STATE OF WISCONSIN
Department of Employee Trust Funds
Eric O. Stanchfield
SECRETARY

801 W Badger Road
PO Box 7931
Madison WI 53707-7931

1-877-533-5020 (toll free)
Fax (608) 267-4549
TTY (608) 267-0676
http://etf.wi.gov

CORRESPONDENCE MEMORANDUM

DATE: March 21, 2005

TO: Wisconsin Deferred Compensation Investment Committee

FROM: Shelly Schueller, Director
Wisconsin Deferred Compensation Program

SUBJECT: Defaulting Closed Fund Account Balances

Prior to the removal of the Janus Fund and the T. Rowe Price International Stock Fund at the end of 2005, staff proposes that the Investment Committee again consider the Board policy of defaulting or “sweeping” closed accounts to the Vanguard Money Market fund.

BACKGROUND

According to chapter ETF 70.08 (3), Wisconsin Administrative Code, after the Board has determined that a fund is no longer acceptable for inclusion in the WDC, the Board is required to tell the WDC administrator to which other WDC fund any remaining participant account balances from the closed fund should be automatically moved or “swept.” The administrative rule *does not* specify to which fund the money is to be swept; that decision is left to the Board.

Selecting a default fund option when removing or replacing an investment option is a fiduciary duty, since the Board is making an investment decision for participants instead of the decision being directed by the participant. In the past when a fund has been removed, the Board has directed that any remaining account balances be swept to the Vanguard Money Market Fund, one of the WDC’s more conservative investment options.

As shown in the table on the following page, the Board has periodically removed investment options from the WDC. Since 1997, the Board has removed four investment options from the WDC and swept the remaining accounts to the Vanguard Money Market fund. These removals affected 4,351 participant accounts. As of March 1, 2005, 2,757 participants (63%) still held assets in the Vanguard Money Market fund.

Although we cannot know for sure why participants have failed to move their balances out of the money market fund, it is troubling that so many remain in the default fund despite repeated reminders to move their balances. It suggests that some WDC participants may not be actively managing their accounts for optimal financial advantage.

Reviewed and approved by Dave Stella, Deputy Secretary

______________________________ ____________
Signature Date

WDC FUND CLOSURE HISTORY				
Fund Name	Date Closed	Number of Accounts	Value of Accounts*	Number Remaining in Money Market
Dreyfus Premier Third Century	12-31-04	1,849	$6,081,547	1,668
Seligman Capital	12-31-99	778	$7,202,451	358
Twentieth Century Growth	12-31-98	1,042	$11,326,219	423
Twentieth Century Select	12-31-97	682	$6,402,527	308
* as of the date the fund was closed and the accounts were transferred				

INDUSTRY PRACTICES
According to the results of "Plans in Transition: IOMA's Annual Defined Contribution Survey," published in the August 10 2004, edition of "IOMA's DC Plan Investing," approximately 77% of plan sponsors (primarily 401(k) plan providers) responding to the survey sweep assets from closed funds to a fund offered by a different investment provider that is in the same asset class and has similar style and characteristics as the closed fund. The larger the plan is, the more likely they were to sweep funds to a similar fund. Only 7% of all respondents indicated that they sweep default funds to a money market.

Moving closed funds to a like fund in the same asset class and not to a money market fund appears to be the default of choice of most government-sponsored deferred compensation programs as well as private 401(k) plans. Staff queried the National Association of Government Defined Contribution Administrators (NAGDCA) and 11 of 13 government-sponsored[1] plans responding indicated that they move closed fund account balances to a like fund and not to a money market fund. One plan sweeps to a balanced fund. The WDC administrator, Nationwide Retirement Solutions (NRS), also states that the majority of their large government clients[2] sweep terminated funds to a similar asset class fund.

DISCUSSION
When selecting a default fund, the following points should be considered:

1. What are the objectives of the WDC?
   The WDC is a supplemental retirement savings program. As such, the WDC provides participants with the opportunity to invest a portion of their annual earnings in investment options on a tax-deferred basis.

2. What are the Board's responsibilities?
   The Board has fiduciary responsibility for the WDC. As fiduciaries, Board members have a duty to exercise diligence and prudence in their actions, including acting as experienced or knowledgeable investors when making decisions. When selecting a default option, the Board needs to consider all available information including legal advice. Accordingly, NRS' legal counsel will be available for questions at the Investment Committee meeting and the WDC Board meeting.

---

[1] Sweep to similar funds: CT, CO, TN, MD, MI, FL, Multnomah Co., cities of Seattle, Pasadena and Anaheim, and Denver Water. One ME local employer grandfathers funds (remain in program but closed). One state (TX) sweeps to a balanced fund.
[2] States of NY, CA, KY and MD

The Board is responsible for establishing criteria and procedures for selecting and evaluating investment options offered by the WDC, including choosing the asset classes to be offered and the fund managers in those classes. In recognition of these responsibilities, the Board has established a thorough investment option selection methodology and a process for monitoring performance of investment option selected for inclusion in the WDC. With the help and advice of the Investment Committee, the Board systematically reviews and monitors WDC investment options to ensure that the options remain suitable for WDC participants.

