice. This is particularly true for those age 46 and older.

Figure 28: Single fund option participants/by age — 2001

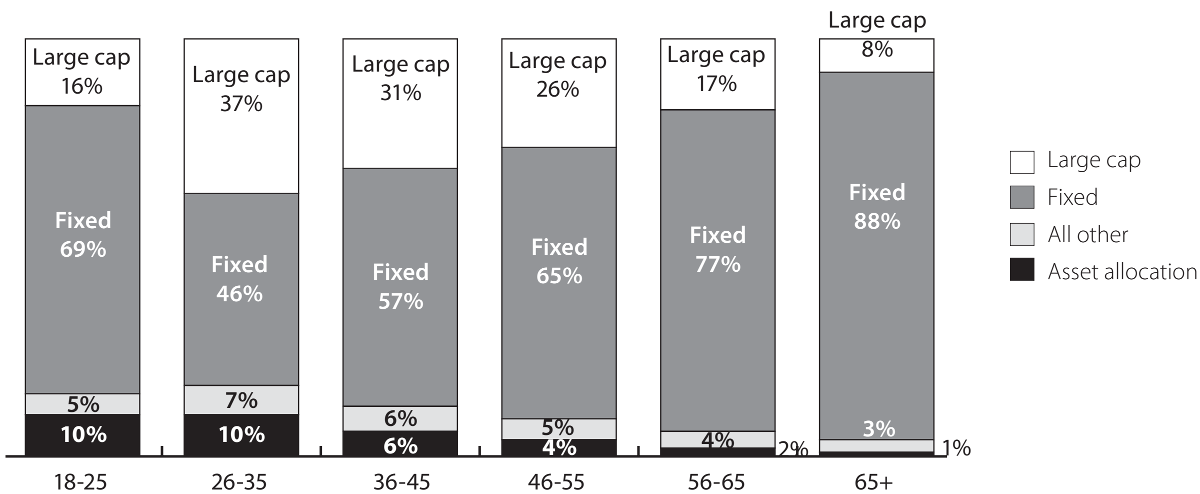
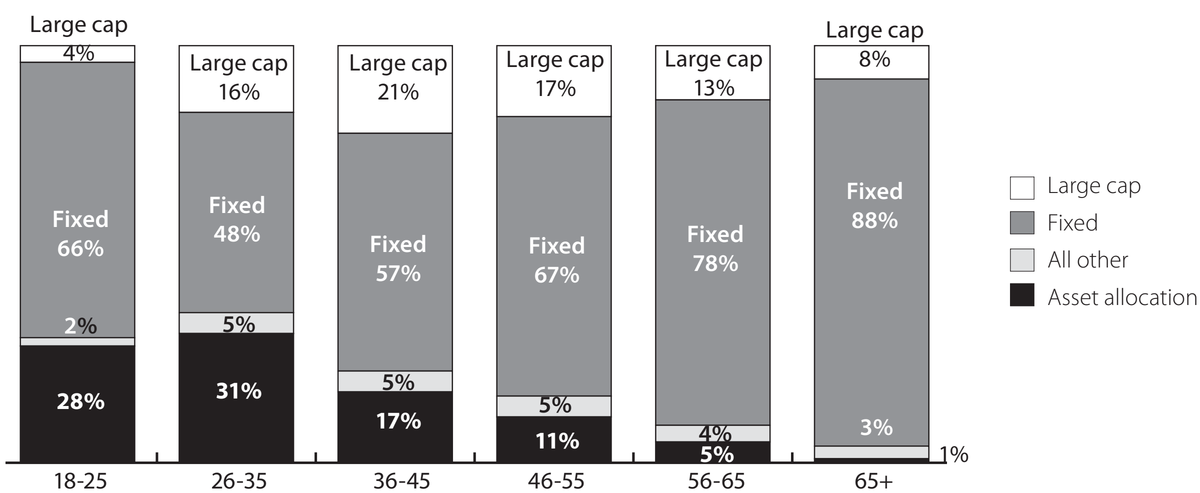


Figure 29: Single fund option participants/by age — 2005



Source: Nationwide Research, 2005.

Single fund diversification — deferrals

As previously noted, reviewing deferrals can provide insights into investment trends as participants are often more willing to adjust deferrals before moving existing account balances. When comparing deferral allocations, the increased use of asset allocation funds is even more significant. In 2003, 6.3% of all participants selected this type of fund compared to 12.3% in 2005. Between 2001 and 2005 there has been substantial growth in the use of asset allocation funds in all age groups, with this growth being most pronounced for younger participants (Figure 30).

Figure 30: Deferrals to asset allocation funds by age group (% of all deferrals)

Age group	2001	2003	2005
18-25	10%	16%	29%
26-35	7%	9%	18%
36-45	7%	5%	10%
46-55	8%	4%	8%
56-65	6%	3%	6%
66+	2%	1%	3%

Source: Nationwide Research, 2005.

In Figure 31, not only do younger participants more readily defer to asset allocation funds but female participants surpass males in their asset allocation preference. Females' deferrals increased significantly from 1.8% in 2001 to 9.6% in 2005, compared to the male population with 1.3% in 2001 and 8.4% in 2005.

Figure 31: Deferrals to asset allocation funds by gender (% of all deferrals)

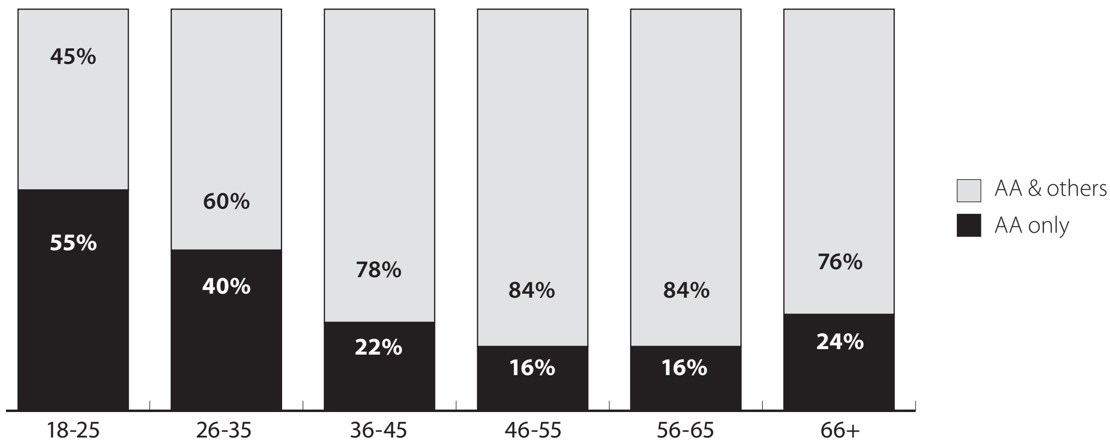
Gender	2001	2003	2005
Male	1%	4%	8%
Female	2%	5%	10%

Source: Nationwide Research, 2005.

Use of single asset allocation (AA) fund rising for age groups

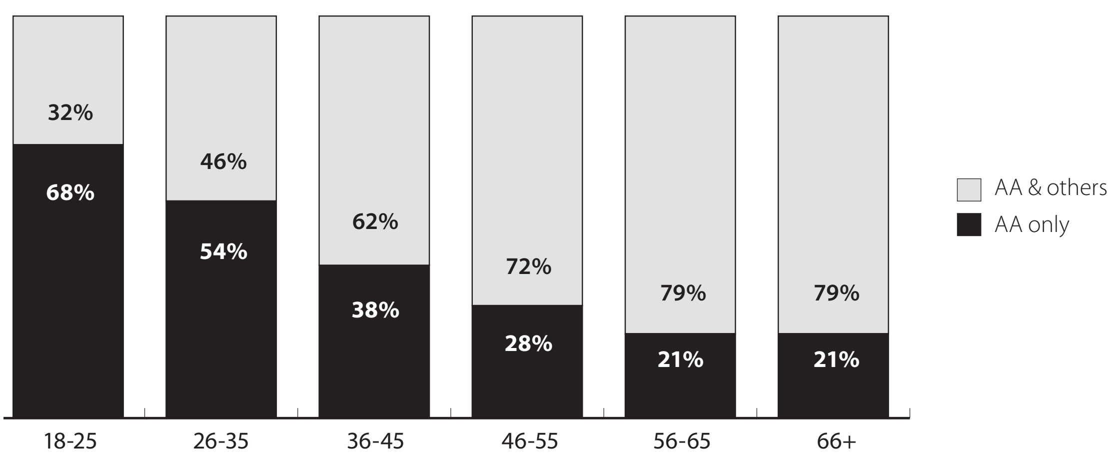
In some cases participants have chosen asset allocation funds as their only option (a single fund) and in others, asset allocation funds have been used in combination with other investment choices. Figures 32 and 33 illustrate these two approaches by age. The graphs demonstrate the fact that the two youngest age groups are more likely to elect an asset allocation fund as their only option than participants at older ages. There appears to be many participants that still do not understand the concept of asset allocation funds in providing easy and complete diversification, as they are using these options as an additional investment within their total portfolio.

Figure 32: Use of single asset allocation fund by age — 2001



Nationwide Research, 2005.

Figure 33: Use of single asset allocation fund by age — 2005



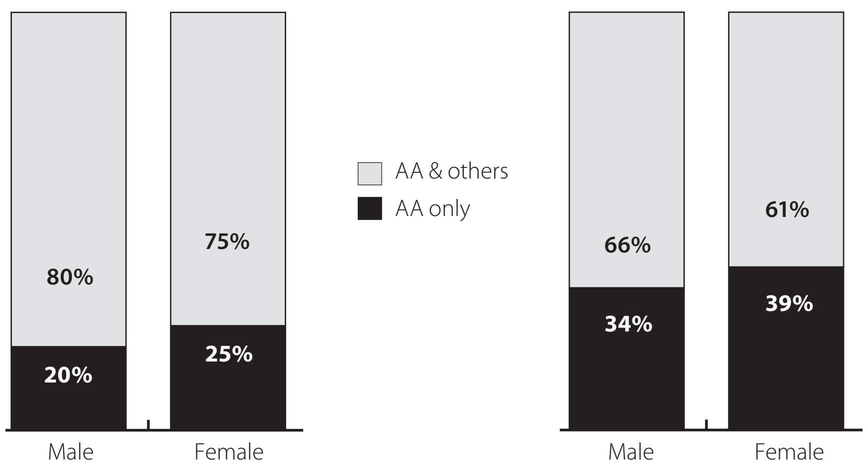
Nationwide Research, 2005.

Use of single asset allocation (AA) fund rising for males and females

The percentage of both male and female participants using a single asset allocation fund for their 457 portfolio has significantly increased (Figures 34 and 35). From 2001 to 2005 female participants have increased their use of a single asset allocation fund from 25% to 39%, and male participants have increased their use from 20% to 34%.

Figure 34: Use of single asset allocation fund by gender 2001

Figure 35: Use of single asset allocation fund by gender 2005



Nationwide Research, 2005.

457 withdrawals

Defined contribution plans have successfully helped employees accumulate wealth for their future retirement. Today's challenge is helping them continue to manage investments while in retirement and establish distribution choices that will provide them with desired income for their remaining lifetime.

Within a 457 plan, distributions can be made only when an employee separates from service (job change or retirement), in the case of a financial emergency (e.g. catastrophic property/casualty losses, family member death, etc.) or has a small/inactive account ($5,000 or less). Participants are allowed to leave their assets in the plan after termination and are not required to begin a distribution until age 70½, which is the required minimum distribution age for all tax-deferred programs.

