Russell Pension Report 2007

Synopsis

The Current State of Corporate Pension Provision in America

Russell

Foreword:
Providing Perspective on Pension Investments

H Paul Reynolds

No one can deny it—there are major changes taking place with defined benefit (DB) pension plans. But with an overwhelming amount of information, there is room for confusion. Many corporations are asking:

- "How do these changes affect our company?"
- "Should we freeze our pension plan and rely on defined contribution (DC) plans for newer employees?"
- "Do we focus on liability matching or enhancing returns?"

These are big questions that require serious consideration. But before you can answer them, it's important to put pension plan issues in perspective. The *Russell Pension Report 2007* is designed to present the key issues facing pension plans, while providing insights into potential solutions for your organization.

This synopsis of the four-part *Russell Pension Report 2007* provides an overview on the current state of defined benefit pension plans in the U.S., including some of the reforms impacting funding and accounting.

In this new environment, it's important to understand your organization's financial challenges before developing an investment strategy. For many plans, the key principles driving decisions involve choosing between liability-matching and return-seeking strategies. And while plan sponsors of frozen plans face many of the same objectives and challenges as others, frozen plans have some unique features that we'll also highlight in this report.

Although prevailing attitudes about pension plans are shifting, one thing is certain—change. Change can be unsettling, but knowing your perspective is key to preparing for what lies ahead. I hope this summary of the *Russell Pension Report 2007* will help you recognize important investment issues and offer insight into how they impact your plan. If you'd like to discuss this synopsis or learn more about the complete *Russell Pension Report 2007*, please contact us.

Regards,

H Paul Reynolds, Managing Director
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Russell Pension Report 2007: Synopsis

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There are major changes ahead for defined benefit pension plans. Plans are freezing, the Pension Protection Act 2006 has been passed, accounting and funding rules have become increasingly complex, and plan sponsors are confronted with an overwhelming amount of information and array of choices. The Russell Pension Report 2007 *describes the changed landscape in which plans and the corporations that sponsor them are currently operating, and begins to provide a course for those seeking to navigate through this changed world.*

THE CURRENT STATE OF CORPORATE PENSION PROVISION IN AMERICA

The way in which U.S. corporations are addressing the question of retirement provision is changing fundamentally. Defined benefit (DB) plans, once the staple of corporate pension provision, are being replaced by defined contribution (DC) plans as the key retirement income source for employees.

Many factors have coincided to produce this trend of plans moving from DB to DC. Funding reform and accounting reform have been two, and the trend has fueled its own momentum; for example, every newspaper headline announcing a plan freeze increases the pressure for others to consider change. The sudden, dramatic decline in funded status has transformed how sponsors see their plans. No longer a profit center, they've become the problem child for many corporations.

The equity market declines of 2000 to 2003 hit plans hard, but a more complete picture of a typical plan's funded status requires looking not just at equity markets and not just at those three years. An increase in liabilities can be just as damaging as a decline in assets. Interest rates fell from over 15% in 1981 to less than 4% in 2003, and as a result pension plan liabilities increased substantially. The impact of that increase in liabilities was not obvious as long as asset values kept pace, which they did (and more) until 2000. But when equity markets fell sharply and interest rates continued to fall, the combined effect was an unprecedented drop in funded levels.

As a result, corporations have had to start finding substantial sums of cash to put into their DB plans. The pain was all the greater because contributions had been so low—zero, in many cases—for so long.

Many sponsors see DC plans as offering a more predictable alternative. And they are widely perceived as cheaper, too. A DC plan does not, of course, really cost less than an equivalent DB plan. After all, like a DB plan, a DC plan contribution can be set (within IRS limits) at whatever level the corporation chooses. It is not the DC structure itself that reduces or increases cost, but rather the employer's choice to contribute at a particular level. Nonetheless, a desire for cost-reduction has been another factor pushing corporations to consider DC.

There has been some backlash against the trend toward DC plans. Proponents of DB plans point out that traditional pensions provide a secure form of income replacement, and the scale and risk pooling they offer can lead to significant efficiencies. DB plans provide professional oversight and place minimal demands on participants; they do not require that employees act as their own plan CIOs, a task for which most show little relish.

But this backlash has been very little compared to what might ordinarily be expected for such a significant change. In part this is because DC plans' portability and explicit account balances make them easier for employees to value; DB pension values aren't regularly published and are difficult for the employee to project (in "today's" dollars).

