



The Newsletter of the Montana University System's Flexible Benefits Program

Investing 101 - Part I

Almost every MUS employee is now an investor. The dramatic shift in the nature of retirement programs in both the public and the private sectors has led to much more employee responsibility and, we should add, risk in the management of your retirement program. Gone are the days when “Ma Bell” or “Ma Anybody” will take full control of your retirement funds and all you will have to do is sit back and wait for your golden or, at least, silver parachute and gold watch. As we all know, there is not now, nor has there ever been, a gold watch for MUS employees. And further, if we do not pay careful attention and “watch” our retirement programs carefully, there may not even be sufficient funds for our golden years.

The reasons for these changes in retirement systems are twofold. First, the era where individuals join a university faculty/staff or company and remain there for their entire careers is simply gone. Data show that most of us will not only change employers many times in our work life, but many of us will change careers as well. Therefore, “portability” or the ability to take our retirement plans with us as we shift from one employer to another becomes increasingly important. Secondly, both public and private sector employers have, in recent decades, limited their liabilities in funding their retirement plans by shifting from “defined benefit” plans (DB) to “defined contribution” plans (DC). A defined benefit plan calculates a retirement amount based on a formula that factors in final average salary and years of service and that benefit is paid to the beneficiaries as long as they live. Employees take no investment risks in DB plans such as our Teachers Retirement System (TRS) plan or our Public Employees Retirement System (PERS) DB plan. If the plans start running short of funds, as both TRS and PERS have done in recent years, the employer (in this case the Legislature) is required to bail the plans out. In the case of DC plans such as our own TIAA-CREF Optional Retirement Plan (ORP) and the PERS ORP plans, the employer makes a contribution to a tax deferred account in the employee’s name and, at this point, the employer’s responsibility essentially ends. All of the risks in a DC plan are shifted onto the employee. If the beneficiary in a DC plan starts running out of funds, they must somehow live with the results. Defined benefit plans work very well with long-term employees of a single employer, but have very limited portability. Defined contribution plans can work very well with the modern and highly mobile workforce, but only if these employees manage their retirement funds wisely.

The Choices Newsletter

is designed to help

promote a sense

of our ownership

and responsibilities

within the program.

All members of our ORP plans are individual investors whether they realize it or not, and so too are the majority of us who tax-defer part of our salaries into one of our 403b or 457 Supplemental Retirement Programs (SRAs). The purpose of this article is to give us the basics of wise personal investment practices. In this brief walk down Wall Street we will stress the essentials of retirement portfolio management: asset classes, types and levels of risk, diversification, asset allocation, time horizons, expense ratios, fund selection, and rebalancing. Since the risks and rewards of these ORP and SRA plans now rest squarely on our shoulders, we would be wise to learn the fundamentals of sound investing. Otherwise, we might just end up in our golden years flipping burgers at the local fast food joint.

1. Asset Classes - There are three broad categories of investment assets - stocks, bonds, and fixed funds. Each of these categories carries with it different levels and types of risk and most financial planners suggest that a well designed retirement portfolio contain some investments in each of these categories. You may invest in these assets individually by buying stocks and bonds direct or you may pool your resources and invest in mutual funds.

A. Stock or equity funds may invest in large companies (large cap), mid-sized companies (mid cap), or small companies (small cap), internationally (excluding the U.S.) or globally (including the U.S.). Sector funds invest in one segment of the market: for example, transportation stocks, utilities,

high tech, etc. Index funds buy the stocks that go to make up a certain market index such as the Dow Jones Industrial Average (DOW) or the Standard and Poor’s 500 (S&P 500). The performance of an index fund essentially tracks the average to which it is associated.

With stocks you are basically a part owner in a company. If the company’s fortunes and profits increase, its stocks go up in value. Conversely, if a company fails or has poor earnings, the value of the stock decreases. As an asset class stocks have the greatest potential for long term growth, but they are also among the riskiest investments, especially in the short term.

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B. Bonds invest in debt and like all loans, there is always some risk that the debt will not be repaid. Bonds can be classified according to the borrowing agency: corporate bonds, municipal or other government bonds, U.S. Treasury bonds, and mortgages. Bonds may also be classified according to the length of the debt: short-term (3 year maturity or less), mid-term (4 to 10 year maturity), and long-term (more than a 10 year maturity). The credit worthiness of the issuer provides an additional means of rating bonds; investment grade corporate bonds or U.S. Treasuries obviously carry less risk than "junk" bonds issued by small companies. As an asset class, bonds carry less risk than stocks but have a lower potential for growth.