There are typically a variety of choices available to participants for distribution of their account balance, including:

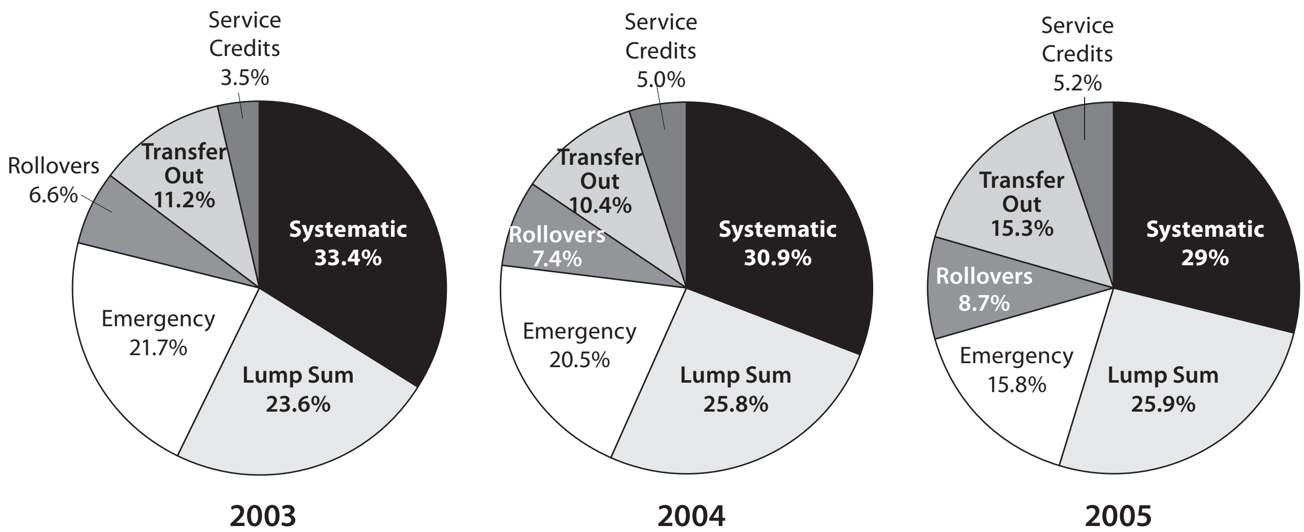
- **Systematic withdrawals:** periodic distributions (monthly, quarterly, semi annually or annually) of a fixed dollar amount or a fixed number of years
- **Lump sum:** either full or partial withdrawal from the account as a single sum
- **Rollovers:** partial or full rollover from the 457 account to another eligible account
- **Transfer:** partial or full transfer from the 457 plan to another 457 plan
- **Service credit purchase:** partial or full transfer from the 457 account to a governmental pension plan for the purpose of purchasing creditable service
- **Emergency withdrawal:** partial or full withdrawal for an approved unforeseen financial emergency
- **Annuities:** account balance used to purchase a lifetime income stream

The total number of participant distributions increased by 2.3% in 2005 from 2003 levels. Figure 36 illustrates the percentage of the total distributions processed during the past three years by the different choices available to participants. This chart shows:

- Systematic distributions continue to be the option most selected by participants, although it has declined from 33.4 % in 2003 to 29% in 2005.
- The percentage of lump sum distributions is remaining fairly constant.
- Rollover distributions have increased each year (from 6.6% in 2003 to 8.7% in 2005).
- Transfers out increased from 11.2 % in 2003 to 15.3% in 2005.
- More participants are using 457 assets to buy service credit in their primary governmental pension plan, as the percentage of this type of distribution has increased from 3.5% to 5.2%. These additional service credits can significantly increase the benefit payment that the participant receives from the defined benefit plan.[29]
- Although offered by some governmental 457 plans, annuity choices are infrequently selected by participants (less than 1% of total for all three years).

[29] Snell, Ronald, *Pensions and Retirement Plan Enactments in 2004 State Legislatures, National Conference of State Legislatures,* October 25, 2004.

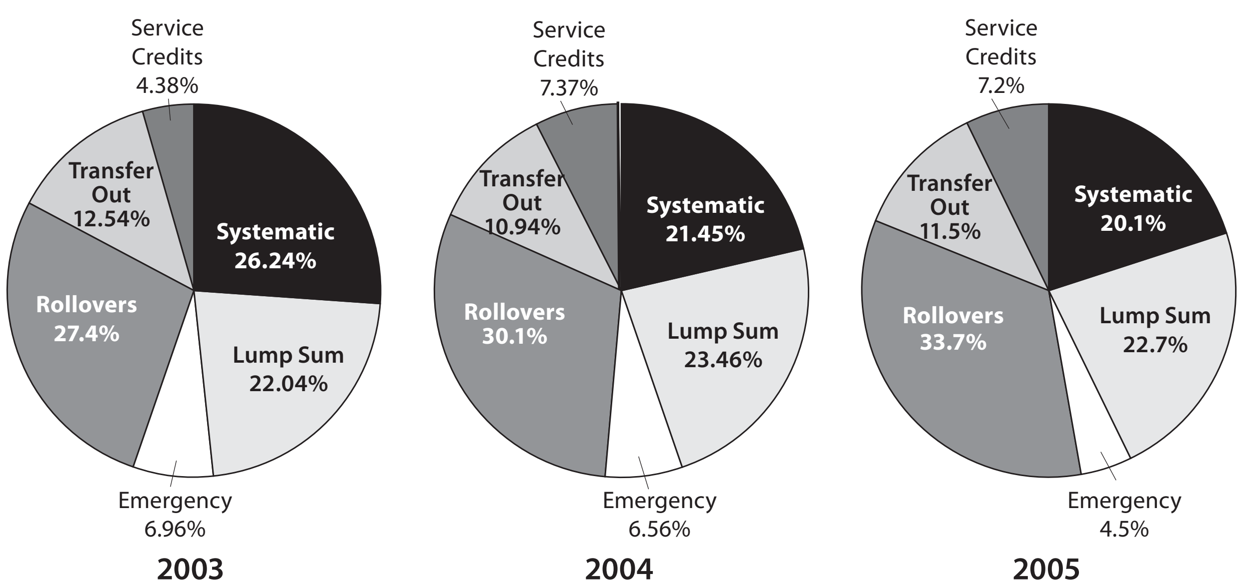
Figure 36: Participant withdrawals (as a percentage of total participant withdrawals)



Source: Nationwide Research, 2005.
Note: Annuities represent less than 1% and are not shown above.

When comparing the percentage of dollars distributed to the percentage of distributions executed during the year by type of withdrawal (Figure 36), it is evident that participants with a higher account balance are choosing to roll their assets into another tax-favored account. This is demonstrated by a smaller percentage of rollovers (Figure 36) than systematic, lump sum or emergency withdrawals, but represents the largest percentage of total dollars being distributed (Figure 37).

Figure 37: Percent of withdrawal dollars



Nationwide Research 2005. Note: annuities represent less than 1% and are not shown above.

The total dollars distributed to participants increased by nearly 28% from 2003 to 2005. Approximately one-third (34%) of the total dollars distributed to participants are rollovers to another tax-deferred account up from 27% in 2003 (Figure 37). Systematic distribution dollars as a percent declined to 23% in 2005 from more than 26% in 2003.

In terms of dollars, rollovers are increasing in both the private and public sectors. According to the Financial Research Corporation report, IRA rollovers account for an estimated 75% of assets distributed from DC retirement plans. Based on the anticipated surge of retiring baby boomers, this percentage is expected to increase to 80% by 2010.[30]

Although participants in 403(b) and 457 plans are eligible to roll their assets into another tax-favored plan or IRA, a higher percentage of rollover assets originate from private sector DC plans.[31] Based on a Financial Research Corporation report, the types of distributions that terminating or retiring employees take from defined contribution plans (primarily private) upon separation of service include:[32]

- 40% roll over to an IRA
- 35% leave it in plan
- 20% take cash
- 5% roll to another employer's plan

[30] Financial Research Corporation, *IRA Rollover Trends, Distribution & Product Strategies for Successful Asset Growth,* November 17, 2003.

[31] *IRA Rollover Trends, Distribution % Product Strategies for Successful Asset Growth*, Financial Research Corporation, 2003.

[32] Cerulli.

Section 5. Employee service needs and preferences

Enhanced emphasis on employee education

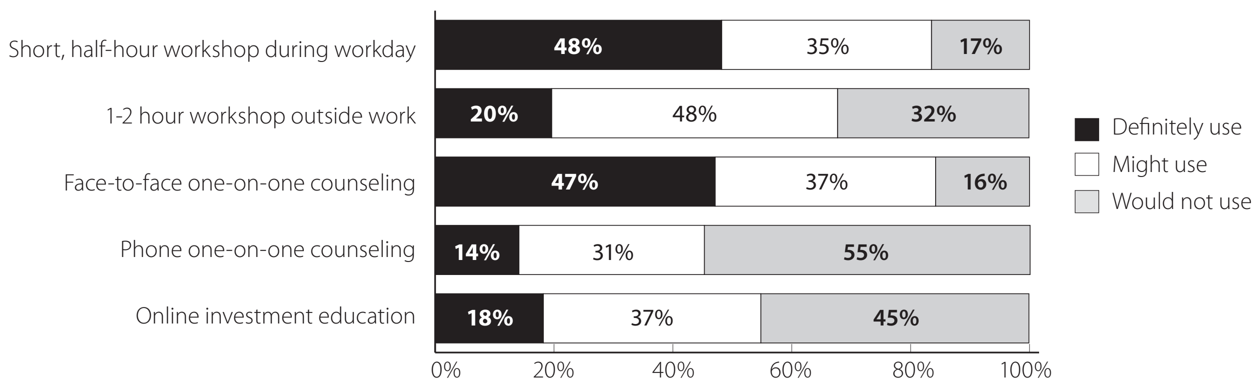
There is increased recognition within the public sector of the importance of educating employees about financial planning for their retirement years. Over the past two years, educational programs have expanded from print and in-person workshops to online workshops, enhanced on-line tools and calculators. These efforts have been centered on the 457 supplemental plans and how they can be used to make up the income gap between retirement need and primary retirement benefits (and Social Security if available).

Research conducted by Nationwide[33] to examine the educational needs of public sector participants identified the following topics that are of most interest (percent very interested or interested):

- Pre-retirement planning (74%)
- Transitioning into retirement (71%)
- Controlling financial future (69%)
- Investing concepts to maximize the value of the 457 plan (61%)
- More advanced investing topics (49%)

This same study also identified that participants' preferred method for receiving financial education is short, half-hour workshops during the workday or face-to-face one-on-one counseling (Figure 38). Phone one-on-one counseling was less preferred as was online investment education.

Figure 38: Preferred method for receiving financial education



[33] 2005 Public Employee Plan Participant Satisfaction Survey, Nationwide, 2005.

More participants are starting to embrace technology for educational purposes, as demonstrated by the increased use of web-based electronic workshops. These workshops typically cover topics similar to those presented during in-person group sessions, including, but not limited to:

- Benefits of participating in employer-sponsored investment plans (457 plan)
- Debt management and how to find dollars to invest
- Investment and asset allocation strategies

Electronic workshops provide an opportunity for employees to learn at their own speed and at their convenience. It also allows them to share the experience with their spouse and/or family member. Although not all employees will find value in this opportunity, the number of those trying electronic workshops is significantly increasing.

