Bellwether CONSULTING

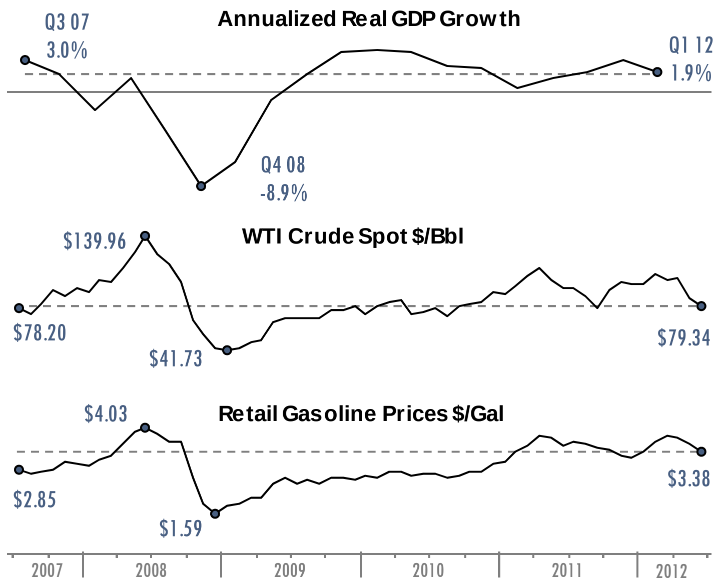
Your Quarterly Update on the Financial Markets

June 30, 2012

2nd Quarter

MARKET Recap

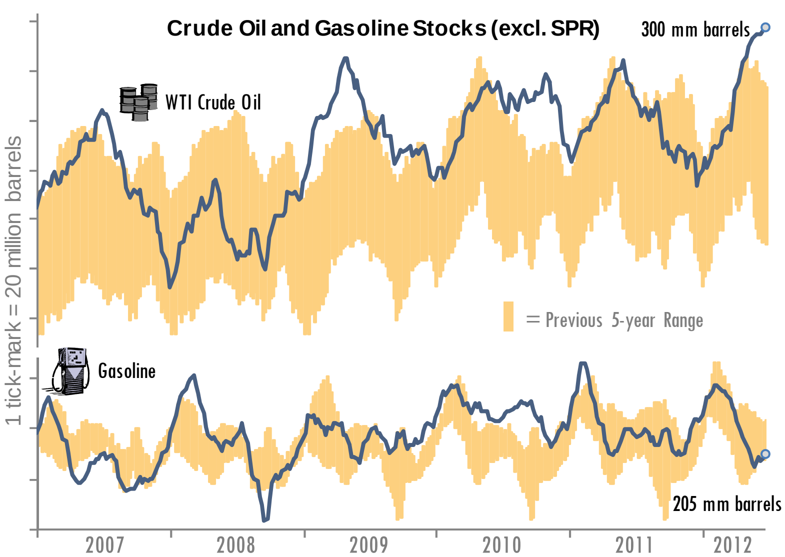
The Economy: *"Oil Greases the Interest Rate Skids"*



After peaking at a 3% pace, US economic growth decelerated to 1.9% in the first quarter. Real government spending continued to decrease, most notably in the defense sector. Domestic corporate profits increased by $26.3 billion, but non-US profits fell by $48.1 billion. Private inventory and non-residential fixed investment also fell in anticipation of a growing European recession. Signals for the domestic economy were mixed, with muted good news on employment and manufacturing offset by muted bad news from the service sector. Absent the drag from Europe, U.S. economic performance might have been characterized as fair.

Europe's sovereign debt and banking crisis dominated headlines and thinking in the second quarter; we will add our two cents on this over-analyzed topic later in this newsletter. Of more immediate interest is the Fed's response, which was to extend and broaden Operation Twist driving rates to new lows. Hawks could do nothing but watch, as oil prices reinforced a widely-held view that inflation is a distant concern (defined as beyond 2014). The price of black gold has fallen 26% since February, accelerating in April and May. Part of the decline is demand-driven, as future reduced consumption due to the (not yet official) recession in Europe is discounted into current prices.

However there is ample evidence that supply conditions are driving down prices as well, with crude inventories now considerably exceeding normal seasonal levels. Partially that's good luck, as recent geopolitical and weather conditions have been relatively benign. It's also a function of last summer's action to draw down about 30 million barrels from the Strategic Petroleum Reserve, which has not been replaced. In contrast, gasoline stocks remain at 5-year seasonal lows, and prices have fallen only 12% from their post-recession peak. Why the disparity? It has much to do with low profits in refining. Policies designed to limit the price of gasoline, combined with taxes averaging 11%, have helped drive profit out of the middle of the production chain. Consequently older refineries are closing, and it is becoming more difficult to replace the lost capacity.



According to the DOE, at year-end 2011 refining capacity stood at 17.3 million barrels per day, a reduction of 414,000 for the year. Prior to the credit crisis, large integrated oil companies were looking to spin off refining operations into master limited partnership structures. Interest in these investments has waned with risk appetite in general, so unprofitable operations are idled instead.

Policies to influence end-product prices from the supply side are less likely to have the desired effect if the price transmission mechanism is broken. Therefore we would expect gasoline prices to rebound more quickly on any pickup in economic activity.