C. Fixed Funds carry the least risk as a class but have the lowest average rates of return. What defines fixed funds as an asset class is a set rate of return sometimes with guarantees. Fixed funds typically include bank savings accounts, money market funds, certificates of deposit, cash-value life insurance policies, and fixed annuities (such as TIAA funds). There is little or no risk of capital loss but little or no potential for appreciation. As a class, fixed funds tend to have lower rates of returns than either stocks or bonds.

2. Risks - There is no investment without risks but the risks come in different forms:

A. Inflation Risk - We all face inflation risk, the loss of the buying power of our money due to the ravages of inflation. Even if we were to put our cash in a sock in our drawer, after 15 years or so of 3% annual inflation, our money would purchase only half of what it would in today's dollars. The sock-the-drawer strategy is obviously a poor one for retirement savings. If we invest conservatively, we could still stand to lose some of our buying power to inflation. The current rate of inflation and the interest rates paid on deposits are, from a historical standpoint, quit low. However, if we were to commit most of our savings to a long-term CD at 5% total return and inflation were suddenly to double to 6%, we would end up losing some of our purchasing power.

B. Capital Risk - When we lend money, there is always a danger of a loan default. Because there is some possibility, however small, that we may never recover our principal, our investments in bonds does involve some risk of capital. Shifting interest rates impact our bond investments as well. There is an inverse relationship between the market value of our bonds or bond funds and interest rates. As interest rates increase, the value of our bonds or bond funds typically decreases. Conversely, our bond funds usually increase with decreasing interest rates.

There is even greater capital risk with stock or equity investments. A company may fail to get sufficient market share; feather the nests of its executives disproportionate to their worth; have disappointing sales, product failures, management problems, unanticipated losses or liabilities, or a host of other problems. All of these will have a negative impact on the company's profits. The value of your stock in that company or the mutual fund holding that company's stock will likely decrease as a result. Most stocks or equities involve even more capital risks than bonds.

C. Currency Risk - In the case of international stocks, bonds, and mutual funds, the risks are compounded by the addition of currency risk, the danger that a good return on investment might be diluted by a weak exchange rate to the dollar. When you invest internationally, you are not only buying into a foreign product or company, but you are betting that the currency of the country will hold its value as well.

D. Liquidity or Opportunity Risk - When you are fully invested, the money you have placed in one asset often cannot be sold readily in order to invest the funds somewhere else. Retirement funds are not liquid and you will pay severe tax penalties for premature withdrawals. You may miss other opportunities as a result. To put it simply, you may not be able to invest in that idyllic retirement cabin in the mountains that just came on the market at a discounted price if all of your money is tied up in your retirement funds.

All of these risks involve trade-offs. By investing in a 403(b) program or the 457 plan, you trade liquidity for tax deferral and high returns. In general, bonds are riskier than fixed funds and stocks are the riskiest of all. The risk categories do overlap, however. Junk bonds are often riskier than blue chip stocks, for example. Historically, bonds have yielded higher returns than fixed funds and stocks have the highest yields of all. In sum, the higher the risk, the higher the potential yield.

With all of these risks that abound, you are probably wondering how anyone is able to reach retirement age with any kind of reasonable financial security. The secret lies in power of time and the power of compound interest, "the greatest force in the universe" Einstein claimed. When you borrow money for short term goals, that force is working against you; when you invest for retirement, the force is with you. A stock or equity investment is very risky if you might need that money in a year or two. The market may and has undergone corrections of 20 or 25% over a short period of time, and you will be hard put if you should need that money shortly after a

major dip. But if you could go out five years, your risk would be greatly diminished and if you could stay invested for 10 years, there would hardly be any capital risk at all. Fortunately, for most of us, time is on our side when it comes to retirement savings. The more time we have, the greater the risks we can take and there are many principles and strategies that we may employ to reduce our risks even further.

3. Risk Tolerance Evaluation - One of the most important considerations you should make is an honest assessment of your tolerance for risk. If you are going to spend all of your time monitoring your funds or enduring restless nights worrying about a drop in the stock market, you are probably far better off putting your funds in a fixed account or one of the new life cycle funds, accepting the lower potential for high returns, and getting on to more important things in your life. If you overestimate your risk tolerance, you might engage in inappropriate and self-destructive behavior.