FUNDING REFORM AND ACCOUNTING REFORM

One of two long-running sagas that had been casting a shadow over pension decision making was clarified on August 17, 2006 when President Bush signed into law the Pension Protection Act of 2006.

The Act will be phased in over a number of years and will push plans closer to funding based on the principles of financial economics; e.g., marking to market the value of assets and liabilities. While the Act does nothing to increase the actual liabilities of pension plans, it will generally increase the amount of money corporations will need to set aside to cover them. It will also increase the year-to-year volatility of reported funded levels.

The other saga was resolved on September 29, with the publication by the Financial Accounting Standards Board (FASB) of Statement No.158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans.* This will take effect, for publicly traded companies, for fiscal years ending after December 15, 2006.

One probable immediate effect of this change will be an increase in the pension liability shown on most corporate balance sheets. In a few cases, this could have a material impact on shareholders' equity. What is attracting most attention, however, is the increased volatility that the changes are expected to introduce to corporate balance sheets. The extent of any additional volatility will vary considerably from corporation to corporation. For many, it will prove to be a non-event. But for others—notably in cases where a company's pension plan is large relative to corporate assets, or where the balance sheet is sensitive—it may make current arrangements unsupportable.

While balance sheets will be greatly affected by the new statement, pension expense most likely will not. The part of the income statement that is most affected by mark-to-market is "other comprehensive income." In effect, any unexpected gain or loss in the pension plan will be treated in the corporate accounts as being exceptional and unrelated to normal business operations and will be reported separately from net income.

In light of these pressures, the pension proposition now appears less attractive to many corporate plan sponsors; some are seeking to "get out of the pension business" altogether. The first step for those doing so is to close or freeze their DB plans. Such a move does nothing to remove an existing funding shortfall, but it does start a corporation down the road of disengagement.

Whether they choose to close their pension plans or keep them open, many organizations are reevaluating their objectives and taking a second look at how their plans are managed.

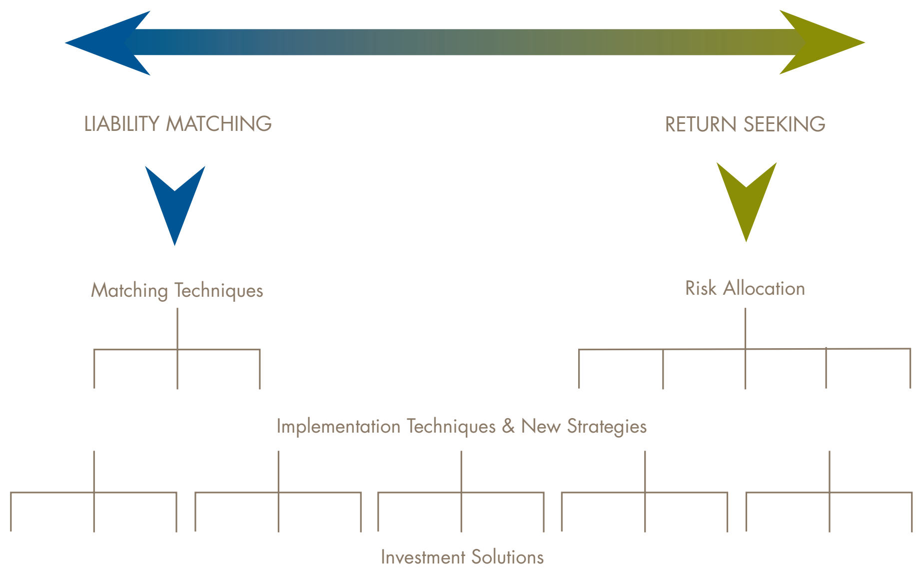
THE RUSSELL ROAD MAP

To help institutional investors make sense of these challenges, we have developed the Russell Road Map, a framework for planning a forward-looking, integrated, ongoing agenda for pension plans. The road map ties decisions about products and strategies to the objectives that drive them.

Starting at the top of the Russell Road Map, plan sponsors must decide what their objectives are for the investment of assets. There are two basic perspectives open to us.

One would lead us to say: "We have made a pension promise. We will purchase a matching asset that will allow us to meet the promise." This represents those who would like to say, "Pay up and be done with it." A second and quite different perspective is to say: "We have set aside assets to meet our pension liabilities.

Exhibit 1: Russell Road Map for defined benefit plans



We want to maximize the return on those assets" to make the investments work as hard as they can. If maximizing return is the objective, then behavior will be different than if the objective is to match the asset to the liability.