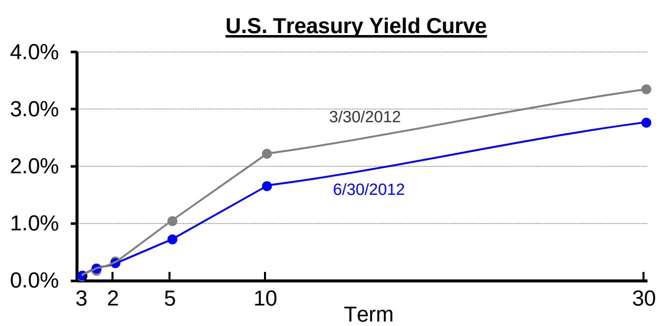
The US Bond Market

It was a tale of two quarters in the US bond market. The quarter ended with falling bond prices as the EU agreement reached at the two-day Brussels summit appeared to calm investors. However, it was not enough to overcome the prior two-month rush to the safe haven of US treasuries. The quarter closed with prices up across all fixed income sectors and long treasuries easily outpacing the pack. However, on a year-to-date basis the picture is quite different – reflecting Q1's "risk-on" market sentiments. Within the BarCap Aggregate Index, corporates returned 4.65% for the first six months of 2012, more than double the return of the US government component of 1.51% and still ahead of the 4.17% returned by long treasuries.

Bond Indices - Total Returns	
BarCap Aggregate	2.06%
BarCap Interm. Gov't	1.45%
BarCap Long Gov't	10.32%
BarCap Interm. Credit	1.53%
BarCap Long Credit	4.97%
BarCap High Yield	1.83%

Over the quarter, the spread between corporate debt and treasuries increased – ending at 219 basis points, up from 192 basis points at the end of Q1, according to the Bank of America Merrill Lynch US Corporate Master Index. However, this still represented an overall narrowing from 260 basis points at year-end 2011 – continued bad news for beleaguered US corporate pension plan sponsors who use corporate yields to discount plan liabilities. While lagging treasuries in the second quarter, many analysts continue pointing to corporate debt as the best opportunity in fixed income markets, with the strong balance sheets constructed since 2008 offering protection against continued global uncertainty. Specifically, significant capital improvements combined with further stabilization in the housing market have helped the balance sheets of US banks. Financial firms represent a large part of the US credit market, approximately one third of the BarCap Corporate Index. Given this, Moody's downgrade of 15 large global banks in the final weeks of the quarter was particularly impactful. On the asset side, pension investors in these bonds took losses. On the liability side, the downgrade caused several of the banks to fall out of the AA universe resulting in a lower average spread. To the extent that any of the bond holders were also using the AA spread as a liability discount rate, the Moody's action was that much more painful.

While the "risk-off" sentiment of the first two months of the quarter helped limit gains in the high-yield market, it still was the best-performing fixed income sector for the first six months of 2012 for a number of reasons. First, defaults remain well-below the historic average of 4.6%. And, the number of companies on review for a downgrade has been steady for the most part, far below credit crisis levels, as refinancing activity has strengthened corporate balance sheets. Second, US high-yield issuance during the first half of 2012 was used primarily for refinancing bonds and loans, according to Barclays. Combined with activity of recent years, it has allowed many US speculative-grade companies to push debt maturities out to 2014 and beyond, lessening the chance they would default should an economic downturn occur in the next year or so. Finally, the high-yield market is somewhat insulated from the crisis in Europe. It is populated primarily by smaller US-based companies, and it includes a lower percentage of European banking and financials than its investment-grade counterpart.



Source: Bloomberg LP

The benchmark 10-year Treasury was at 1.65% at quarter-close, down 56 basis points from the end of Q1. This included a 36 basis point drop in May alone, the most in nine months. Yields on benchmark 10-year notes fell to a record low of 1.44% on June 1, after the economy added fewer jobs in May than analysts had forecasted and fears that the European sovereign-debt crisis may be impacting growth in the US reawakened. Over the quarter, the yield curve flattened, with the spread between the 2-year and 10-year notes narrowing to 134 basis points from 188 basis points at the end of Q1 and from 165 basis points at year-end 2011. The shift was driven by a continuation of Operation Twist, the Fed's program to boost lending and lower longer-term interest rates. The extension of the program confirmed the Fed's accommodative stance and signaled its lack of concern over inflation. According to data from the Commodity Futures Trading Commission, hedge-fund managers and other large speculators increased their net-short position in 10-year note futures in response to the Fed's action, betting on a softening bond market. Speculative short positions rose by 142% from the third week to the fourth week of June.

The US Stock Market

Equity markets digested developments in the continuing European saga of debt crisis management, an upheld healthcare mandate, and policy responses from central banks around the world. The fiscal cliff is also on the radar, with taxes potentially increasing by the most in history if no congressional action is taken to extend the Bush-era tax cuts by the end of the year.

