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ABSTRACT

This publication presents a collection of essays from top investment thinkers and financial commentators who share their views on the revolutionary retirement plan options now available to college and university employees. The essays were prepared for a conference that was convened by the New England Board of Higher Education in Boston to help interpret the meaning and significance of what has been taking place in the higher education pension and retirement marketplace. Among the essays' topics and general discussions are the following: (1) the broad issues facing pension plan administrators; (2) key areas to consider in providing retirement investments and services to faculty and staff; (3) market timing for university retirement funds; (4) the two new options ("transferability" and "cashability") that are available to participants in the Teachers Insurance Annuity Association-College Retirement Equities Fund (TIAA-CREF) pension system; and (5) several observations about investing and recessions, the attraction of stocks, risks in stocks, comments about balancing portfolios, and market timing and index funds. Included is a discussion of the experience at Tufts University (Massachusetts) in making policy decisions regarding pension plans. (GLR)

# NEW CHOICES
# FACING COLLEGE AND UNIVERSITY PENSION FUNDS





New England Board of Higher Education, Boston, Massachusetts

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# NEW CHOICES
# FACING COLLEGE AND UNIVERSITY PENSION FUNDS

New England Board of Higher Education, Boston, Massachusetts

Edited by Melvin H. Bernstein, J.D., Ph.D.
Senior Fellow, NEBHE

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# FOREWORD

The historic opening of TIAA-CREF's pension system to ***transferability*** and ***cashability*** on March 1, 1990, compels a fundamental re-examination of retirement plans and priorities in higher education. For the purpose of reviewing the dramatic and rapid changes that have taken place in 1989 and 1990 alone, the New England Board of Higher Education convened a distinguished array of commentators in October of 1990 at a conference in Boston to help interpret the meaning and significance of what has been taking place in the higher education pension and retirement marketplace. The papers prepared for the conference have developed into the collection of essays presented here. Ably edited by Dr. Melvin Bernstein, NEBHE Senior Fellow, who organized the conference with the wise counsel of Louis Morrell, Vice President and Treasurer of Radcliffe College—this publication represents both the depth and breadth of the options now before colleges and universities throughout the United States. The theme of the conference and the publication remains the same: "New Choices Facing College and University Pension Funds."

Andrew Carnegie had the vision and commitment in 1905 to give a $10 million gift to establish a free pension fund for college professors, later to blossom into TIAA in 1918 and CREF in 1952. TIAA-CREF eventually became a nationwide system of pensions for faculty and staff in higher education. Today it encompasses 1.4 million participants at 4,500 educational institutions. New England alone accounts for approximately 550 of those institutions, a noteworthy 12 percent of the national market.

Then, as now, college and university faculty are sorely underpaid among members of the professions in the United States (for educating students destined to become the nation's leaders). Andrew Carnegie hoped that "this Fund may do much for the cause of higher education and to remove a source of deep and constant anxiety to the poorest paid and yet one of the highest of all professions." Full professors earned an average of $1,000 a year then, about as much as office clerks made. His aim was to provide economic security in retirement for professors who could not afford to do so on their own.

Carnegie's vision and generosity made possible, through its embodiment in TIAA, a *portable* pension system that enabled professors to move from campus to campus *taking their accumulated pension funds with them.* This singular innovation in the world of pensions, perhaps the greatest of TIAA-CREF's accomplishments, gave professors the *mobility* to advance their careers without suffering the loss of their retirement benefits each time they changed campuses. Colleges and universities were likewise empowered with the flexibility needed to attract high quality faculty resulting in the richness and diversity that makes American higher education unique among the world's powers.

American higher education has not only become more diverse but increasingly cosmopolitan throughout the post World War II period. Institutions have been able to compete with business and government as well as create academic programs, departments and research institutes, which would have been far more difficult and of lesser quality if such *faculty flexibility* did not exist. That the nation has far greater numbers of first-rank universities today than would have been otherwise the case is in no small measure because of the TIAA-CREF system.

*That the nation has far greater numbers of first-rank universities today than would have been otherwise the case is in no small measure because of the TIAA-CREF system.*

Now that a shortage of faculty is emerging in the 1990s, due to a large cyclical wave of retirements taking place, stiffened competition requires that campuses improve their benefits if not their compensation, as incentives to recruit and retain qualified faculty. Campus administrators are looking for ways to strengthen pension plans to attract highly qualified new faculty and to encourage older faculty to take early retirement rather than to *linger on* because of the need to earn a decent income. Making it possible for older faculty to take retirement in their sixties opens the way for younger faculty to move onto tenure tracks and senior professors' slots, renewing the life blood of their institutions and thereby the intellectual and research capacity of the nation.

Ernst Benjamin put it well when he said in his commentary that in an era of retirement by choice, "pension programs must be designed not only to permit but to encourage timely retirement."

TIAA-CREF's astute investment of its retirement funds has contributed mightily to making this possible.

Thirty-five years ago, I joined Wesleyan University's administration as a baby dean for the grand sum of $400 per month, a 20 percent increase over my salary as a school teacher. When my first pay day arrived I noticed in my salary check a deduction I couldn't understand. I hesitated as a fledgling administrator to see the vice president for finance, Howard Matthews, but finally mustered the courage to do so.

Howard, who had earlier served as Robert Hutchins' vice president for finance, told me it was my contribution to TIAA-CREF and let it go at that. Though I really didn't know what it was, I must confess that it was years before I really paid much attention to TIAA-CREF. I later discovered that the $15 I was then paying monthly into my CREF account is now worth $348.55, *23 to 25 times the value of my original contribution.*

*For most professors, colleges and universities are still attractive places to work compared to business and government, where many retirement plans lack the options of portability and early vesting.*

Now under the SEC settlement agreement, higher education's faculty and staff have the opportunity to *choose* other investment companies to manage their retirement monies if their campuses allow it. Successful investment companies, such as Fidelity Investments, The Vanguard Group and Lincoln Investment Planning, with differing philosophies and a bewildering number of funds, further enrich investment choices for the employees of colleges and universities. For most professors, colleges and universities are still attractive places to work compared to business and government, where many retirement plans lack the options of portability and early vesting. Higher education's strong pension system, led by TIAA-CREF, helps to make America more competitive for it is our campuses, after all, that provide the core of brainpower for the nation's economy.

John C. Hoy
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New England Board of Higher Education

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# CONTRIBUTORS

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Ernst Benjamin has been general secretary of the American Association of University Professors since 1984. He also serves as a member of the national TIAA-CREF Advisory Council and co-chair of the Pension Committee of the Washington Higher Education Secretariat.

Dr. Benjamin has been a reasoned and articulate voice on behalf of the nation's faculty in retirement finance since he joined AAUP. His published research includes papers on faculty retirement benefits, collective bargaining and an article, "The Faculty Contribution to Economic Competitiveness" for *Currents*. He earned his M.A. and Ph.D. from the University of Chicago and his B.A. from Ohio Wesleyan University. He taught political science at Wayne State University from 1965 to 1984.

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Dr. Melvin H. Bernstein serves as senior fellow for governance and finance at the New England Board of Higher Education and is president of The Bernstein Group, a Boston consulting firm. He has edited and authored with John C. Hoy several books on economics and finance, including *Financing Higher Education, New England's Vital Resource*, and *Business and Academia.*

He began his career on Alan Greenspan's research staff at the economics consulting firm of Townsend, Greenspan & Company in New York City. Dr. Bernstein later served as an assistant vice chancellor and lecturer at the University of California, Irvine, and as vice president and adjunct professor at the Monterey Institute of International Studies. He earned his J.D. from Harvard Law School, his Ph.D. in Political Science and International Relations from UCLA, and his B.S. in Economics and Finance from New York University.

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Thomas T. Bieniek is senior vice president of Fidelity Investments Institutional Services and general manager of its Tax-Exempt Services Division which handles higher education pension plans. His earlier experience in the financial services industry had been with Aetna Life and Casualty, CNA Insurance and Kemper Financial Services.

Mr. Bieniek has authored articles on tax-exempt plans for *Pension World* and *Broker World*. He earned his B.A. in American History/Economics and his J.D. from Boston University School of Law. He began his career by practicing law for three years.

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Before joining S & P in 1982, Mr. Blitzer was a corporate economist at McGraw-Hill, Inc. and a senior analyst for National Economic Research Associates, Inc. A graduate of Cornell University with a B.S. in Environmental Systems Engineering, he holds an M.A. in Economics from George Washington University and a Ph.D. in Economics from Columbia University.

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John C. Bogle is chairman and chief executive officer of each of the funds in the Vanguard Group of Investment Companies, and of The Vanguard Group, Inc., positions he has held since founding Vanguard in 1975. Through a predecessor company, he has been associated with the Group since 1951, following his graduation from Princeton University, *magna cum laude* in Economics.

Mr. Bogle has served as chairman of both the Board of Governors of the Investment Company Institute and the Investment Companies Committee of the National Association of Securities Dealers, Inc. He serves as a director and chairman of several boards and committees, including the Princeton University Investment Company and Bryn Mawr Hospital.

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Mr. Heller received his B.S. degree in Engineering and Economics from Tufts University and has eight years of experience in the financial service industry.

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John C. Hoy has been president of the New England Board of Higher Education since 1978. Before that he was the vice chancellor for university and student affairs at the University of California, Irvine, from 1969 to 1978. He is the author of *Choosing a College,* and editor and co-author with Melvin H. Bernstein of several books on colleges and universities, *Business and Academia, Financing Higher Education, New England's Vital Resource,* and one on the American presidency, *The Effective President.*

In 1985, he received the Distinguished Alumnus award from Wesleyan University where he had been a dean from 1964 to 1969 and earned his bachelor's and master's degrees earlier. He is a member of the Board of Directors of the New England Loan Marketing Corporation. He holds Honorary Doctor of Laws degrees from Notre Dame College, North Adams State College and Franklin Pierce College.

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Maggie Mahar is a financial writer for *Barron's Business and Financial Weekly,* covering business, politics and public policy stories. She has been a reporter for the *New York Times* and a writer for Time, Inc.

Ms. Mahar was one of the first women to graduate from Yale University, earning her B.S. there in 1971 and later her Ph.D. as well. She went on to become an assistant professor of English at Yale before embarking on a professional writing career. She is well known for the clarity, depth and force of her stories.

## STEVEN S. MANOS

Steven S. Manos is executive vice president and treasurer of Tufts University. He was in charge of the campus decision-making process that resulted in the choice of an alternative investment company to TIAA-CREF.

Before joining Tufts in 1981, Mr. Manos had served as assistant executive director of the American Bar Association, senior administrator of the New York Hospital–Cornell Medical Center and chief executive officer of the Manhattan Bowery Corporation.

He received his J.D. from the New York University School of Law where he graduated first in his class, his M.P.A. also from NYU, and his B.A. *summa cum laude* from the University of Minnesota. He currently serves on the BayBank Middlesex Regional Board and formerly was a trustee of the American Bar Retirement Association.

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As an executive vice president of TIAA-CREF, John J. McCormack is in charge of the Pension and Annuity Services Area, which works directly with institutional administrators and individual staff members in the establishment and administration of their retirement plans.

A graduate of St. Bonaventure University, Mr. McCormack has been with TIAA-CREF for 24 years. He serves on many boards, including the President's Council of St. Bonaventure University, the Board of Trustees of the American Psychological Association Investment Committee and the Employee Benefit Research Institute.

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David J. Rights is co-founder of the Lincoln Timing Program, serving over 6,000 investors. He also is the co-founder and senior portfolio manager of the Rightime Family of Funds, serving more than 30,000 shareholders and 800 educational organizations. He currently manages approximately $600 million.

Mr. Rights has been quoted in a wide range of financial publications such as *The Wall Street Journal, Barron's, Money, Business Week, Financial World* and the *International Herald Tribune.* He earned his B.S. degree in Electrical Engineering from Lehigh University in 1969 and has conducted over 20 years of research on stock market behavior and portfolio management.

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Mr. Wilson has an Sc.B. in Mechanical Engineering from Boston University and an M.L.A. in History of Ideas from Johns Hopkins University. Before coming to Johns Hopkins he served for nearly a decade in Vermont state government, first as commissioner of economic development and later as secretary of administration.

# I. INTRODUCTION: HIGHER EDUCATION'S PENSION MARKET

By Melvin H. Bernstein
*Senior Fellow*
New England Board of Higher Education

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# I. INTRODUCTION: HIGHER EDUCATION'S PENSION MARKET

*Make no mistake about it, the pension funds of the nation's 3,504 colleges are a mega-business.*

Make no mistake about it, the pension funds of the nation's 3,504 colleges are a mega-business. Higher education's accumulated retirement funds amount to an estimated $135 billion. That sum is greater than the operating budget of every American college and university put together. Retirement funds cover the 2.3 million employees in colleges and universities, 1.7 million full-time, 648,000 part-time. Private pension companies hold the lion's share, roughly 70 percent, of the total $135 billion of fund assets, dominated by TIAA-CREF's whopping market share of over 90 percent.

In view of the massive size of a market that's been virtually closed until 1990, intense competition is expected between TIAA-CREF and companies offering many of the same services and a seemingly endless array of investment funds to choose from.

John McCormack of TIAA-CREF says we are dealing here with retirement funds, not investment funds, which makes a critical difference. Others would say that pension savings have the earmarks of both retirement funds and investment funds, that the two types of funds are not mutually exclusive.

David Blitzer of Standard & Poor's says that during the disillusionment of the current economic downturn, especially for New Englanders, we should remember that "recessions and expansions are all part of the game. Don't ignore the recession, but don't be paralyzed by it either" — a healthy antidote for those made sick by doomsday prophets who see depression where we are experiencing recession. Many of those jeremiahs are the same ones who, 10 years ago, used oversimplified straight line reasoning to forecast oil at $100 a barrel once it had soared to $34.

We are told by Louis Morrell of Radcliffe College that retirement funds represent one of the most important financial assets higher education employees will ever accumulate. Because more professors are living to retirement than ever before and living longer lives in retirement, these pension accumulations have become crucial to their post-retirement security. Mr. Morrell discusses the importance of re-balancing investment portfolios periodically according to target objectives and age.

CREF has achieved remarkable investment results employing a buy-and-hold strategy and avoiding the short-term swings of *market timing.* The CREF strategy is found in its booklet, *Guiding Your Retirement Savings,* relying on the premise that "It is impossible to know the future, and thus it is extremely difficult to make market-timing moves correctly over an extended period of time."

Fidelity Investments in its own booklet, *Evaluating An Investment Manager,* likewise cautions against the short-term swings of market timing. Fidelity stresses *fundamental investing* based upon the individual merits of a security and an *active management strategy* monitoring securities markets to take advantage of above average investment opportunities.

On the other hand, the Lincoln Market Timing Program reports an annual gain of 17 percent compounded annually, net of fees, from 1979 to 1990 compared with the 13 percent gain of the Lipper Growth Fund Index during the same period. Lincoln's David Rights says, "its goals over a typical 3-to-5 year market cycle are to provide an investment which is no more than one-half of market risk as well as to provide returns which are higher than the market, higher than cash and higher than the rate of inflation."

Vanguard's Paul Heller also takes a dim view of attempts to move into a stock before its value increases and out of it before it drops. He says that the right of a college to allow the transfer of CREF funds is "certainly not an institutional endorsement for speculation or market timing." Though many academic commentators and some Wall Street observers remain skeptical of market timing, Lincoln continues to have confidence in the benefits based on its own record of performance.

Higher education's readers are sure to get a rich mix of investment views and pension advice in these pages from the people who run the companies, write the columns, and manage retirement programs. We welcome your comments and reactions to this publication.

Melvin H. Bernstein
*Editor*

# II. A NEW INVESTMENT ERA FOR COLLEGES AND UNIVERSITIES

By Louis R. Morrell
*Financial Vice President and Treasurer*
Radcliffe College, Harvard University

Most colleges and universities participate in Teachers Insurance Annuity Association-College Retirement Equities Fund (TIAA-CREF). As such, their trustees are now faced with a number of key decisions regarding possible changes in the investment options of their retirement funds.

In March of 1990, TIAA-CREF made several announcements. In terms of investment vehicles a new CREF Bond Market Account was created that invests in high and medium grade fixed securities, seeking returns consisting of both income and capital appreciation. This is in contrast to the traditional TIAA fund that holds investments to maturity, guaranteeing an income earnings rate. A second vehicle called the CREF Social Choice Account is intended to provide returns reflecting those of the broad financial markets while following certain social criteria.

Two other announcements of a non-investment vehicle nature were made. One involves a cash payment arrangement under which employees would be permitted to take all or part of their CREF accumulations in cash at retirement or termination of employment; the other would permit employees to transfer CREF accumulations to other employer-approved companies.

Thus, each institution must decide which of the new investment alternatives, if any, are to be made available to its employees as well as whether to permit transfer of CREF accumulations, cash withdrawals at retirement or termination, and the introduction of new non-TIAA-CREF investment options for the core retirement program.

As institutions address the above decisions, they should be aware of a number of factors as follows:

## Title to Assets

*Although retirement plans are often described as staff or fringe benefits, in reality retirement income is something earned by an employee.*

When considering funds held in retirement accounts, as well as contributions being made to such funds, it is easy to look upon them as two distinct entities: monies provided by the employer and monies provided by the employee. Although retirement plans are often described as staff or fringe benefits, in reality retirement income is something earned by an employee. It is a form of deferred compensation. In effect, there is a tacit agreement between the employer and the employee that the present benefit of current compensation is to be deferred in return for the future benefit of such compensation in retirement. Recognizing the social benefit of such an arrangement, the Internal Revenue Service is willing to wait until retirement to collect taxes due on such compensation. This is unlike pure benefits such as employer paid health insurance, dental plans, and disability premiums where income taxes are not assessed.

## Nature of Retirement Plan

A second major factor to be considered is the nature of the retirement plan. Traditional retirement plans, provided by approximately 80 percent of U.S. employers, are what are known as *Defined Benefit* plans. Under such an approach, the employee is assured pension payments based on a formula that takes into consideration two key factors: final average salary and years of service. A typical plan would provide retirement income based on 60 percent of the average of the final three or five years' salaries. The percentage would be reduced for those individuals who did not have sufficient years of service to qualify for a full pension. The *Defined Benefit* plan has a number of advantages for both the employee and the employer. The basic concept is straightforward and easily understood. While the exact benefit amount is not known in advance, it is directly tied to the ending salary, assuring the worker of future financial security. The employer is able to reward longer term employees who are encouraged to remain with the firm. No action is necessary by the employee as the retirement plan is self-administering. The worker assumes no investment risk as his/her pension is not related to the performance of the securities market. Nor is the worker exposed to inflation risk since salaries move in the same direction as the Consumer Price Index during the working years. Salaries are driven by inflation—pensions are tied directly to higher salaries.

One major disadvantage to the employee is that once fixed, the amount of the annual retirement benefit changes only at the discretion of the employer. This can place the employee in jeopardy from the impact of inflation while in retirement. As persons live longer this becomes an increasingly important problem. Only about 10 percent of firms in private industry with defined benefit plans make regular adjustments to benefit levels of persons retired. One additional disadvantage to the employee could be the financial insecurity of the corporation. There have been instances in which poor investment returns on retirement assets or inadequate funding of retirement reserves have jeopardized the income of retirees. The recent collapse of the junk bond market has had a negative impact on certain retirement funds although such assets account for less than 3 percent of retirement asset holdings.