Traditionally, investment in return-seeking assets was possible only by forgoing investment in liability-matching assets. So the liability-matching and return-seeking decisions both largely came down to making a trade-off between the two objectives. In practice, this meant finding a balance between bonds and equities.

Today's environment offers greater potential for separating liability-matching and return-seeking decisions than has traditionally been the case. With the greater availability and liquidity of interest rate derivatives and a fast-growing swap market, the opportunity exists to directly manage part of the liability risk. And increasingly, this can be done without giving up the return seeking assets.

When liability risk (and particularly the interest rate component of it) is considered an optional extra in return seeking, rather than a necessary component, it is usually an unappealing risk; the expected reward for taking this risk does not compare favorably to that available for other risks.

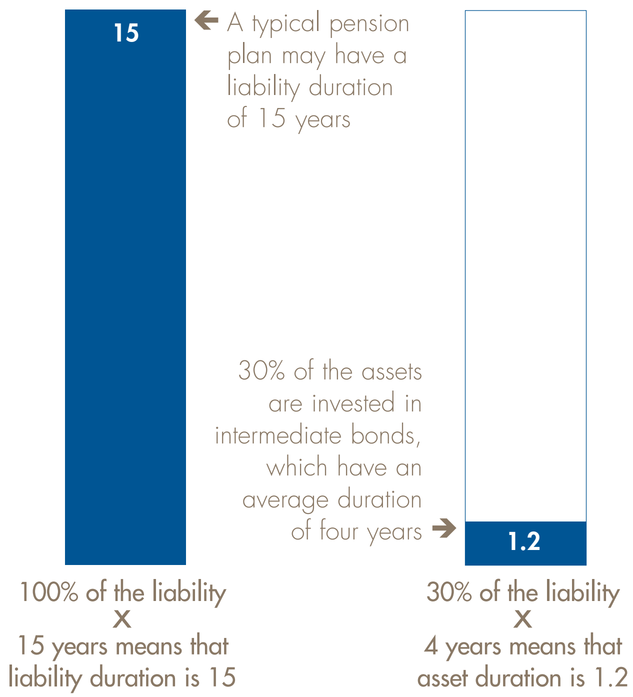
LIABILITY MATCHING

Liability matching is a strategy that ties together the two sides of the pension balance sheet: the assets and the liabilities.

Cash flow matching is the purest, most precise form of matching. It is not (for the time being at least) widely practiced, since only in the later stages of the life cycle of a frozen plan does it become appealing. Before that point, there are other risks that cannot be managed with enough precision that cash flow matching becomes worthwhile. Annuities are closely related to this form of matching and they, too, offer plans a more extreme form of liability matching than is generally exercised at this time.

Unless the precision of cash flow matching is required, it is more common to capture the broad characteristics of a plan's liabilities and then to invest the assets appropriately—a strategy commonly referred to as "liability driven investing" (LDI). LDI normally involves the management of interest rate risk, which is the largest component of liability risk. Typically, a 1% fall in interest rates leads to a 10% to 15% increase in a plan's liabilities. The increase in asset values after a 1% fall in interest rates is much less. This is illustrated in Exhibit 2: In a typical pension plan, as much as 90% of the interest rate exposure in the liabilities may be mismatched.

Exhibit 2: Interest rate exposure in assets and liabilities



For illustrative purposes only.
The exact asset and liability durations vary from plan to plan.

Until recently, the only route normally considered for increasing interest rate sensitivity on the asset side was to increase the physical exposure to fixed income. This remains an effective step toward the liability-matching objective. It does, however, impact the ability of the plan to seek enhanced returns.

Another step that can be taken is to lengthen the duration of existing fixed income investments (for example, by investing in a long bond fund rather than a broad bond fund), thus increasing their sensitivity to interest rate movements. This step is relatively easy, but it only goes so far. For example, if the duration of the bond portfolio in Exhibit 2 were to be lengthened from four to ten years, the asset duration would then increase to three years.

DERIVATIVES-BASED SOLUTIONS

Some other solutions involve derivatives, such as futures or swaps. Derivatives offer the advantage of working with margin, providing greater flexibility. The swap market appears particularly well suited to meeting many pension plans' LDI needs. Contracts can be tailored to the needs of the plan; the length of the contract is open to negotiation, and other special features can be built in. Desired exposures can be achieved with a precision not possible in either the physical or the futures markets. The initial outlay on the part of the plan can be minimal. In addition, the interest rate swap market has historically offered a material premium over U.S. Treasuries, typically 0.4% to 0.5%. While there is no guarantee that this premium will always exist (and the growing interest in LDI may push the premium down), it adds to the attraction of the swap market at present.