Nationwide introduced a series of *eWorkshops* in 2003. During the first 15 months, these workshops were accessed by employees 8,800 times, with 1,700 returning. During the first 11 months of 2005, this number increased to 12,500, with 3,800 employees accessing more than one workshop.[34]

Customer service preferences

There are several ways that participants contact their 457 plan provider for information and to execute transactions, including:

- On-line (web)
- Voice response units (VRU)
- Customer service area (CS) by telephone
- Personal meetings with a local retirement specialist, by phone and/or in person

Based on research conducted by Nationwide, participants identify that they make 4.5 contacts, on average, to the provider each year through a combination of service methods.[35] The reasons for these contacts include:

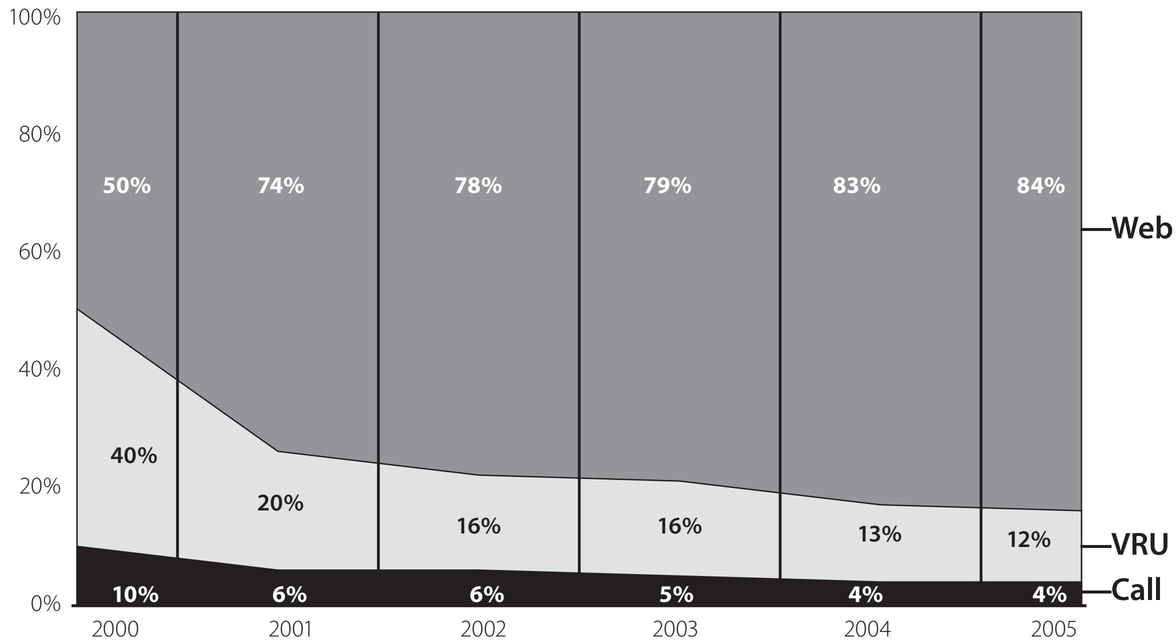
- Obtaining information about investment options and account balances
- Performing transactions such as fund exchanges, deferral changes and address changes
- Conducting more sophisticated actions such as income planning or goal setting

[34] eWorkshop Review, Nationwide, 2005.

[35] Nationwide Research, 2005.

Figure 39 illustrates the methods participants have used to contact the 457 service provider over the past six years. This chart shows that the percentage of contacts through the web has continued to increase each year, to 84% of the total in 2005 compared to only 50% in 2000.* The total annual contacts that are made to the program also increased each year, with service volume in 2005 at 17.2 million contacts, compared to 16.1 million in 2004 and 14 million in 2003.

Figure 39: Customer service contacts



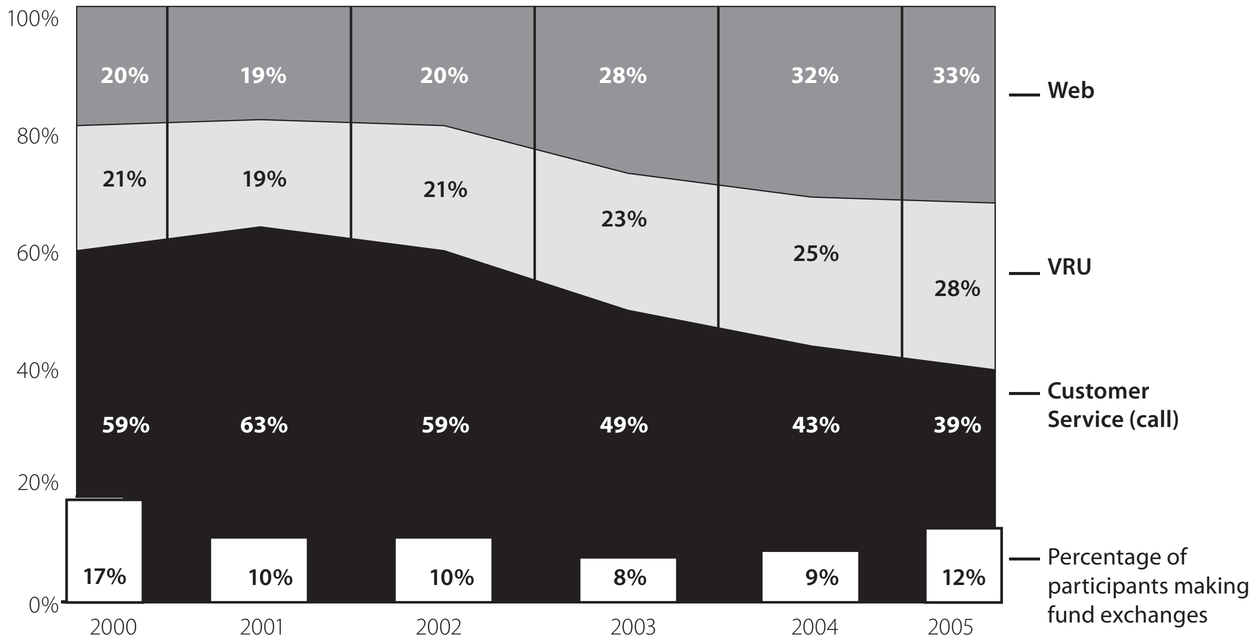
Source: Nationwide Research, 2005.
Chart illustrates total contacts to provider — participants may have multiple contacts. Nationwide data for 2005 is annualized.
*Important Note: The data in Figure 39 differs from the 2004 report findings as a result of a recalculation of the prior years. The previous report identified automatic fund mapping (when investment options were removed from a plan) as a customer service contact. This year, these automated actions have been removed from the fund exchange illustration for all years that are shown. Figure 39 now reflects only participant initiated transactions.

Although Internet usage continues to increase each year, the purpose of this contact is often for informational purposes only (e.g., obtaining account balance information) and less frequently to execute transactions. Figure 40 illustrates participant preferences when executing a fund exchange (transferring existing balances from one investment to another). web usage continued to increase, to 33% in 2005, but there are significant numbers that continue to use customer service representatives for transactional purposes.

The trend for transactions to be handled by customer service is consistent with research indicating that consumers tend to perform research through technology mediums (checking balances), but elect to actually speak to a person for purchases and/or financial decisions.[36] This trend is discussed in more detail later in this report.

[36] *Which Channels Financial Consumers Use,* Forrester Research, March 2003.

Figure 40: Methods used for fund exchanges



Source: Nationwide Research, 2005. *Nationwide date for 2005 is annualized.

Figure 40 also shows the percentage of participants who are making fund exchanges during the year. This activity increased slightly from a low of 8% of participants in 2003 to 12% in 2005. Looking at this statistic on a year by year basis, it appears to be a fairly consistent indication that only about one in ten participants periodically rebalances their account to match a selected model portfolio. Seeing this slightly up in 2005 is a positive trend and may be an indication that education is gradually taking hold to help participants understand the benefits of asset allocation and rebalancing.

In 2005, Nationwide conducted additional research that revealed 457 participant preferences on various customer services. Some of the findings from this effort include the following:

- 45% of participants visited their 457 plan web site at least once; of those, 83% accessed their account information
- 32% of participants visited their plan's web site within the last year
- 25% of participants have called a toll-free 800 number and spoke with a customer service representative within the last year
- 8% of participants used a voice response unit (VRU) within the last year

Figure 41 provides an overview of participants' identified preferred methods of contacting their 457 service provider from the Nationwide survey.

Figure 41: Participants preferred method of contacting plan providers

	Call Center	Customer Service	In-Person	Website
"Make changes to how your account is allocated"	19%	9%	47%	23%
"Make changes to address or beneficiary"	31%	11%	25%	32%
"Obtain information about plan investments"	14%	10%	44%	29%
"Make changes to the amount you are deferring"	23%	8%	46%	22%
"Receive education about investment choices"	10%	8%	51%	27%
"Get answers to questions you have"	39%	14%	32%	13%

Source: Nationwide Research, 2005.

Contact methods:

Call Center: Toll-free call to live call center representative

Customer Service: Additional guidance provided by staff with investment counseling expertise

In-person: Local retirement specialist servicing the plan

Web site: Access to account by logging on through the plan's web site

Study on general behaviors and attitudes

Understanding consumer attitudes, behaviors and trends in regard to financial products and services can provide insights into how employees use (or don't use) employer sponsored retirement savings plans, including Section 457 and 401(k) plans. To aid in this discussion, Nationwide conducted a comprehensive consumer study in December 2004 of the general population, which was segmented by those individuals participating in 457 and 401(k) retirement plans. Findings from this study are discussed in this section.

Both public and private sector employees are more likely to shop for consumer goods online than they are financial products. While more than six in ten state they buy consumer goods online, only one in ten employees shop for financial products online.

This study explored the attitudes and behaviors in the following categories:

- Internet
- Investments
- Retirement planning and credit management

Where appropriate, other research studies were also examined to add additional context. In general, private and public sector employees' attitudes and behaviors were very similar except in a few areas, which will be noted in the following text.

Internet

In the United States as of 2004, approximately 68% of adults access the Internet from home, work or other location,[37] compared to 29% in 1997. This correlates with personal computer ownership, although showing some signs of slower growth in recent years, as 60% of adults have access to the Internet at home.

Within the public sector, a much higher percentage of employees have access to a computer with Internet capabilities (93%) and report using it (95% of

[37] *The Harris Poll* Data through January 2004.

those with access). More than 78% of public sector employees have access to the Internet both at home and work. This is not surprising as there is a much higher percentage of occupations within the public sector that are office related and/or professional positions than the general U.S. population, which results in more ready access to, and familiarity with, computers.

For both public and private sector employees, Americans tend to use the Internet to shop for consumer goods (researching, pricing and buying), but significantly fewer use this for financial products (Figure 42). According to the Nationwide study, more than six in ten (63%) adults use the Internet for shopping consumer goods while less than one in ten (8.5%) shop for financial products through this medium. The complexity of financial products, including investments and insurance products, as well as the potential longer term commitment (annuities) could be factors in this variance.

Figure 42: Internet shopping

	Consumer goods			Financial products		
Activity within the last 12 months	All	Public	Private	All	Public	Private
Researched	43.4	49.5	49.7	9.7	14.3	11.5
Priced	41.1	49.3	46.8	5.7	9.1	5.5
Purchased	63.3	69.4	71.6	8.5	12.3	7.8
None of the above	20.2	14.6	13.8	81.4	73.6	80.7

When you compare the different sectors, public sector participants are using the Internet slightly less when shopping for consumer goods (e.g., books, movies, furniture, clothing) than the private sector (69.4% versus 71.6% respectively), while their usage of the Internet for financial products is slightly more, 12.3% versus 7.8% respectively. Both public and private sector participants use the Internet more than the total surveyed population to research financial products. This could potentially be attributed to the access to information on financial products through their 401(k) or 457 plan providers' web sites.

Overall, respondents have a positive attitude toward technology (Figure 43) as the majority of adults feel their lives have been made easier as a result of technology, with no significant difference between public and private sector participants or the survey population as a whole.

Figure 43: Response to: Technology has made my life easier.

Technology has made my life easier.	All	Public	Private
Agree or somewhat agree	79.7	83.1	83
Somewhat disagree or disagree	5.3	2.8	4.1
Neither agree or disagree	15	14.1	12.9

Investments

When examining specific attitudes about saving, public and private sector participants appear to have similar goals. Among all respondents, the most frequently stated important goal is saving for retirement. Figure 44 illustrates the savings goals identified in the Nationwide study.

Figure 44: Response to: Which one goal is the most important to your household right now?

Which one goal is the most important to your household right now?	All	Public	Private
Saving for retirement	25.5	40.2	39.7
Saving for an emergency	15.8	10.9	14.1
Saving for a home	9	11.5	9.9
Providing for heirs, children, grandchildren	8.5	9.2	5.7
Saving for education	5.2	4	8.1
Saving for future medical needs	5.3	2.6	2.7
Other mid or long-term needs	16.9	14.1	14.6
Have no savings/investment goals	13.8	7.5	5.2

Looking at other savings priorities, less than five in ten participants (both public and private sector) have savings that could cover three or more months of income in case of an emergency (Figure 45). Less than four in ten of all respondents have emergency savings at this level. In regard to a statement that it is more important to enjoy today than take care of tomorrow, more than three in ten of all respondents agree (Figure 46).