In contrast to the above type of retirement plan, most college and university employees participate in what are known as *Defined Contribution* plans. Under such an approach, it is the payment to the retirement fund (made during the working years) that is "defined" —not the benefit paid in retirement. Once the monthly check is mailed by the institution to the retirement fund, no further obligation exists for the college or university. It is the individual employee who assumes full responsibility for the management of the funds invested. Although most institutions of higher education have established retirement plan income goals, or targets, of 70 percent to 80 percent of average final salaries, such goals are not guaranteed. How well the assets are managed will determine the adequacy of retirement income to the individual. While this presents an opportunity for financial reward, it comes with an element of risk to be borne by the employee.

*It is the individual employee who assumes full responsibility for the management of the funds invested.*

## Investment Environment

The financial environment in which the employee must cope has become increasingly complex. There are now more investment alternatives available, both domestic and foreign. The markets have become increasingly volatile as evidenced by the crash in 1987, the 190-point-drop of October 1989, and the average decline of 15.5 percent in stock funds that occurred during the third quarter of 1990, the worst since 1974 (excluding the crash of 1987). There has been little comfort in bonds as third-quarter calendar year 1990 returns for government securities bond funds were zero as price declines were equal to yield. If the current bear market turns out to be similar to the nine bear markets that have taken place since World War II, one can anticipate a decline in the Dow Jones Industrial average of 27 percent.

## Societal Changes

*The combination of earlier retirement and longer life expectancies has drastically changed the ratio between earning years and retirement years.*

People are now living longer, more active lives. Such lifestyles call for greater levels of retirement income for travel and recreation. The tour has replaced the rocking chair. Men age 65 today are expected to live another 14.8 years while women are anticipated to live 18.6 more years. At the same time, people are retiring at earlier ages, even those employed by colleges and universities. People have become more inclined to retire before age 65. In the past one would retire at age 65 and die at age 72.

The combination of earlier retirement and longer life expectancies has drastically changed the ratio between earning years and retirement years. For example, assuming one started working at age 28, retired at 65, and died at age 72, the working phase would equal 84 percent of the timespan with the balance of 16 percent in retirement. Changing the assumptions to more closely reflect the current situation of retirement at age 64 and death at age 82, the working phase would decrease to 67 percent of the timespan with the balance of 33 percent in retirement, twice the allocation in the earlier model. The relatively longer period in retirement adds a new element of risk.

*Unfortunately, most employees place far too much emphasis on avoiding investment risk and too little on coping with inflation risk.*

There are two types of risk that one must cope with — investment risk and inflation risk. Investment risk pertains to the danger that the price of a stock or bond will fall. Inflation risk comes from the possibility that one will not be able to maintain his/her standard of living because of the loss of purchasing power of retirement income as the result of inflation. Such risk increases the longer one is in retirement. Unfortunately, most employees place far too much emphasis on avoiding investment risk and too little on coping with inflation risk. They seem willing to forgo significant opportunities for investment return in order to avoid the ups and downs of investment values. A recent study conducted by T. Rowe Price and Coopers & Lybrand shows that a retiree with a fixed annual retirement income of $20,000 in 1968 would require an annual income of $68,000 in 1988 to maintain his/her purchasing power. To attain such a level of income growth, to protect against inflation, stocks are the only proven vehicle able to do so. Yet, the retirement funds of many college employees are underrepresented in common stocks while containing money market account investments, the poorest hedge against long-term inflation.

## Sources of Retirement Income

Employees must rely on two basic sources of retirement income: Social Security and private pension plans.

It is unrealistic to count on Social Security as the major source of retirement income, as illustrated by the following benefit projection.

## Annual Social Security Benefits (Based on 1989 Benefit Levels)

| | Current Annual Income | | | |
|---|---|---|---|---|
| | $20,000 | $30,000 | $40,000 | $45,000 or more |
| | Projected Benefit | | | |
| Individual | $ 8,256 | $10,092 | $10,608 | $10,788 |
| Percent-Annual Income | 41% | 34% | 27% | 24% |
| Combined-Worker/Spouse | $12,384 | $15,132 | $15,912 | $16,176 |
| Percent-Annual Income | 62% | 50% | 38% | 36% |

*Source: Social Security Administration*

As noted above, pensions with income that is $45,000 or greater are able to look to Social Security for only 36 percent of their current annual income. The percent decreases as income levels increase. For example, with a salary of $50,000, Social Security would provide a replacement income of only 32 percent as the top annual benefit payment of $16,176 holds constant. The situation is made more difficult as a result of taxation. Under current law, one-half of Social Security payments are subject to taxation when a couple's income in retirement exceeds $32,000. Thus, the above maximum payment of $16,176 would be further reduced (after taxes) to $12,132 for those couples in a 28 percent tax bracket, lowering the replacement income to 24 percent from 32 percent. The recently rejected plan to reduce the federal budget deficit would have increased the taxation rate from 50 percent of benefits at present to 85 percent. Since it is widely assumed that one needs a minimum of 70 percent of pre-retirement income to maintain a comparable standard-of-living in retirement, the private pension plan becomes increasingly significant.

## Employee Role

There are three major factors that influence the asset level in one's retirement fund and the stream of income that it will provide. The ability of the employee to influence each of the above factors varies as follows:

*There are three major factors that influence the asset level in one's retirement fund and the stream of income that it will provide.*

***Timespan Assets are Held*** — Generally, the longer one holds investments, the greater their value due to the impact of compound return. The sooner that assets are added to the retirement fund the better and the longer they remain invested prior to withdrawal, the better. To provide an idea of the power of compound return, assuming a rate of return of 9 percent and a goal of attaining a sum of $200,000, the following applies:

| Investment Period | Annual Contributions | Total Contributions | Total Earnings | Total Available |
|---|---|---|---|---|
| 30 years | $ 1,467 | $ 44,000 | $155,990 | $200,000 |
| 25 years | $ 2,361 | $ 59,025 | $140,975 | $200,000 |
| 20 years | $ 3,909 | $ 78,180 | $121,020 | $200,000 |
| 15 years | $ 6,812 | $102,180 | $ 97,820 | $200,000 |
| 10 years | $13,164 | $131,640 | $ 68,3[illegible]0 | $200,000 |

*Sources: T. Rowe Price Retirement Planning Workbook*

As shown above, by starting the annual contribution five years earlier (15 years instead of 10 years) the annual deposit required to attain $200,000 is cut in half.

An employee has a limited influence on the timespan factor. The one action over which he/she has some degree of control is the timing of starting retirement. Taking an early retirement will have a negative impact on the level of retirement income, while delaying the start of retirement increases the level of income.

***Investment Input***—This refers to the dollar input (contribution) to the retirement fund and is usually a function of one's salary level. With the exception of participation in a supplemental retirement plan, there is little influence that an employee can have on the investment input factor.

***Investment Return***—This is the most significant factor in the determination of the size of the retirement fund and the resultant level of retirement benefits in the future. Fortunately, it is also the factor over which the individual can have the most control by taking steps to enhance investment return and reduce risk.

## Institutional Role

*Considering that the retirement assets belong to its employees, financial markets are becoming more complex, the employee bears all of the investment risk, and higher returns are needed to cope with longer periods of high inflation during retirement years, colleges and universities should take two steps:*

Considering that the retirement assets belong to its employees, financial markets are becoming more complex, the employee bears all of the investment risk, and higher returns are needed to cope with longer periods of high inflation during retirement years, colleges and universities should take two steps:

1. ***Offer reasonable alternative investment vehicles to employees for their retirement funds.***

The new investment alternatives should be well-established companies that have proven records in both investment performance and retirement program management. Particular attention should be paid to the degree of flexibility offered in the various retirement payment options and the quality of financial planning services provided both to those upon entering retirement and once in retirement.

2. ***Ensure that the employees have a basic understanding of sound retirement management principles.***

This is important even to the employees of those institutions that decide not to allow new investment alternatives by non-TIAA-CREF vendors. While there may not be a legal requirement for colleges and universities to educate their employees in the basics of investing, there is an ethical one, considering the defined contribution nature of their retirement plans. In designing such programs, institutions should address the seven most common mistakes that persons make in managing their retirement funds as follows:

1. ***Failure to become educated***—by not learning about investment and retirement plan management, inaction or improper action can have a detrimental impact on investment performance and one's standard of living in retirement.
2. ***Failure to diversify***—by putting all or most of their eggs in one basket, individuals are subjected to increased volatility and poorer investment return over time.
3. ***Failure to re-balance asset mix***—prices in the securities market change daily, which constantly alters the investment mix in one's retirement fund. Steps should be taken to re-balance the assets to a pre-determined target.
4. ***Failure to change the asset mix based on age***—as one moves closer to retirement, the asset mix should be changed to reduce risk as follows:

21

| Asset Class | Allocation | | | | |
|---|---|---|---|---|---|
| Common Stocks | 80% | 70% | 60% | 40% | 25% |
| Bonds | 10% | 20% | 30% | 50% | 75% |
| Money-Market Funds | 10% | 10% | 10% | 10% | 0% |
| Age | 30–39 | 40–49 | 50–59 | 60–69 | Retirement |

5. ***Failure to provide for growth*** — Those achieving a total return that is less than inflation suffer a reduction in their standard of living. At all times, including once retired, some component of the fund assets should be held in common stock.
6. ***Lack of flexibility***—by committing funds to assets that are frozen, such as annuities and single-premium life insurance policies, the individual loses flexibility necessary to cope with changing situations.
7. ***Emphasis on risk avoidance***—by seeking to minimize investment risk, funds are placed in assets such as money-market accounts and bonds with the resultant loss of investment return and exposure to the impact of inflation.

Schools should pay particular attention to the current practice of many employees who contribute one half of their annual retirement payments to TIAA and the other half to CREF. Such a practice does not deal with two of the above common mistakes: failure to re-balance the asset mix to pre-determined target levels and failure to change the asset mix based on age.

There are a number of ways in which colleges and universities may ensure that their employees have a basic understanding of pension fund management. Training sessions can be conducted by in-house staff or outside consultants can be hired to provide such a service. Publications that offer information on how to manage one's retirement can be made available to employees at little cost.

Retirement funds represent one of the most important financial assets for college and university employees. How well the funds are managed will have a significant influence on the future income stream from such assets and the resultant quality-of-life that one will enjoy in retirement. This behooves trustees and administrators of colleges and universities to take steps that will help to enhance the retirement funds of their employees.

*How well the funds are managed will have a significant influence on the future income stream from such assets and the resultant quality-of-life that one will enjoy in retirement.*

# BEYOND TRANSFERABILITY AND CASHABILITY: BROADER ISSUES FACING PENSION PLAN ADMINISTRATORS

By John J. McCormack
*Executive Vice President*
TIAA-CREF

As you can imagine, it's been an exciting and eventful year for us at TIAA-CREF. The introduction of transferability and cashability on March 1st brought fundamental changes to our pension system, and with all the related communication that's been going on, I'm sure—to some extent—readers are familiar with the subject matter.

Not surprisingly, the availability of these two new options has prompted much debate on campuses throughout the country, and in gatherings of educational organizations such as the one that led to this publication.

These debates have, in large part, helped to focus attention on the nature and purpose of retirement programs, and that's a good thing. It has also led many institutions to think seriously about their relationship with their TIAA-CREF retirement plan, and we feel that's a good thing also. At a time when some individuals seem to be insisting that we should become something that we are *not*, we welcome the opportunity to clearly define what it is that we *are*.

*A choice needs to be made as to whether this is a retirement fund or an investment fund.*

As the General Secretary of the American Association of University Professors, Ernst Benjamin has so ently noted in regard to the alternatives now available and the decisions each institution must make regarding its pension plan: "A choice needs to be made as to whether this is a retirement fund or an investment fund. If it is a retirement fund, there should be some restrictions to see that it fulfills the intended function."

"Is it a retirement fund or an investment fund?" To me, this seems to be the question at the heart of much of today's debate. At TIAA-CREF, we know what our answer would be—and we're hopeful that your considerations have led you to the same conclusion. It is, and should be—first and foremost—a *retirement* fund.

Our answer comes from experience. We have provided retirement benefits and services exclusively for the educational community since 1918—a community with whom we have a special relationship, and a people we've come to know and understand.

Indeed, the charters of both TIAA and CREF clearly define our purpose: To "aid and strengthen nonproprietary and nonprofit-making colleges, universities and other institutions engaged primarily in education or research" through our retirement-oriented products and services.

These are our objectives, and to achieve them, we have forged a structure — and developed and implemented an investment philosophy—that we feel is the most conducive to achieving these goals.

*And "retirement savings" is really the key term, because it is the driving force behind the investment philosophy underlying both TIAA and CREF.*

TIAA and CREF complement one another, providing the security, diversification, earnings potential, and balance that most people need and want for these retirement savings. And "retirement savings" is really the key term, because it is the driving force behind the investment philosophy underlying both TIAA and CREF.

Let's look at TIAA first. With over $48 billion in total assets, TIAA is among the top 5 insurance companies in the country. TIAA offers safety and security, guaranteeing principal and a basic interest rate plus the opportunity to earn dividends—which have been declared for the past 41 years.

To support the guarantees it makes, TIAA's investment philosophy is to diversify its portfolio to achieve the highest possible rate of return within reasonable risk limits. And because of the long-term nature of retirement planning, TIAA seeks consistency in returns over long periods.

Accordingly, TIAA's assets are invested primarily in long-term opportunities such as business loans, income-producing real estate and selectively chosen, publicly-traded bonds. And TIAA has exceeded the industry average net rate of return for the past 41 years.

CREF's investment philosophy is a diversification-based one as well. This diversification is perhaps most clearly reflected in the portfolio of the CREF stock account.

On one level, this diversification is reflected in the domestic passive component of the portfolio, which is indexed to the U.S. equity market as a whole. Further diversification is achieved through the domestic active portion of the portfolio, where holdings are actively selected and managed for their investment potential. Additional levels of diversification are found in our international investments, an area in which we have realized significant gains and in which we are continuing to expand our interests.

In seven of the past 10 years, the CREF stock account has equalled or topped the S&P 500 Index, due in part to this portfolio diversification which goes beyond those stocks solely representative of the U.S. market.

But CREF offers more than just a stock account. Our participants have the choice of allocating contributions in whatever ratio they choose among the CREF stock and money-market accounts, and—if adopted by their institution—the CREF bond market and social choice accounts. Of course, each of the CREF accounts has a somewhat different objective. But what all of these objectives have in common is a heightened sensitivity to the long-term needs of retirement planning—and to the importance of avoiding unnecessary risk in managing funds that are accumulating for the purpose of paying retirement income for as long as a participant will live.

And over the years, CREF's investment philosophy has proven to be a solid one. Today we're the largest equity fund in the United States and if you compare the CREF stock accounts performance for periods ending September 30th to the Lipper Growth Fund and General Equity Funds Index average for the last one-, five-, and 10-year periods, you'll find we've been outperforming the mutual funds on average — by some fairly substantial margins. That says something about how effective CREF's investment philosophy has been over the years, and especially about how suitable it is for the long-term needs of retirement plans.

*And over the years, CREF's investment philosophy has proven to be a solid one.*

This is not to say that some individual funds have not done better than CREF over short periods of time. However, we do *not* think that the performance objective of a retirement plan should try to be "first place" each and every year—history has told us that the top performing fund will not be able to maintain that position over a retirement planning time horizon of 30 to 50 years.

We believe that long-term participation in equities offers the real possibility of higher rates of return than fixed investments, and that participation in overall equity returns is far more important than taking the significant risk associated with trying to substantially outperform the market on a year-by-year basis.

While providing our participants with investment alternatives that are tailored for the long-term nature of retirement planning continues to be a driving force behind our efforts, high-quality service and low cost remain at the cornerstone of the TIAA-CREF system.

A survey conducted last year by the Roper organization showed that a wide majority of TIAA-CREF retirees are highly satisfied with the service they received during the retirement process. Ninety-two percent of those surveyed gave a favorable rating to our service during the overall retirement process, with 67 percent of them rating it excellent.

When the respondents were asked to compare their experiences with TIAA-CREF to their experiences with other financial institutions—such as banks, insurance companies and mutual funds — 62 percent rated us better than most other financial companies, while 31 percent rated us the same. We were very pleased by the results of this survey as they confirmed our belief that service to our participants should be a commitment to provide the help they need while they're working and throughout their retirement years.

As many of you know from first-hand experience, our services are not confined to our participants. Our counselors work closely with campus benefits administrators, conducting staff and pre-retirement meetings and one-on-one counseling sessions, as well as meeting personally with them to discuss their special problems and concerns. We have provided extensive services — including workshops, bulletins, and software programs — to assist institutions in their efforts to comply with nondiscrimination rules. And of course, our continuing line of publications, videos, software programs and other helpful materials.

We are not content, however, with the status quo—introducing expanded products and services is our top priority. The strategic plans outlined in the *Future Agenda*, published in November of 1987, continue to guide our efforts.

The two new CREF funds introduced on March 1st — the Bond Market Account and the Social Choice Account — are products of those efforts. Other new funds are on the drawing board, as are new minimum distribution options that will help annuitants meet regulatory requirements in an easy-to-understand and convenient way.

*There are pros and cons on the issues of transferability and cashability, and they will no doubt continue to be important topics on campus, and both certainly deserve special consideration and study.*

There are pros and cons on the issues of transferability and cashability, and they will no doubt continue to be important topics on campus, and both certainly deserve special consideration and study. However, they are just two trees in an ever-growing forest of thought-provoking retirement issues: The appropriateness of your plan's benefits objectives and your contribution rates; the impact inflation will have on benefit levels; long-term care; the elimination of mandatory retirement ages and early retirement incentives are just a few that come to mind. We urge you not to lose sight of this forest for the two new trees that sprang up on March 1.

The time is right to carefully review all of the issues that will have an impact on your institutional retirement plan and I would encourage you to consult with our institutional counseling staff who are ready to help in any way possible.

We've been together for a long time — many of our institutions have been with us for more than half-a-century. After all that time, I'm not going to talk about what we're "promising" you — I'll leave that to those who have something to prove to you.

# FOUR KEY POINTS FOR COLLEGE AND UNIVERSITY LEADERS

By Thomas T. Bieniek
*Senior Vice President/General Manager*
Fidelity Investments Institutional Services Company

As I prepared my remarks for this publication, I realized more than ever the complexity of the issues you face as college and university leaders. It won't be enough to merely *survive* the 90s and last into the 21st century--your challenge is to provide what it takes for your institution to *flourish*. You are faced with constant change—and in the retirement plan arena, this change is more evident than *ever before*.

Recognizing that the scope of your responsibilities ranges from capital budgeting to sufficient faculty parking spaces, I can appreciate that the retirement plan needs of your faculty and staff are but *one* of a myriad of your concerns. What I'd like to leave you with are *four key points* to consider in providing retirement investments and services to your faculty and staff.

## Point #1: Mutual Funds Make Sense

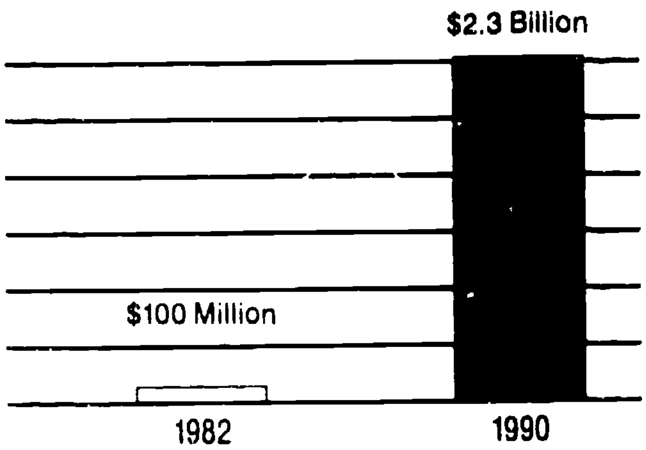
To understand the future, it is necessary to look at the past. In the last 20 years, significant changes have occurred to bring us to the retirement plan environment as we know it today.