Because the swap market is an over-the-counter market, however, attention must be paid to contract and pricing negotiations. The competitive bidding process is essential for best execution.

While most liability-matching solutions currently focus on duration management (the largest source of liability risk), a more sophisticated analysis of the sensitivity of liabilities to interest rates would look at other features of the yield curve, such as slope and convexity. Once the question of duration has been adequately addressed, this next level of interest rate risk management becomes worthwhile. At this point, the question of inflation risk may also be considered.

In addition, the liabilities of pension plans are also sensitive to other, non-financial variables, such as demographic risk. Generally, it will be plans later in the frozen plan life cycle that are most interested in managing these other facets of liability risk.

Plans considering swap contracts or any other form of liability-matching solutions must consider how those solutions will be managed once they are put into place. In many cases, plan sponsors will prefer to outsource that management role rather than attempt to acquire the expertise or resources needed to carry it out themselves.

INVESTMENT PERFORMANCE REPORTING

Any decision made for the purposes of liability matching has important implications for performance reporting. While corporate reporting metrics are based on the funded status of the plan, the typical reporting by which a plan's progress is monitored and assessed is not.

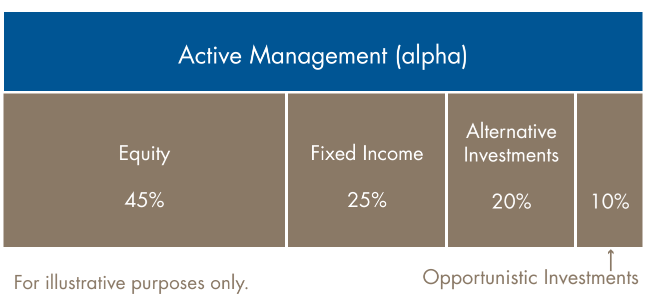
As plans make decisions driven by liability-matching considerations, some then judge the success of those decisions as if they were return-seeking investments, because they continue to use traditional reporting showing asset returns only. If interest rates fall, there is no problem: the liability-matching strategy appears successful on either criterion. But if interest rates rise, a liability-matching decision will appear to have been unsuccessful if judged by asset returns only: the reporting will show a loss on the strategy. The strategy may even be abandoned on the back of this apparent failure.

To avoid this problem, plan performance reporting must move beyond an asset-only perspective and measure success against liabilities. Reporting will then correctly point to the conclusion (in the event of an interest rate rise) that: “Interest rate risk was rewarded, and the plan is better off. Lengthening duration caused an opportunity cost.” The outcome is looked at in terms of an opportunity loss, not as a failed strategy.

RETURN SEEKING AND THE RUSSELL MODEL PORTFOLIO

At the other end of the Russell Road Map lies the pursuit of returns. Return seeking means risk taking. For this reason, a discussion of diversification—managing risk by spreading it out—belongs at the return-seeking end of the road map spectrum, not at the liability-matching end. Return seeking is about deciding which risks (and how much of each) to take, and about how to combine strategies to create an effective overall portfolio. These are complex issues. To simplify discussion of these issues, we have created the Russell Model Portfolio.

Exhibit 3: The Russell Model Portfolio



For illustrative purposes only.

The model portfolio is not an all-or-nothing proposition, but rather a vehicle for capturing a combination of the best of the old thinking and the best of the new; it incorporates some strategies that have been around for decades and others that are only just beginning to be properly understood.

Twelve insights on which the Russell Model Portfolio was built are:

#1: To get a return above the risk-free rate, you need to take risk

The Russell Model Portfolio takes a moderate to high level of risk in pursuit of roughly an 8% total portfolio return target. Some investors may adopt a more concentrated portfolio and more aggressive strategies in pursuit of higher returns. Others may take less risk, reducing or removing allocations to certain strategies and seeking even greater diversification within other parts of the portfolio.

#2: Traditional strategies alone do not offer enough fuel for success against most investors’ targets ...

The institutional investing landscape is in a state of change. Unlike, for example, the leading endowments, pension plans as a group still have not fully embraced alternative investments, even though the vehicles have been available for many years. The alternatives category can include real estate, private equity, commodities and other asset classes that lie outside the traditional exchange-traded assets.

#3: ...but you do need to be selective

New strategies merit consideration, but not every new strategy merits adoption. It is important to apply the discipline of the Russell Road Map and to keep the total portfolio view in mind.