Figure 45: Response to: I have an emergency fund to cover three to six months of after-tax income

I have an emergency fund to cover 3 to 6 months of after-tax income.	All	Public	Private
Yes	38.7	45.1	42.2
No	61.3	54.9	57.8

Figure 46: Response to: The important thing is to enjoy today and tomorrow will take care of itself

The important thing is to enjoy today and tomorrow will take care of itself.	All	Public	Private
Agree or Somewhat agree	33.9	35.1	32.5
Somewhat disagree or disagree	43.2	45.4	45.3
Neither agree or disagree	22.9	19.5	22.2

When provided three basic responses to how investment decisions are made, it appears that four in ten agree that a mix of investments is the most appropriate approach (Figure 47). Public sector participants tend to be slightly more conservative in their investment selections, with more preferring investments with a low degree of volatility and fewer looking for high yielding investments than private sector participants. Overall, approximately four in ten respondents state that they do not invest. Note that the participants of public and private plans who indicated they don't invest may have considered the question to be asking about their investments outside of employer-sponsored plans.

Figure 47: Response to: Which statement best describes how you choose your investments?

Which statement best describes how you choose your investments?	All	Public	Private
Select investments with a low degree of volatility	15	17.8	13.4
Select a mix of investments that may yield lower returns and have lower risk and others that yield higher return but with a higher degree of risk	41.8	49.1	60.5
Select only investments with potential for high return	5.8	5.2	8.9
I don't invest	37.4	27.9	17.2

The next three tables (Figures 48, 49 and 50) identify additional attitudes about investing. Almost half of all respondents feel uninformed about investment products. When sectors are compared, there are more public sector participants who feel uninformed (55%) than private sector (48%). Additionally, a higher percentage of public sector participants feel uninformed than the consumer population in total (50%). More public and private sector participants state that they rely heavily on facts and "shop around" when it comes to investment decisions than the total consumer population, although no significant sector differences are noted.

Figure 48: Response to: I feel uninformed about investment products.

I feel uninformed about investment products.	All	Public	Private
Agree or somewhat agree	49.9	55.2	48.2
Somewhat disagree or disagree	24	23.8	28.4
Neither agree or disagree	26	21	23.4

Figure 49: Response to: I count heavily on facts when making a decision.

I count heavily on facts when making a decision..	All	Public	Private
Agree or somewhat agree	76.1	82.2	80.6
Somewhat disagree or disagree	5.7	4.6	5.2
Neither agree or disagree	18.2	13.2	14.2

Figure 50: Response to: When it comes to investments, the returns vary greatly so it is worth shopping around.

When it comes to investments, the returns vary greatly so it is worth shopping around.	All	Public	Private
Agree or somewhat agree	70.1	75	75.3
Somewhat disagree or disagree	5.1	3.2	5.3
Neither agree or disagree	24.7	21.8	19.4

Credit and risk management

Public sector retirement plan participants feel better prepared for retirement relative to private sector retirement plan participants and respondents in general (Figure 51). Nearly five in ten feel better prepared versus four in ten private sector retirement plan participants and more than three in ten (35%) of all respondents. This may be in part because more than half (52%) of public sector retirement plan respondents view themselves as being disciplined in their savings and spending decisions (Figure 52).

Figure 51: Response to: I am better prepared for retirement than most people my age.

I am better prepared for retirement than most people my age.	All	Public	Private
Agree or somewhat agree	34.5	47.7	40.6
Somewhat disagree or disagree	41.3	27.3	35.2
Neither agree or disagree	24.2	25	24.2

Figure 52: Response to: I am very disciplined in savings and spending decisions.

I am very disciplined in savings and spending decisions	All	Public	Private
Agree or somewhat agree	48.3	52	49.5
Somewhat disagree or disagree	30.8	28.7	32.2
Neither agree or disagree	21	19.3	18.3

Overall, respondents were very optimistic about their future (Figure 53), with more than six in ten respondents expecting to be better off financially in five years. Private sector participants were the most optimistic, almost eight in ten (76.5%) with public sector participants close behind at more than seven in ten (72.7%) expecting to be financially better off in five years.

Figure 53: Response to: I expect to be better off financially in five years.

I expect to be better off financially in five years.	All	Public	Private
Agree or somewhat agree	65.3	72.7	76.5
Somewhat disagree or disagree	13.1	9.5	7.3
Neither agree or disagree	21.7	17.8	16.1

How personal debt is managed can have a significant effect on employees' ability to save and invest for retirement. Respondents were asked how they handle credit card debt. Overall, the most common response was to pay more than the minimum payment, but less than the full balance, with slightly more public sector participants selecting this approach (Figure 54). Approximately three in ten employees state they pay off their total bill each month.

Figure 54: Response to: Which do you do when paying your credit card bill each month?

Which do you do when paying your credit card bill each month?	All	Public	Private
Pay total amount due	32	29.7	30.7
Usually pay all, but occasionally leave an unpaid balance	10.9	12.6	13
Pay more than the minimum, but less than balance	36.5	45.4	40.7
I don't have a credit card	14	7.5	9.4

Figure 55: Response to: If I really want something, I am likely to buy it on credit rather than wait.

If I really want something, I am likely to buy it on credit rather than wait.	All	Public	Private
Agree or somewhat agree	33.5	35.6	36.4
Somewhat disagree or disagree	49.1	45.7	47.3
Neither agree or disagree	17.4	18.7	16.2

Section 6. Managing income in retirement — The payout phase

For more than 20 years, employers and plan administrators have focused most of their attention on helping employees accumulate wealth for their retirement years through their employer-sponsored defined contribution plans. The emphasis has now shifted to helping employees who are close to, or in, retirement manage their income and structure distribution methods that will last their remaining lifetime.

Both public and private sector employees are concerned about adequately planning to meet retirement income needs.[38] However, public sector employees are generally more secure because their personal retirement savings is a supplement to income they receive from their primary pension. Within the private sector, there is more personal responsibility for retirement income from savings in 401(k)s, IRAs or other retirement plans. As a result, the private sector is on a faster track to provide their employees with retirement income solution. The financial services industry is competing to capture the $1.7 trillion projected market for retirement rollovers through 2010.[39]

Retirement income management involves several factors including:

- Retirement age and readiness
- Debt and expenditures
- Income management, advice and solutions

[38] *MacroMonitor 2004-2005,* SRI Business Intelligence.

[39] *Registered Rep,* per Cerulli Associates, 1 November 2005, *Trolling for 401(k) Treasure.*

Retirement age and readiness

The United States is undergoing dramatic demographic shifts, as the 77 million baby boomers retire over the next 20 to 25 years. They are the largest demographic segment in U.S. history, representing more than one-fourth (27.5%) of the total population and nearly half (47%) of U.S. households with more than $2 trillion in estimated annual spending power.[40]

Boomers influence the work environment, investment world, solvency of employer benefit programs and consumer markets overall. Their exit from the workforce will place burdens on younger generations to support Social Security and Medicare programs. There is a growing question as to if they have achieved sufficient prosperity and will be able to manage their assets wisely to support a comfortable lifestyle throughout their retirement years.

Today's employees are indicating that they don't expect a traditional retirement lifestyle. Many are planning to:

- Continue employment with their current (or a different) employer for a set number of years or as many additional years as possible
- Phase into retirement through a part-time or temporary position
- Go into business for themselves, either in the same industry as their working career or a totally different endeavor
- Renew a healthy lifestyle

When employees are asked about their retirement future, many appear to have a somewhat optimistic view, based on the findings of the EBRI 2005 Retirement Confidence Survey.[41] The majority of American workers identify that they are at least somewhat confident about having sufficient income for a comfortable retirement. This confidence is not necessarily a direct reflection of their actions as 20% of those who stated they were "very confident" about financial prospects are not currently saving for retirement at all and 37% have not attempted to calculate their retirement financial need.

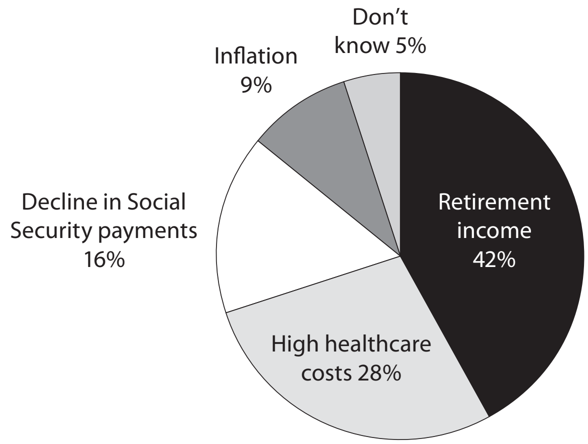
Although some are optimistic, many are fearful about their financial future in retirement as well. According to a 2005 report from the National Association for Annuities (NAVA), 95% of the population identifies at least a certain amount of trepidation over their retirement future relating to having sufficient income, escalating health care costs, uncertainties of Social Security and the effects of inflation (Figure 56).[42]

[40] *American Demographics,* "Power of the Purse", July/August 2002; Primedia Insight, October 6, 2005; MetLife Mature Market Institute, 2005.

[41] The Retirement Confidence Survey, conducted by the Employee Benefit Research Institute (EBRI) and Mathew Greenwald & Associates, Inc. and underwritten by Nationwide, 2005.

[42] *2005 Retirement Fears,* NAVA, March 28, 2005.

Figure 56: 2005 number one financial retirement fears



Source: NAVA 2005.

It is human nature to focus on today's needs, particularly when retirement seems so far away. As a result, the consequence of not saving for a future retirement often doesn't influence current behavior. The disconnect between knowledge and action can be attributed to the following:[43]

- Exact income needed for retirement is difficult to understand and estimate
- Payoffs are too distant in the future
- Pleasure tomorrow means pain today
- No immediate, tangible penalty for not saving today
- Deadlines (meaning a retirement date) are arbitrary

Not only do psychological factors contribute to non-saving behaviors, but complex or too numerous investment choices, lack of consumer knowledge and lack of consumer trust toward financial companies fuel inertia and consequently, inadequate retirement savings.[44] Nationwide research confirmed that behaviors learned in the early, formative years from families, or other role models, can have a significant impact on savings and spending patterns. For example, employees who have a family background where savings was valued and taught are more likely to:

- Consider planning for their future very or extremely important
- Start earlier and save more for retirement, often up to the maximum allowed
- Use a financial advisor or establish their own personal investment plan
- Be more confident and make more rational decisions in regard to investments and savings

[43] Pension Research Council, The Wharton School, 2003.

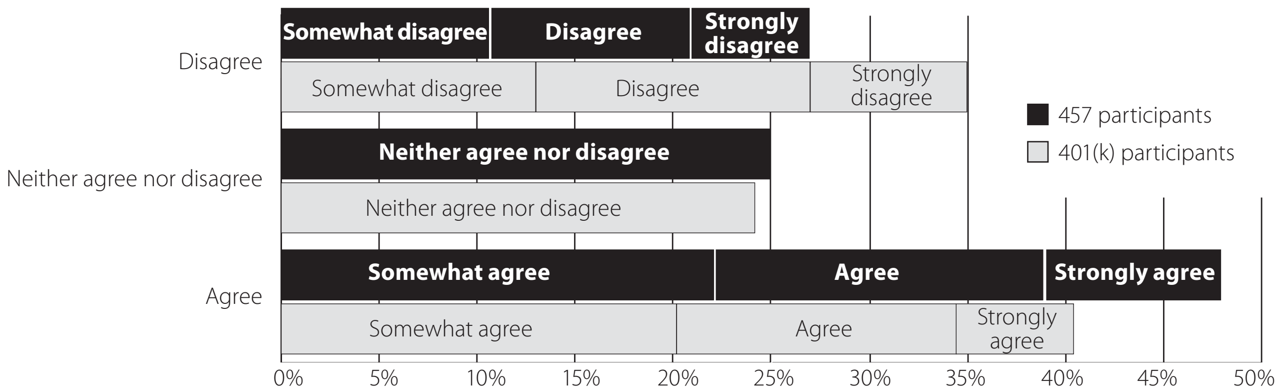
[44] *A Matter of Trust,* IAB, 2004.