- In 1974, mutual funds first became legally permitted investments for university retirement plans.
- The Tax Reform Act of 1986 has forced your institutions to *totally re-examine* your retirement plans. You now need to satisfy *strict* anti-discrimination rules and coverage tests. These types of changes directly impact *your cost* of providing retirement plan benefits.
- Finally, in 1990, policyholders of the College Retirement Equities Fund (or CREF), were given the right to transfer accumulated assets and take cash distributions from their retirement plans, if your institution permits. Like it or not, and whether you're ready or not, *you* — not an insurance company — are in control of your retirement plan.

*Like it or not, and whether you're ready or not, you—not an insurance company —are in control of your retirement plan.*

Hundreds of colleges and universities throughout the country have added mutual funds as an alternative to more traditional insurance-oriented investment offerings. In 1982, 403(b) retirement assets held in mutual funds at Fidelity totalled less than $100 million. Today, we manage over $2.3 billion in 403(b) assets for more than 125,000 participants. (See Chart 1.)

CHART 1
FIDELITY INVESTMENTS
403 (b) Assets Under Management




Why the upsurge in mutual funds as an investment vehicle? The answer, I believe, lies in their inherent advantages.

- First, mutual funds offer *professional money management*, with fully disclosed investment objectives and strategies.
- Second, they offer *diversification*. Most funds are invested in a broad portfolio of securities, thereby reducing risk and increasing earnings potential.

- Third, mutual funds are *liquid* investments. Most can be bought and sold on a daily basis, providing your employees the freedom to change their retirement investments to keep pace with their personal objectives.
- Mutual funds are also a *low-cost* investment, unencumbered with the expenses and mortality fees often associated with insurance annuity products.
- And finally, mutual funds can take advantage of the *breadth* of the investment world available to us. In today's truly global economy, mutual funds can be established with investment parameters that enable them to capitalize on investment opportunities both here and abroad. *There are many types of mutual funds — because there are many types of investors.*

CHART 2

CUMULATIVE ASSET CLASS RETURNS*
1950–1989

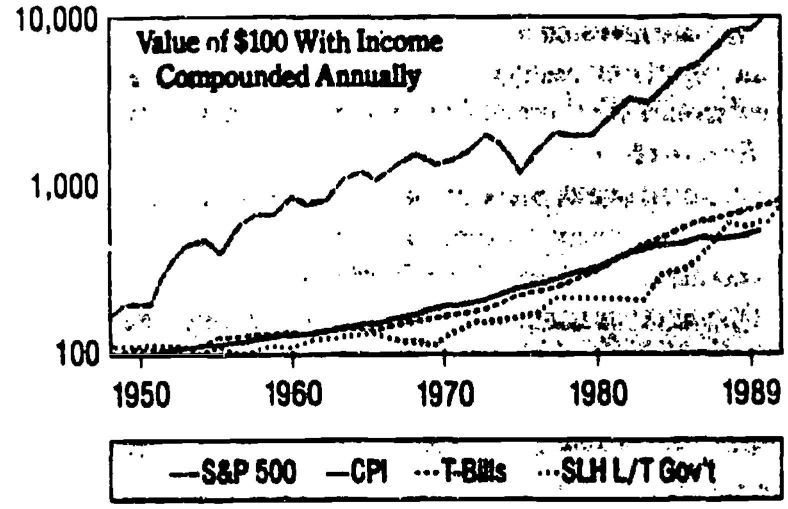



Chart 2 shows the growth of three asset classes — money market instruments, bonds, and equities along with the Consumer Price Index — since 1950.

The long-term growth we see here is compelling evidence for *including equities* in a properly allocated portfolio. In an equity mutual fund, investors can realize the growth of the equity market without the risk of buying individual securities.

There are other opportunities with mutual funds. Twenty years from now, if we were to look again at the growth of money markets, bonds, domestic equities, *and* international equities, I venture to say that international equities would represent a portion of *every investor's* portfolio. Many investors have already made this decision, for during the month of August alone, mutual fund sales for international and global equity funds in the U.S. totalled more than $840 million.

In considering the investment alternatives that fund your retirement plans, you need to ask yourself three basic questions:

- Does the addition of a mutual fund family to your plan assist in attracting and retaining key faculty, administrators, and staff?
- Is it desirable to offer greater investment choice and flexibility to your employees?
- And finally, would you and your employees benefit from competition among your retirement plan vendors?

If you've answered "yes" to one of these questions, then you are faced with selecting a mutual fund family.

*S&P 500, (a registered trademark of Standard and Poor's Corporation), is an unmanaged index of common stock prices.

CPI refers to the Consumer Price Index.

T-Bills refer to U.S. Treasury Bills.

SLH L/T Gov't is the Shearson Lehman Hutton index of long-term government bonds.

## Point #2: Carefully Evaluate Your Investment Manager

If you were to ask each investment professional here today to list the criteria for evaluating an investment manager, the answers would undoubtedly differ. However, there are some key points upon which we all would agree.

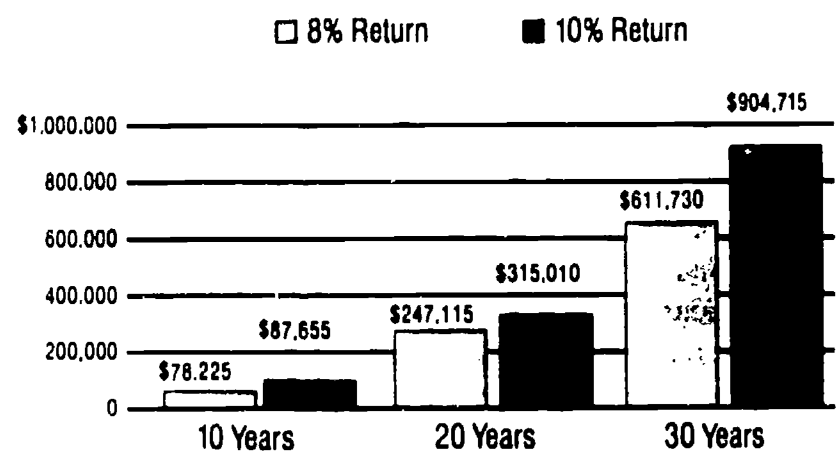
***First—experience counts.*** An investment manager should have a proven ability to manage money in all investment disciplines. How long have they managed money in each of the different investment disciplines? What are their assets under management? How have they performed versus their competition? With dozens of companies offering mutual funds, you can well afford to be selective.

***Variety also matters.*** Each of your employees has a different investment objective and personal tolerance for risk. Your investment program should therefore offer the range of investment options to meet their needs. At Fidelity, we offer over 50 funds for our retirement plan investors. It so happens that 90 percent of our higher education assets are invested in just eight funds—but we've let the participants make that choice. Since most university retirement plans are fully and immediately vested, it's the employees' money, it's their choice—it's their financial future.

***Research.*** The value you place on research in academia should also be sought in the investment world. Some managers make decisions based on macro trends. They look for one or two major themes, and buy securities accordingly. But in an ever-changing investment world, trends are hard to spot.

On the other hand, investment decisions can always be made using a research-driven approach. Look for a manager who goes out to kick the tires, to hug and hold the companies in which they will invest. They are the ones who will find the hidden gems. Above all, make sure that you and your administrators are comfortable with the manager's investment style.

CHART 3
THE IMPORTANCE OF MAXIMIZING RETURN




*Assumes annual investment of $5,000*

Finally, there's the issue of investment performance, the key to which is consistency. Any investment manager can show a winning quarter or two. However, since investing for retirement is investing for *long-term* results—usually the 20 or 30 years you have until retirement—match your long-term needs to a manager's long-term performance. In doing so, you'll see how they performed in a variety of economic conditions and in varying markets.

*A 2 percent difference in the rate of return over periods of 10, 20, and 30 years results in startlingly different account balances for an employee approaching retirement.*

Performance is critical—there's no doubt about it. In Chart 3, you can see the critical importance of consistent performance. A 2 percent difference in the rate of return over periods of 10, 20, and 30 years results in startlingly different account balances for an employee approaching retirement. In selecting an investment manager, there's a simple rule you can follow: *Demand the best.*

## Point #3: Communicate the Plan to Your Employees

The third point may come as a surprise to you and yet at Fidelity, our experience has proven it. The key to a successful retirement plan is *communicating* it to your employees. For many of us, particularly those in their twenties and thirties, saving for retirement is somehow an admission of our own *inevitable aging*. And yet, the facts are indisputable: Those who start saving sooner are going to have *more later.*

Therefore, it's critical that your employees know what investment choices are best for them. But how?

At Fidelity, our commitment is to use our communications to *educate* and *inform* the employees of our client institutions. With the right knowledge, they can make *informed investment* decisions. Because people absorb information in a variety of ways, we have found that a variety of media are most effective in promoting an understanding of a retirement plan. Slide shows, brochures, videos, and workbooks; seminars, benefits fairs, workshops on specific topics of financial education—*all of these* can help motivate your employees to begin preparing for their personal financial future.

*At Fidelity, our commitment is to use our communications to* educate *and* inform *the employees of our client institutions.*

Employee communications are perhaps more accurately described as employee education. And we consistently hear of the need for *financial education.* More than an explanation of the options available in a retirement plan, employees are seeking information about:

- Their personal net worth;
- Allocating their assets;
- Saving for children's education;
- Buying insurance, writing wills, and preparing taxes.

Institutions have chosen to respond to this need in a variety of ways. In tackling problems such as the issue of financial education, it becomes remarkably clear that you must . . .

## Point #4: Select an investment provider who offers much more than insurance annuities and mutual funds.

We are seeing many institutions "reclaiming" their retirement plans. The retirement plan you offer your employees is *your* plan—that of *your institution.* After all, it's *your institution*—not the vendor—that makes very substantial contributions to your plan *every month* of *every year.*

*The retirement plan you offer your employees is* your *plan—that of* your institution. *After all, it's* your institution—*not the vendor—that makes very substantial contributions to your plan* every month *of* every year.

So that you can provide your employees the best *possible* retirement plan, your investment provider should offer:

- High-quality service;
- Consistent, ongoing support; and
- A consultative approach to meet the challenges of preparing your employees for their financial future.

Service sounds so simple. But it's not enough to have an 800 number that's staffed by people unfamiliar with retirement plans. Nor is it sufficient to have a customer service staff that goes home at 5 p.m.

Your employees deserve professional presentations that *spell out* their retirement plan options. They should receive accurate statements that arrive on time. When they call a 24-hour hotline, they should get *correct* answers to their questions. And you—you should settle for nothing less.

What about your administrative staff—what should they expect? Keep in mind that the more service you receive from an investment manager, the *lower* the cost of administering your plan. If you're considering an alternative investment manager, have your data processing and payroll people *talk* with their systems people. Have your human resources and benefits staff *talk* to their employee communications professionals. Do they have the capacity to handle your account? Are there back up systems in place?

Finally, it is a consultative approach that sets one investment company apart from another—and I'd like to, if I may, spend a moment on this.

In the face of constant change, your investment manager should *listen* to what you need . . . not give a *cookie-cutter* solution that's inappropriate for your situation. Furthermore, they should actually *anticipate* what you need.

Let me give you a few examples.

The Tax Reform Act of 1986 that I mentioned earlier brought with it sweeping changes to retirement plans. Fidelity responded by having the first IRS-approved 401(a) Prototype Plan for universities in 1988. By using the Prototype, our clients have been able to bring their plans into compliance with the new rules with a minimum of technical complexity and at virtually no cost.

On Capitol Hill, legislation that deals with retirement plans continues to change. To keep our clients abreast of these and other benefits issues, Fidelity sponsors regional client conferences. Topics at our recent September meeting included the implications of ERISA Section 404(c), investment updates, market research findings and other technical information.

To remain attuned to trends in the industry, we attend the NACUBO and CUPA conferences. To understand how we're perceived in the marketplace, we've used outside firms to execute comprehensive market research surveys. And to find out just what participants need to know to prepare for retirement, we've asked them directly.

Whether it's a simple brochure explaining mutual funds or technical assistance on how to deliver your payroll deduction information, an investment manager needs to be a *"full-service"* provider.

*No longer is a retirement plan a "nice" thing to have—the state of our economy has made it an* absolute necessity.

No longer is a retirement plan a "nice" thing to have—the state of our economy has made it an *absolute necessity*. Social Security alone will not provide enough retirement income. And financial experts agree that each of us will need an annual retirement income equal to *60 to 80 percent* of the salary we earn in our last working year. Couple that with the ever-increasing numbers for life expectancy—and the truth becomes self-evident.

I encourage you to consider mutual funds as a viable alternative for your retirement plan. I *caution* you to *carefully* evaluate your investment managers. And finally, I urge you to demand the *best* of your retirement plan vendors. As you prepare for *your own future financial security* and that of your employees, you quite simply—deserve the best.

# MARKET TIMING FOR UNIVERSITY RETIREMENT FUNDS

By David J. Rights
*President*
Lincoln Market Timing Program

A suitable investment strategy for retirement planning must provide for:

1. Capital preservation during down markets.
2. Capture of a reasonable gain during up markets.
3. Above average returns over medium and long term periods.
4. Ownership of the investment account and the flexibility to withdraw money according to the changing needs of the account holder.
5. Personal financial counseling to consolidate retirement accumulations with other personal financial assets.

*We believe that the lowest risk, highest performing option available is tactical asset allocation, more popularly known as market timing.*

We believe that the lowest risk, highest performing option available is tactical asset allocation, more popularly known as market timing. Market timing is a money management concept utilizing mutual funds as the underlying investment vehicle. The Lincoln Market Timing Program adopts a "defensive" position, investing in a government security or money market fund, to protect past gains and to preserve principal for future investment. Lincoln will only take an "aggressive" position, investing in equity mutual funds, when we anticipate that the stock market has a low risk profile with good upward potential. These positions are automatically implemented by exchange of dollars between an equity mutual fund and a money market fund within a specific family of mutual funds available for timing. Lincoln executes and confirms each exchange. The investor has a separate account, individually registered and owned, with complete liquidity of invested dollars at all times.

The Lincoln Market Timing Program is designed to reduce market risk to less than half of the risk of buy-and-hold strategies. Lincoln has achieved and has maintained this exceptionally low level of risk, with above average returns, since 1979 when the Program was implemented. Our market timing approach is a well tested alternative to the retirement annuity formula offered by insurance companies or to the fully exposed market risk option offered by growth mutual funds.

Lincoln's performance speaks for itself. **From 1979 through September, 1990, the timing model has achieved a cumulative total gain of 501 percent, equivalent to 17.2 percent compounded annually to the investor, net of all fees. Other investors using a buy-and-hold strategy as measured by the Lipper Growth Fund Index, have only gained 310 percent or 13.3 percent compounded annually.**

Let me now put our investment strategy into the context of the 1970s and the 1980s. And then we can look at the outlook for the 1990s and our recommended approach to retirement planning.

The 1980s were excellent for investing—the 1990s may not be so easy. Therefore, as the decade of the 80s has drawn to a close, it is important that we reflect upon what we have learned and determine how we may best profit from those lessons in the future.

You remember that we entered the 1980s with historically very high inflation rates, high interest rates and an undervalued stock market. Indeed, the stock market had suffered a rocky road during the 1970s. But, as the 1980s unfolded, we benefited from a generally declining rate of inflation, generally declining interest rates, healthy economic growth, and favorable tax policies. Excess liquidity flowed into the financial markets resulting in historically high rates of growth in stocks, bonds and real estate.

Please refer to the 1980s line of Table 1. Note that the S&P 500 Stock Index gained 17.6 percent per year. This is far above its long-term historical norm. Both 10 year

T-Bonds and T-Bills had very respectable gains, also. The 10 Year T-Bonds averaged 12.3 percent per year while T-Bills averaged 9.3 percent per year. All financial assets outstripped the rate of inflation, which averaged 5.2 percent per year.

TABLE 1

| Gains During | S&P 500 | Lipper | 10 Yr T-Bond | T-Bills | CPI |
|---|---|---|---|---|---|
| 1970's | + 5.8%/Yr | + 3.3%/Yr | + 6.2%/Yr | +6.5%/Yr | +7.3%/Yr |
| 1980's | +17.6%/Yr | +15.1%/Yr | +12.3%/Yr | +9.3%/Yr | +5.2%/Yr |

Let's continue our analysis. Let's dig deeper into history to gain the proper perspective we need for our future planning. It is vitally important for an investor to expand his time horizons when investing. Only then can an investor develop realistic goals and follow a disciplined approach to investing. Only then will an investor be patient and allow the plan to work.

Let's examine the last 20 years, 1970–1990. These years make a good case history for the study of financial markets. Please refer again to Table 1. We have already reviewed the 1980s. Now let's review the performance of various financial assets during the 1970s. Immediately you see that the 1970s were the exact mirror image of the 1980s. None of the financial asset classes beat the rate of inflation, which averaged 7.3 percent per year. It might surprise you to learn that the best performing asset class during the 1970s was T-Bills which gained 6.5 percent per year. T-Bonds gained 6.2 percent per year while the S&P 500 Stock Index gained 5.8 percent per year. The average growth mutual fund, as measured by the Lipper Growth Fund Index, gained 3.3 percent per year. This was a little closer to real investor returns in the stock market.

Taken as a whole, then, the last twenty years represents a more normal slice of American financial history. Numerous academic studies have shown that the long-term growth of stocks during the last 20, 40, 100 and 200 years has been 9–10 percent per year. During the last two decades, the S&P 500 Stock Index gained 11.5 percent per year while the Lipper Growth Fund Index gained 9.0 percent per year. Since T-Bonds are lower risk than stocks you would expect a slightly lower return from T-Bonds, which gained 9.2 percent per year. Normally, you would expect the lowest returns from T-Bills, since they are considered to be essentially riskless. T-Bills averaged 7.9 percent per year. Of course, you would expect all financial assets to give some return above the rate of inflation and, during these two decades, all of them did, including T-Bills which beat the rate of inflation by 1.6 percent per year.

The stock markets suffered three bear markets in the 1970s and three bear markets in the 1980s. Beyond that, however, the 1970s and 80s were very much different. The bear markets of the 70s were more severe. When that decade had ended, the average growth mutual fund, after much movement up and down, gained only 3.3 percent per year. (I suspect that this figure is below your current expectations.) By contrast, in the 1980s, the bull markets predominated and the average growth mutual fund gained 15.1 percent per year, above the historical norm of 9 percent per year.

**This historical backdrop is imp tant in the development of our timing strategies. Our philosophy of market ing was born out of the 70s; matured and prospered in the 1980s. We are equipped and ready for the 1990s. We have adopted the slogan "manage for the worst, hope for the best!"**

*We believe that asset allocation is more important than the underlying security selection.*

Lincoln adopted the timing strategy over eleven years ago, after 10 years of continuous research. We believe that asset allocation is more important than the underlying security selection. In other words, it is more important to know if you are in stocks or cash than it is to know *which* stocks. We believe that over a complete market cycle, 3–5 years, we may achieve superior performance at lower risk through the systematic application of our timing principles. Furthermore, we believe that it is absolutely mandatory to have a disciplined, unemotional approach to investing. To have the requisite staying power, we believe it is also mandatory to adopt an approach which is both conservative and emphasizes the preservation of capital in down markets. The Lincoln Market Timing Program uses the Rightime Market Model (RTMM) to implement our timing strategies. The Rightime Market Model is economically based and quantitively driven. It has no subjective override. The Rightime Market Model merely attempts to exploit the changing relative attractiveness between stocks and cash. RTMM has a contrarian style which tends to sell into rising markets and buy into falling markets. The result of the Lincoln Market Timing Program is a systematic allocation between stocks and cash.