#4: Opportunity doesn’t knock for long

The opportunistic category is a recognition that to get the most from fresh opportunities, you need to be a relatively early adopter. These are investments that may be characterized as “Go generate return wherever you find it.” Return-seeking investors need a structure that will enable, not resist, quick inclusion of opportunistic strategies in their portfolios. Hedge funds should be seen as an example of opportunistic investments.

#5: It’s the total portfolio that counts, not the parts

Risks should be balanced, so that no one source of risk is allowed to dominate the total portfolio. Reporting, likewise, should be focused on the total portfolio; it should not overemphasize the parts or adopt too short a time horizon.

#6: Portable alpha allows (within limits) separation of the alpha and beta portfolios

Portable alpha removes a constraint on active management and greatly frees up portfolio construction. If a particular field of active management is judged attractive, it can be incorporated into the model portfolio, even if the asset class on which it is based is only a small part of the market allocation or is not present at all.

#7: Today's return is more dependent on active management than yesterday's was

For many reasons, investors have reevaluated the balance between market exposure (beta) and active management (alpha) and are looking to active management to carry more of the burden of return seeking than they did in the past.

#8: If you find a source of (positive) alpha, take it

For all practical purposes, the right amount of alpha to target is, currently, as much as you can find that you have confidence in. Of course, this depends on the ability to find alpha. The challenge of finding good sources of added value remains the most important constraint on active management.

#9: The equity risk premium is not dead

Traditional asset classes—equities and fixed income—have not been abandoned. The model portfolio diversifies away from equity risk but does not abandon it.

#10: Bonds can be beautiful

Bonds have a place in a return-seeking portfolio. They can provide a valuable source of diversification and exposure to this important $20 trillion-plus market. The allocation to fixed income is one of the areas that will change as different investors assess their own situations and risk appetites.

#11: To stay fresh, stay flexible

Details of the division of the broad investment areas into subcategories should depend on practical considerations, such as the availability of suitable investment products and the state of the market at any point in time.

#12: It is time to reconsider portfolio constraints

Many pension plans have investment policies that are more restrictive than is desirable. Some, for example, still place a blanket restriction on derivative instruments. Other restrictions that plans are reassessing include constraints on short selling or on many types of leverage, and the narrowness of their active management assignments.

We should emphasize that the Russell Model Portfolio gives no thought to liabilities; its focus is on risk allocation and the return seeking side of the Russell Road Map spectrum. It is about being positioned to win the risk-taking game by spreading risks widely and being more flexible and nimble than the average investor.

BEYOND TRADITIONAL EQUITY AND FIXED INCOME MARKETS

The Russell Model Portfolio relies less on traditional equity and fixed income markets for its return and more on other sources of return. Two of those other sources are increased allocations to alternative investments and opportunistic investments.

A third source of return that is receiving more attention is active management. Active management has long been part of the return-seeking tool kit for most pension plans, but its role is being broadened and changed in today's environment.

As the application of portable alpha matures, it is moving beyond the simple "small cap alpha to large cap beta" application that became the iconic example. The alpha portfolios are becoming more diversified. And active management strategies are being incorporated into portable alpha programs that go well beyond the main traditional areas of asset management. These include global tactical asset allocation (GTAA) and active currency. GTAA can be a much more effective vehicle than those traditionally available for exploiting insights into opportunities at the broad market level. Active currency overlay assignments appear to offer a particularly attractive source for potential active management returns, due to the broad range of participants in the market (including central banks, corporations with exposures to hedge and tourists) with widely diverse objectives, not all of whom are profit motivated.

Another interesting category of development has been the field of portfolio engineering. Two of the more noteworthy recent advances in this field have been 120/20 (long/short) strategies and select holdings. 120/20 strategies allow investment managers to more effectively exploit insights into securities with poor prospects, not just those with strong prospects. Russell developed its select holdings strategy with the goal of enhancing returns in a multi-manager portfolio by identifying stocks that represent the collective best ideas of individual managers and increasing the allocation to these stocks.

REDUCING RISK WHILE ENHANCING RETURN POTENTIAL

Using Russell's capital market and alpha assumptions, the outcome of the model portfolio is an increase in the expected return assumption, compared to a traditional 60/40 portfolio, from 8.3% to 9.3% annually (as shown in Exhibit 4). At the same time, the standard deviation assumption (a measure of risk) of the portfolio is reduced from 10.0% to 8.2%. These would be significant enhancements.