Macroeconomic concerns created a backdrop for a volatile quarter, indicated by a 71% intra-quarter increase in the Chicago Board of Trade Market Volatility Index (VIX), before returning to more subdued levels by quarter-end. The VIX is a forward-looking index that shows the 30-day implied volatility of the S&P 500, calculated by using premiums of index options. Also known as the "fear gauge," readings above 30 are associated with highly uncertain markets, while readings below 20 indicate a lower level of stress or even complacency. Interestingly, the VIX peaked on June 1st and proceeded to fall into the close of the quarter as the European Union summit at the end of June offered signs of cooperation and hope among Eurozone leaders.

Over the quarter, investors preferred lower-risk equities, choosing defensive over cyclical sectors. Telecom stocks performed best, attracting assets seeking higher dividend yields in the continued suppressed-rate environment. With dividend yields of 4.6% and 5.0% respectively, Verizon and AT&T both gained over 15%. Utilities also performed well, offering investors hefty dividends and stable cash flows during uncertain times. Growth stocks, on the other hand, underperformed value stocks over further concerns of a US slowdown as the Bureau of Economic Analysis revised real GDP growth for Q1 down to a weak 1.9% annualized rate.

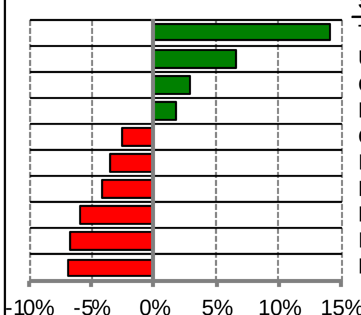
Stock Indices - Total Returns

Largecap Stocks		**Midcap Stocks**	
S&P 500	-2.75%	S&P Midcap 400	-4.93%
Russell 1000	-3.12%	Russell Midcap	-4.40%
Growth	-4.02%	Growth	-5.60%
Value	-2.20%	Value	-3.26%
Broad Markets		**Smallcap Stocks**	
Russell 3000	-3.15%	S&P Smallcap 600	-3.58%
DJ Wilshire 5000	-3.13%	Russell 2000	-3.47%
		Growth	-3.94%
		Value	-3.01%

Energy, financials, and technology rounded out the bottom three performing sectors. Oil prices dipped on renewed global slowdown worries and deflationary concerns stemming from the financial sector's deleveraging process. Financial stocks were also pressured by a Moody's downgrade of 15 global banks, including the top five US lenders. Counter to trend, when the news finally hit markets, bank stocks rallied as the downgrades were on the whole not as bad as expected.

Healthcare stock price action came to a climax as the Supreme Court upheld the individual mandate on grounds that Congress has the right to tax, and furthermore tax individuals that do not have health care. While for the quarter health care stocks were relatively flat (+1.57%), subsectors showed diversion. Hospital stocks were the big winners jumping 5.4% on the day of the ruling, since the large portion of non-paying patients will significantly decline. Conversely, health insurance providers declined on concerns over higher taxes and lower margins. Finally, medical equipment providers also fell on worries over greater regulation and a 2.3% excise tax on US sales.

S&P 500 Economic Group Components - Total Return



Sector	2Q12
Telecom	14.13%
Utilities	6.55%
Consumer Staples	2.88%
Health Care	1.75%
Consumer Disc.	-2.60%
Industrials	-3.56%
Materials	-4.19%
Energy	-5.99%
Info Tech	-6.68%
Financials	-6.83%

Source: Standard & Poor's

During the quarter, 27 initial public offerings came to market raising $21.2 billion, heavily skewed by Facebook's $16 billion offering. Interestingly, since Facebook's IPO in mid-May, there has been no further new issue activity to round out the quarter. Facebook was the most-hyped IPO since Google back in August of 2004. What went wrong? For the underwriter (Morgan Stanley) and issuer (Facebook), nothing. Their mutual goal is to maximize the value of the issuing price, which they clearly achieved. Yet, cries came from investors that got burned as the stock traded from an IPO price of $38 per share ($104 billion valuation) to a low of $25.52 per share, a 32.8% fall in value. They pointed to Facebook's filing of new amendments up until the first day of trading, Wall Street's preferential treatment of institutional clients, and NASDAQ's overwhelmed servers causing a delayed open to trading. Any issuance that is received with such hysteria deserves a view through the contrarian's lens. Longer-term, it will be interesting to see how the top social networking site stands up to its great expectations.

Overseas Markets

Volatility ruled global markets as performance vacillated from strongly positive in the first quarter to solidly negative in the second. A June 2012 report on the World Bank's view of the global economy warned that fears regarding the Eurozone had reduced investor's tolerance for risk – with investors rotating to the "risk-off" trade again. The report forecasted sluggish growth for high-income countries including the US, Japan and Germany for the next few years. The Bank expects modest growth in middle-income economies such as China and Brazil – some of the main growth engines of the last few