What we do is very simple! We believe that stocks provide long-term growth and are good long-term investments. And, although long-term investing in stocks is good, every investor recognizes that there are times which are more or less favorable for stocks. Remember, every 3–5 years the markets have become significantly over valued. Examples of this cycle are the stock markets in '68, '73, '77, '80, '83, '87 and, finally, in 1990. We believe that realistically there is no such thing as a "long-term investor," that every investor in reality makes strategic decisions to be invested more or less heavily in favor of stocks, bonds or cash. We do the same thing!

"Is it a good time to invest now?" If you have asked that question then you already believe in timing. You recognize that in the short term there is a good time and a bad time to invest in securities, even, if in the very long term securities investment is favorable. So, your only decision is not whether timing is good or bad, but merely whether you think we can do a better job of timing for you than you could do for yourself. The primary difference between what we do and what most other investors do is that we make timing decisions based upon a quantitative, systematic, disciplined modeling process and most other investors make these decisions on a subjective, emotional and/or random basis. This is a fatal error, because most investors, left to their own devices, are emotionally out of sync with the markets.

*The primary difference between what we do and what most other investors do is that we make timing decisions based upon a quantitative, systematic, disciplined modeling process and most other investors make these decisions on a subjective, emotional and/or random basis.*

What are the goals of timing? Over a market cycle typically lasting 3–5 years, we attempt to provide an investment which is no more than one-half of market risk as well as attempting to provide returns which are higher than the market, higher than cash and higher than the rate of inflation. These are *relative* goals and not absolute goals.

What is our outlook for the 1990s? We entered the 1990s with the burden of the 1980s financial excesses upon us. There has been a huge buildup of debt: government, corporate and personal debt. Likewise, there has been a high proportion of high risk debt. The S&L crisis, for example, is essentially the result of excessive debt built up in high risk, real estate development. There has been a huge amount of debt from the mergers and acquisitions mania of the 1980s. LBO's (leveraged buy-outs) were financed primarily with junk bond debt and direct borrowing from the major money center banks. Defaults from real estate loans and junk bonds are now affecting the viability of S&L's, major money center banks and insurance companies. We have entered the 1990s with overdeveloped and overpriced real estate markets. We are experiencing a worrisome increase in the rate of inflation. The recent oil crisis will only serve to aggravate this situation.

Due to the continued budget and trade deficit, the dollar vis-a-vis other major currencies is weak. We are now experiencing a slow economy with a probable nationwide recession. Anyone living in the northeastern United States should recognize that we are *already* in a recession. Unfortunately, all of this is occurring at a time when stock prices are already relatively expensive on a fundamental basis.

We believe that the financial excesses built up in the 1980s will unwind in the 1990s. Long-term cyclical change in the real estate markets has occurred and the demographics will continue to make real estate underperform the rate of inflation. All of these factors have come together in such a way to put a great deal of pressure on other financial assets such as stocks and bonds. Therefore, financial assets will experience more of the roller coaster environment of the 1970s than the strong upward trend of the 1980s.

*Therefore, financial assets will experience more of the roller coaster environment of the 1970s than the strong upward trend of the 1980s.*

We are extremely excited by this prospect of opportunity. Exciting times come in markets when they are either significantly overvalued or significantly undervalued. We believe that the next great opportunity will come when stocks and bonds are both significantly undervalued. Therefore, it is extremely important to have an economically based, systematic, disciplined investment style to enable us to take advantage of that great opportunity when it occurs, as it surely will. That discipline is the Rightime Market Model and the Lincoln Timing Program!

Please refer to Tables 2 and 3 for the performance of timing versus various alternatives over time.

TABLE 2

| | Performance (%) Since: | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| *(as of 9/30/90)* | 1/1/90 | 1/1/89 | 1/1/88 | 1/1/87 | 1/1/86 | 1/1/85 | 1/1/84 | 1/1/83 | 1/1/82 | 1/1/81 | 1/1/80 | 6/15/79 |
| Lipper Growth Fund Index | −12.5 | 12.4 | 30.1 | 31.4 | 52.3 | 98.5 | 92.9 | 135.5 | 183.7 | 159.8 | 258.0 | 310.3 |
| Money Market Fund Index | 5.9 | 15.2 | 23.3 | 30.8 | 39.0 | 49.8 | 64.9 | 79.0 | 94.8 | 135.4 | 164.9 | 180.6 |
| Lincoln Timing (LTPI) | 2.3 | 15.1 | 25.3 | 60.6 | 81.9 | 127.3 | 140.9 | 168.9 | 234.7 | 301.9 | 433.8 | 501.6 |

TABLE 3

| | Equivalent Annualized Compounded Performance (%/Yr) Since | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| *(as of 9/30/90)* | 1/1/90 | 1/1/89 | 1/1/88 | 1/1/87 | 1/1/86 | 1/1/85 | 1/1/84 | 1/1/83 | 1/1/82 | 1/1/81 | 1/1/80 | 6/15/79 |
| Lipper Growth Fund Index | −16.4 | 6.9 | 10.0 | 7.5 | 9.2 | 12.6 | 10.2 | 11.6 | 12.6 | 10.2 | 12.5 | 13.3 |
| Money Market Fund Index | 7.9 | 8.4 | 7.9 | 7.4 | 7.1 | 7.2 | 7.6 | 7.8 | 8.3 | 9.2 | 9.4 | 9.5 |
| Lincoln Timing (LTPI) | 3.0 | 8.4 | 8.5 | 13.4 | 13.4 | 15.3 | 13.9 | 13.6 | 14.8 | 15.3 | 16.8 | 17.2 |

# A PERSPECTIVE ON THE HISTORY AND MEANING BEHIND THE NEW OPTIONS

By Paul A. Heller
*Director of College and University Retirement Programs*
The Vanguard Group of Investment Companies

I am a relative newcomer to the college and university marketplace. Although I've been a crewmember, as we say, on the Vanguard ship for six years, I assumed responsibility for Vanguard's 403(b) effort just over a year ago. So it is a fresh, candid, and, I hope, distinctive perspective on college and university pension funds that I bring to you.

I would like to address two topics:

- First, the historical events—the backdrop—for recent developments in the college and university marketplace.
- Second, the result of those historical events: two new options that are now available to participants in TIAA/CREF—options with important benefits, known—a bit awkwardly—as "transferability" and "cashability." I hope to dispel any confusion that might exist as to what these new provisions really are.

Let us first begin with the historical events.

## The Historical Backdrop

*Institutions of higher education have been offering retirement plans of one sort or another since the early part of this century.*

Institutions of higher education have been offering retirement plans of one sort or another since the early part of this century. Traditionally, the cornerstone of the plan was the fixed annuity contract, offered by an insurance company. The annuity contract provided a guarantee of principal along with a competitive rate of return; it was backed by the insurer's portfolio of bonds and mortgages. At retirement, the participant's balance was converted into a fixed monthly income for life. So, annuities provided a straight forward and effective option for the majority of individuals.

Yet, it was clearly evident to some participants, that fixed annuity contracts, the backbone of the university retirement system, were simply not enough. Historically, common stocks, despite their risks, had provided substantially higher rates of return, and TIAA participants had no way to enjoy those potential benefits. The solution during the 1950s was to introduce the College Retirement Equities Fund or CREF, TIAA's companion. It was an annuity contract, but this time it was backed by a portfolio of common stocks and had a value which could rise and fall in tandem with the stock market.

Business in the college and university market continued along this path for almost two decades—two choices, TIAA and CREF—when several events conspired to undo this simple arrangement:

- In 1974, ERISA (the Employee Retirement Income Security Act) was passed. Under ERISA, mutual funds gained entrance to the 403(b) market; they were authorized as investment options for new contributions to 403(b) plans. Existing contributions—in so-called "basic" plans—had to remain put. But for the first time participants had an alternative to annuities for their retirement savings.
- The second consequence of ERISA was more subtle. ERISA codified the distinction between a plan sponsor and an investment provider. In the past, at many institutions, no real distinction was drawn between TIAA-CREF and the institutions's retirement plan. They were one and the same in the minds of both participants and plan sponsors. ERISA and subsequent pension legislation help make it clear that TIAA and CREF weren't the plan, but simply investment options within it. The plan had an independent existence of its own; it would be the final arbiter of choices and restrictions.

- There were other developments, far afield, that contributed indirectly to events in the university marketplace. Ceilings on interest rates paid by banks and savings and loans led to the development of money market funds. Rather than invest through intermediaries like banks, investors began to buy directly in the money markets.
- ERISA also introduced the IRA. Through the IRA, a wider range of investors during the 70s and 80s would gain experience with investing in the stock and bond markets, particularly through the vehicle of mutual funds.

Here then was a clear theme. Certain individuals—educated and self-motivated—were assuming responsibility for making their own investment decisions. Increasingly, they were abandoning traditional financial intermediaries—such as banks and insurance companies—in favor of making their own investment decisions. They demanded choice and flexibility—and the result was a proliferation of investment alternatives.

*They demanded choice and flexibility—and the result was a proliferation of investment alternatives.*

With these trends in mind, it is not surprising to see what happened next in the college and university market.

## Changes at CREF

By the early 1980s, TIAA-CREF found itself the target of criticism. The complaint: lack of investment flexibility, especially in light of the unprecedented changes in the financial system. Basically, the educational community was requesting change along three lines:

- First, participants wanted additional investment alternatives; TIAA and CREF were simply not enough.
- Second, many argued that each institution would be given the right to allow its employees to transfer TIAA and CREF balances to competitors. After all, the retirement benefits at TIAA-CREF were being funded by the universities' own plans; those plans, not TIAA-CREF, should decide the range of alternatives available. This was the distinction borne of ERISA—the distinction that the plan sponsor, not the investment provider, should be in the driver's seat.
- Third, many universities believed that additional distribution options should be offered at retirement. The inflation of the 1970s had devastated the living standards of retirees on a fixed income. While an annuity made sense as one important method for distributing retirement savings, it was clearly not the answer for all participants. Some sought increased control over their retirement savings—namely, a lump-sum payment of benefits, in cash, at retirement.

*By the early 1980s, TIAA-CREF found itself the target of criticism.*

## The Settlement Agreement

TIAA-CREF did respond to these challenges, and in 1985, CREF sought to register mutual funds with the Securities and Exchange Commission. All mutual funds must be filed with the SEC and are governed by rules of The Investment Company Act of 1940.

In its 1985 filing, CREF requested exemptions from several core provisions of the 1940 Investment Company Act. In particular, it sought to continue to impose certain restrictions on its proposed mutual funds that were incompatible with the Investment Company Act and the spirit of increased flexibility.

Not surprisingly, there were vigorous objections to CREF's request. A group of higher education organizations and investment companies became formal participants in the SEC proceedings. The group challenging TIAA-CREF included the American Council on Education; the American Association of University Professors; the National Education Association; the United University Professions; Stanford University; and four mutual fund organizations including Vanguard.

In December of 1988, after several years of negotiation, TIAA-CREF and the participants in the SEC proceeding finally reached a settlement. The net result: CREF could implement its new investment options, but only if it lifted previously imposed restrictions. The lifting of TIAA-CREF restrictions was given two names: transferability and cashability.

Given this historical backdrop, I would like to spend the remaining time discussing the new options, and share with you how Vanguard's major college and university clients have incorporated these choices into their plans.

## Transferability

*Offering employees the ability to transfer their CREF assets does not mean that an employee can transfer his or her savings to any type of investment at any type of financial institution.*

Let's start with the new transferability option. Transferability is an institution's right to permit employees to move existing basic CREF balances to alternative investments. Today, transferability is limited to CREF monies; the transfer privilege will be extended to TIAA balances begining in August of 1991, according to a restricted ten-year schedule.

A couple of key points about transferability. Offering employees the ability to transfer their CREF assets does not mean that an employee can transfer his or her savings to any type of investment at any type of financial institution. Rather, it is up to each college and university to authorize specific investment providers within the provisions of their plan. Also, within each approved company, the institution must authorize specific investments to which participants can transfer. Furthermore, the institution can either elect to sign off on individual transfer requests or simply allow participants to transfer at will to approved funding vehicles.

To illustrate, hundreds of prestigious colleges and universities already offer Vanguard Funds. To date, over 90 percent of them have approved transferability of basic CREF accumulations, with approximately 30 percent requiring individual sign-off on each transfer request.

So for many, transferability is a fairly straightforward issue. Transferability is not opening your door to the latest salesman who happens to work his way into your faculty club. Nor is it giving your employees the right to risk their retirement savings on the current "hot" investment product. And, transferability is certainly not an institutional endorsement for speculation or "market timing."

Rather, transferability is the right, and perhaps the responsibility, of an institution to offer a suitably diverse range of investment options. And at last, for colleges and universities that do want to offer choice, they are now truly free to do so.

## Cashability

Now consider the second option – cashability. Cashability is an institution's right to allow an employee to receive all or part of his or her retirement savings as a lump-sum payment. In simple terms, it means providing participants with more flexible access to their retirement savings, either upon termination or, more importantly, at retirement.

Historically, most institutions required that participants take an annuity income at retirement – partly because that was the accepted practice, partly because of restrictions imposed by TIAA-CREF. Over time, TIAA-CREF restrictions were partially relaxed, so that today TIAA offers a 10 percent cash option when you retire, and CREF monies can be withdrawn as a lump sum. Now that most of the remaining TIAA-CREF restrictions will be lifted, institutions must confront the question head on: What degree of flexibility should participants be given?

*Now that most of the remaining TIAA-CREF restrictions will be lifted, institutions must confront the question head on: What degree of flexibility should participants be given?*

Cashability, I should point out, is not an all-or-nothing alternative. Rather, each institution may specify its own plan limits for cash withdrawals. For example, an institution can choose to limit cash withdrawals to those individuals who are retiring or to those who reach a certain retirement age, versus those who simply quit or terminate employment. Cash withdrawals can also be limited to some percentage of an employee's balance or only to employee contributed savings.

Prior to the settlement agreement, the majority of Vanguard's clients considered themselves fairly paternalistic in their retirement plans. Yet, just six months later, over 85 percent of our clients now offer some enhanced form of cashability upon termination or retirement.

It would be easy to spend the rest of my time discussing the pros and cons of annuities versus lump sum payments. But that is really not the issue at hand. I don't think that anyone would suggest that annuities do not play a critical role in most retirement plans. For many individuals, who have neither the need, desire, nor expertise to manage a lump-sum investment, an annuity is still the preferred choice.

Unfortunately, many have found out the hard way that the "safe" and "guaranteed" $10,000 annuity they started in 1970 at age 60 purchases only $3,000 worth of goods 25 years later, due to the ravaging effects of inflation.

Even in a less inflationary environment, there are a growing number of participants for whom an annuity is no longer an ideal distribution option. This group prefers to manage its money on its own, and does not wish to delegate investment management responsibility to a traditional financial intermediary. They would like discretionary access to a pool of savings at retirement – not a fixed monthly income. They see, in the lump-sum option, the potential for protection against inflation that a fixed annuity cannot afford. They also prefer the greater flexibility of a lump sum in estate planning.

In other words, there are compelling advantages to the cashability option. Against these, of course, an institution must balance the risk of an employee potentially mishandling his or her retirement savings.

Historically, in response to these risks, the compromise has been to limit everyone's options by imposing a mandatory annuity requirement. Yet a mandatory annuity pay-out no longer stands up to close scrutiny, especially against the backdrop of increased flexibility in the financial marketplace. Every responsible college and university retirement plan should continue to offer an annuity option. And, I would suggest, every plan should also offer the alternative: the flexibility and choice that comes with a "cash" option.

## Conclusions

*The new choices are the product of significant changes in the financial marketplace—the trend away from traditional financial intermediaries, and the move towards individual control and discretion in making investment decisions.*

To complete my talk this morning, I would like to propose suggestions for moving forward with changes to your institution's plan. First, it is clear that the decisions you are faced with today did not come about by happenstance. One narrow explanation of today's options is that they resulted from a disagreement between TIAA-CREF and mutual fund groups. A broader, and I think preferable, explanation is that the new choices are the product of significant changes in the financial marketplace—the trend away from traditional financial intermediaries, and the move towards individual control and discretion in making investment decisions. Both TIAA-CREF, in offering new investment options, and mutual fund companies, with their families of funds, have sought to accommodate these developments.

How should the plan sponsor—the university or college—respond? There are two courses of action I would recommend:

- First, introduce a reasonable assortment of competing funds and allow transfers to and from those funds, including CREF.
- Second, provide a lump-sum or "cash" option at retirement, in addition to the traditional annuity.

Will there be those who, with the transfer option, abuse the new choices—by trying to time markets, by moving monies excessively, by investing all of their assets too aggressively? Possibly. But your plan document can prohibit excessive transfers and control the individual options that are made available to participants.

Perhaps more importantly, will there be those who, with the cash option, spend their savings unwisely? Again, it's possible, but there are means available to minimize such risks. One is to allow a cash option only at retirement, another is to allow a partial cash option. Generally, and, above all, the best way to mitigate risk is to work with and educate your participants on the ne[illegible]ices.

In the long run, it becomes harder and harder to rationalize the current set of restrictions, especially in a marketplace of self-motivated, intelligent, and resourceful persons. Participants may end up making right decisions or wrong decisions, but I am not sure who should presume in advance to distinguish "right" from "wrong" in this incredibly uncertain and challenging investment world.

I strongly encourage you to take full advantage of the new options. Now is a great time to pull your retirement plan document out of the cabinet, shake off the dust, and embrace your new choices.

# IV FOCUS ON DECISION MAKING: CONSIDERING THE CHOICES

By Marcia Selz
*President*
Marketing Matrix, Inc.

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We undertook our study of 355 educational institutions that participate in TIAA-CREF at the request of various providers of investment alternatives because they wanted to better understand the decision-making process and environment at colleges and universities. The survey conducted in June and July of 1989, provided information that was particularly important in light of the changes that would be occurring from the agreement between TIAA-CREF and the SEC.

Overall, the research objective involving decision-making was to understand by what criteria providers are judged. More specifically, we wanted to:

- first, understand what decision-making factors were important when schools were considering adding or changing providers for their basic or supplemental plans,
- and second, we wanted to determine the extent to which these factors were important to people on campus who work with providers and many times are the linkage wi' enrolled employees. These people, in many cases, are significant contributors to the decision making process for evaluating and selecting various providers.

To develop the questionnaire for the study, we conducted a series of in-depth, one-on-one and group exploratory interviews with:

- people who served on their school's decision-making Board or the committee that has the responsibility for evaluating providers. (From this research we know that 81 percent of the schools make decisions through this collaborative, committee process.)
- people who were the "gatekeepers" of opinion and contribute to that decision-making process through their experiences with and opinions about various providers.
- enrolled employees at various types of educational institutions.

*We believe that by using a core set of attributes, institutions will be better able to rank investment providers and the benefits and* added value *that is being offered—and later received.*

Respondents were asked to rate the importance of 21 attributes. We believe that by using a core set of attributes, institutions will be better able to rank investment providers and the benefits and *added value* that is being offered – and later received. See Table at the end. We then broke the rankings into four basic categories:

- Plan administration
- Customer service
- Overall image
- Investments and products

What we found within these groupings, the first of which I'll talk about will be plan administration, was that the importance of these attributes varied according to job function. Among human resources managers or officers who comprised 29 percent of the sample, the importance ranking of these attributes was different for people in benefits, finance and payroll. Benefits and pension managers, who comprised 22 percent of the sample, rated fees more important than brochures that were provided to the schools for administrators and employees. Payroll personnel rated brochures higher in importance because, in many schools, when someone doesn't understand something about the retirement plan, payroll deductions and so forth, these are the people who get the questions. Payroll and associated personnel comprised 21 percent of the sample, while finance directors and staff comprised 19 percent of the sample.