This enhancement is achieved by a number of means. The Russell Model Portfolio reduces the contribution of equities to total risk to half that of the traditional portfolio. It relies more on alpha than on beta. It broadens the range of alpha sources, relaxes benchmark constraints for managers of traditional asset classes and increases the use of derivatives, leverage and short selling.

FROZEN PLANS

In closing our discussion of the Russell Road Map, liability matching, return seeking and the model portfolio, we explore their application to the specific case of frozen plans. Frozen plans face the same basic objectives and many of the same challenges as do other plans. But they have some notable features that are worth drawing out and addressing separately.

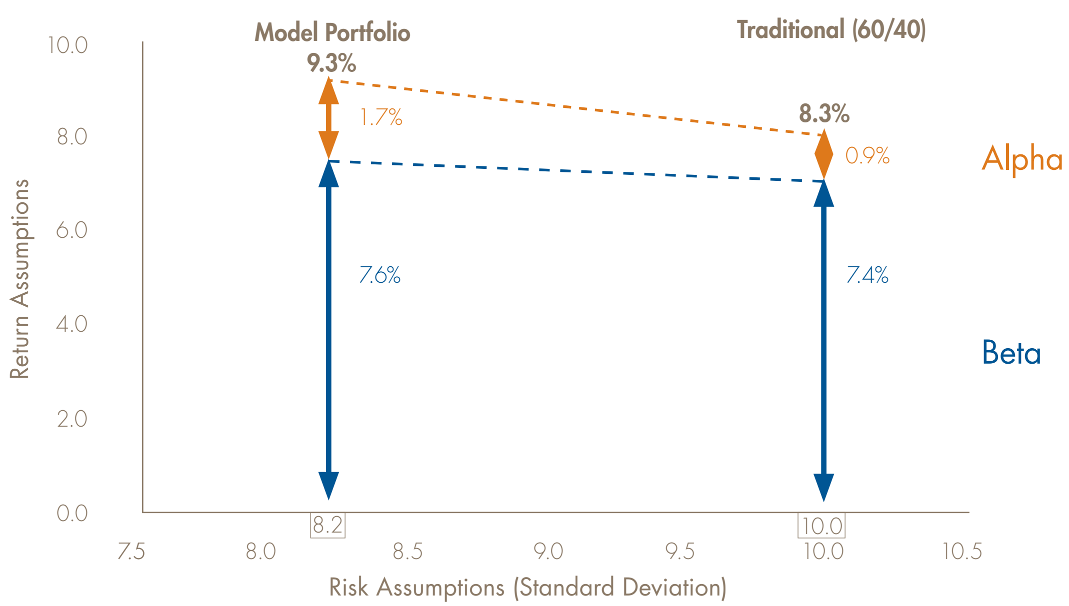
Freezing a plan is certainly no magic leap to freedom from the pension issues sponsors face. Indeed, it can act to throw those issues into sharper relief. But if a DB plan is seen as a problem, freezing does change it from an open-ended problem to a closed-ended one. The frozen plan must still be managed, probably for many years.

There are four key steps in the life cycle of a frozen plan.

Step one: closing the plan

The most basic type of freeze is to close a plan to new entrants while allowing current plan participants to continue accruing benefits. A soft frozen plan is like a closed plan, except that existing members no longer accrue new benefits. A pension plan does not exhibit a great deal of obvious change immediately following a freeze, but the future dynamics of the plan are altered.

Exhibit 4: Return and risk assumptions summary†



For illustrative purposes only. Not meant to represent an actual investment.

† Please note all information shown is based on assumptions. Expected returns employ proprietary projections of the returns of each asset class. We estimate the performance of an asset class or strategy by analyzing current economic and market conditions and historical market trends. It is likely that actual returns will vary considerably from these assumptions, even for a number of years. References to future returns for either asset allocation strategies or asset classes are not promises or even estimates of actual returns a client portfolio may achieve. Asset classes are broad general categories which may or may not correspond well to specific products. For example, Russell's assumptions for hedge funds are based on non-directional hedge funds and may not reflect important characteristics of directional hedge funds or other products that may fit under the broad label "hedge funds." Additional information regarding Russell's basis for these assumptions is available upon request.

Opinions and estimates offered constitute our judgment and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. The views and strategies described may not be suitable for all investors.

Formulation of the end game must start even in these early years. The extent of the emphasis on return seeking is largely a question of risk tolerance, corporate strength and other such variables, just as it is in an open plan.