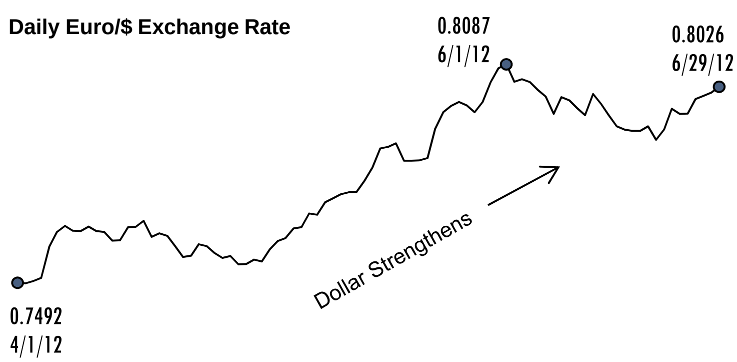
Foreign Stock & Bond Indices - Total Returns			
MSCI Broad Indices		**Barcap Global Indices***	
World Index	-5.07%	Global Aggregate	0.62%
EAFE (Developed)	-7.13%	Pan-Euro	-3.29%
Emerging Markets	-8.89%	Asian-Pacific	3.87%
		Eurodollar	1.23%
MSCI Regions		Euro-Yen	3.36%
Europe	-7.47%	Other Currencies	-0.51%
Japan	-7.30%	*Unhedged*	
Pacific ex-Japan	-4.89%		
Latin America	-13.16%		

years, and slower growth in emerging economies. The bank forecasts global output to increase 2.5% in 2012 and 3.0% next year, much lower than an IMF forecast of 3.5% and 4.1%, respectively.

The Eurozone remained in focus as the continuing sovereign debt crisis threatened to undermine the Spanish and Italian economies and the Euro itself. European leaders, the IMF, and the ECB met numerous times over the quarter in an attempt to solve at least some of the issues threatening the region. In mid-June the ECB called for leaders to create a "banking union" that would oversee large banks, help shield sovereigns and their taxpayers from paying for the mistakes of large lenders, and ensure that ailing banks do not bring down entire countries. However Germany, the largest and most solvent economy in the Eurozone, objected as the plan required them to shoulder the heaviest burden. Other ideas were offered up, but Germany remained standoffish. EuroBonds? Nein! Less than full austerity? Nein!

However, an announcement from the European Summit at the end of the quarter surprised most pundits as European leaders took a step towards integration; Germany conceded and agreed to help directly refinance banks. Leaders moved toward having a more centralized banking system and granted their bailout funds more flexibility to provide aid to Spain and Italy. A coalition appears to be forming between France's new socialist president, Francois Hollande, Italy's Prime Minister Mario Monti, and Spain's Prime Minister Mariano Rajoy which proved effective in forcing Germany's Chancellor Angela Merkel into a compromise, agreeing to concessions which may ultimately lead to a pooling of liabilities. For its part, Germany got the agreement for a single banking supervisory agency run by the ECB.

The banking authority agreement is considered the best chance for stabilizing the sector. Leaders are hopeful that its creation will help European banks weakened by their holdings of government debt and further debilitated by losses on mortgages in the region. Spain recently sought €100 billion ($125 billion) for its banks, but bristled at adding additional debt to the country's balance sheet rather than having funds flow directly to the banks themselves. Investors pushed yields on Spanish and Italian debt up to near-historic, and long-term unsustainable, levels. Through the agreement, bailout funds will flow directly to Spanish banks from the European Financial Stability Facility (EFSF) and European Stability Mechanism (ESM) rescue funds upon the creation of the new authority.



The picture in Europe remains unclear. The announcement of the banking authority gave a boost to world markets, but as with all plans it has been long on hype and short on details. The European banking system remains the heart of the issue. If the banking system remains solvent then Europe should be able to work through its sovereign and Euro issues through a combination of fiscal austerity and time – shoring up sovereign balance sheets and giving poorly performing assets the opportunity to recover. European leaders, through their recent agreement, have shown a willingness to step in and prop up the banking system, but mixed resolve on relieving economic hardships within the periphery. It remains to be seen if their collegial spirit will continue as the banking system remains under pressure.

In Japan, the BOJ increased the size of its asset purchase program by about ¥5 trillion ($61.7 billion) to ¥70 trillion. The scale of the intervention met some analysts' expectations, but many economists believe that the move fell short of an aggressive action required to stem the tide of on-going deflation. The central bank left its policy interest rates unchanged in the range of 0.0% to 0.1% stating: "in order to overcome deflation, it is crucial to tackle the long-term structural challenge of declining trend growth rates amid rapid population aging. The goal of overcoming deflation will be achieved through such continued efforts by business firms, financial institutions, the government, and the Bank within their respective roles," indicating that responsibility for ending deflation in Japan needed to be a team effort. Earlier this year the BOJ set a goal of boosting inflation to 1% over time. Japan's jobless rate unexpectedly rose in April, causing fears that the economy could be weakening. The unemployment rate rose to 4.6%, up 0.1% from March, the first deterioration in employment in three months. Economists expected no change in the jobless rate. Slumping Eurozone demand for Japanese goods could be a major factor.