In terms of customer service, again payroll staff, as well as finance people rated these attributes differently than those in human resources or benefits departments. Customer service attributes are the added-value at you should expect from providers, either those you currently have or might add or change to. Customer service differentiates one provider from another, and in today's world, it is clearly within your purview to expect and receive a level of customer service that is according to the standards that are mutually agreed to with your providers. That could mean that, for example, a provider's response time to inquiries should be anywhere from "now" to 24 or 48 hours, depending on the type of inquiry. Customer service standards would, of course, vary depending on the role that your providers play in record keeping, administrative support and so on, but I suggest to you that specific standards for customer service should be set—and monitored for adherence.

*Customer service differentiates one provider from another, and in today's world, it is clearly within your purview to expect and receive a level of customer service that is according to the standards that are mutually agreed to with your providers.*

Image frequently has a great deal to do with how decisions get made. These image attributes were voiced within all job functions as important, although to a lesser extent than attributes for plan administration or customer service. We found that a "high rating by financial experts" helped people feel that the paternalistic responsibilities of the school to its employees were being satisfied, in part, through this "blessing" by credible sources.

Regarding attributes associated with investments and products, clearly the provider's record of investment performance is important. Overall, to people in human resources, it was more important than any other of the 21 attributes. Providing flexible plans and a range of investment products was important, but *not* as important as these other attributes.

Now, just to give some flavor to these rankings, let me share with you what a few people in these job functions said regarding various criteria for selecting investment providers.

We heard from an assistant vice president for human resources who had mixed emotions about performance and what standards should be set. We found last year that almost half of the schools were moving towards or had some expectations for specific investment performance as criteria for providers to meet. Last year, people with expectations believed that fixed-income investments in retirement plans should be higher than the T-Bill rate, and on average, they believed it should be 2.68 percent higher. For equities, they said it should be, on average, 3.08 percent higher than the S&P 500. We found this year that expectations were even higher.

We heard from a benefits officer regarding the need for providers to understand how their school operated, and that it was important to know the culture and personality of his school. He said, "All of our vendors have to fit like hand in glove." But he wasn't sure how to measure that "hand in glove" feeling. It seemed to come down to the elusive characteristic, of "likability"—if I like you I'll do business with you. However, this only goes so far if decisions are made by Boards of Trustees and committees using quantitative standards.

It's very clear that decision-makers want information for their schools, from all providers—and part of this is because they are receiving it now. But we heard about how important it was for providers to give "manageable information" that helps the school understand the interests of its employees—again added-value that you should expect from your providers and that you should inquire about during the evaluation process.

*"Flexibility" is the operative word here because as more employees become aware of the choices that are available elsewhere, to some extent, ,n the future, having choices may become a hiring advantage in a marketplace where there are limited human resources for certain educational specialties.*

Choices and the flexibility to choose are important. "Flexibility" is the operative word here because as more employees become aware of the choices that are available elsewhere, to some extent, in the future, having choices may become a hiring advantage in a marketplace where there are limited human resources for certain educational specialties.

And clearly, the person "in the trenches," who handles the day-to-day activities for enrolled employees, wants to minimize the aggravation associated with problems. It may be that you are already consulting with and including people from the payroll function in your decision-making process. However, we believe that these "gatekeepers" are a valuable resource for contributing to the decision-making process, and they may not be included in this process to the extent that they should be, given their direct contact with providers and enrolled employees.

And just to round out this discussion, let me share with you some comments from enrolled employees that we obtained during the development phase of this research study.

Employees are interested in what is going on concerning their retirement plans—more so this year than last, as information has bubbled up through various on-campus newspapers as well as through word-of-mouth.

But they are not sure what to do, and they need and want more information about what changes have occurred with TIAA-CREF and the SEC and what changes are occurring or about to occur at their schools.

Change does not necessarily occur quickly nor easily. Academicians, by nature, study things carefully, are careful in their judgments and assessments, and typically arrive at their conclusions after reviewing information provided by their schools and providers.

Employees want information about their investments and their alternatives, they want to know about the companies they're investing in and they want to learn more about their retirement plans in general. They perceive information as added-value and being showered with what they perceive to be valuable information gives them a warm, fuzzy blanket to wrap themselves in for security. However, due to pressing time constraints stemming from school responsibilities and perhaps outside activities, we believe they set this information aside for reading at a later date. This reinforces the need for schools to provide special on-site meetings and even one-on-one sessions to help employees understand what is being offered as well as the steps that your schools have taken to provide these particular choices to employees.

Well, what does it all mean? Well, these are complex issues that don't necessarily have pat answers. But it does mean that—if you know the choices that are available to your school, match your needs and the needs of your key retirement plan employees to those choices, and identify opportunities for "added-value," you will place your school in a "win-win" position—providing suitable choices for your employees while fulfilling your responsibilities to seek out those suitable choices.

## Top Ten Important Strengths for a Provider*

1. Accurate response to inquiries
2. Timely response to inquiries
3. Record of investment performance
4. Record keeping ability
5. 800 telephone number
6. Ease of in-house administration
7. High rating by financial experts
8. Understands the school
9. Fees for services provided
10. Informative brochures

**The 1990 Market Survey of Schools That Participate in TIAA-CREF* by Marketing Matrix, Inc., reports the top ranking attributes that decision-makers seek from investment providers as: accurate response to inquiries, record-keeping ability, responsiveness to inquiries and a favorable record of investment performance.

# [illegible] OF THE 1990

By John C. Bogle
*Chairman and Chief Executive Officer*
The Vanguard Group of Investment Companies

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# V. A VISION OF THE 1990s

A challenge it surely is to present "a vision of the 1990s" in a month as ominous to the financial markets as October, on a date only two days removed from the third anniversary of the Great Crash of 1987. On October 19 of that year, the Dow Jones Industrial Average dropped a staggering 508 points in a single day, an incredible loss of −22.5 percent almost overnight. Before that day came to its merciful close, the total market value of U.S. equities had dropped from about $2.8 trillion to $2.3 trillion—an eradication of $500 billion of market value.

Standing by itself, that Great Crash *might* not have been enough to give October its odious reputation in the markets. But there is more: the Great Crash of 1929 began on October 16 and culminated on October 29, known ever since as "Black Tuesday," a sickening decline of −35 percent. (It was, of course, to get much worse, beginning in July 1930.) Another crash, the downward leg of the virulent 1973–74 decline, began on October 29, and before it was over, one year later, the Dow Jones Industrial Average had dipped by −37 percent.

Time precludes my describing still other dark Octobers when the stock market turned downward, but there were many. While the bond market is rarely subject to major crashes, it was to begin the sharpest and deepest decline in its history when the Federal Reserve Open Market Committee moved to a new policy of freely floating interest rates on, yes, October 6, 1979. (This *must* be pure coincidence!) The yield on the long-term U.S. Treasury bond was to rise from 9.1 percent to 15.2 percent over the ensuing two years, with a total price decline of −41 percent at the bottom—on October 19, 1981.

Well, my purpose is not to write about extraordinary, unpopular Octobers, the madness of markets, or the delusions of crowds. Rather, the objective is to present my visions of retirement plan investing for the 1990s. And so I have begun with these dramatic examples of risk in the financial markets. For in my view, intelligent investing begins with the consideration of risk—the risk that an investor's hard-earned capital is lost, or depleted so greatly that it cannot sustain the income on which virtually all investors will come to rely in their retirement years.

Risk can be abrupt and spasmodic where the stock market is involved. It is usually both—and not only in October. Mark Twain had it right when he said: "October. This is one of the particularly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August and February." In the bond market, such spasms are much less common, with the major risk being "locking in" low-interest rates when higher rates—unbeknownst to mere mortals—are in prospect. In the money market, risk is far more subtle. It is, of course, the gradual erosion of returns in the battle between short-term interest rates and inflation.

If the short-term risk of lost purchasing power appears small, it nonetheless is sufficient to substantially obliterate the entire return on cash reserves over time. For example, during the past 60 years, the average annual return on U.S. Treasury bills was +3.6 percent of which an impressive but debilitating −3.4 percent was consumed by inflation. Net annual return: +0.2 percent, a rate at which your investment doubles every 347 years. Just for the record, at a +6 percent real return, money doubles in 12 years.

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So, *how* you invest for retirement involves different kinds of risks. But whatever kind of investment risk we are prepared to accept—short term, long term, and everything in between—decide we must on how to accumulate assets for retirement. October 1990 is a challenging time to consider this issue. Fear, it seems to me, has driven hope from the driver's seat of investing. I speak not only of the fear of war in the Persian Gulf; indeed, that may prove to be the least of our worries. Whatever—and whenever—the outcome of Saddam Hussein's threat to peace, he has almost single-handedly produced a domino effect on worldwide economic activity, sending oil prices into a quantum leap, driving interest rates upward, and raising the prospects for recession, if not something even worse.

Nonetheless, I believe that the greater fear affecting U.S. securities markets today is the accumulation of America's domestic problems: a heavy overload of Federal government debt, the increasing share of corporate income claimed by interest payments, the precipitous crash in the junk bond market, and declining earnings for our business enterprises. The 1990 Federal budget deficit—estimated, believe it or not, by the Office of Management and Budget, to be $65 billion when the year began—is now expected to be $250 billion, and the administration and the Congress have yet to agree on any combination of increased revenues and reduced expenditures to alleviate the deficit in 1991 and beyond. Indeed, there is a good argument that we have lost the ability to govern ourselves. If so, that would scarcely be grounds for bullishness.

Having said that, I should observe that out of such fears is market opportunity created. It is, as they say, always darkest before the dawn. If the 1980s could be described as a period of greed, then the patterns of the past would suggest it is entirely normal to be followed by a period of fear, which, after a time, will be followed by a rebirth of hope. Just when that time will be, no one knows, but surely the cycle of greed, fear and hope has been repeated over and over again throughout the long history of financial markets.

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That the 1990s is beginning on a somber note could hardly be a surprise to Vanguard Fund shareholders. A year ago, in all of our 1989 Annual Reports, we cautioned our investors not to expect a repeat of "the Golden Decade" of the 1980s in the decade then beginning. In our folder, "Some Plain Talk about Investing in the 1990s," we suggested that an evenly balanced investment program—one-third stocks, one-third bonds, one third reserves—might produce a nominal (pre-inflation) annual rate of return of +8½ percent, compared with +13 percent in the 1980s—the best decade in our nation's financial history—and with +5¼ percent over the prior 50 years. (Believe it or not, only +2 ¼ percent in real terms, after adjustment for inflation.)

In the face of these challenges, how should you encourage your colleagues to plan for their retirment years? Indeed, since each of you are investing for retirement, how should *you* plan? First, save you must. Despite the risks I have described, investors cannot simply throw up their hands in surrender, spend every penny they earn, and hope that the Federal government will provide adequate retirement income. While investors have been burnt in the past—and will be again—we should keep in mind another warning from Mark Twain: ". . . the cat that sits down on a hot stove lid will never sit down on a hot stove lid again—but also she will never sit down on a cold one anymore either." Do not make that mistake, for you cannot afford the risk of *not* participating in our financial markets.

Second, a balanced investment program is essential. While risk must be borne, risk can be minimized. The best way to deal with the various long-term, intermediate-term, and short-term risks I have described is to balance them. At what balance? A simple, if expedient, starting point would be equal thirds of stocks, bonds, and reserves. For younger or more aggressive investors, the mix might comprise 75 percent-15 percent-10 percent respectively. By contrast, for more risk-averse investors or those approaching retirement, a respective 25 percent-50 percent-25 percent mix might be appropriate. (You should know that I am a believer that this reduction in stocks should be made gradually and certainly *not* on a "market timing" —i.e. market speculation—basis.)

I should underscore my deep-seated conviction that balanced programs are essential encompasses not only "balanced" but "programs." By programs, I mean broadly diversified portfolios in each of the three components. Equity diversification—in 50 or 100 or even 500 individual issues—is almost too essential and too well-accepted to belabor here. But let us not forget that the risk-reducing attributes of diversification in bonds and in money market instruments can, in essence, be achieved without any sacrifice whatsoever in yield.

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Third—and while this may seem obvious, it surely cannot be ignored—take advantage of every possible opportunity to invest in qualified retirement plans, with every penny you can muster. In the best of these plans, pre-tax dollars are invested, and return accumulates on a tax-deferred basis. Your 403(b) plan is a classic example of these two mammoth advantages, and the value of accumulating capital for retirement through a qualified plan is, well, staggering.

Consider, for example, an investor who has $4,000 per year to invest over a 25-year period. In a direct, non-tax-advantaged account, earning an +8½ percent compound return and assuming a 25 percent marginal tax bracket, the terminal value would be $188,975. In a qualified 403(b) plan, the terminal value would be $356,442—nearly *double* the accumulation. (To be sure, withdrawals from the qualified plan are ultimately taxable, but given the complexity of the Internal Revenue Code, and the variety of options available at retirement or later, I have not attempted to quantify the impact of taxes in this example.) I believe that the tax structure accorded to qualified plans—investing pre-tax dollars, and accumulating returns that are tax-deferred—is the biggest single benefit presently available to investors.

Fourth, pay attention to cost. The range of costs incurred in the ownership of balanced and diversified investment programs is extremely wide. The average equity mutual fund carries an annual cost of 2.0 percent per year—and for the highest cost decile, the cost averages 3.2 percent. (Costs include fund expense ratios plus any sales charges, amortized over five years.) For bond funds, the annual expenses are only slightly lower, averaging 1.9 percent; money market fund expenses average about 0.7 percent.

These differences may appear trivial; however, they are anything but trivial. Other factors being equal, low cost increases return in a dimension that adds enormously to capital accumulation over time. Recall my earlier example in which the investor in a qualified plan, earning an +8½ percent return accumulated $356,442. If, however, the return had been +10 percent, the accumulation would have been $459,913—a $103,000 increase in return that *may* be achieved without the assumption of even an extra scintilla of risk. How to get the additional 1½ percent? Simply by utilizing a program whose annual cost is, not 2 percent, but ½ percent. In fairness, however, choose the low cost option only when the cost differential is meaningful, and do *not* choose it if you have reason to believe the higher costs will insure higher returns. (The record is bereft of evidence that would support this point.)

Those, then, are the essential four ingredients of my vision for successful investing in the 1990s: (1) Save you must; (2) Invest all you can in a tax-deferred account; (3) Maintain a balanced and diversified investment program; (4) Pay the lowest reasonable cost. This four-point list of essentials may sound as if I am endorsing TIAA-CREF, and to a material degree, I am doing exactly that. In particular, I have followed CREF's performance with care over the years, and I believe that this high grade, market-indexoriented, low cost equity fund has served the educational community well. Surely the success of TIAA-CREF has surpassed even what Andrew Carnegie might have hoped for when he funded the initial TIAA program in 1905.

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Nonetheless, early in the 1980s, it became apparent that more investment options were necessary to meet the needs of the academic community, and in 1984 TIAA-CREF properly — if belatedly — responded with a series of recommendations to expand the number of investment options to include internally managed money market and bond funds. At the same time, however, the TIAA-CREF Ad Hoc Committee Report took the position that CREF itself provided the "appropriate policy base" for investing in equities, and in essence, that the participation of "free riders" from outside the TIAA-CREF system (including mutual funds) should be minimized; i.e. that CREF's substantive monopoly should be continued.

In any event, the new CREF funds were formed, only to be met by a hue and cry from regulators and from mutual fund industry participants. CREF, they said, was itself a mutual fund, and should be regulated as such. This battle might still be going on today if the events of October 19, 1987 had not transpired. But the perceived need for a CREF money market fund clearly reached giant proportions after the Great Crash, with many participants demanding a haven from stock market storms, with the correlative ability to hoist sails again when the weather turns fair.

(My own view, however, is that few participants indeed would have had the foresight to get our of their CREF stock investment *before* the Great Crash. However, in all likelihood they would have had the hindsight to get out right *after* — an unfortunate, counterproductive, and all too typical misadventure in "market timing." Certainly this is what happened at the margin in the mutual fund field, but perhaps educators — especially the professor of economics, finance, statistics and business — would have got the timing right: out of stocks in July and August, back in immediately after the Crash. Personally, with all due respect, I am skeptical of this hypothesis.)

But, for whatever reason, the time for action had come, and CREF finally got its long-awaited money market fund. As a *quid pro quo,* CREF agreed both to be subjected to regulation by the Securities and Exchange Commission as an investment company, and to allow mutual funds to make a full-bore entry into the educational retirement plan market, at the same time allowing existing plans to transfer from CREF into the new funds. This event formally took place on March 1, 1990, a date now almost forgotten, and hardly one that will "live in infamy," despite strong feelings on both sides. In the brief period since then, proportions of plan assets that could be fairly described as "modest to a fault" have moved from CREF into competitive "regular" mutual funds.

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Capital flows — large or small — are not the point however. The point is that an organization has relinquished its monopoly, opening the field of retirement plan investing to free — if still somewhat fettered — competition. In short, we have come a long way since Henry Ford declared, "you can have any color car you want, just so long as it is black." The members of the educational community have, in effect, demanded other colors and other models, and they shall now be served, both by an expanded list of CREF mutual funds, and by the entry of independent mutual fund organizations, with, in the aggregate, an extraordinary range of investment options.

The world of investment management is rapidly changing. New techniques for investing are developing apace, including quantitative programs, driven by computers; futures and other derivative instruments; and an ever-expanding range of investment choices.

There were 365 equity mutual funds a decade ago; today there are 1,043. Not all of them are desirable, not even all sensible, but educational institutions and educators should have the right to make their own choices—even their own mistakes—just as do other investors.

So, let the competition begin! Let it begin with the first three essentials I mentioned: save you must; when you can, save through qualified plans; and when you do, use investment programs that are both balanced and diversified. As to the fourth point—consider cost in evaluating return—let those who wish to compete with CREF's remarkably low costs respond with price competition. Already one mutual fund complex provides costs as low as — or even lower than — CREF's. (It would be inappropria[illegible] for me to identify this complex here!) And let those who wish to compete with CREF's solid returns—carefully defining any differences in risk—respond with consistently excellent returns. (This is no mean task!)

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We have now come full circle. Beginning with risk and considering return — those twin essentials of responsible investing — I am closing with them. My vision for the 1990s, then, is for a decade that will reward the investors who have "hope," but will disappoint those motivated by "fear" and "greed" alike. My vision for the 1990s also reflects the manifestations of free and unfettered competition in providing a full range of investment choices for the retirement plans of the members of the academic community. Even though we consider these issues in the dangerous month of October, with a mine field, as it were, of hot stove lids before us, there is every reason to begin the job of sensible investing, for comfortable retirement. In my judgment, our hope for realistic returns will indee[illegible]ealized, and the benefits of competition will be made manifest. If I am right, it will [illegible]rilling and productive decade for us all.

# SOME COMMENTS ON INVESTING WITH EMPHASIS ON EQUITIES

By David M. Blitzer
*Vice President & Chief Economist*
Standard & Poor's Corporation

To start, I will make a few remarks about what Standard & Poor's does, to give you some idea of my angle or position in the game. Then we will get into the main issues: investing and recessions; the attraction of stocks; risks in stocks; some comments about balancing portfolios; and, some thoughts on two specific issues — market timing and index funds. At the end, a warning about how investors — on and off the Street — often fight the last war.