I remember a colleague some years ago who asked my advice on retirement investing. I suggested a solid no-load blue-chip index fund with a good long term record and low expenses. A few months after he invested in this fund the market dropped 500 points, he panicked and transferred his funds to a money market account. Shortly after that time, the market went up over a thousand points. This individual had overestimated his tolerance for risk, and by "buying high and selling low," he had violated the cardinal principle of all investing.

On the other extreme, it is easy to get into serious trouble by underestimating risks. There are some investments that are simply too risky for a retirement portfolio. If you have a gambler's soul and enjoy life on the edge, you should probably "play the market" with your discretionary funds and not your retirement savings. Pork belly futures, highly specialized sector funds, single country international funds, precious metals, and start-up companies may well make you rich some day, but are simply too risky to bet your retirement on. Set aside some "play money" and gamble on the market if you wish. Your odds of succeeding are probably far better than they would be at Las Vegas. But do not put your retirement monies in jeopardy by inappropriate risk taking.

4. Diversification - Do not put all of your retirement eggs in one basket. Often as one asset class goes up, another class goes down thereby smoothing out your returns and reducing your portfolio's volatility and

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risks. The easiest way to diversify is to pool your resources with others by buying mutual funds or annuities rather than individual stocks or bonds. You get professional management of your investments and usually a family of funds to invest in. Every retirement portfolio should include some combination of stock, bond, and fixed funds and you should have some exposure to world markets too.

5. Dollar Cost Averaging - If you are contributing every month to a retirement plan, you are *dollar cost averaging* without even knowing it. The **dollar cost average** strategy involves investing set amounts in funds on a regular basis over a period of time. When the market is up, the cost per share is higher; when the market is down, the share cost is lower. Dollar cost averaging works because the **average** purchase cost per share is likely to be lower than it would be with a onetime lump-sum investment. Since all of us should be saving for our retirement on a regular basis anyway, dollar cost averaging is a natural strategy for us to follow.

The opposite strategy to dollar cost averaging is **market timing**, attempting to sell shares just before prices drop and purchasing shares just before they appreciate. Since no one knows exactly when financial markets might rise or fall, few succeed at this strategy, even the professionals. Market timing is a very risky technique to employ with retirement funds and most people would be far better off with a "dollar cost average/buy and hold" approach.

6. Asset Allocation - Asset allocation is the apportionment of your funds into different asset classes - stocks, bonds, or fixed funds, national or international. The question is what percentage of your retirement portfolio should be invested in these various asset classes. The answer is highly complex and dependent upon your age, years to retirement, dependents, other assets, other retirement programs in which you participate, tolerance for risk, and a host of other variables. Yet experts agree that the asset allocation model that you select more than anything else has the greatest impact ultimately on the overall risks you take and the rewards you will receive. So important, in fact, is asset allocation that you would be wise to talk to a representative from TIAA-CREF if you are in the ORP or a representative from your supplemental retirement program and evaluate what allocation is most appropriate at your age, years to retirement, risk tolerance, etc. All of our retirement plan providers have good information on their web sites to help with these decisions and toll free numbers (listed in the side-bar on page 4).

7. Know Your Investments - It always amazes me how little people know about the funds they are invested in. Do you know the general investment strategies, expense ratios, holdings, and long-term performance records for every fund you own? Many of us, for example, participate in the Optional Retirement Program. Yet few of us are aware of the fact that the CREF Stock fund is a mixed fund: about 65% of the holdings are in U.S. large cap stocks indexed to the Russell 3000; about 20% is invested internationally; and the remainder is invested in growth stocks. Few of us know that the TIAA fund guarantees principal and a minimum 3% annual return on investment; that the CREF Social Choice Fund is really a "balanced" fund investing in both stocks and bonds; or that the CREF Global Equities is 28% invested in the U.S. Often we understand far more of the technicalities of our automobile than our mutual funds despite the fact that the latter usually has far greater consequences for us.

We should really never invest in anything we do not understand. What this means is, yes, we should always read the prospectus before we plunk down our money. Perusing prospectuses is not exactly most people's definition of a "good read" but no where else can you uncover essential information on a fund's investment strategy, holdings, fees, expenses, and performance. The SEC requires that all mutual fund companies issue "plain English" summary statements following a standardized format. This should enable all of us to make easy comparisons among the various funds.