China's imports grew less than expected in March, raising concerns of a slowdown that could point to weakening domestic demand. China reported a trade surplus of $5.3 billion while median estimates were for a monthly trade deficit of $3.5 billion. Exports rose 8.9% from a year earlier to $165.6 billion, while imports climbed 5.3% to $160.3 billion. Imports were broadly weak as non-commodity imports have fallen sharply since November, indicating soft underlying domestic demand, while manufacturing-related imports were generally flat and implying that exporters have low expectations for future orders growth. Exports to Europe contracted about 3% from a year earlier. Economic growth slowed the most in almost 3 years in the first quarter from a combination of weak export growth and sluggish construction activity. GDP grew 8.1% in the January to March period, according to the National Bureau of Statistics, below analysts' expectations of an 8.3% expansion. Fixed asset investments were up 20.9% in the quarter, according to the statistics bureau, compared to 24% growth in the same quarter a year earlier. Both a downtrend in housing and in infrastructure-related spending, as indicated by the fixed asset investment pull back and over-reliance on exports to fuel its economy hurt growth. The PBOC cut borrowing costs for the first time since 2008 and loosened controls on banks' lending and deposit rates in an attempt to combat a deepening slowdown as Europe's debt crisis threatens global growth. The one-year lending rate declined by a quarter percentage point to 6.31% and the one-year deposit rate dropped to 3.25%. Banks will also have the autonomy to determine rates at variance from the official setting. Banks can offer a 20% discount to the key lending rate, up from a previous 10% and lenders will, for the first time, be able to offer savers deposit rates that are up to 10% higher than the benchmark.

Singapore and Hong Kong are dealing with their own property bubbles. Mirroring Federal Reserve policy, both nations rapidly lowered rates in 2008 to rock-bottom levels of under 0.5%, and asset price recoveries have been robust. In addition, Singapore and Hong Kong offer strong infrastructures, transparent legal systems and favorable tax rates, ranking 1 and 2 respectively on the World Bank's Ease of Doing Business Index. To put property values in perspective, according to Demographia, Hong Kong's housing prices are 12.6x median annual household incomes, compared with just 3.1x for the US. In response to surging prices, Singapore's authorities have introduced 5 housing market cooling measures since the rebound in 2009, most recently imposing additional stamp duties on certain buyers, and higher levies on foreigners.

Brazil's central bank took further measures to stimulate its economy, reducing its target interest rate to a record low of 8.5% in May. Citing reduced inflationary pressures, central bank officials are now more focused on growth, as the country's annualized GDP growth has slowed to 0.8%. Interestingly, Brazilian President Dilma Rousseff's approval rating hit a record high of 59%, even with meager economic activity. She has made it a priority to continue slashing rates, helping to reduce Brazil's unemployment to 5.8% in May. Also helping her approval rating, she increased the minimum wage by 14% in a move to reduce the country's wealth gap. Argentina faces similar economic pressures, as its GDP growth rate fell to 5.2% for Q1 2012 from a recent high of 11.8% in Q2 2010.

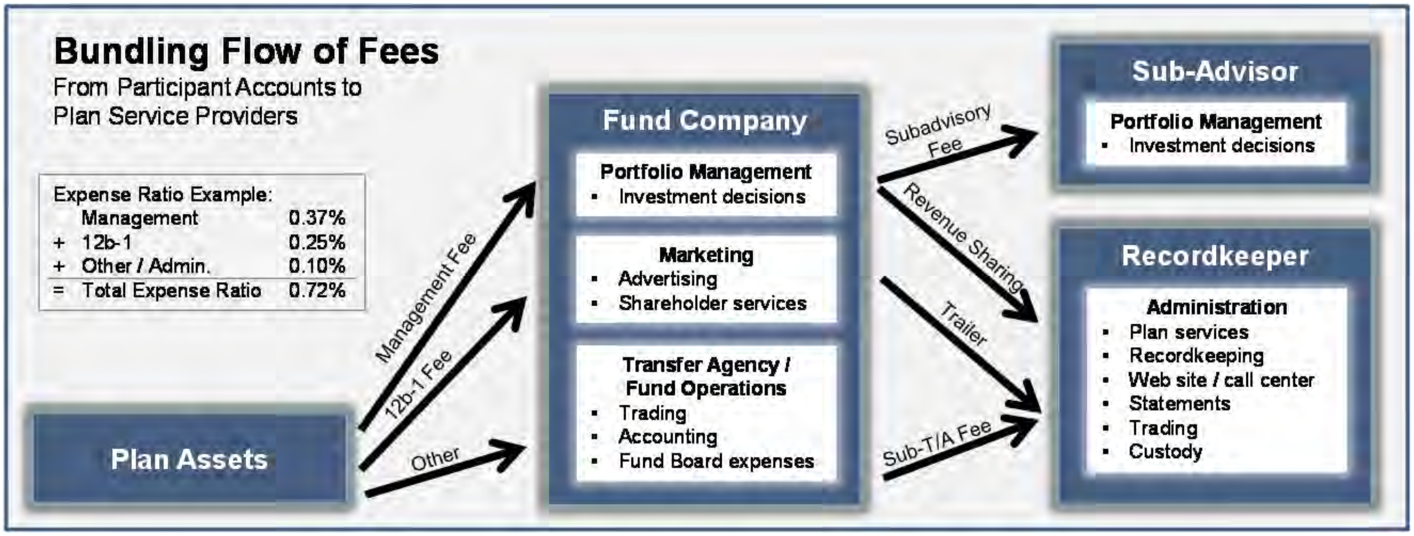
Focus On: *Unitization, the Great Fee Equalizer*

In February the long-awaited rule to improve the transparency of fees charged by defined contribution plan service providers was finalized by the Department of Labor, with many of the disclosures rolling out for the first time this week. But plan sponsors' attention has been focused on fees for some time. While perhaps not the most exciting aspect of investing, good fiduciaries know that understanding and monitoring fees is a fundamental responsibility. Fees are the only component of investment returns we know with certainty in advance. Further, it has not always been easy to ascertain the exact level of fees being paid. Sure the cost of investment management is easy to document. It's clearly stated, either as a defined component of a mutual fund expense ratio or the management fee of a collective trust or separate account. But what about the rest? What is the real cost of all the necessary recordkeeping services that go into running a defined contribution plan? How should the modern plan sponsor account for the cost of administering the plan? And finally, how can fees be assessed fairly across the participant base?