## Standard & Poor's

S&P likes to think of itself as the information source in the financial sector of the economy. We don't manage money, underwrite bonds or sell stocks. We do sell information about almost any financial investment. We've been doing it since 1860 — one of our predecessors was Henry Varnum Poor who started here in Boston with a handbook of railroad bonds in 1860. Then there were virtually no stocks as we know them now. In about 1923 we began to publish ratings on bonds, describing their credit risk by letter grades not too different from those given in some college classes. Not too long after bond ratings appeared, we also began compiling a stock index which evolved into the S&P 500. While many newspapers and individuals follow the Dow Jones Industrials, ours is more widely used by professionals. In 1941, S&P was formed when Standard Statistics merged with Poor's Publishing. Our principal business today is selling financial information — bond ratings, stock recommedations and more data in almost any form than almost anyone would want. TIAA-CREF is a client, as are most of the people who have written for this publication.

But so much for my biases, let's look at investing. If what follows seems like common sense, you're in good shape as long as you aren't too unlucky.

## Investing and Recessions

The economy looks pretty glum these days. If I tell someone that my economic forecast is not absolute total gloom, doom and recession, and that I don't think the world is about to end if oil hits $45 per barrel, I'm likely to be marked as some kind of nut who thinks the world won't end with $45 oil. Likewise, if I tell someone to keep some money in the stock market — which is down sharply from its July peak — I am clearly nuts.

Recessions and expansions are all part of the game. If you can predict recessions perfectly, they can be played for great advantage. If you can't predict recessions that well, you should probably play through them. Don't ignore the next recession, but don't be paralyzed by it either. S&P's current position on stocks is bearish for the next six to 12 months. But we think there will come a time, not too far from now, when today's price of the Dow at near 2375 and the S&P at 295 will look awfully cheap.

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Over the course of a business cycle, just about everything in the economy fluctuates. Stock prices fluctuate more than many other things. If you can find a lot of reasons to buy a stock when its price has been climbing for a year or two and reaching new highs for several months, it shouldn't be hard to find some reason to buy it when it's cheap.

My own feeling is that an investor should have a minimum proportion of his holdings in equities at all times. While I would be at that minimum now, the number of 40 or 50 percent or more might not be a bad figure for the present.

## Attractions of Equities

The basic argument for owning stocks as well as bonds is that stocks do better. If you're retiring this year at the age of 65, you were born in 1925. Suppose that when you were born, some wealthy relative had invested $1,000 in the stock market and instructed you leave it untouched until you retired at 65. That investment would be worth over $500,000 today, having earned more than 10 percent per year since then—for 65 years. Not bad. U.S. Treasury bonds would have earned about 4.9 percent per year, corporate bonds 5.2 percent per year. To be fair, let me add that I am excluding taxes and I'm skipping inflation. Stocks pay more. As impressive as these numbers sound, some of you may be thinking that the good results are merely a gift of the 1980s. True, the 1980s were a good decade for equities. But the 1950s were better. Moreover, stocks beat bonds or other securities before the 1980s as well.

Although I don't want to belabor the arguments for looking at stocks, the argument seems to require some emphasis. About a year ago, the people who manage our own pension and 401(k) funds at S&P made a presentation to senior employees. They reported that less than 25 percent of the self-directed funds were invested in equities. The pension managers acknowledged that, given the numbers I have just mentioned, it seemed low. In fact, given that we have a defined-benefit pension plan behind the 401(k), it is very low. The real surprise was that our employees were unusual—in most companies, the percentage of 401(k) funds in stocks is much lower. Stocks seem to have a bad reputation.

## Risks in Equities

Of course, owning stocks isn't without risk. We all remember October 19, 1987, when the market took a little step backward and gave up over one-fifth of its value in a day. Or there was October 13, 1989 when the collapse of the UAL buyout sent stocks down 7 percent in one afternoon. And there is the Fall of 1990 and oil.

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The risks in holding stocks are greater than the risk in holding bonds. Let me be a bit more precise. If we use the historic data from the last 64 years, the expected return to holding stocks is greater than the return to holding bonds. The standard deviation of the return is greater for stocks than for bonds. No one is assured that the return to stocks will always be greater than the return to bonds. As the 1981–1982 recession was ending and Wall Street was watching with awe as the stock market surged from August, 1982, a number of investors were quietly holding 30-year U.S. Treasury bonds with 14-percent coupons (yes, *14 percent*) that substantially outperformed stocks for several months running.

More to the point, a series of plausible assumptions about the dynamics stock and bond returns and the relation between the two suggests that there is a 33 percent chance that after 10 years it is bonds, not stocks, that will be ahead. This reflects the greater volatility in stocks than in bonds. However, while the stocks' volatility is stable, bonds' volatility has risen in the last two decades.

## Balancing Portfolios

One way to deal with the risk is to hold a mix of stocks and bonds. While similar arguments can be applied to adding real estate or gold or various other assets to a portfolio, I am going to concentrate on stocks and bonds. On philosophical grounds, I tend to avoid gold and I don't claim any special knowledge of the risks and returns in real estate.

Because of the risk and return properties of stocks and bonds, most pension funds and similar investment programs hold both. The balance between the two is probably the most difficult and the most important issue in running a pension fund. One common simple suggestion for individuals is to let the percentage of fixed income assets in your portfolio equal your age. This is a good rule of thumb. But a pension fund has no "age." However, it does have expected patterns of contributions and payments to retirees in the future. The timing of these should be considered in developing a stock-bond mix. Generally, the longer the time horizon, the larger the stock portion can be.

## Market Timing

Discussions of how much to hold in stocks leads to talk of market timing. Market timing is the idea that you can predict the stock market well enough to be in stocks when they rise and in bonds when stocks fall. If your timing is perfect, the rewards would be impressive. The alternative is to choose a stock-bond proportion and stick with it through thick and thin. Market timing can work in theory. But it is very difficult in practice. If you miss, you may end up doing a lot worse than the simple approach of keeping to an established balance. You could be in the wrong place at the wrong time.

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A mistaken timer who got out of stocks in late 1986 would have missed an incredible year in 1987—a year when stocks rose more in the first eight months than in most years and a year that actually ended on the upside. Moreover, a timer who got out of the 1987 market in the first half of the year but failed to get back in after the crash would have had dismal results since then.

For pension funds managing other people's money it is difficult to buy stocks and bonds without watching the market. Some attempt at timing may be inevitable; but for most of us, the less the better. The majority of studies—both Wall Street and academic—confirm this.

Since stocks and bonds don't move in lock step, the balance of stocks and bonds changes because of the market. If one starts with a 50–50 mix of stocks and bonds and stocks return 20 percent and bonds return 5 percent, we have a 53–47 mix in favor of stocks. If this continues, we will lose the original mix. In investing jargon, the fund should be rebalanced.

Selling stocks because they've gone up may seem to be cutting profits. But it usually makes sense. First, if the balance between stocks and bonds is the right balance, then one shouldn't move too far from it. Second, there is some evidence of what the specialists call "mean reversion." Simply put, good years tend to be followed by bad years, and vice versa. So, periodic rebalancing provides a discipline that can either lock in the gains or position the portfolio for the next market move.

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Yes, this is a mechanical form of market timing. Maybe its greatest attribute is that it avoids emotion and ego—you don't claim to know what will happen next.

## Index Funds

So much for the arguments to hold stocks. What stocks? I'm going to argue for holding at least part of the stocks in index funds. An index fund—which you probably heard about earlier today—mimics the stock holdings of a broad stock index. The S&P 500 is often used for index funds. We do not choose them for investment performance. We have two general concerns for adding stocks: First, we would like the index to reflect the mix of stocks in the U.S. markets. Second, changes in the index should not disrupt the market. We see the index as descriptive, not proscriptive.

In most years less than half of the fund managers beat the index, and last quarter was even worse. Second, most pension managers are risk averse — they are playing with other people's money. True, someone may think that this is the year for oil service stocks, or high-tech, or low-tech or defensive soap stocks or anything else. A good approach may be to put a chunk of the funds into an index fund and then use a few managers to pursue those special ideas. If they come in, the funds have done well. If not, the overall equity fund had a risk profile close to the market because of the large portion in the index fund.

## Wall Street and Fighting the Last War

Finally, let me give a quick warning about a disease that seems to afflict Wall Street as much as the military and some other organizations in our society: We often seem to be fighting the last war. In the wake of the 1987 crash, asset allocation — how to get out of stocks before the collapse — was the rage. Now we are hearing more and more about investing with the business cycle just as the economy closes in on recession.

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I suppose one solution is to read advice from some other cycle than the present. Possibly a better way is to remember the two oil crises that preceded the current one. In 1979, as oil prices reached $40 per barrel, forecasts of $50, $60 and $80 were heard. Money poured into oil shale, coal gasification, synthetic fuels (aptly termed sin-fuels) and other schemes. Out in the wilderness, some voice was heard saying that "trees don't grow to the sky." They don't. In 1986 oil sold for $10 per barrel. At the risk of letting you forget all the wise comments you've just heard, I suspect that oil could reach $10 before it reaches $60. It will probably reach $20 before $50. Trees still don't grow to the sky.

## Summary

Let me sum up with a few points:

First, equities are attractive, probably more attractive than you think. Second, despite that, some balance is worthwhile. Maintaining that balance is also important. Rebalancing — and buying stocks in down markets — is good practice. Of course, beware of the miracle workers on Wall Street and don't fight the last war or try to relive the 1980s.

# REVISITING THE COLLEGE TEACHERS RETIREMENT FUND

By Maggie Mahar
*Financial Writer*
Barron's National Business and Financial Weekly

When I was preparing these remarks, I talked to a friend of mine who is a money manager on Wall Street, and I said to him "Imagine $87 billion under your management." He just grinned. He's a fairly young money manager and quite hungry. And then I said to him, "Okay, now imagine investing, trying to invest $87 billion dollars in today's market."

And he winced. The problem, of course, is that in 1990 there doesn't seem to be any surefire place to put a few billion dollars. Both the stock and the bond markets are in decline both here and abroad. As for real estate, if you own your own home almost anyplace in the country, you know what is happening with real estate. 1990, very simply, is a tough time to be rich and to have to figure out what to do with the money.

Well, I didn't pick $87 billion dollars out of the air. $87 billion happens to be roughly the amount of money that TIAA-CREF has under management: invested in equities, bonds, mortgages and real estate. What I'm talking about today is the dilemma that TIAA-CREF faces trying to invest all of that $87 billion and some questions that you might want to ask of TIAA-CREF when trying to find the safest, most prudent place to put your retirement money.

I don't want to be unduly gloomy about the 1990s, but let me put it this way: In the 1980s, if you had money it was easy to make more. Even a computer could do it and a lot of computers *did* do it, making a lot of money through program trading. In the 1990s, it may be much harder. It looks as if it could be tough to keep your retirement fund ahead of inflation, and that's the key. That's what you have to do. If the house you live in is depreciating, you can still live in it. It's still useful as a structure and as shelter, even if it was worth $200,000 last year and is worth $150,000 this year. As long as you don't have to sell it, you can live in it.

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Your retirement fund is only as useful as it keeps ahead of inflation. Now in 1990, it seems clear to most people that we are at the beginning of a recession. Some pessimists on Wall Street say that we could be heading into a depression. No one, of course, can guess how long a recession will be. But what seems entirely clear is that what's happening now in our economy is unprecedented. First, consider the S & L crisis, the size of it, the fact that it's probably going to take 30 years to pay it off. Now it's becoming clear that it isn't just the savings and loans, it's the banks, some very big banks: banks like the Chase Manhattan, Citicorp. If you read the newspapers you've seen the cracks appearing in those institutions. Many people on Wall Street say big, reputable insurance companies are going to be showing their vulnerability next. Big, reputable insurance companies are heavily invested, in many cases, in both real estate and junk bonds. The world will not come to an end, but the fabric of the economy is unravelling in some fairly crucial places and no one knows who will put Humpty Dumpty back together again or when or how or at what cost to whom.

In other words, we're entering a period in our financial history that's uncharted waters. It's a time when anyone who has money in a retirement fund, or anyone who is responsible for advising others in investing in retirement funds is likely to be asking a lot of questions.

In the 1980s, you didn't ask questions; you just said yes, and whatever you said yes to, it was likely to work out—stocks, bonds, real estate. The 1980s was an age of financial enthusiasm. Some call it the decade of greed. Let's be kinder and say it was an age of financial enthusiasm. If so, I think the 1990s is likely to be quite properly an age of financial skepticism, a time when people are going to be quite properly asking many, many questions.

Today, I'm going to suggest some of the questions that you might want to ask if you're putting money into TIAA-CREF—or considering the alternatives to TIAA-CREF. As I mentioned, TIAA-CREF is managing $87 billion. That makes it, quite simply, the world's largest pension fund. And that makes the task of managing money particularly difficult in a treacherous market. TIAA-CREF is like a big ship. It's hard to turn a big ship quickly if a market starts to slide. As a result, TIAA-CREF has, quite understandably, traditionally followed an investment policy of investing for the long-term. They buy something and they hold it until it matures, rather than trying to move in and out of a market as it goes up and down. And that strategy of investing for the long-term—buying and holding—has worked very well when markets are going up. It certainly worked very well in the 1980s.

*Today, I'm going to suggest some of the questions that you might want to ask if you're putting money into TIAA-CREF—or considering the alternatives to TIAA-CREF.*

But what if a market starts to decline? Real estate has been in a long bull market. It had gotten to the point when people felt that buying a house wasn't just buying a place to live, it was buying an investment that you could count on to appreciate year after year. Many readers remember a time, let's say in the 1950s, when you might buy a house for $13,000 and sell it sometime later for $11,000. A house, like a car, depreciated; it didn't necessarily appreciate. Now, if you think the bull market in real estate is over, then we are back to a time when real estate will cease to appreciate, where it may stay flat, which means you lose money to inflation and it depreciates. If that's the case, then the strategy which TIAA has followed in the past—buying real estate and holding it long-term—probably won't work out as well in the future.

I decided that I wanted to ask TIAA-CREF if they plan to stick with that long-term strategy that worked so very well in the 1980s. After all, about half of TIAA's $47 billion is in mortgages and real estate. Some big office buildings in TIAA's portfolio have already begun to default on loans. The other half of TIAA's $47 billion is mainly in bonds, some of it, junk bonds. You may want to ask what they plan to do with them.

As for the $36 billion dollars in CREF, that's largely invested in stocks, and most of it is indexed in the stock market. Sixty percent is indexed to the S&P. This means that the bulk of CREF tends to do about as well as the S&P. This year, since January of 1990, the S&P has dropped 11 percent. Since January of 1990, the value of CREF's funds has dropped 13 percent. So, I wonder, do they plan to stick with their strategy of indexing 60 percent of their money to the S&P index and another 10 percent to another market index? Do they plan to continue buying real estate and holding it?

These were some of the questions that *Barron's*, that's the magazine that I work for, wanted to ask TIAA-CREF and we called up and asked for an interview about a month ago. We had interviewed TIAA-CREF about three years ago, in August of 1987, but since then, we knew that TIAA-CREF had undergone some substantial reforms, the reforms you heard about earlier this morning. At the same time, we knew they were facing major new competition, some of the competition you've been hearing about from the other commentators.

So we wanted to know, in the face of the competition, given the reforms, given what is unquestionably a difficult financial environment, what were their plans? Did they plan to change the strategy or stick with it? We asked for an interview and about a week later we got a reply. "We deeply regret, we sincerely regret, but after how they fared the last time that you interviewed them, none of the men are willing to talk to you." So, we didn't talk to TIAA-CREF. Now it is true that the last time we talked to them, we did ask a lot of questions and we found out that TIAA-CREF didn't much like a lot of the questions, probably because they were not used to a lot of questions.

*If you're a monopoly—and TIAA-CREF has had a monopoly of college and university pension funds virtually since 1918—you get used to doing things a certain way, without having to answer a lot of questions.*

If you're a monopoly—and TIAA-CREF has had a monopoly of college and university pension funds virtually since 1918—you get used to doing things a certain way, without having to answer a lot of questions. Competition raises questions. When you have competitors they do things a different way and then people say, well hey, they serve pistachio, why don't you serve pistachio and then you have to have a reason why you don't. Without competition, you don't have the same number of questions being raised.

What TIAA-CREF's competitors offer, for instance, is the option to bail out of the stock market — or the bond market — and to transfer money from one retirement fund into another. They do so because they are regulated by the SEC and, under the Investment Act of 1940, they have to let you transfer your retirement money from one fund to another. TIAA-CREF wasn't regulated by the SEC in 1987 when we first talked to them. TIAA still isn't regulated by the SEC, only CREF is. When we wrote about TIAA-CREF in 1987, one of the questions we asked is "Why don't you let people transfer money from one fund to another?" We also asked "Why don't you disclose the market value of the real estate and bonds in TIAA's $47 billion portfolio?"

Today, by the way, TIAA still doesn't disclose the market value of the real estate and bonds in its $47 billion portfolio. And while you can now transfer money out of CREF since it's regulated by the SEC, you still can't transfer money out of TIAA. Sometime next year we're told TIAA will begin to let you transfer money out 1/10 at a time over a 10-year period. But on day one you must tell them exactly how much you plan to take out over the 10 years.

In other words, TIAA makes it very, very difficult to do the kind of rebalancing of your portfolio that David Blitzer and other people have been writing about here. If you can only take out a tenth at a time over a 10-year period, you have to predict what's going to be going on eight years from now.

But, we didn't have a chance to ask TIAA-CREF questions about transfers. It seems TIAA-CREF hadn't changed as much as we thought: They still objected to questions. Now, of course, that only made me more interested in the questions, so I sat down, and with the help of some Wall Street experts who specialize in bonds, equities and real estate, we took a close look at the TIAA-CREF portfolios. And I came up with a list of questions that participants in TIAA-CREF might well want to ask when investing their money.

Let's start with CREF. That's the $36-billion portfolio invested in the stock market. Since 1981, CREF has been using one particular strategy that you've been hearing about today: "indexing." If you're "indexing" your investments, that simply means that you set up a computer program to mirror the make-up of either the S&P 500 stock index or to mirror some other familiar yardstick of the market. Then, you sit back and you let your computer invest your money according to the program so that your rate of return will pretty nearly match that of the market or the index that you're using. Some people call it robot investing, the computer does the work and you're guaranteed not to do too much worse or too much better than the market as a whole or the broad index you're using.

When the market is going up, it's a swell system. CREF started using it in 1981 and in the 1980s the S&P went up nine years in a row. The problem is, no one I know on Wall Street expects the S&P to go up nine years in a row in 1990. It's never happened before in financial history and the 'Nineties doesn't look like it's shaping up to be the decade when it's going to happen again. In fact, as I mentioned earlier, since the beginning of the decade—since January of 1990—the S&P has lost 11 percent and CREF has lost over 13 percent, partially because 60 percent of CREF is indexed in the S&P.

Nevertheless, CREF continues to be 70 percent indexed, 60 percent to the S&P, 10 percent to something else, and that's a high percentage of indexing when compared to other big pension funds. For instance, if you look at New York State's common retirement fund, they have about $45 billion under management, of which $16 billion – or roughly one third – is indexed in the S&P 500.

To understand why CREF indexes so much, I went to a fellow named George Keane. I went to him because he knows something about the subject, in small part because he worked at TIAA-CREF from 1958–1968. He was an advisor to participating colleges. But more important, Keane is in a similar business. He runs something called The Common Fund, which manages colleges and university endowment money. In fact, it's the biggest pool of endowment money in the country – Keane manages about $10 billion.

So, Keane knows how hard it is to manage a large pool of money that you're not supposed to lose. After all, he's managing college trust fund money. You don't gamble with it.

I asked Keane why CREF began indexing so heavily. He explained that CREF began indexing in 1981 because before that, in the 1960s and the 1970s, CREF was having a hard time hand-picking stocks and staying ahead of the market. CREF just wasn't doing better than the market average.