Step two: the hard freeze

A hard freeze means closing the plan to new entrants, ending the accrual of benefits by current plan participants and ceasing to escalate accrued benefits in line with salaries. This is a substantially different situation than that of a closed or soft frozen plan.

The primary challenge facing the sponsor of a hard frozen plan is to move to full funding of the economic liability, plus some margin to cover those risks that cannot be hedged. Return seeking can remain an objective for hard frozen plans, to help make up any shortfall against this full funding target.

Liability matching is clearly a high priority, and the details of liability matching take on more importance as full funding is approached; risks that are relatively unimportant in an open plan (with its many moving parts) can be significant in a plan seeking to remove, as far as is possible, any source of potential shortfall.

Step three: the fully funded phase

When full funding is achieved, a frozen pension plan enters a new phase. The process of corporate disengagement is advanced by this stage: With the achievement of full funding, the goal now is to maintain it. As a result, the plan is now driven almost exclusively by liability considerations. Matching is paramount, and the risk associated with seeking extra return becomes unattractive.

Step four: the end game

As assets are depleted due to ongoing benefits payments and as plan participation diminishes over time, the plan will eventually become too small to be feasible as a stand-alone entity. At some point, a buyout of remaining benefits may need to be negotiated with an insurance company. While simple in concept, this step can be complicated and time consuming in practice.

In summary, freezing a plan is the start of a long process, and the normal operation of the plan does not need to be thrown out the window immediately. It is a process that can proceed quickly or slowly. Indeed, it can even be reversed: frozen plans can, and sometimes do, thaw, and accruals can start up again. No matter what path a freeze follows, however, a long-term plan that includes a realistic calculation of what it will take to bring the plan to full economic funding is essential.

We summarize in the table below the evolving emphasis on the two basic objectives throughout this process:

Exhibit 5: Four steps of a frozen DB plan

	LIABILITY MATCHING	RETURN SEEKING
OPEN PLAN	Moderate to high	High to low
STEP 1: Closed	Increasing	High to low
STEP 2: Hard frozen	High	Reducing
STEP 3: Fully funded	Maximum	Low to zero
STEP 4: End game	Maximum	Zero

401(k) PLANS

While for the most part we have chosen in the *Russell Pension Report 2007* to concentrate on the management of DB plans, DC plans also have some work to do if they are to accomplish their objectives as the primary retirement savings vehicles for private-sector workers.

For example, nearly one in four of those employees eligible to participate in a 401(k) plan does not actually do so.[1] Too often, nonparticipation is less the result of conscious choice than of inertia. Workers intend to join the plan, but never quite get around to it.

In response to this, the Pension Protection Act of 2006 introduced an antidiscrimination safe harbor to encourage more 401(k) plans to introduce auto-enrollment of participants. Auto-enrollment (with an opt-out option), which makes participation the path of least resistance, has been widely espoused as the most effective antidote to employee inertia.

Participation is a necessary step toward meeting the objectives of a DC plan, but it is not enough. Contributions must be sufficient to provide adequate retirement income. Investment decisions are frequently poor. Retirement accounts are dipped into for other purposes. As a result, income replacement levels for many are going to be disappointingly low.

[1]PSCA (2005). *48th Annual Survey of Profit Sharing* and *401(k) Plans.*

None of this is to say that DC plans are fundamentally flawed; like DB plans, they are a fundamentally sound retirement savings mechanism if properly implemented. They face real issues, however, and as elementary as these issues may appear to be, they are important ones for plan sponsors to address if DC plans are to serve their purpose well for most participants, not just for a few.

CONCLUSION

The world of retirement provision looks and feels very different today than it did just a few years ago, at the turn of the century. Pension plans have been badly hurt by both low interest rates and low returns. After years of living large on the back of one of the greatest bull markets in history, the traditional pension plan has become the problem child of many corporate balance sheets.

One of the underlying challenges for those responsible for plans today is an old one: Maximize the return on assets. But meeting that basic challenge is far more complex than it was even ten or five years ago. The number of strategies to be dealt with and the breadth of exposures to be managed have expanded greatly. Return seeking is a competitive game.

Meanwhile, an increased focus on liability matching has added a new dimension to the challenge of running a plan. The need for better asset-liability management has led to the growth of liability-driven investing (LDI).

At the same time, DB plans are reducing in their importance to many corporations; for those corporations, DB plans are no longer seen as a key plank in recruitment or a necessary component of a competitive benefits package. Corporations are often reluctant to devote additional resources to meeting the increased challenges of plans today.