In today's defined contribution market, there are three basic ways to cover a plan's administrative recordkeeping costs: through bundling, as a paid expense item, or through unitized accounting. Each method presents its own benefits and challenges, but increasingly we find that plan sponsors are moving away from bundled arrangements in favor of the more transparent fee disclosure offered by the other two methods.

Bundling Basics

In a bundled arrangement, the recordkeeper uses revenue received on the plan from investment management firms to offset their expenses and generate profit. For mutual funds, revenue comes in a variety of forms: 12b-1 fees, sub-transfer agency fees (or sub-T/A fees), and other revenue sharing. (Other investment structures like collective trusts or separate accounts may have a recordkeeping offset incorporated into its expense ratio or generate no offsets whatsoever.) While the 12b-1 fee is explicitly disclosed in the fund prospectus, the others, including those associated with non-mutual fund investments, can be more difficult to figure out. Because they are based on negotiated agreements between an individual fund company and an individual recordkeeper on a fund-by-fund basis and are not disclosed in any regularly released documents like mutual fund prospectuses, it can be problematic to ascertain exactly what the plan is paying for recordkeeping services. The only way to find out what a recordkeeper is receiving in sub-T/A fees or other offsets on a particular fund is to ask the recordkeeper to disclose the information. Fortunately, as more and more industry attention has been focused on fees, recordkeepers are increasingly willing to provide this information. If a recordkeeper does not do so proactively, it is usually just a matter of requesting the data.



While fee transparency can be difficult in a bundled arrangement, the greater challenges are in ongoing investment lineup maintenance and fee equality across participants. In a bundled arrangement, the recordkeeper is always trying to strike a delicate balance between accommodating the client and generating enough revenue to cover the cost of their operations. Inevitably, there comes a time in the maintenance of the investment lineup where the plan sponsor is forced to select a more expensive share class or perhaps a completely different fund to keep the pricing balance intact. While this is understandable and reasonable from a service perspective (a good service provider who continually loses money will soon go out of business), it is anathema to a fiduciary.

In addition, with varying levels of sub-T/A fees paid on funds, a participant's asset allocation decision ends up determining the amount they pay toward the administration of the plan. For example, many plans offer low-cost index funds that do not include shared revenue as well as higher-cost actively-managed funds that do. A participant who chooses to invest in index funds ends up being subsidized by those who invest in the active funds, since they pay no recordkeeping cost.

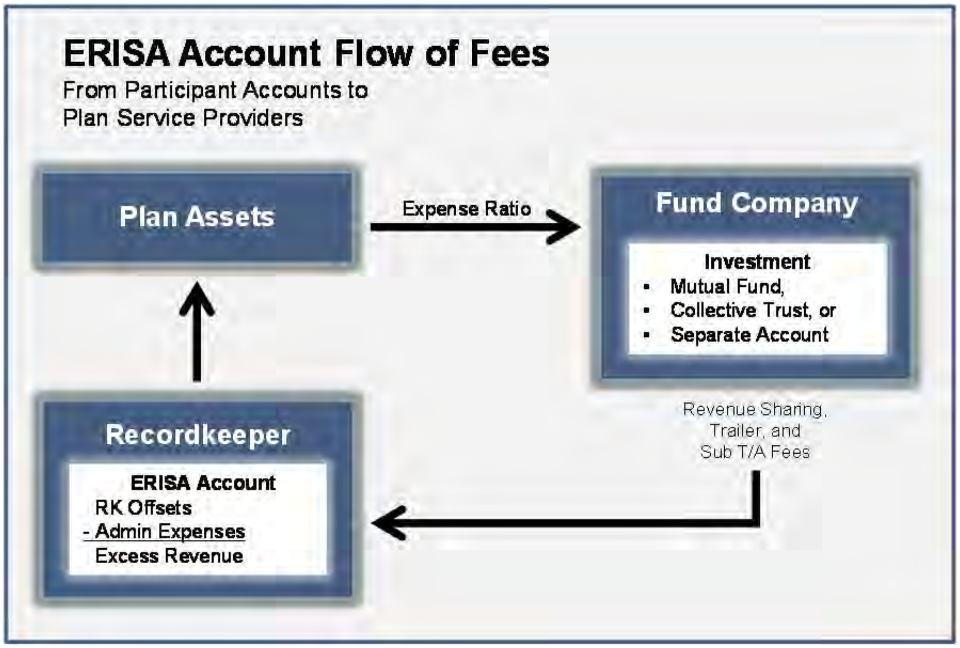
A Clear Alternative to Bundling

To overcome the challenges inherent in bundling, many plan sponsors have elected to pay administrative costs as an explicit expense item. In these cases an ERISA account, also known as an ERISA budget or expense-reimbursement account, is used to collect any available revenue payments for the plan's benefit. ERISA accounts are essentially a bookkeeping convenience to facilitate the offset of plan-generated revenue against plan expenses. Now available to most plans, their use is practically limited to plans large enough to generate revenues that exceed the costs of their administration, including the cost of the additional work by the recordkeeper to administer the account. In cases where revenues do not exceed expenses, the remaining amount is charged back to participants or paid by the plan sponsor.