3. What are the participants' responsibilities?
WDC participants are responsible for selecting the investment options within the asset classes in which to invest and the amount to place in each. These are choices made by each individual who decides to participate in the WDC.

DEFAULT OPTIONS
There are several default options available to the Board. The table below lists the options, along with the pros and cons of each.

DEFAULT FUND OPTIONS		
FUND	**PROS**	**CONS**
Like Asset Class Fund (e.g., large cap to large cap)	• The participant stays in the asset class they originally selected • Generally, movement between like funds in an asset class should not incur market losses • May reduce the Board's fiduciary risk: the move can be defended by demonstrating that default fund is in the asset class originally selected by the participant	• May not preserve principle • May have to decide on which fund to send default accounts – an asset class may have both active and passive (index) funds • May be confusing for participants • May be problematic because the Board cannot know for sure if the participant has specifically selected the fund manager and the asset class or just the asset class
Balanced Fund	• May preserve more of participants' principle because it is a conservative option	• May increase the Board's fiduciary risk: to default a participant to a balanced fund would change the participant's asset class allocation and may be contrary to participant's intent • Could potentially make the Board responsible for any loss incurred by selling out of the participant's deleted fund and the loss of earnings between the participant's selected asset class and the balanced fund • May be confusing for participants
Money Market Fund	• Preserves participants' principle because it is a very conservative option	• May increase the Board's fiduciary risk: to default a participant to the money market fund would change the participant's asset class allocation and

DEFAULT FUND OPTIONS		
FUND	**PROS**	**CONS**
Money Market Fund		may be contrary to participant’s intent • Could potentially make the Board responsible for any loss incurred by selling out of the participant’s deleted fund and the loss of earnings between the participant’s selected asset class and the money market fund • May be confusing for participants
Stable Value Fund	• Preserves participants’ principle because it is a conservative option • Provides more potential for investment return than a money market fund while not necessarily increasing risk of loss of principle	• May increase the Board’s fiduciary risk: to default a participant to the stable value fund would change the participant's asset class allocation and may be contrary to participant’s intent • Could potentially make the Board responsible for any loss incurred by selling out of the participant’s deleted fund and the loss of earnings between the participant’s selected asset class and the stable value fund • Would have trading restrictions: the stable value fund has a 90 day equity wash rule • May be confusing for participants
Establish account through Schwab Personal Choice Retirement Account (PCRA) Fund	• Participant remains in the exact fund they originally selected	• Proactively creating a brokerage window to keep a fund deemed unacceptable by the Board may be viewed as a breach of fiduciary duty. If the fund is removed from the WDC core, presumably for performance or other issues, why would it be appropriate to let participants remain in that fund through Schwab? • Sets precedent: if the Board permits this, is it prepared to make a similar decision with respect to any future investment option closings? • Undermines the Board’s disclaimer of fiduciary responsibility for participants’ PCRA decisions • May not preserve principle • May not be offered by Schwab • May be confusing for participants • May change reimbursements to the Board • May be a cumbersome process • May have Schwab transaction fees • Would require contract amendment with Schwab

RECOMMENDATION

Given the potential for large numbers of WDC participants to be in a position to be affected by the default policy, staff proposes that the Investment Committee consider recommending one of the following alternatives as a default policy:

Alternative 1: Default to a fund in the same asset class. If the asset class has both active and passive funds and an actively managed fund is terminated, accounts will be defaulted to the active fund in the asset class. If there is no equivalent actively managed fund in the asset class, accounts will be swept to the passive fund.

- This policy keeps participants in the asset class they originally selected, with the same levels of risk and return as the participant originally accepted.
- It reduces the Board's fiduciary risk that participants may sue because of a failure by the Board to invest default account balances appropriately for the long term.
- It also raises issues should participants lose principle in the new fund.

Alternative 2: Always default to a passive fund in the asset class

- Defaulting to an index fund in the same asset class would keep participants in the asset class they originally selected, with nearly the same levels of risk and return as the participant originally accepted, but without the risks associated with active fund management.
- It also reduces the Board's fiduciary risk that participants may sue because of a failure by the Board to invest default account balances appropriately for the long term.

Alternative 3: Default to a balanced fund

- This option preserves participants' principle while providing for slightly more potential for investment return than a money market fund. However, it takes a participant out of the asset class they originally selected.
- It also may expose the Board to fiduciary risk, as the participant has not made the selection and the WDC may be held responsible for any market-related losses.

Alternative 4: Continue to default to the money market fund

- While this option preserves principle, sweeping to the money market fund takes a participant out of the asset class they originally selected.
- Moving participant accounts to the money market fund may expose the Board to fiduciary risk, as the participant has not made the selection and the WDC may be held responsible for any market-related losses between the asset class the account was originally in and the money market.

Staff will be available at the Investment Committee meeting to discuss this memo.