The services required by DB plans are also evolving, and the supply side is evolving in response. More and more, plan sponsors are looking to outsource components of plan management. This outsourcing may involve little more than increasing the breadth of the services already being provided by trusted third parties. The marketplace—Russell included—is responding by offering a range of outsourcing solutions, customizable to a wide variety of individual plan needs and situations.

... AND A LOOK TO THE FUTURE

In closing, we offer some purely personal opinions for what the next one to two years might bring.

Bob Collie's opinions: I believe we'll see the breaking up of the pension plan herd. "At risk" DB plans and cash-sensitive corporations won't respond the same way to the Pension Protection Act of 2006 and accounting change as well-funded plans and earnings-sensitive corporations. There is a widespread trend toward more innovative strategies, but not all plans will embrace that change. Industry, culture, employee attitudes, unionization and workforce mobility will all drive plans in different directions.

All bond strategies, swap contracts, aggressive pursuit of innovation and the leading edge: Each of these strategies will be tried by some, but perhaps none by a majority. As new paths are trodden, there will be successes and failures.

In due course, the herd may well regroup; herds generally do. Some strategies will stand the test of time better than others, and a new normal may emerge. But the next few years will see pension plans more than ever before moving in different directions and testing new ideas. It's going to be an interesting time.

Rob Blackwell's opinions: I believe (or is it fear) that the next retirement crisis will be precipitated when baby boomers nearing retirement sit down with their investment advisors to consider how to draw a retirement income from their 401(k) and other savings. There will be a dawning realization that pension plans with their sharing of longevity risk features and steady income stream were in fact very desirable and therefore valuable benefits, a benefit that is extremely costly to buy as an individual in the form of an annuity. The second realization, I fear, will be that for many baby boomers, collective retirement savings will fall short of what is needed to provide the kind of retirement they thought they would have. On the investment front, one of the developments I will watch with considerable interest is the so-called DBization of DC. That is the application of the same investment structures to 401(k) plans as has been traditional in DB space through the use of institutional managers at institutional-level fees.

For more information or to request copies of the *Russell Pension Report 2007* please visit www.russell.com/pensionreport

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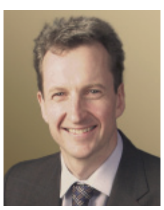
Previously, Rob held various positions throughout Russell, including leading the client services group for Russell's institutional investment business and serving as director of consulting at Russell's Sydney office.

Prior to joining Russell, Rob was director of equity trading and derivatives with Potter Warburg (the Australian office of S.G. Warburg) from 1992 to 1995.

From 1987 to 1992, Rob was with Dominguez Barry Samuel Montagu (now part of UBS), where he was involved in system development and quantitative analysis across the firm's equity and fixed-interest brokerage and funds-management businesses.

Before pursuing a career in investment management, Rob held a variety of positions in the computer industry, starting with IBM Australia, after completing his graduate studies in 1978.



ROBERT COLLIE, F.I.A., DIRECTOR, STRATEGIC ADVICE

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Robert Collie is director of strategic advice for Russell Investment Group's U.S. institutional investment services area. In this role, he has responsibility for oversight of the delivery of Russell's investment content to institutional clients.

Bob has been closely involved with the initiative to develop standards for the presentation of transition results, and was the author of the T standard, a standardized method for the calculation of portfolio performance during a transition. Other published work includes *The New Trustee's Guide to: Trading Costs*; the Russell Viewpoints *It's Time For More Choice in FX*; *How to Survive the After-Thanksgiving Day Sale: A Disciplined Approach to Market Valuation Analysis*; *Look Both Ways Before You Cross*; and (with Michael Thomas) *Mind the Gap—Effective Policy Implementation*. He was also co-author of the Russell London Monograph *Socially Responsible Investment: Does Your SRI Policy Pass Five Tests?* He has written on subjects as diverse as transition management, tactical asset allocation, fund governance, advance corporation tax, fiduciary responsibility, the impact of style biases, private equity, rebalancing, the Myners Review, transaction costs, interim portfolio management and hedge funds. He is a member of Russell's U.S. index content committee.

Bob moved to the U.S. at the end of 2001, having previously headed Russell's U.K.-based consulting practice, overseeing all consulting relationships with clients serviced out of London, covering the U.K., Europe, the Middle East and Africa. He holds the Certificate in Derivatives of the Institute and Faculty of Actuaries.

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