Typically, an ERISA reimbursement account is structured as a cash account inside the 401(k) plan, similar to a forfeiture account. All revenue generated by the investments of the plan, whether it be from 12b-1 fees, sub-T/A fees, or some other source, is collected in the account. Plan administrative expenses are deducted from the account as agreed upon between the plan sponsor and recordkeeper.

To the extent that revenue collected exceeds the cost of recordkeeping, plan sponsors can elect to pay other plan expenses from the account such as fees for participant education and communications. Essentially, anything that is allowed to be paid from plan assets can be paid out of the expense account. Another option is to have the excess revenue returned to participant accounts, which can be a little more complicated. In a perfect world, the recordkeeper would distribute the excess back to participants based on how they were invested over the period. Participants allocating assets to options that generate less recordkeeping offsets would get a smaller reimbursement than those who had allocated to funds generating more recordkeeping offsets. However, in the average plan, this would require complex tracking which may be beyond the capabilities of the recordkeeper. A more common method is to credit the excess back to participants pro-rata either by participant or by asset level.

Often revenue collected in the account will fall short of what is required to pay the recordkeeper – especially for plans with less favorable demographics (e.g., high turnover, lower wages, low participation). The balance of fees can be charged out to participant accounts on an equal basis per-head or based on assets. Of course this can present a challenge in terms of the optics of the plan and its costs. Many participants in bundled plans do not realize that they are covering the administrative costs of the plan through the expense ratios charged on their investment options. Rather, they believe participation in the plan is free. Many plan sponsors fear that if participants see a charge for administration on their statements, they will drop out of the plan – and this is not idle speculation. Experience has shown that many participants reject almost any service – even one they have requested on survey after survey (e.g., investment advice), if they are charged for it. However, thoughtful communication around administrative charges along with a clear comparison to participation in a bundled arrangement can overcome resistance to seeing the cost of administration as a discreet expense item on their statements.



Running an ERISA account comes with its own challenges. Plan fiduciaries should insist on regular reconciliation of the account to monitor, audit, and document the recordkeeper's administration of the assets and ensure excess balances are regularly paid out (and not building). This becomes even more important if the plan sponsor is considering switching recordkeepers so there is no chance a balance remains behind with the old vendor. While paying recordkeeping costs as a separate expense can free the plan sponsor from considering the recordkeeping offsets generated by the funds when making investment selections, in most cases it only lessens the instances where a participant subsidizes another's participation in the plan. Even if excess recordkeeping offsets are restored based on how participants have allocated their assets, recordkeeping expense have already been netted against them. It is still quite likely that participants investing in index funds are subsidized by participants investing in actively-managed funds.

With Equal Fees for All

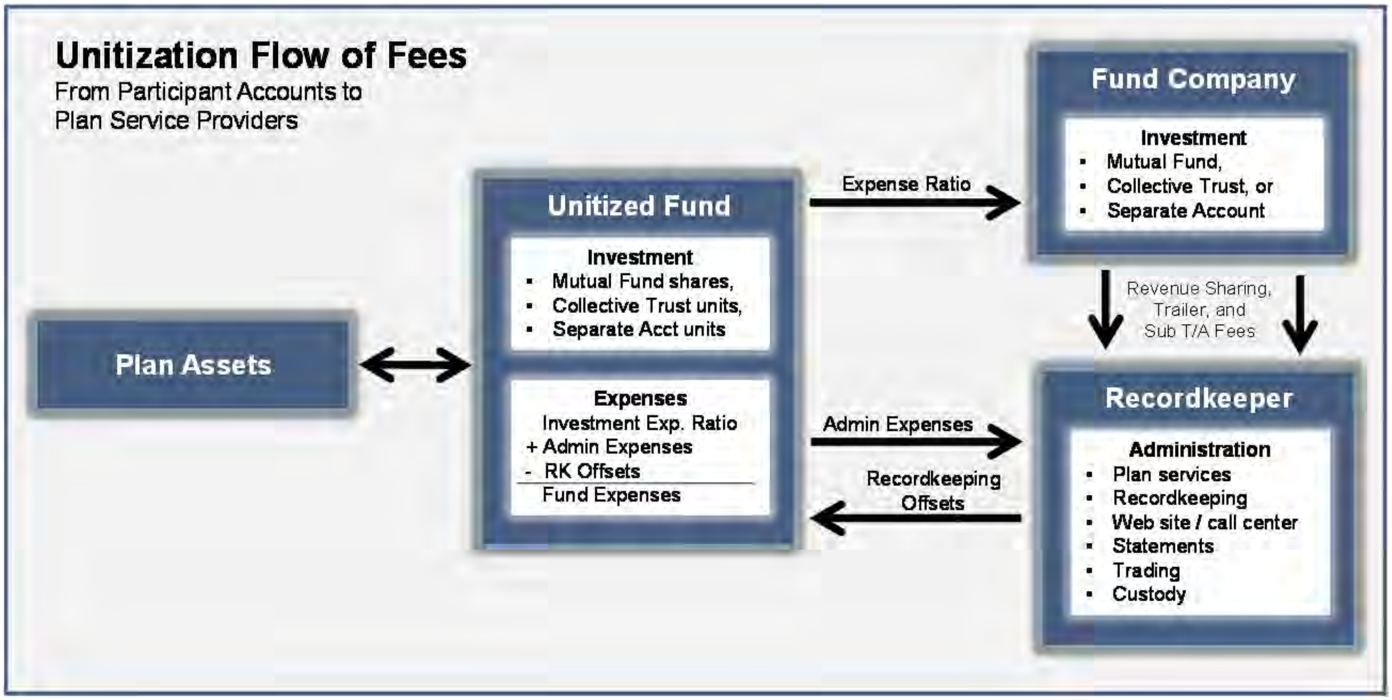
"Unitization" is a very common accounting process by which an investment portfolio is divided into discrete ownership interests, each with an equal value. All investment funds used by defined contribution plans are unitized – for example, mutual fund portfolios are divided into "shares" which have an equal "share price" or Net Asset Value (NAV). Unitization allows multiple people to share ownership of a pooled investment portfolio while keeping their interests separate. It also facilitates the collection of fees, which are assessed by reducing the value of each unit.