There are only small differences between public and private sector employee attitudes about retirement preparedness, according to the 2004-2005 DataMonitor.[45] Almost three-fourths (70%) of public sector workers identified that they were concerned about having adequate retirement income, compared to 75% of private sector employees. These responses seem to correlate to the level of satisfaction employees had with their savings and investments, which were identified as:

- 37% percent of both private and public sector employees indicated they were not very or not at all happy with their savings and investments
- 40% stated they were somewhat happy

Although the above identifies that both private and public sector employees are concerned about retirement, it should not be surprising that those participating in their employer sponsored plan (401(k) and 457) feel better prepared. Nationwide research identified that 39% of 457 plan participants felt they were better prepared for retirement compared to most people their age and private sector participants are only slightly below this level of confidence, with 35% feeling better prepared (Figure 57).[46]

Figure 57: 457 public sector participants feel slightly better prepared for retirement than private sector



Source: Nationwide Research, 2005 .

When employees plan for retirement, one of their major concerns is health care. Based on multiple surveys, the majority of American workers (from 45% to 60% depending on the study) state they plan to work during retirement to obtain healthcare insurance.[47] The fear of not having sufficient funds to pay premiums, deductibles and other out of pocket expenses is prevalent. Many public sector employees anticipate receiving continued healthcare benefits in retirement from their employer. If current budget situations continue, these benefit levels are likely to be reduced or eliminated in the future.

[45] 2004-2005 MacroMonitor, SRI Business Intelligence, April 2004.
[46] Nationwide Research, 2005.
[47] *Houston Chronicle,* August 23, 2005, "Baby Boomers Set to Revolutionize Retirement;" PR Newswire, Conference Board managing mature workers working group; September 20, 2005.

Debt and expenditures — how baby boomers and empty nesters spend their money

Finding dollars to invest for retirement is often difficult because of life stage priorities, living expenses and debt. This does not necessarily change as people age, as evidenced by evaluating living expenses of baby boomers and empty nesters (those aged 55 to 64 in 2003). The top three 2003 expenditures (latest statistics available) for younger boomers, older boomers and empty nesters (Figure 58) according to the Bureau of Labor Statistics include:

- Housing
- Transportation (auto and associated costs)
- Personal insurance and pensions

Overall, expenses have not changed significantly from 2001 to 2003, although segmentation by demographic age reflects a somewhat different story. Spending priorities fluctuate depending on life stage and lifestyle need. For example, expenses associated with children are more likely to affect younger boomers; older boomers are more likely to focus spending on college education costs and personal insurance and pensions; empty nesters spend more on healthcare (Figure 58).

Figure 58: How boomers spend their money and accumulate debt
(Includes only major annual expenditures*)

	Younger Boomer (age 35-44)		Older Boomer (age 45-54)		Empty Nester (age 55-64)	
	2001	2003	2001	2003	2001	2003
Housing	$15,870	$16,098	$15,026	15,624	$12,802	$13,714
Transportation (includes insurance/ maintenance)	9,202	8,892	9,355	9,766	8,093	4,824
Personal insurance & pensions	4,971	5,196	5,224	6,003	4,401	4,819
Food at home	3,589	3,600	3,659	3,693	3,238	3,315
Utilities	3,111	3,142	3,192	3,335	2,998	3,089
Food away from home	2,653	2,672	2,792	2,688	2,204	2,215
Healthcare	1,879	2,105	2,265	2,479	2,703	3,059
Entertainment	2,508	2,519	2,233	2,407	2,337	2,414
Household furnishings & equip.	1,712	1,731	1,802	1,801	1,653	1,831
Education	669	694	1,036	1,377	438	743
Total	**$46,164**	**$46,649**	**$46,584**	**$49,173**	**$40,867**	**$40,023**

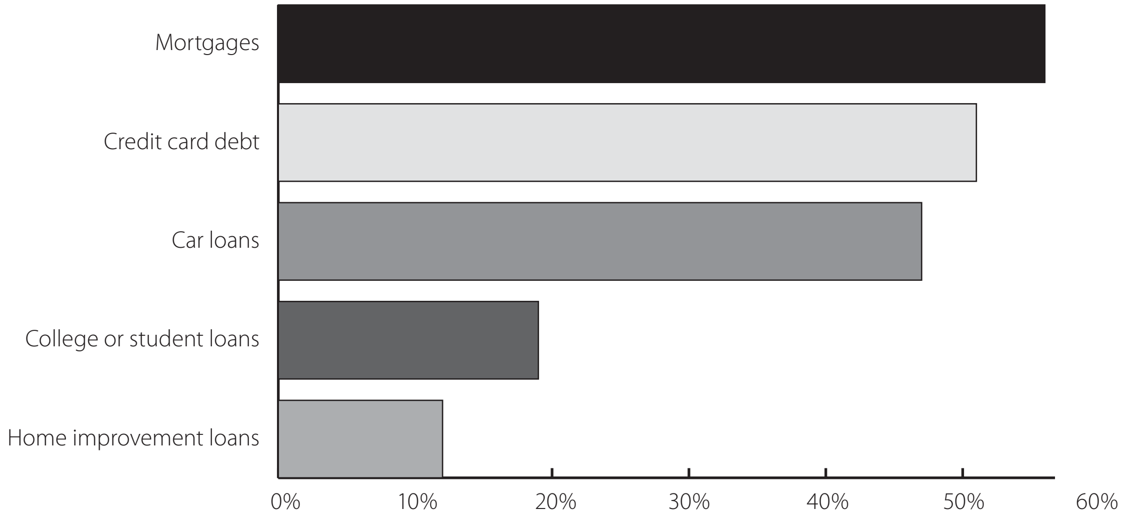
* Note: Age Breakdowns according to Bureau of Labor Statistics.
Source: Consumer Expenditures in 2001 and 2003, U.S. Department of Labor, Bureau of Labor Statistics.

Based on the spending statistics and annual salary levels of 401(k) and 457 participants (averaging $58,130 and $48,100, respectively), it is not surprising that the majority of the middle market has some form of debt.[48] Also not surprising is that more than one-third of both public (38%) and private (35%) sector employees participating in their employer-sponsored plans [457 or 401(k)] are not happy with the balance between their spending and income.[49] This dissatisfaction is likely attributed to debt levels, particularly with lower income workers.

Many workers may not recognize the impact that debt has on their ability to save and invest for retirement. According to the EBRI 2005 Retirement Confidence Survey, more than half of respondents report carrying some type of debt (Figure 59): 56% mortgage debt, 51% credit card debt and 47% car loans. This survey also illustrates that those who report being behind schedule in saving for retirement are almost twice as likely as workers who are ahead or on-track to say their level of debt is a problem.

Credit card debt affects more than 50% of the population and many boomers will carry this into retirement. Some younger boomers accumulate credit card debt and live beyond their means, but they believe they are just beginning their careers and will be able to manage credit card debt as salaries and careers advance.[50]

Figure 59: Workers reporting types of debt



Source: Employee Benefit Research Institute and Mathew Greenwald & Associates, Inc., 2005 Retirement Confidence Survey

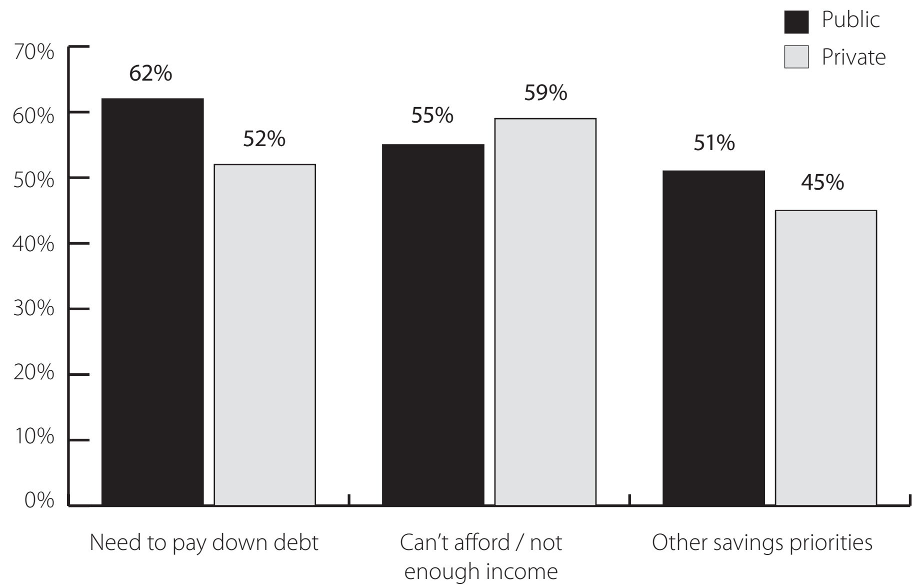
[48] LIMRA, Four Faces of the Middle Market, 2003.

[49] Nationwide Research, 2005.

[50] Nationwide Research, 2005.

When comparing public to private sector, Nationwide research shows that public employees are more likely to say that the need to pay down debt and it is their top reason (62%) for not contributing to their deferred compensation plan (Figure 60). Not having enough money (55%) or other savings priorities (51%) are also reasons stated by more than half of the public sector workforce. In the private sector, slightly more workers identify not having enough money (59%) as their top reason for not participating in their 401(k) plan, followed closely by the need to pay down debt (52%) and other savings priorities (45%).

Figure 60: Top reasons employees do not contribute to DC retirement plans



Source: Nationwide Research, 2004.

Investment choices at retirement or separation of service

Mutual funds either inside or outside an employer-sponsored retirement plan continue to be the preferred investment choice for most Americans. A 2005 Investment Institute Survey identified that:

- 35.6 million U.S. households own mutual funds inside employer plans
- 38.9 million households own funds outside these plans
- Overall, 53.7 million U.S. households or 47.5% of all U.S. households and 91.3 million individual investors own mutual funds

There have been various reports within the financial industry on what employees do with their defined contribution assets when they switch jobs or retire. Depending on the study, 60% to 72% of retirement account decisions result in the money leaving the employer plan.[51] The types of distribution choices available from defined contribution plans include lump sums, systematic withdrawals, annuities and rollovers to IRAs or other plans.

Public sector plans typically provide a range of choices for distributions that permit, and even encourage, participants to leave their assets in the employer plan. The types of distribution choices available generally include full and partial lump sum withdrawals, periodic systematic withdrawals and period certain or life annuities. Although participants in 403(b) and 457 plans are eligible to roll their assets into another tax favored plan or IRA, a higher percentage of rollover assets originate from private sector DC plans.

The transition to income management

Helping plan participants better understand how to manage accumulated assets and establish retirement income streams is an important role for employers and plan administrators. Today, many are choosing to roll funds from their employer plan to an IRA because they have an existing relationship or other accounts with a financial advisor or financial company. Some participants take full or partial lump sum withdrawals to use the accumulated assets to pay off mortgages or other debt. In general, however, once an employee separates from service or retires, they feel a need to have more control over their retirement accounts.[52]

[51] Industry experts including Cerulli, FRC, Brightworks Partners, Conning, and LIMRA.

[52] Nationwide Research, 2005.

Some income management efforts are occurring in the marketplace. Consumers, financial service companies and plan providers have been focused on the accumulation phase of the investment life cycle and are starting to prepare for the strategic and implementation phase of retirement income management. Statistics (from a variety of studies regarding consumer vulnerabilities in managing their accumulated wealth from employer defined contribution plans) show that:

- **Few establish an income plan:** Only one in five retirees has established an income plan to insure any degree of confidence that their accumulated assets will generate an income stream to support their lifestyle in retirement.[53]
- **Few are familiar with an income annuity:** More than one-third (40%) of individuals between age 55 and 64 have never heard of an income annuity.[54]
- **An income and distribution strategy is desirable:** Developing an income withdrawal strategy (21%), determining an asset allocation strategy (21%) and better understanding 401(k) payouts (19%) were at the top of the wish list for many recent retirees.[55]

Similar research studies have also explored plan sponsor attitudes and plans of action in regard to helping employees manage their retirement income and have found that:

- More than half (54%) of private sector plan sponsors state they intend to focus on ways to help employees manage their retirement savings once they leave the plan (e.g., provide seamless ways to roll lump sum payouts into an IRA or low-fee lifetime income plan).[56]
- The top three methods among employers who are likely to focus on helping employees manage income once it leaves the plan include:[57]
  - Increase communication via normal channels — 77%
  - Facilitate rollover to select IRA programs — 69%
  - Provide seamless ways to roll lump sum payouts into an IRA or low-fee lifetime income plan — 30%

In regard to the financial services industry, according to a survey by FRC, 88% state they are developing or enhancing retirement income products and services and view this as "very important" or "of vital importance" to strategic

[53] *Investment News Roundtable,* Transcript discussion, Investment News, October 5, 2005.