Now this was not necessarily because the people at CREF were bad at picking stocks. The problem was they had so much money. If you're a monopoly and you keep taking it in and taking it in, the fund grows and grows and grows. CREF became huge. The result was that when CREF picked a stock and began buying it, CREF created demand for that stock and drove the price up *while CREF was buying it.* If you are CREF and you're buying a stock, you're not buying 10 shares, you're buying a huge block. It takes time to find sellers for that huge block. And during the time that you're buying, you're creating an incredible demand on the market. When demand increases, prices go up.

Similarly, when CREF tried to unload a stock, while they were selling it, they were driving the price *down* of the very stock they were trying to sell. This is what I meant earlier when I talked about TIAA-CREF being a big ship that is hard to turn in a changing market. It's very hard to turn it without making waves that splash all over you. So, rather than trying to pick stocks and watch the prices go up the moment you begin to buy the stock, TIAA-CREF decided to begin indexing in 1981.

*In the 1980s, CREF did very, very well indexing.*

In the 1980s, CREF did very, very well indexing. The S&P went up. CREF went up. CREF even beat the S&P five years out of 10 in the 1980s. To be fair, many money managers did very well in the 1980s. I checked with a group called SEI which tracks many, many mutual funds and they looked at their database of 5,500 funds and told me that from the years 1981–1989 CREF beat the median of those 5,500 funds five years; the other four years CREF didn't do as well as the median.

But in any case, there was no reason to complain about CREF's performance in the 1980s. With 70 percent of its money indexed, CREF couldn't help but do well – it was tied to a bull market. And of the other 30 percent of CREF's money, almost half, a little over 13 percent – was invested abroad, a good portion of that in Japan and the Pacific Rim, and that was working out very well too.

Today, of course, it looks like the Pacific Rim is no longer such a surefire investment opportunity as it once was. Even if you're not an investor, you probably know that bad things have been happening at Pacific Rim markets. What you may not know is that CREF has over 5 percent of its total $36 billion invested in the Pacific Rim, by which I mean Southeast Asia, Japan, Australia.

*So, a question you might want to ask CREF is: "If indexing turns out not to work so well in the 1990s, would you consider using outside managers to manage some of the money the way The Common Fund does?"*

So one question you might want to ask CREF is: Given what's happening, is CREF planning to ship money out of the Pacific Rim, and if so, how quickly? Or does it plan to hold there long-term? Going back to the question of indexing, does CREF plan to keep 70 percent of its fund indexed? Does it plan to stick with the S&P long-term into the 1990s?

Now, you might wonder if, in the case of indexing, CREF really has any choice given how much money they have under management. If CREF began handpicking stocks, wouldn't it run into the old problem of pushing prices up? The answer is "yes." If CREF tried to manage that $36 billion chunk as one block--one monopoly. But, there are other options. For instance, you might want to break up the portfolio by leasing it out to a lot of smaller, outside money managers and let them actively manage small chunks of the $36 billion.

That way, you would have diversity. Each money manager could use a different strategy and you would avoid the problem of being a big ship that has a hard time turning in rough water. In fact, that is exactly what Keane does with his $10-billion Common Fund, the largest pool of college endowment money in the country. Keane takes the money and leases it out to some 30 individual, outside money managers, and lets each of them follow their own strategy. None of the money is indexed. All of it is actively managed. Keane tells me that over the past decade, while CREF did very well, he said, 'We did a little better in all but the last couple of years.' So, it *is* possible to hand-pick stocks and do well; it's not necessarily a foolish idea. In the 1990s, if you think the markets may be going down, it might indeed be greatly preferable to try picking stocks rather than sitting and sinking with the S&P.

But, Keane points out, the way he runs The Common Fund means management "from the bottom up." He lets those entrepreneurial outside money managers each work independently, following his or her own disciplined strategy – much the way college professors work, each pursuing his own discipline, his own theories. By contrast, TIAA-CREF has always been managed from the top down, not from the bottom up. And TIAA-CREF has never used outsiders, as far as I know. So, a question you might want to ask CREF is: "If indexing turns out not to work so well in the 1990s, would you consider using outside managers to manage some of the money the way The Common Fund does?"

Finally you might want to ask CREF if they are worried about the fact that so much money is now indexed. At the beginning of the decade, in 1980, only about $10 billion worth of investment money was indexed nationwide. At the end of the 1980s, something in the vicinity of $300 billion was indexed. The problem is that, as a result, index fund managers are increasing demand for S&P stocks – pushing up the prices of those shares at the same time. Whenever a company is added to the S&P, the price immediately appreciates – maybe 2, maybe 3 percent – and it tends to hold that increase in price.

Now, this leads some people – critics of indexing – to say that because indexing has become so popular, the S&P 500 are now overvalued. Share prices have been pushed up by the very fact of indexing. In other words, in the 1980s indexing created a virtuous circle: Indexing helped to push S&P prices up, which made indexing all the more popular. But in the 1990s, that virtuous circle could become a vicious circle. Imagine what would happen if the S&P index continued to slide for a sustained period of time. All of those index fund managers would rush out of the S&P as rapidly as they rushed in. The effect on prices of the S&P 500 would be predictable and dismal.

So, without knowing what's going to happen, you might want to ask TIAA-CREF: Do they think it is possible that indexing will become less popular in the 1990s? What do they think the effect on prices would be and what is their strategy for handling that contingency?

Now, those are questions to ask the people managing the CREF money—that is, the money that is invested in the stock market. When I looked at TIAA, the fixed income fund that invests in mortgages, real estate and bonds, I had different questions.

Everyone sitting here in Boston knows what has happened with real estate in New England. TIAA has nearly $5 billion dollars invested in mortgages and real estate in New England. Most of it is in office buildings and shopping centers. They have another over $6 billion invested in the West, in four Western states, probably much of it in California. They would not disclose how much is in California. As you know, California is a market that is just beginning to come apart, as the price of real estate plummets and vacancies rise.

All told, TIAA has some $24 billion dollars invested in mortgages and real estate across the country. And there aren't many places in the country—just a handful of cities—where vacancies are low and prices are high. Moreover, TIAA doesn't just hold mortgages on these buildings; often they are involved in what are called "participation agreements." What that means is: when I give you a mortgage and I give you a good rate, in return you give me some participation in the income from that building, assuming there is income. With vacancy rates high, there may not be much—or any—profit to share.

*Moreover, TIAA doesn't just hold mortgages on these buildings; often they are involved in what are called "participation agreements."*

Now, TIAA has refused to disclose what percentage of its mortgages involves participation agreements. At least when *Barron's* asked, they wouldn't tell us. But that might be a question that you want to ask. TIAA also refused to disclose what percentage of its mortgages might be defaulting. I can only give you one example that was recently reported in a trade newspaper called *Pensions & Investments*. It seems that TIAA had lent money to Trammell Crow, a developer, to build five office buildings in suburban Minneapolis. Now the developer is defaulting on the mortgages. It wants to give TIAA four of those office buildings and sell TIAA the fifth office building at a discount. TIAA refused to disclose just how much money they had lent to this developer. What we do know, according to that trade newspaper, is that the buildings are only 70 percent occupied, 30 percent vacant.

That's one example. I don't know if there are any others or how many other examples there might be, of cases where TIAA-CREF has lent to developers who are beginning to default on mortgages. You might want to ask them. But, what I do know is that on Wall Street, many real estate specialists feel that real estate prices will never come back to the highs that they've reached in the past decade. A condo in Boston that, in the 1980s, suddenly became worth $200,000, may never be worth that much again. Over a period of time inflation might push the price back up to that point, but in real terms that $200,000 will never be recovered. That condo was worth that for the one, magic moment when one developer put a price tag on it and managed to persuade one person to buy it or one bank to lend him money in the belief that it was worth that much.

*But, what I do know is that on Wall Street, many real estate specialists feel that real estate prices will never come back to the highs that they've reached in the past decade.*

The reason that prices went so high in the 1980s is something I discussed with a real estate specialist at Salomon Brothers by the name of Michael Giliberto. He explained how in the 1980s, real estate prices were driven up not by demand, but by easy money, by the fact that it was easy to borrow money, and as a result, he said, "the current decline is different from past cycles. In the 1980s, the country was simply overbuilt and supply ceased to have any connection to demand. Developers were building just so that they could borrow more money so they could build more and borrow more money. Supply was investor driven rather than demand driven. The pace of retail sales weakened, yet they kept putting up more shopping centers. And in some cities, after October of 1987, the demand for office space was weakening, yet they kept building more office buildings because the developers could only make money by building and the bankers and S & L people were still happy to lend it to them."

So as a result the country is now overbuilt. You might want to ask TIAA-CREF if they believe that real estate is going to come back to the place where it was at its highs in the 1980s, if they feel it still makes sense to hold such a large portfolio of real estate? Do they plan to continue buying? Finally, you might ask what percentage of loans in their real estate mortgage portfolio might possibly default.

The other half of TIAA's $47 billion portfolio is its bond portfolio. Again, there are similar questions you might wish to ask. What percentage of these loans could default? What percentage of the bonds are junk? Here, I took the portfolio to Craig Davis, the head of research at an outfit called R. D. Smith, a securities firm that specializes in bad debt, bank debt, stress debt and junk bonds. They are one of the biggest specializing in that area. Davis looked at about $12 billion-worth of TIAA's bond portfolio and he said that, just from looking at the names in the portfolio, about 15 percent of it appeared to be junk; of that, about two-thirds of what he called "junk-junk," companies on the verge of default, with bonds 50 to 60 cents on the dollar.

Now, Davis was looking at a list of companies that TIAA invested in and based his estimates on the names of the companies he *knew* were faulty in one way or another. He said that he did not recognize all of the names. TIAA itself has recently said that half its portfolio is direct placements: that is, bonds that are not publicly traded. TIAA revealed that its own internal people rated those loans and rated them on average BBB, BBB+. That's certainly investment-grade, at the same time it's not "AAA".

Without question, TIAA has gotten a higher yield than most insurance companies over the past decade. The question to ask is: Just how much risk are you taking for the high yield and how much risk are you personally willing to take? According to SEI, the company that tracks mutual funds and pension funds, when it looks at its database of 32 public pension funds, it finds that low grade bonds comprise only about 3 percent of the average portfolio, a much smaller percentage than the 15 percent junk Davis estimates in TIAA's portfolio. Davis also points out that, over time, TIAA's strategy with high-yield or junk bonds, as with other bonds, has been to buy them and hold them. According to Davis, "They just sit on the stuff, even if they should sell it."

Now in the 1990s, sitting on junk could become a painful proposition. There are no easy answers here, but this is a final question to ask TIAA-CREF.

# CAMPUS PENSION FUNDS: A COLLEGIAL PERSPECTIVE

By Ernst Benjamin
*General Secretary*
American Association of
University Professors

Pursuant to the new options for campus pension funds, the AAUP has initiated discussions with the Association of American Colleges to revise the joint "Statement of Principles on Academic and Retirement Insurance Plans." The AAUP seeks to accommodate the increasing number of faculty who wish their institutions not only to permit selection among alternative investment and annuity funds, as our policy already permits, but also to permit the option of withdrawing their accumulations in a lump-sum cashout rather than through an annuity sometimes. Accordingly, we proposed to modify the current recommendation regarding pension plans:

5e. *It should be such that the participant may receive the accumulated funds only in the form of an annuity. Exceptions might be made for (i) small portions of the accumulations of retiring participants, or (ii) small accumulations in inactive accounts.*

We would recommend instead:

5e. *It should be such that the participant will receive the accumulated funds preferably in the form of an annuity. The plan may also provide for the withdrawal of part or all of the accumulated funds.*

5f. *Some plans permit participants to transfer their accumulations among alternative funds or investment providers, and some plans permit retiring participants to purchase annuities from among alternative insurers. In such situations, the institution should assure that the providers of the investment services and annuities adhere to the terms of the institutions' overall retirement plan, with particular reference to any individual plan restrictions on transfer of accumulated funds or availability of lump-sum distribution. Institutions should also meet their legal obligation to ensure that annuity providers employ gender-neutral actuarial tables.*

*Indeed, it is market pressure, not the SEC agreement, which led CREF to offer a cashable option.*

In sum, we propose to permit cashability, but continue to favor annuitization. Each institution will have to decide whether and to what extent it wants to accommodate the increasing desire of participants for cashability. Market pressure is likely to drive policy toward cashability. Indeed, it is market pressure, not the SEC agreement, which led CREF to offer a cashable option. Although CREF's own survey showed no strong faculty interest in cashability, CREF believed that in the competitive environment created by transferability, cashable plans would become more attractive. I am not sure that this would have been true if faculty had had to choose between continuing their established CREF plans and adding a new alternative altogether. But, given the growing awareness of the option for a cashable CREF, faculty pressure for its adoption is increasing and many deans support the change to enhance faculty recruitment and retention.

Few faculty express the desire to cash out their own accumulations. Many, however, feel it is a desirable no-cost, "just-in-case" option, especially in the event of a medical emergency or a variety of family circumstances such as providing for disabled dependents. Many also believe that others who wish the option of cash-out should have it. And any effort to urge the dangers of a cash-out option comes wi prompt charges of paternalism and the "it's my money!" response. In view of these increasingly strong feelings, it is important to understand why the AAUP continues to express a preference for annuitization as an institutional, as well as an individual policy.

The possible individual advantages of a cash-out option should be weighed against certain shared costs. I do not refer here to the allegedly paternalistic, though in my view sensible, concern that individuals may be victimized by their own errors. I refer rather to those systemic consequences of cashability that may diminish the common resources and impair the common academic program for which we share collegial responsibility. The problem is that cashability and even unrestricted transferability have shared as well as individual costs and consequences. This will be of crucial significance after January 1, 1994, when mandatory retirement of tenured faculty will be forbidden by federal law. Thereafter, policies heretofore designed merely to enable retirement will have also to *motivate* retirement.

Consider first the problem of pre-retirement accumulations. Even transferability has institutional costs beyond the obvious administrative ones. If transferability is unrestricted, accumulations may be invested in volatile funds that do not provide even a reasonable probability of assuring that an individual will be able to retire at the time the individual and her or his colleagues might otherwise find mutually desirable. Frequency of shifts among funds may have similar consequences. These institutional as well as individual risks are inherent in transferability but can be moderated by restricting the specific funds available. If the options are not so restricted, participants may also transfer to funds that permit borrowing or pre-retirement hardship withdrawals—even for such routine matters as the purchase of a home or tuition expenses. Either of these options, by diminishing the rate of savings or earnings, might diminish the likelihood of timely retirement.

*Even transferability has institutional costs beyond the obvious administrative ones.*

The conflict between individual and collegial interests is especially serious with respect to cash-out by individuals who move from one academic institution into another. We have always permitted cash-out of "small accumulations in inactive accounts." If institutions go beyond this practice to permit faculty who separate from the institution to cash out their accumulations regardless of amount, then the rate of retirement saving will diminish substantially. This will occur because, as empirical studies have established, the vast majority of individuals cash out their retirements savings upon changing jobs.

Institutions have little incentive to enforce restrictions on the accumulations of former staff. But if each institution considers only its immediate interest, then otherwise desirable, mobile faculty may arrive at their final position at age 50 or 60 with no retirement savings. This might compel them to remain long beyond the cessation of their ability to contribute effectively to the academic program in order to build an adequate retirement fund. We have had a portable plan, not only in the sense that retirement savings were vested, but that funds contributed at one institution were carried to the next.

If institutions do not preserve restrictions on the pre-retirement accumulations of their former employees, then we will cease to have such a plan and, since the risk of appointing senior faculty will increase, mobility will decline. The risk of senior appointees outstaying the quality of their performance due to inadequate savings and the consequent risk of decreased academic mobility are significant collective costs of replacing a regulated pension system with a market-based system.

In the case of post-retirement cash-outs, the individual risk is obvious, but the shared cost is easily overlooked. The individual risk results not only from the danger of disinvestment or poorly chosen investment but from a common lack of understanding of annuities and the annuity principle. Many participants compare the earnings on investments with those from annuities without understanding that part of the expense of an annuity is for insurance that no one will outlive it. Those who do dissipate and outlive their savings will probably have no legal claim for institutional assistance, but there may be significant institutional costs in denying the supporting pleas of concerned former students and colleagues. Moreover, although spousal consent will be necessary to cash out retirement savings, spouses of ill or profligate retirees will be confronted with a difficult choice by the institutional permission to give cash out.

Conversely, the collective cost will come from adverse selection precisely by those who do understand the insurance principle and accurately estimate that their particular circumstances favor cash-out. This will increase the cost or cut the benefit of those who continue to annuitize. The best known example of this problem will occur in the case of single men, many of whom will profitably choose not to purchase annuities based on gender-neutral actuarial tables. By this adverse selection, they will diminish the benefits of women and couples. Some might regard this simply as a reallocation of costs among individuals. But it may, in fact, increase the overall cost of retirement programs. This may occur because, following the elimination of mandatory retirement, it will be necessary to induce retirement. In these circumstances, we have no reason to suppose that individuals will lower their expectations for retirement income. On the contrary, we must anticipate that the average prospective annuitant will defer retirement for at least the additional time necessary to achieve the level of benefits expected prior to the costs imposed by adverse selection.

The shared costs of increasing individual retirement options do not necessarily outweigh the advantages of enhancing individual choice. Certainly there is merit in providing some accommodation to individual circumstance in a complex world. I would strongly caution, however, that there is absolutely no reason whatsoever to project an average improvement in financial outcome. The illusion that choice will improve outcome, despite the well known fact that fewer than 20 percent of funds outperform the market, is a disturbing reminder of the individual dangers of choice. Moreover, even if participants do as well on average as they did prior to increasing their options, there is bound to be a greater disparity of outcomes and consequent sense of inequity. Many individuals will pay a high price for errors that may be their own, but would not have occurred absent the decision to afford others the opportunity to speculate more successfully.

Institutions must now decide how to balance the legitimate contending interests of individuals and the community. In my view, institutions faced with the abolition of mandatory retirement should be especially careful regarding pre-retirement accumulations. I think it well to limit the number and type of alternative funds, to discourage or disallow both borrowing from and so-called hardship withdrawals, and especially not to permit cashout of significant accumulations upon separation from employment prior to retirement.

I think institutions should strongly encourage annuitization and try to preserve the equity as well as the security inherent in the annuity principle. There is room, however, in the post-retirement situation for a variety of plausible compromises. These could include, for example, permitting genuine hardship withdrawals on a case-by-case basis, and increasing the generally available lump sum to approximate the accumulation resulting from the participant's (typically one-third to one-half) matching contribution.

Above all, we should recognize that in an era when retirement will be a matter of individual choice, pension programs must be designed not only to permit but to *encourage* timely retirement. We cannot afford to underwrite individual speculation but we must respond adequately to individual needs. It is likely that the academic market will vary greatly between disciplines in the future as it has in the recent past. It is also likely that individual performance by senior faculty will vary significantly. Since retirement, like recruitment, has become a matter of choice, retirement policy, like employment, should combine a sound general policy with an appropriate range of individual options. If the choice among options inheres entirely in the individual, the institutional and collegial costs will be excessive. Academic retirement policy, like academic personnel policy in general, should respect both individual and collegial needs. The new retirement options should be assessed and adapted in accordance with this balance, both of individual needs and collegial responsibilities.

*Above all, we should recognize that in an era when retirement will be a matter of individual choice, pension programs must be designed not only to permit but to* encourage *timely retirement.*

# THE TUFTS EXPERIENCE

By Steven S. Manos
*Executive Vice President and Treasurer*
Tufts University

In talking about Tufts' experience, I would like to start with six assertions:

- faculty and staff lack sufficient wisdom and knowledge to make their own investment decisions,
- faculty and staff are high risk takers,
- desires can be easily shaped to fit pension plans, tax laws, and personal circumstances,
- personal circumstances do not differ from person to person,
- paternalism is a good, and, as a corollary, paternalism will foster harmonious labor relations, and
- colleges and universities should be responsible for the fate of faculty and staff after employment.