The problem is that investment funds are unitized with fees that do not reflect the specific arrangements for a particular retirement plan. Larger plan sponsors can correct this by having the recordkeeper or trustee "re-unitize" all of the investments, creating custom unit values for each plan investment. In the process, the plan's specifically negotiated fees can be deducted and paid to the recordkeeper by reducing the custom unit value, and any imbedded revenue sharing can be credited back to participants by increasing the unit value. This method allows for plan expenses – including those for administration, to be spread evenly across each investment option in the plan rather than paid based on the revenue sharing arrangements that happen to be in place between the recordkeeper and each fund manager.

For plan fiduciaries, it's a very useful arrangement. Investment products can be selected based purely on their investment merits and management fees, without any regard for the recordkeeper. Fees for recordkeeping can be negotiated based on the level of service desired, without regard for impact on the investment lineup. Administrative fees are always spread equally among participants based on assets, and there is never an overage or underage to manage.

While it is a relatively simple concept, it can be complex to implement. Shares of each mutual fund (or units of other investment products) become the "holdings" of the custom unitized fund. The expenses of the plan are applied as an asset-based fee and any sub-T/A or other fees paid by the mutual fund are used to offset expenses *for that fund*. With the recordkeeping offsets, to the extent they exists, applied only toward investments in that fund (instead of across plan assets in all funds), no participant subsidizes any service fee of another.

Unitization removes some fiduciary headaches, but there are issues to consider before implementing unitized accounting. The first is potential participant resistance. Once funds have been unitized, participants no longer have a lineup of recognizable mutual funds (if that is what they had before). They have a lineup of institutional accounts. While this is not uncommon in defined contribution plans – for example, many larger plans use collective trusts instead of mutual fund in-investments to take advantage of more competitive fees, and some products which are very familiar to participants (e.g., stable value) are not available in mutual fund form – it can represent a change for participants accustomed to tracking mutual funds online or in the Wall Street Journal. This can be addressed through thoughtful communication. One way to ease the transition is to avoid generic names for the new funds. The more descriptive the fund name, the easier it is for participants to understand the strategy.



A more significant challenge is that unitized funds require the commitment of more resources from the plan sponsor. A trustee must be hired to handle the accounting. This requires additional vendor management, first to select and then to manage the relationship. Can the recordkeeper interface with the trustee? Is there a process in place to detect and correct errors? What is the additional cost? In addition, just as with other institutional investments, many of the resources available as a matter of course with mutual funds will need to be duplicated for unitized funds. Even if the underlying assets are comprised of mutual fund shares, each account will have its own unique performance due to the way expenses are applied, and fact sheets will need to be created to reflect this. But this is not insurmountable; plan sponsors can address these issues during recordkeeper selection, or by retaining other resources like a communications vendors.

The Bottom Line is More Than the Bottom Line

Despite the additional resources required, increasingly plan sponsors are turning to unitized accounting for their defined contribution plans. As with so many trends in the industry, it began with the largest plans but now has filtered down even to the mid-market. Regardless of the size of their plan, most fiduciaries aspire to focus with clarity on the individual components of their responsibilities. One way to do this is to disaggregate investment decisions from administration issues – especially the cost of recordkeeping. While running an ERISA account provides more transparency when it comes to plan costs, it does not eliminate the issue of subsidization among participants. Unitization requires no revenue generation whatsoever. Even more, it can accommodate any amount or any disparity of amounts of revenue generation among the investment options. But most importantly, it ensures that each participant's administrative fee experience is the same. While this may cost a little more in terms of time or money, it is unequivocally fair – a fact that may become more important as participants absorb the new fee disclosures.

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