[54] EBRI, *Managing 401(k) Plans; How Employers Can Help Their Employees Save for Retirement,* September 1, 2005.

[55] Fidelity Workplace Services, Fidelity Investments Retirement Transition , December 2004.

[56] Hewitt Associates LLC, *Survey Findings: Hot Topics in Retirement 2005,* March 2005.

[57] Ibid.

planning for the next three years.[58] Companies providing services to employer plans are recognizing that it is important to provide services for the total life of participants — from enrollment through account distributions — to help plan sponsors fulfill fiduciary responsibilities and improve asset retention.[59]

- Financial advisors are transitioning products and services to the de-accumulation phase, versus the accumulation phase, to provide a more comprehensive approach to counseling and advice to better help investors who are near, or in, their retirement years.
- DC providers, particularly in the private sector, are developing hybrid product offerings that combine accumulation vehicles with guaranteed income streams at retirement to provide participants with an alternative that resembles benefits from pension plans.
- Private sector DC providers are increasingly partnering with technology platform companies to offer seamless IRA rollover solutions.[60]

Helping employees during the de-accumulation phase is generating a new focus on guidance and advice solutions. The need for advice varies between the public and private sector. Most public sector employees will receive a steady stream of income from their pension benefits during their (and their spouse's) remaining lifetime, often with inflation protection. The uncertainties regarding possible changes to benefit levels and retiree health care coverage paid by the employer may point to an increasing need for customized guidance on retirement income needs. Private sector employees have greater responsibility for their future income in retirement, as 401(k) plans and/or personal savings may be their only retirement income source aside from Social Security benefits.

Recent product solutions and services are being developed to assist individual and group investors with retirement income investment and management. For example, immediate income annuities are being explored as a desirable feature of employer sponsored defined contribution plans so that participants are provided with an option to establish a guaranteed level of income for life. Annuities outside of a retirement plan that guarantee principal, or guarantee income or both, are more examples of solutions to help retirees receive adequate, yet reliable income. Products like these and others will continue to expand and evolve as the baby boomer generation moves into retirement.

[58] Lafferty Limited, *U.S. Retirement Trends: The great savings transition* from FRC survey, June 30, 2005.

[59] Nationwide Research, 2005.

[60] Ibid.

Section 7. Trends
… looking ahead to the future

State and local governments' pensions and health care benefits

Budget pressures continue

State and local government employers continue to struggle with budget shortfalls while the increased pressure of an aging society creates more demands on public services. Over the past two years, the emphasis within the public sector has been to further reduce spending, which often leads to proposals to modify employee pension and health benefits.

Although there appears to have been fewer budget cuts in 2005 than two years ago, this doesn't mean that the public sector financial situations have necessarily improved. In fiscal 2003, 37 states made reductions to budgets after they had been enacted, while in fiscal 2005 only five states reduced enacted budgets.[61] Aggregate state spending has been more in-line with historical levels, growing at 6.6% above prior years, which has been aided by federal relief packages that increased fiscal revenue. This temporary surge in revenue overstates their budget outlook. The growth in spending in fiscal 2006 is expected to be a more modest 3.8% and, despite Federal assistance, many states are still experiencing budget shortfalls (20 experienced Medicaid funding shortfalls in fiscal 2004 and 24 in fiscal 2005).[62]

Among our nation's cities and towns, the picture is even less rosy as fiscal difficulties are expected to continue. In a survey of city financial officers,[63] 61% said they expected their cities to be less able to meet their 2005 needs than the previous fiscal year. Three out of ten city officials warned that if city taxes and fees are not increased, taxpayer services might be decreased. When examining reasons for the financial conditions, three of the top five identified pertain to employees' wages and benefits (see sidebar).

National League of Cities Survey: City Fiscal Conditions in 2004

Top five issues impacting local finances

1. Employee health benefits (91%)
2. Employee wages (89%)
3. Public safety needs (78%)
4. Infrastructure needs (74%)
5. Employee pensions (74%)

[61] National Governors Association, *Fiscal Survey of the States,* June 2005.

[62] National Governors Association, *Fiscal Survey of the States,* June 2005.

[63] National League of Cities, *City Fiscal Conditions in 2004,* August 2004.

DB plan funding challenges

At the same time state and local government employers are facing severe budget concerns, they also are challenged by ongoing funding of their defined benefit pension obligations. According to a Wilshire and Associates 2004 State Retirement Funding Report, 93% of all state retirement plans were under-funded (defined as less than 100% funded), compared to 51% in their 2002 report.

The Wilshire 2004 report identified that falling asset values combined with continued liability growth caused state pensions plans to go from a $180 billion shortfall in 2002 to $366 billion in 2003.[64] It also noted that 14 state pension plans had funding ratios below 70%, with the lowest being 40% funded.

Reports on the funding status of public sector pension systems vary widely and are often conflicting. For example, the 2004 Public Fund Survey, conducted by the National Association of State Retirement Administrators (NASRA) portrays a somewhat different picture of the public defined benefit pension systems.[65] The 2004 survey represents approximately 88% of the nation's total public sector retirement systems and identifies that the combined funding level for these plans is 87.8%, down slightly from the previous year's report of 91.2%. The report also shows that the average funding level of all plans included in the survey is 85.2%, with the median at 86.7%.

While opinions vary on the financial condition of public pension systems, there appears to be little disagreement that budget situations make it difficult to continue to support the current benefit levels into the future. This is causing both political and taxpayer pressure to look at alternatives. Many state and local government employers have made, or are considering, changes to pension benefits and/or major transitions to adopt alternate plans, such as hybrids or optional defined contribution plans for new employees.

[64] *2004 Wilshire on State Retirement Systems: Funding Levels and Assets Allocation,* Wilshire and Associates, March 12, 2004.

[65] Brainard , Keith, *Public Fund Survey Summary of Findings for FY 2004* National Association of State Retirement Administrators, September 2005.

Public sector continues to evaluate retirement programs

State and local government employers continue to recognize that defined benefit (DB) plans are an important employee benefit. More entities have made, or are considering making changes. In the late 1990s, there was increased interest in defined contribution (DC) plans, specifically employer-funded 401(a) plans, to address a more mobile workforce and the potential to reduce investment risks (and therefore costs) to the employer. Recently, there appears to be interest by some governmental employers that previously established DC plans to create a more hybrid approach.

The three types of hybrid or stand-alone DC plan types that employers are exploring include:

1. A hybrid plan that combines features of both DB and DC into a single plan, often referred to as a cash balance plan, where employees generally receive a benefit based on both the employee's length of service and the investment returns of the plan (as in a DC plan)
2. A more traditional form of hybrid plan that maintains two separate plans, one providing a smaller defined benefit based on a reduced formula multiplier (to determine benefit levels) combined with mandatory employee participation in a traditional DC plan
3. A stand-alone optional DC plan that usually replaces the DB plan for new employees and is an optional election for existing employees

Some of the recent activity pertaining to public sector retirement plans includes:[66]

- 2002 — Nebraska established a hybrid cash balance plan for new state and county employees and existing DC plan participants who elected to switch.
- 2003 — Oregon established a more traditional hybrid plan approach for new employees to replace the DB plan.
- 2004 — Colorado established a new optional DC plan for state employees (beginning January 1, 2006).
- 2005 — Alaska closed its DB plan for most public employees (both school teachers and state employees) who are hired after June 2006 and will offer a DC 401(k) type plan in its place.
- 2006 — West Virginia reopened its DB plan to new teachers.

[66] National Association of State Retirement Administrators and EBRI; *Overview of plan types and their use among state retirement systems, 2005.*

Governors and/or legislatures in several states proposed actions during 2005 that were unsuccessful to replace or alter current retirement benefits. For example, Governor Schwarzenegger in California proposed replacing the state's pension plan with a 401(k) type arrangement. Other states, such as South Carolina, Virginia, New Mexico, Maryland, Georgia, Minnesota and New York, introduced proposals or are studying the issue of pension reform.[67]

It seems very likely that state and local governments will continue to propose changes to DB plans to modify structures or reduce benefit levels, resulting in more responsibility placed on public employees for their retirement future. As a result, supplemental retirement benefits, such as the 457 plan, will have an even greater role in the coming years to help employees meet their retirement income needs.

Public sector employers tackle increasing healthcare costs

Health insurance benefits for both active and retired employees continue to be a challenge for state and local government employers. As costs rise, employers search for lower cost solutions for their active employee benefits as well as the health coverage provided to retirees.

A 2005 report by the Kaiser Family Foundation and Health Research and Educational Trust, *Employer Health Benefits: 2005 Summary of Findings,* found that the percentage of public and private employers providing health insurance to employees dropped from 69% to 60% over the last five years. The percentage of firms providing high deductible health plan (HDHP) benefits to at least some of their employees also increased, as 25% of firms offering health benefits offer an HDHP. More employers are also pursuing consumer driven arrangements with 2.3% of employers providing health benefits offering health savings accounts (HSA) and 1.9% providing health reimbursement accounts (HRA).

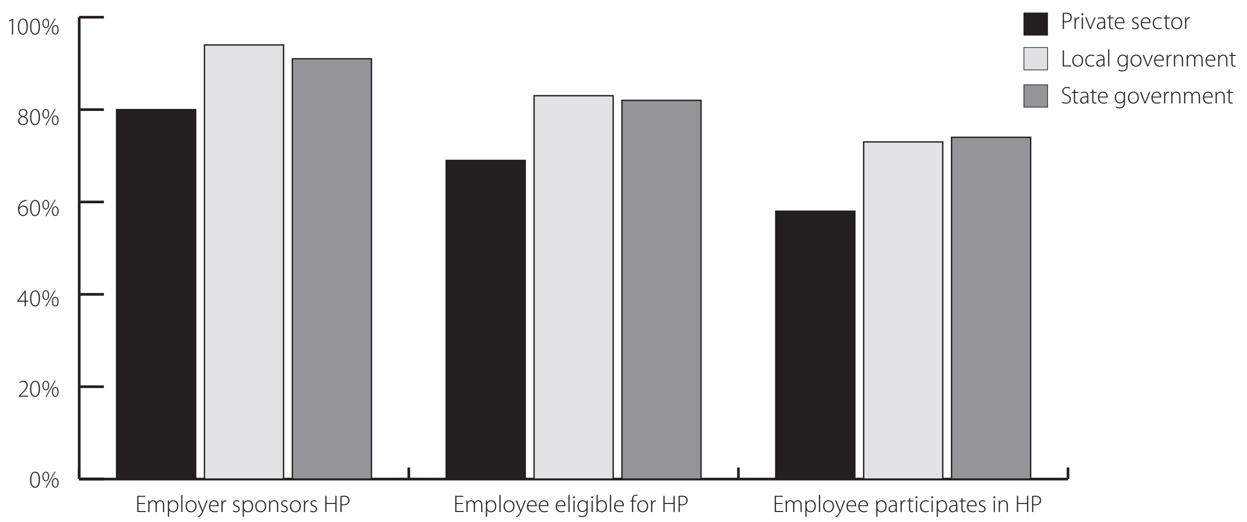
In regard to retiree health benefits, the Kaiser report identified that 33% of large firms (200 or more employees) offer retiree health care, which is virtually the same percentage as in 2004, but down from 66% in 1988. Of those providing retiree benefits, 94% offer these to early retirees while 81% offer benefits to only Medicare-age retirees.