By now you will understand that I intend these six statements to be ironic, although there are some who would accept them as fact or at least working hypotheses. Certainly it's fair to say that some version of these assumptions underlay pension planning for colleges and universities for several decades. Indeed, although we at Tufts now treat them as largely antiquated, we arrived at this conclusion by fits and starts and, even yet, with one or two reservations. Let me discuss and challenge each of them.

## Faculty and Staff Can't Make Investment Decisions

The fact is that, even in the confines of TIAA-CREF, faculty and staff have long had the choice of two funds with entirely different investment performance objectives. But in a larger sense, all individuals make investment decisions all the time. To buy or rent, to use a bank account or other "cash" investments, to consume or save for college, to choose an IRA or not and so forth. Why, I ask this rhetorically, should we assume an incapacity to make decisions about pension investments and their use?

## Faculty and Staff are High Risk Takers

The concern expressed in this statement is that pension savings will be dissipated by unwise decisions, but in fact most investors — particularly with their pension assets — are quite conservative.

The Employee Benefit Research Institute reports a survey showing that *70 percent* of Americans would invest their retirement benefits in low-risk, low-return investments if they were to bear the investment risks themselves. In this same survey, 62 percent of the respondents said that "they would prefer to *make their own investment decisions* rather than having their employer do so."

From personal experience, I know that attorneys in the American Bar Retirement Association, although given a wide choice of investment vehicles, strongly prefer the low-risk, fixed-income guarantees. And at Tufts, where we have had considerable freedom of choice in investments for close to half a dozen years, faculty and staff tend strongly to retain their conservative investment philosophy.

In fact, a greater concern may be that faculty and staff are insufficiently great risk-takers. After all, the capital markets reward risk, and life-long caution in investment strategies is likely to be punished.

*After all, the capital markets reward risk, and life-long caution in investment strategies is likely to be punished.*

## Desires Can be Adjusted to Pension Plans, Tax Laws and Personal Circumstances

My only comment on this is that circumstances can be adjusted, but that may not result in optimum outcome for a given individual, a given class of individuals, or an entire group.

## Personal Circumstances Do Not Differ from Person to Person

This is patently false. A well-off individual might desire to buy a yacht at retirement, paying cash. An individual who is dying might desire to take that once-in-a-lifetime, round-the-world trip. An early retiree might desire to invest in a personal business opportunity. If it is argued that these desires might sometimes be unwise, that may be true, but are we in the business of forcing wise decisions? A successful pension plan should, to the extent possible, take into account differences from individual to individual.

## Paternalism is Good and Will Foster Harmonious Labor Relations

Paternalism can be argued to be good in two senses: it protects the employee and it protects the employer.

It would take us down a very long road of philosophy and opinion to tease out all the implications of a statement that paternalism is *not* desirable from the standpoint of an employee. I do want to point out, however, that as a nation and as individual employers we have moved a long way from paternalism as we have developed defined contribution plans, 401(k) plans, flexible benefit plans, and the like.

Employers trust their employees to know what is best for them, even if employees are at risk from their own judgments. And of course, one of the reasons employers do that is that employees feel that self-determination is their right and that, given information, they are capable of exercising it. And if employers do not trust their employees, they frequently pay for it in anger, distrust and recriminations.

*There may be a sophisticated argument for paternalism, but it is one I have not seen made.*

There may be a sophisticated argument for paternalism, but it is one I have not seen made. Some experiments have shown that individuals will take greater risks with others' money than their own. Since the market rewards risk over time, employers may be willing to take greater risks than employees, and employees might benefit from a greater total investment return. Our endowments, even though subject to substantial income constraints, reflect this greater propensity to take risk.

However, no one has shown, I believe, that employers are willing to take the risk and to share the benefits with their employees beyond what a single prudent investor with a life-time investment plan might achieve.

I have not yet spoken to the possibility that paternalism may be good for employers. I will do so as I address the next, and final assertion.

## Universities Are or Should be Responsible for the Fate of Faculty and Staff After Employment

Perhaps not the only concern but certainly the major one is that employees will become the ward of institutions because of poor investment decisions. This fear is usually supported by anecdote: the faculty member who speculates widely and returns to the doorstep in rags.

Aside from the fact that anecdote is a poor basis on which to make policy decisions, looking at control over the management of pension funds is a very narrow view of an institution's responsibility for individuals, if responsibility there is. Do colleges and universities agree to support a minimum lifestyle, protect against all acts of god, protect against unwise purchases, or act as a guarantor for all non-pension investment decisions?

Certainly not, yet those events or decisions may have as significant an impact on an individual's life and finances as decisions about investment of pension assets. The only requirements, I would argue, are a clear understanding of what the institution's obligations are, and the best possible education an institution can provide concerning the results of choices.

Having observed those requirements, will paternalism benefit the college or university? True, the paternalistic institution has moderated -- but only moderated -- the possibility of impecuniousness. If an employee can't invest rashly or spend his or her pension savings in one vainglorious swoop, the institution does not have as great a liability to ensure a minimum level of retirement welfare. But have colleges and universities really contracted to guarantee lifestyles or ensure against adversity?

Each institution must ask that question, and if the answer is yes, ask what the implications of that answer are. At some institutions, and I predict many more will join them, the good of individual responsibility is considered to outweigh the obligation of minimum welfare.

My thrust has been to argue in favor of choice and against paternalism, even while admitting that paternalism may yet have a benevolent and societally-acceptable rationale. If I have swayed you at all, or if you have been swayed by previous authors, then you will see why in 1984 Tufts made the decision to offer an alternative to TIAA-CREF and to permit relatively unfettered investment choice. And you will see why when transferability and cashability became possible, Tufts had very little trouble making a decision to permit transferability and, later with somewhat more difficulty, to permit 100 percent cashability.

This is the point for a little humility—and by that I mean *personal* humility. Looking back, Tufts did arrive at these decisions with relative ease. The debate was well-mannered and the conclusions of staff unanimous. The Trustees concurred with grace. But for some of us—and I include myself—there was a tingle of apprehension, a fear that poor investment decisions by staff or faculty members would come back to haunt us. So we did not jump in the bay on New Year's Day and emerge from our full immersion with a grin. We got wet one limb at a time.

Let me start with 1984. In that year we undertook a comprehensive review of our pension plan. One of the goals we soon settled on was to increase the number of investment options available. (Unlike many other schools who made this early decision, we did not focus to any great degree on TIAA-CREF's investment performance.)

Having decided to extend the range of investment offerings, we settled on the following criteria for selection of a company: investment performance, administrative flexibility, communications, administrative costs, and prior experience. We sent out an RFP and eventually interviewed two finalists.

As I look back, either would have made an excellent choice, and we remain satisfied with the firm we did select. We decided on one firm, and have stood by that decision because we believe we have achieved the investment choice we wanted without unduly adding to the administrative burden of either the University or pension plan participants.

In our decision-making, how paternalism-free were we? Not entirely, as we chose to close off one extremely popular fund and also some narrowly-focused funds, fearing that employees would leap into these potentially highly-volatile funds without understanding the consequences. Subsequently we took the constraints off the large, popular fund, and I would not be surprised if some time in the future we ended all limits, consistent with our general philosophy.

Although five years is not a long period of time in which to judge these matters, so far we noted no untoward circumstances. There have been no reports of impoverishment, and as we expected, our employees have taken a generally conservative approach to investments.

Let me give you a couple of numbers. Recent employees choose TIAA-CREF (the more "conservative" choice?) over its alternative by about eight to two, and we believe the greatest amount of money goes to TIAA. If we look at all employees, younger employees, those under 35, are more likely to choose the alternative investment firm. About 25 percent do so. If we look at our voluntary plan, participants seem to feel they can take more "risk." About 30 percent of those under 35 choose the alternative.

When in 1990 the SEC made its ruling on transferability, our decisions were relatively easy. By offering an alternative to TIAA-CREF, we had already indicated our acceptance of the concept of transferability. The question of cash-outs had already been before us, when we decided that they would be permitted from our alternative investment institution in the same ratio as those from TIAA-CREF: 10-percent cash-outs were permitted.

But the discussion at that time had been heated and thoughtful, and it was clear to all of us that there were many arguments in favor of permitting a much larger cash-out. When we revisited the question, it wasn't whether we should permit cash-outs but their size. Eventually, considering our philosophy that our faculty and staff should be permitted to make their own choices, we decided on the availability of a 100 percent cash-out at retirement. Our faculty and staff will be able to shop for the annuity of their choice—to find the best deal—or to decide against an annuity if they wish.

This is an appropriate point to add a word or two about process. In our decision-making in 1984 we involved faculty lightly and staff not at all. In 1990, with our philosophy well-anchored, our decision-making rested principally with the University's senior administrators. The President and Board of Trustees readily concurred. Each institution is different, of course, and culture will dictate the degree of participation of faculty and staff. Tufts itself is different from the Tufts of 1984. Today we would have more involvement: a committee of administrators, faculty and staff now meeting to resolve a crisis in indemnity health insurance is a good example of our current approach.

*Having decided to extend the range of investment offerings, we settled on the following criteria for selection of a company: investment performance, administrative flexibility, communications, administrative costs, and prior experience.*

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If I may distill some lessons from our experience, they are:

- ***Know your philosophy.*** Balancing paternalism against employee responsibility and choice, how do you come out? If there are different opinions, how do you resolve them?
- ***Plan your process.*** Involve the right people. Decide on your decision-making criteria. Use an RFP, not only to get the best bid but to learn about issues and opportunities. Make sure relevant constituencies are involved in the analytical and decision-making process.
- ***Accept the consequences of your philosophy.*** Be prepared for differences of opinion. Educate. If the worst happens, know what you will do. And hope for and expect the best.

There is an important correlative to the decisions we made at Tufts. We did decide that Tufts, the employer, has an important obligation, and that obligation is education. While the institution that provides our alternative investment vehicle has an excellent educational program, we feel that we have a personal obligation to our employees, and so we have run hundreds of sessions for staff on their investment choices and on retirement planning. We have also provided written and audio-visual material. However, we avoid giving investment advice; we do not feel that is our obligation or appropriate.

Thus, if you choose to provide transferability and cashability, education becomes a critical obligation. What better way is there for me — a representative of an educational institution — to end than by underlining the importance of education and the values of choice and independence it promotes.

# FACING NEW CHOICES...AND MANDATES

By Robert M. Wilson
*Vice President for Personnel Programs*
The Johns Hopkins University

*For many years individuals and institutions suggested that TIAA and CREF were paternalistic, rigid, and inflexibile.*

This publication, of which my chapter is a part, is designed to present different perspectives on the effect of changes at CREF. Those changes are the availability of new investment choices and transferability during the working years, and cashability at the time of retirement. For many years individuals and institutions suggested that TIAA and CREF were paternalistic, rigid, and inflexibile. The cry for change took the form of the critic's watchword, "Give us choice, flexibility and control." Now that these features are more available, we come together to discuss the short and long-term implications for our institutions and our retirement plan participants.

In this chapter, I will attempt three things: first, to describe the views that I have heard expressed by business and personnel offices on campuses both large and small across the country; second, to tell the Hopkins "story" and relate lessons learned from our experiences; and, third, to focus attention on new mandates that will affect our institutions' planning for faculty and staff retirement in the future to an even greater extent perhaps than the changes we are discussing here.

What then is the prevailing view about these new CREF options on campus? I find the answer is the same as always, "it depends!" Given the great diversity in American higher education among public and private, two and four year colleges, institutes and universities, it seems all but impossible to define that prevailing view. It depends so much on the culture of each campus it is risky to attempt one answer. Nonetheless, I am ready to suggest that in many organizations it can be described with a single word — apathy.

Apathy is, of course, defined as a lack of emotion; lack of interest; listless condition; unconcern; or indifference. I find this apathy, this lack of interest in these issues to be widespread.

Certainly most of the public colleges and universities whose destinies in benefits and retirement planning issues are controlled in state legislatures are not much concerned about such matters. Certainly, those larger, more sophisticated universities and colleges that offered choice, flexibility and control to their participants in retirement plans years ago have little or no concern about these changes at CREF. And, naturally enough, there continues to be strong resistance to change in many quarters. Some of this resistance to change manifests itself as downright hostility. Many overworked business and personnel offices see these changes as burdensome and simply plan to do nothing about implementing any changes. There is another group representing, perhaps, two out of every five institutions who see in these changes a relatively trouble-free way to meet participants' interests and who will continue to maintain their exclusive retirement planning relationships with TIAA and CREF. And finally, I suspect that there is a very small number of institutions that may now be ready to think about providing alternatives to TIAA-CREF to their faculty and staff.

*Many overworked business and personnel offices see these changes as burdensome and simply plan to do nothing about implementing any changes.*

In these latter two groups, where changes are apt to be implemented in the next year or so, the real interest may well manifest itself principally in offering CREF or other new investment choices, and transferability among them, *not* in offering the cashability at retirement option.

Summing up this picture, I would suggest that for those with an interest in choice, flexibility and control, there is a willingness to accept the new CREF options and internal transferability and generally speaking, resistance to offering other alternatives and cashability at retirement. Others will sit tight and do nothing now. We shall see how this plays out over time.

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The situation I have described here is essentially a reflection of the situation of American higher education. Common threads get woven together in wonderfully different ways.

Now, if I may, let me turn to the Hopkins story. I believe there will be some lessons here that will be of interest and value to institutions considering retirement plan changes. First, a word about The Johns Hopkins University. We are a major research university located in Baltimore, Maryland. We have a full-time faculty of just under 2,000 supported by 5,500 staff members serving 3,400 full-time undergraduate students and 2,800 full-time graduate students in our eight academic divisions.

What have we done, and why? In 1981–82 we commissioned and completed an extensive study of our pension and retirement plans. The study focused on the array of plans offered, their adequacy in terms of meeting institutional goals and the performance of the organizations offering the plans to our faculty and staff.

As a result of these deliberations, it was decided among other things that we would make additional investment alternatives available to our faculty and staff in our 403(b) defined contribution plan. To do this, we established criteria for the selection of a mutual fund family for retirement plan management. We decided at the outset that any fund to be considered must meet three fundamental criteria and seven additional criteria. The fundamental criteria were:

- must offer 403(b) (7) plans
- should not charge a sales fee
- should offer a "family" of funds

In addition, we examined the following areas:

- breadth of options
- administrative support
- quality of communications
- investment philosophy
- performance record
- personnel
- organization

In terms of our benefits program, the underlying Hopkins philosophy confirmed during this study was that we wished to remain fully competitive with our peers, and that in our defined contribution plans for faculty and senior administrators, we wished to provide significantly more latitude than offered by TIAA-CREF. Subsequently, we determined that the alternatives should provide reasonable choice—but not so much as to become chaos—flexibility in terms of the individual's ability to elect and change investments as desired and, for those interested, significant individual control over management of this important personal asset both during the accumulation period and at retirement.

As a result of our research, we chose the Vanguard group and Twentieth Century Investors to serve as investment alternatives to CREF. Additionally, we chose Connecticut General—now CIGNA—to provide an alternative to TIAA.

*With nearly eight years of experience in offering choice, flexibility and control, I can say unequivocally that everyone likes the outcome.*

What have we discovered as a result of the choices we made available in 1983? With nearly eight years of experience in offering choice, flexibility and control, I can say unequivocally that everyone likes the outcome.

Participants are pleased and executives and administrators have the benefit of a trouble-free program that is well-received by faculty and staff. Choice has been very important to participants, flexibility somewhat less so. In 1990 we find that a little more thi half the money the University and individuals contribute to the defined contribution plan is directed to the alternative investments, the balance to TIAA and CREF. A switching of funds takes place but no retiree has yet asked for a lump sum payment at retirement.

One thing that we learned early as a result of these changes is the importance of education and communications. We have made a major effort to create awareness and understanding of the power of the University's retirement plans and their significance to individual participants. We have done this through retirement financial planning seminars, pre-retirement planning programs, individual counseling and in printed materials with retirement updates, plan booklets and performance reports.

This is, in our judgment, not a burden but a basic responsibility; one which when discharged results in significant enhancement of faculty and staff relations. It is, in fact, somewhat like magic because we have found that the understanding and utilization of the benefits of our retirement plan have been significantly improved through these efforts. Additionally, the high level of enthusiasm for these 1983 changes made the implementation of a comprehensive flexible compensation program easy in 1986.

*The proof of all of this is further confirmed by the fact that in this area of retirement planning— providing choice, flexibility and control— if we had it to do over again, we would do it just the same way.*

The proof of all of this is further confirmed by the fact that in this area of retirement planning — providing choice, flexibility and control — if we had it to do over again, we would do it just the same way. That is not to say that we do not have retirement planning problems. We do. They manifest themselves in the use of a not-too-well designed incentive retirement plan and in difficulties we have had in complying with federal legislation and regulation over the last few years.

*Let me call your attention to new mandates that will affect our planning for faculty and staff retirements in the near future.*

This, of course, brings me to the third point I wish to cover with you. Let me call your attention to new mandates that will affect our planning for faculty and staff retirements in the near future. At the risk of not conforming to my charge and to the theme of this publication, I suggest that new mandates I will describe are of equal or greater importance to those of us using some 403(b) plans than the subject matter we are treating here.

To set these concerns into context, let me suggest that we look at the "*THEN, NOW* and *NEXT*" of institutional retirement planning and external influences, particularly that of the federal government. *THEN*, in the good old days we had near total freedom from rule and regulation. *NOW*, in a trend that has accelerated through the 1980s, we are pressed in many ways to comply with public policy mandates, many of which have been very difficult to understand and respond to. *NEXT*, I suggest that things are going to be more difficult, for some of us ***much more*** difficult.

For example, the Internal Revenue Service proposed rules for implementation of only two sentences in the Tax Reform Act of 1986 by publishing 350 pages of regulations to "clarify" non-discrimination and other compliance requirements. These proposed regulations for Section 401(a)(4) of the Internal Revenue Code were recently amended with an additional 100 pages and, I must say, they still do not address the concerns that many of us in the 403(b) environment share.

Hearings recently completed (with testimony expressing the higher education community's concerns ably presented by Caspa Harris of NACUBO and Monica Calhoun of TIAA-CREF) give some hope that somewhere down the line the special requirements of 403(b) defined contribution retirement plans will be recognized in workable regulations. Nonetheless, it is obvious to me and other observers of the scene that the noose is tightening and that we must be prepared to deal with significant changes in the way we operate our plans and offer benefits to various classes and categories of our staff.

I might add that it is important to understand that these new regulations apply to *all* colleges and universities, be they private or public. The proposed compliance date is next July for the private sector, 1993, for the public sector. There probably will be relief, but believe me, these regulations will create terrible problems for us whether they are effective in 1991 or 1993.

And, if that is not enough to startle you, there is on the horizon a set of rules published (and recently amended) by the Financial Accounting Standards Board that is going to change dramatically the way we account for post-retirement medical benefits. In the Hopkins case we will be recognizing an unfunded liability of some $22 million and increasing our booked expenses by $3 million a year. This is *after* we have made dramatic changes in our eligibility for and our pricing of post-retirement medical benefits. If you provide any post-employment medical benefits and if you have not gone through this exercise, think about it and get on it now because it will come home to hurt you later if you need a "clean opinion" from your public accounting firm in future years.

The three items that I have reviewed here—the view from our campuses, the Hopkins story and its lessons, and my concern about the tightening noose of mandates that we must reckon with—might be of benefit to you when reviewing your own retirement plan.

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