[67] "Eight States Considering Shifting to DC Plans," *Pension & Investments,* February 7, 2005.

In the public sector, health insurance benefits continue to be a major fiscal challenge for employers. Historically, state and local governments have provided more and better health care coverage for their employees than the private sector (Figure 61). An August 2005 report published by EBRI[68] found that public sector workers are more likely to be covered by an employer's health plan, as 82% to 84% of employees were eligible for health benefits in 2002 (with 72 to 74% participating), compared to 69% of private sector workers being eligible (with only 58% participating) (Figure 61). The strong union presence combined with a larger proportion of white collar/office occupations in the public sector has likely contributed to the greater presence of employee health coverage.

Both public and private sector employers have begun implementing measures to help reduce the cost of health benefits. Some approaches that states are using include: inpatient pre-certification, disease management, pharmacy benefits managers and prescription drug pre-authorization.[69]

Figure 61: Health plan (HP) sponsorship public and private sector



Source: *EBRI Issue Brief* No. 284, August 2005.

[68] *EBRI Issue Brief* No. 284, August 2005. Employment Based Health Benefits: Trends in Access and Coverage.

[69] *Governing,* June 2004, p. 60, Segal State Health Benefits Survey, 2003.

According to an EBRI report on retiree health benefits,[70] state governments and local governments with 5,000 or more employees were more likely to offer retiree health benefits in 2002 than they were in 1997. However, as public sector employers struggle with the current and future costs of these programs, they are beginning to review or implement cost saving measures such as:

- Require retirees to pay a greater share of premium
- Tighten eligibility requirements for retiree coverage (e.g., age and tenure requirements)
- Institute caps or ceilings on the total amount that employers are willing to spend on retiree health benefits
- Reduce or eliminate retiree benefits for employees hired after a specific date

Another issue affecting retiree health benefits in the public sector is new accounting rules that will soon go into effect. The Government Accounting Standards Board (GASB), which is the independent regulatory board that sets accounting standards for state and local governments, passed a rule in 2004 to require disclosure of long-term retiree health care liabilities on financial statements. This accounting change begins to be affective for health plans in 2006 and employers in 2007 (on a tiered schedule based on employer size).

This will impact government entities that have funded retiree health care on a pay-as-you go basis, as future liabilities will now have to be calculated and accounted for on financial disclosures. Rating agencies will take note of these stated liabilities, which could raise borrowing rates for entities that don't have an adequate plan in place to address the cost of retiree health care liabilities.

A similar measure was passed in the early 1990s for the private sector by the Financial Accounting Standards Board (FASB), which required companies to show long-term retiree health care liabilities on their balance sheet. Since this rule passed, many large employers who fund retiree health care have slowly made changes to their plans. This includes requiring retirees to pay a greater share of health care premiums, reducing benefits and lengthening retiree health eligibility periods for current employees (future retirees). While few larger employers have dropped retiree coverage outright, most new companies have not offered this benefit, which has resulted in the percentage of employers offering retiree health benefits in the private sector to steadily drop.

[70] *EBRI Issue Brief* No. 279, March 2005, "The Impact of the Erosion of Retiree Health Benefits on Workers and Retirees."

As employers struggle with funding health care benefits for active workers and retirees, employees are being asked to take more responsibility for these expenses. The impact is that more of their income and retirement savings will be diverted to pay health care premiums.

In a 2004 EBRI Health Confidence Survey, 25% of employees affected by rising medical costs said they reduced retirement savings to cope with the situation, while nearly one-half (48%) reported cutting other savings.[71] For those with annual incomes of less than $35,000, the shift away from savings is even greater, with 57% decreasing their savings versus 48% overall. While this study focused on private sector employees, it clearly showed that employees who are forced to take more responsibility for their health care coverage are more likely to reduce or stop contributing to long-term savings accounts.

Baby boomers and phased retirement

The aging of the workforce is another critical issue facing public sector employers. According to the Bureau of Labor and Statistics (BLS), there are 76 million baby boomers (people born between 1946 and 1964) representing more than one-quarter of all Americans. The first baby boomers reached age 60 in January 2006 and BLS estimates that there will be a shortfall of ten million workers by the year 2010.

State and local government employers have a higher percentage of employees who are baby boomers than private sector employers. At the same time, the retirement age in the public sector, particularly police and fire, tend to be lower. They are already beginning to feel the impact of boomer retirements. The Department of Labor projected that between 1998 and 2008 more than 400,000 elementary and 350,000 secondary teachers will be needed to replace retiring teachers.

Most baby boomers aren't planning a traditional retirement with an immediate and abrupt end to their working career at a specific age. Most expect to work in some capacity (either for pay or volunteer-based) after retirement or plan to take a more gradual, phased approach to transition into retirement, such as in a bridge job.[72]

Some of the reasons for this changing view include:

- People are living longer, which means more active retirement years.
- Retiree living expenses are increasing, particularly health and long-term care costs.
- Future retirees may be more likely to have at least some financial responsibility for extended family members (elderly parents, children and grandchildren).

[71] *Employee Benefit News,* December 2004, p. 19.

[72] Bridge jobs are generally considered transitional employment in the one to five years prior to retirement. These positions may be temporary, part-time, or lower in physical or mental stress than career employment.

According to the 2005 EBRI Retirement Confidence Study, 66% of workers are expecting to work for pay in retirement, compared to 68% in the 2004 study. Although employees often state that they expect to work in retirement for the additional income or health benefits, most indicate they will likely continue some form of employment to stay involved or connected.

Because of the changing retirement expectations and the possible worker shortage from baby boomers aging, public employers are examining phased retirement options. From the employer perspective, phased retirement options can help them retain trained, skilled workers (human capital) and be structured to address labor shortages in certain employment fields. They can also help reduce employer's hiring and training costs, which is crucial considering many state and local governments' current budget situations.

From the employee perspective, it allows them to gradually shift into a full retirement without changing employers or careers. Depending on how phased retirement options are structured, it may also offer employees an opportunity to "lock-in" benefit calculations to ensure their retirement income from pensions is not reduced as a result of a transitional approach to retirement.

Three types of phased retirement options are:

- Re-employment opportunities for retirees, such as developing programs to hire retirees for limited hours or temporary positions (often these programs are geared to employment categories with demonstrated worker shortages)
- Transitional or "bridge" jobs prior to retirement, which could include staying in a pre-retirement position with reduced hours or responsibilities, or creating temporary or short-term reassignment opportunities, job-sharing, flex-time or telecommuting arrangements
- Deferred retirement option programs (DROPs) that have been around for several years and are structured as a delayed distribution from a qualified employer defined benefit plan (see sidebar)

  DROP is often adopted to encourage employees to remain in the workforce (with the same employer) beyond their earliest retirement date. Public sector employers have considerable flexibility in the design, but the pros and cons of these arrangements need to be carefully examined by both employers and employees.

Typical DROP design

- Employee must be eligible to retire
- Benefit is calculated and frozen based on current earnings and service
- Employee elects a future date for full retirement
- Annuity payments are separately recorded and distributed at retirement
- Employees often must retire on their identified retirement date or DROP election is canceled
- DROP account may be distributed as a lump sum or rolled into a tax favored plan

Defined contribution plans issues and trends

Increased awareness of fiduciary responsibilities

There is an increased emphasis on fiduciary oversight in both public and private sector defined contribution plans. This is a positive result from the mutual fund scandals, regulatory pressures and investigatory attention that has focused on late trading, market timing and fees and commissions.

In the past, state and local government employers focused more attention on their defined benefit plans and its investments, often delegating full responsibility to contractors for their supplemental defined contribution plans. Today there is more oversight from plan sponsors and contract administrators, such as by establishing investment policies to guide decisions on what investment options will be made available to participants.

There is also an increased awareness that more investment choices are not necessarily better. Over the past two years, employers appear to be more willing to make changes to their investment line-up that include removing options and replacing them with new choices that are determined to be more appropriate investments, instead of just adding more investments to the offerings.

The proposed and final Security and Exchange Commission (SEC) regulations that address market timing and late trading are also resulting in more fiduciary oversight by both plan sponsors and contract administrators on mutual funds that are included in the investment line-up. More attention is also being placed on monitoring and understanding investment management fees and fund reimbursement arrangements.

Automatic enrollment and simplified choices

Recognizing fiduciary roles also increases awareness that supplemental defined contribution plans are an important part of the total retirement benefits package. As a result, there is renewed interest by state and local government employers to provide a plan structure that encourages employee participation and is designed to better meet their long-term retirement income needs.

One trend to increase employee participation in the private sector is automatic enrollment. Employees are automatically enrolled unless they "opt out," and the employer establishes a default deferral amount and investment choice for employees who do not make personal decisions. Nearly 20% of large U.S. businesses have initiated automatic enrollment processes within their plan.[73]

[73] Hewitt Associates from *Deseret Morning News,* July 31, 2005.

Research shows that automatic enrollment has a positive impact on participation rates in defined contribution plans.

- The 2005 *EBRI Retirement Confidence Survey*[74] found that 66% of workers not currently enrolled in a retirement plan would be very or somewhat likely to remain in their employer's plan if automatically enrolled.
- Another study conducted by EBRI[75] found that automatic enrollment increased participation rates in certain 401(k) plans (private sector) from 66% of eligible workers to 92%, with the impact on lower income workers being the most significant.
- In a 2004 National Tax Journal report entitled "Plan Design and 401(k) Savings Outcomes,"[76] automatic enrollment is shown to have a dramatic increase on employee participation, particularly in lower tenure and lower income employees.

In 2004, the trend towards automated plan features was on the rise as nearly half (47%) of 401(k) private sector plan sponsors were somewhat or very likely to implement automatic enrollment, rebalancing or contribution rate increases. At that time, about 33% of plan sponsors state they were uncomfortable adopting automatic features because of potential employee reactions and concern about fiduciary liability, particularly in regard to default choices. Reports during 2005 indicate that the interest and support for automatic plan designs is on the rise. Figure 62 illustrates the automatic features private sector employers would be most likely adopt, based on a Hewitt survey in 2005.

Figure 62: Automatic features employers most likely to offer

Offering automatic enrollment or automatic enrollment in conjunction with other features — lifestyle funds and/or contribution rates in increases	59%
Offering automatic contribution rate increases	51%
Offering automatic rebalancing	42%
Managed accounts (providing way for participants to delegate management of their 401(k) account to a professional advisor	19%
Other (e.g. offer Quick Enrollment™ , online enrollment)	5%

Source: Hewitt Associates LLC

74 The Retirement Confidence Survey, conducted by the Employee Benefit Research Institute (EBRI) and Mathew Greenwald & Associates, Inc. and underwritten by Nationwide; EBRI Issue Brief No. 280, April 2005; www.ebri.org.

75 "The Influence of Automatic Enrollment, Catch-Up and IRA Contributions on 401(k) Accumulations at Retirement;" *EBRI Issue Brief* No. 283, July 2005; www.ebri.org.

76 "Plan Design and 401(k) Savings Outcomes," written for the *National Tax Journal Forum on Pensions,* June 2004, authors: James, J Choi, David Laibson, Brigitte C. Madrian.

A drawback to automatic enrollment is that employees who may have otherwise elected to participate may retain default choices for their account and fail to take actions to increase deferrals or select different investment options to meet their personal long-term needs. Employers are addressing this concern by establishing automatic contribution rate increases initiated on an annual basis or tied to compensation adjustments.

Another concern regarding default choices is that employees are often placed in the most conservative investments, such as stable value funds or guaranteed investment options, when a more moderate or aggressive approach may be needed to meet their retirement income goals. To address this, research is showing that a more appropriate default investment may be a lifecycle fund based on employee age.

Automatic enrollment is just one method employers are examining to increase participation rates in their defined contribution plans. Figure 63 shows other methods to increase contribution levels[77] reported by private sector employers in a recent Hewitt report.

Figure 63: Top ranking methods to increase private sector employee contribution levels

Targeted written communication around this topic	42%
Increasing written communication around financial security	29%
Seminars/workshops on this topic	29%
Providing online modeling tools	25%
Through existing communication channels	15%
Tailor communications to various employee groups (hourly vs salary; age, ethnicity, etc.)	14%
Implementing automatic contribution rate increases	12%

Source: Hewitt Associates.

Lifecycle/life style funds and managed accounts

Simplifying investment choices is a positive trend in both public and private sector defined contribution plans. The most popular approach is adding lifestyle and/or lifecycle funds to the investment line-up. Per the 2005 Hewitt Universe Benchmarks report, 40% of 401(k) plans offered lifestyle funds and 39.3% of participants who were offered these elected to invest some or all of their account balance in them.

[77] Hewitt Associates LLC, *Hot Topics in Retirement,* 2005.

It appears that these simplified choices encourage more employees to participate in their employer-sponsored plan. The 2005 Retirement Confidence Survey[78] identified that two-thirds of American workers who are not currently enrolled in the defined contribution plan would be much more or somewhat more likely to participate if they were offered a lifecycle fund. Almost 50% indicated they would be more likely to participate if a lifestyle fund was offered and 35% would participate if a managed account was available.[79]

Enhanced education, guidance and advice

In addition to simplifying investment choices, many plan sponsors are enhancing their plan's educational efforts to go beyond investment and include budgeting and debt management topics. Providing employees guidance and/or advice to help them with their investment decisions is also a growing trend.

According to a 2005 EBRI report, American workers identified that access to a professional advisor would be the most helpful to them to save for retirement. In addition, more than six in ten workers (64%) stated they would be very or somewhat likely to use financial advisor services that were part of the employer's plan if it were offered in person. Online and telephone advice was identified by only 45% and 28% of employees, respectively, as something they would be very or somewhat likely to use.[80]

Other research also identifies that a majority of public sector employees would like specific guidance and/or advice on their personal finances and investment decisions as:[81]

- 72% indicated selecting appropriate financial products is complicated
- 60% preferred conducting financial business in person
- 53% participants need help selecting the best saving or investment products

In other research, plans that have adopted more personalized telephone or in-person assistance and counseling within defined contribution plan services have seen improvements in employee involvement, as follows:[82]

- Participation rates increase up to 16%
- Contributions as a percentage of pay experience up to a 17% increase
- Employee actions to change investment allocations increase up to 11%

78 The Retirement Confidence Survey, conducted by the Employee Benefit Research Institute (EBRI) and Mathew Greenwald & Associates, Inc. and underwritten by Nationwide; EBRI Issue Brief No. 280, April 2005; www.ebri.org.

79 *EBRI Issue Brief*, No. 280, "Encouraging Workers to Save: The 2005 Retirement Confidence Survey;" April 2005.

80 *EBRI Issue Brief,* No. 280; April 2005.

81 *MacroMonitor,* 2004-2005, SRI.

82 *PR Newswire,* Ernst & Young and ExecutNet 2004 survey of HR and Employee Benefit Professionals, November, 2004.

Employer match plans

It is no surprise that offering a matching contribution to a defined contribution plan, based on an employee deferral, increases employee participation. In the private sector, 401(k) plans have achieved strong growth as a result of employer matching contributions, offsetting to some extent the decline in the number of pension/defined benefit plans. Within 401(k) plans, 85% of employers with plans more than $5 million and 76% of employers with plans less than $5 million providing matching contributions.[83]

During 2005 some large private sector employers like Hewitt Associates, Hewlett-Packard, Sears Holding Co., Motorola and IBM increased their 401(k) match to offset pension or health benefit reductions, specifically when terminating or freezing an existing defined benefit plan.[84] Among those that report they are likely to make changes within 2005, nearly half indicated that they may increase the employer match. Only 3% said they may decrease their contributions.[85]

Within the private sector, an employer match increased participation rates to 70.3%, from 69.8% between 2004 and 2003.[86] Nearly 47% of employees participating in a 401(k) plan contributed more than required to obtain the full company match. The company contributions average 2.9% of pay.[87]

A 2005 EBRI report identified that, for those not currently contributing to their employer-sponsored retirement plan, more than seven in ten workers indicated that an employer contribution of up to 5% of their salary would make them much more or somewhat more likely to participate.[88]

Outsourcing human resource and employee benefit functions

Human resource outsourcing (HRO) and total retirement outsourcing (TRO) are two trends from the private sector that are starting to make headway in the public sector. As many state and local governments are facing a skills crisis (with the retirement of baby boomers) and continuing budget cuts, there is increased interest in finding ways to reduce the current workforce and transfer responsibilities to contractors.

[83] Society of Professional Recordkeepers and Administrators (SPARK) *Marketplace Update 2005.*

[84] *Employee Benefit News,* September 15, 2005, "401(k) Matches Ease Pain of Benefit Cuts."

[85] Hewitt Associates, *2005 Hewitt Hot Topics in Retirement.*

[86] 2005 Hewitt Universe Benchmarks.

[87] Profit Sharing Council of America's 48th Annual Survey of Profit Sharing and 401(k) Plans.

[88] *EBRI, Issue Brief,* No. 280; April 2005.

Outsourcing can provide considerable cost benefits to employers, particularly as technology (legacy) systems need to be updated or replaced. Companies that provide HRO or TRO are making considerable investments in technology, instead of the employer funding their own information technology platforms and business process solutions.

In addition to what it provides employers, outsourcing can also benefit employees with:

- Improved communications
- Faster feedback
- Rapid problem solving
- Computerized training
- Do-it-yourself and consolidated HR programs and benefits information

A 2004 report from Hewitt Associates that reviewed private sector outsourcing trends predicts an 11% to 20% growth in human resource business process outsourcing in 2005.[89] Industry movement indicates that many HR and benefit plan providers are enhancing their array of products and services to address the growing need for these solutions by offering administration of one or more of the following:

- Human resources
- Defined contribution and defined benefit plans
- Health and welfare plans
- Payroll and benefits
- Stock option programs

A report published by The Conference Board in 2004 revealed a significant increase among large companies to outsource HR functions, with 76% of respondents outsourcing one or more major human resource functions and only 9% rejecting this practice (compared to 23% ruling this out in the prior year). In contrast, HR outsourcing in the public sector on the national, state and local levels has not yet experienced similar growth.[90] It is likely that more public sector employers will turn to outsourcing as a solution for antiquated, multi-platform IT systems or decentralized HR systems serving multi-tiered levels of state and local government benefit programs.

[89] Hewitt Associates, *HR BPO Goes Mainstream: What's next for 2005,* December 7, 2004.

[90] The Conference Board, HR Outsourcing in Government Organizations, *Emerging Trends, Early Lessons, 2004.*

A total outsourcing approach can be used to reduce costs, achieve efficiencies and provide new capabilities that economies of technological scale offer. Public sector employers typically encounter several obstacles concerning the acceptance and implementation of these processes. Political climate, unions, local economies, employment balance, procurement rules and available funding all contribute to complications that the public sector faces in implementing these strategies. Generating job loss, skills transfer and unemployment costs are factors weighed by government officials when contemplating outsourcing strategies.

In addition to human resource outsourcing, there is a trend increasing in the private sector towards "total retirement outsourcing" (TRO) for DC and DB plans to help employers cut cost and simplify communications through availability of one web site or call center. Mutual fund and insurance providers are increasing their TRO services with the addition of advice, rollover services, retirement income solutions and healthcare alternatives like HSAs.[91] Some retirement plan providers in the marketplace have experienced more client demand for total retirement consolidation with 401(k) and pension administration services so participants can plan more effectively for retirement.

Federal legislative activity impacting public sector retirement plans

Federal policy makers continue to explore options to improve Americans' ability to achieve financial security for their retirement years. Some of the legislative and regulatory proposals that are currently being considered could impact the primary and supplemental retirement benefit programs that are sponsored by state and local government employers.

At the end of 2005, Congress passed a legislative proposal that addressed defined benefit plan funding and included certain provisions to enhance defined contribution plans. In the House, this proposal is the Pension Protection Act and the Senate's version is the Pension Security and Transparency Act. There are many differences between these two retirement bills that will need to be worked out in a conference committee. It is anticipated that this will occur in early 2006. If these can be resolved, the joint bill will go back to Congress again for a final vote before it can be signed by the President.

[91] *Defined Contribution News,* "Total Retirement Outsourcing Opens New Market," April 29, 2005.

Social Security reform

Reforming Social Security was a hot topic in 2005. Although not successful, there will be an ongoing dialogue about needed changes to address the long-term future of this program. Some of the provisions previously discussed will likely be revisited and, if enacted, could affect government sector employers and their employees. If changes were made to Social Security that are perceived to reduce future benefits, employers could feel pressured to increase the retirement benefits that they provide to employees.

Some provisions being discussed, such as establishing private accounts as an "add-on" feature to Social Security and leaving the current payroll taxes intact, could create competition for employees' voluntary contributions for retirement. This could potentially have a negative impact on the participation and asset growth in employer-sponsored plans (including 457, 401(k) and 403(b) plans).

Reform discussions also have identified that mandating employee participation in Social Security, including State and local government employees who are currently exempt, would address the insolvency issue by increasing revenues into the Social Security system. Public sector employers who currently provide alternate retirement benefits in lieu of Social Security coverage would be subject to an additional payroll tax burden and forced to reexamine current benefits.

Simplification and consolidation

Over the past two years, and again in 2006, the Bush Administration has proposed three new savings vehicles — the Lifetime Savings Account (LSA), Retirement Savings Account (RSA) and Employer Retirement Savings Account (ERSA) to replace existing tax-favored plans (including IRAs, 401(k), 403(b), 457 plans, etc.). In the report from the President's tax reform committee in the fall of 2005, a variation of these proposals is also recommended — Save for Family, Save for Retirement and Save at Work. These proposals have been introduced as a way to simplify the federal tax code.

Although there are several issues with each of these proposals, the most troubling for public sector employers is the consolidation of all employer sponsored defined contribution plans (e.g., 457(b), 401(k) and 403(b)) into one universal plan type, such as an ERSA or Save at Work option. If enacted, this would add complexity to employee communications and increase administrative, recordkeeping and education costs that would likely be passed on to participants.

A consolidated defined contribution plan, such as the Save at Work option, could also result in a less attractive benefit for public sector employees who currently participate in a Section 457(b) or 403(b) plan. The unique features of these plans, such as their catch-up provisions and the exception to the application of the early distribution penalty for withdrawals from 457 plan accounts, would likely be repealed.

An overhaul of the current federal tax code to create a new employer plan and repeal all other plan types would also likely require similar amendments in state statutes and perhaps local laws and ordinances. As many plan sponsors may remember from the 2001 Economic Growth and Tax Relief Reconciliation Act (EGTRRA), securing changes in state statutes to address federal law changes can be difficult and time consuming.

Automated plan designs

During 2005 there were several legislative proposals introduced that included provisions to encourage employers to automate employee decisions for enrollment and deferral increases. These proposals have included guidance and fiduciary safe harbors for decisions that employers make regarding default investment choices and deferral amounts for those participants who don't opt out of the automatic options. Although these proposals specifically pertain to private sector employer plans governed by ERISA, they would also provide public sector employers with guidance on structuring automatic enrollment and deferral increases in their supplemental plans.

Encouraging lifetime income streams

Legislators are also beginning to recognize that there is a need to encourage workers to create lifetime income streams from the assets that they accumulate in defined contribution plans. As 401(k) plans continue to replace defined benefit plans in the private sector as employees' primary source of retirement income, ensuring that distributions last throughout retirement is an increasing priority.

Some of the legislative proposals introduced in 2005 were designed to encourage employers to offer a form of annuity or other lifetime income option as a distribution choice that is made available to participants. Safe harbor proposals are being identified to help plan fiduciaries with their decisions about the annuity choice that is the most appropriate to be made available to participants. Individual employee incentives also are being proposed, such as to provide a tax break up to a certain dollar amount each year that is distributed in lifetime payouts from retirement accounts.

Final thoughts….

The only thing certain about legislative and regulatory proposals is that Americans' retirement needs will continue to be a priority. Whether any proposals will soon be enacted is anyone's guess. What is clear is that the policy direction at the federal, state and local government level is migrating to individual responsibility and away from programs that share the risk of securing adequate retirement savings with others (employers and the federal government).

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