8. Stay the Course - The most powerful strategy for reducing risk is to choose appropriate investments to begin with and hold them through all the twists and turns and ups and downs of the market for the long term rewards that are almost certain to come. When it comes saving for retirement, time is what we have and patience is what we need. The "buy and hold" strategy may not be as exciting as buying and selling, attempting to guess what markets may do, or following the lead of the latest market guru or the hot tip that is "certain" to make us millions. The reality is that index funds outperform funds actively managed by professional stock-pickers over 90% percent of the time and few funds ever outperform the market in the long haul. This should give us pause if we are really considering trying to better the experts. Most of us are very unlikely to outdo the pros and the pros rarely outdo the market itself. Investing for retirement is the art of growing rich slowly. ■

Editor's note: In Part II of this series, we will

look at strategies for picking funds for our retirement portfolio, the importance of expense ratios, rebalancing our portfolios, and target age funds. In the interim, you may wish to expand on the themes outlined here with some additional reading. John Bogle's The Little Book of Common Sense Investing (2007) and Burton G Malkiel's A Random Walk Down Wall Street, 9th ed. (2007) are sound and straightforward treatments of basic investment strategies and highly recommended.

The Director's Chair by Paul Bogumill

Our Pharmacy Benefit Manager (PBM), Pharmacare, is being integrated into CVS/Caremark. Just a couple years ago we experienced a similar transition when EHS was acquired by Pharmacare. The retail pharmacy networks and mail order options you have been using have not changed. You will begin noticing the CVS/Caremark "name change" on literature you normally receive as you utilize the prescription benefit. **BUT THIS IS SO MUCH MORE THAN JUST A NAME CHANGE.** Our prescription benefit has seen higher than normal trends in the last year, and it is imperative that our Pharmacy Benefit Manager is a partner that will work with us as we navigate the tricky waters of prescription benefits.

The PBM market is dominated by 3 large players - Medco, CVS/Caremark, and Express Scripts. After that, you have several mid-sized players - Walgreens, Prime Therapeutics, MedImpact - and lots of captive PBM's (i.e., part of a managed care company) - WellPoint, Aetna, Cigna. The three largest PBM's manage drug benefits for over 200 million Americans - 95% of Americans with prescription drug coverage. Pharmacy benefits being associated with a larger player can be advantageous to us as we utilize them to garner access to manufacturer rebates, set up clinical programs, provide cross pharmacy data for drug - drug interactions, and other pharmacy benefit set ups. But just as important for us is to be sure this large vendor performs from a customer service perspective, and works with us to manage our prescription plan to the benefit of our plan members and not to the benefit of the company's bottom line. To date, we have been very aggressive with CVS/Caremark to obtain these criteria elements, and they are being responsive. For our MUS health plan we spend nearly a million dollars a month on our pharmacy benefits, and the prescription benefit has matured into over 20% of our total claims costs each month. Thus, an active partner in the management of this benefit is vital to our plans' success. ■

Retirement Plan Transfers

Our Regular and Supplemental Retirement or 403(b) plans are qualified by the IRS as eligible for tax deferral. To maintain our eligibility MUS must therefore follow all IRS regulations strictly. There are some recent and pending IRS rules that have or will have serious consequences for all of our ORP, 457 and 403(b) plan participants. All members should pay strict attention to the following note from Paul Bogumill, MUS Director of Benefits:

Recently released IRS rules are going to require the MUS to provide more oversight and coordination with our various pension/retirement options for our employees - even the employee only contribution programs. This activity stimulated our campus/system wide Pension Think Tank meeting in September. We formed a committee to tackle these issues in more detail at our Fall Retreat and IUBC meeting. The majority of these regulations will not become effective until January 1, 2009 and this working group will keep you informed as we are required to focus on these important benefits.

At this point - PLEASE BE AWARE OF THE FOLLOWING INFORMATION AND SHARE IT WITH OTHERS THAT MAY BE INVOLVED:

-After September 25, 2007, contract exchanges (90-24 transfers) between 403(b) providers may cause loss of the tax-qualified status.

Until September 24, 2007, participants were allowed to transfer an existing 403(b) con-

tract or account to another 403(b) account under Revenue Ruling 90-24 (commonly referred to as 90-24 transfers). Any transfers made on or after September 25, 2007, should only be made to accounts associated with the plan. Transfers not made in accordance with these provisions can become fully taxable to the participant. **THUS - for any transfers to another 403(b) plan please coordinate with the vendor or your campus payroll/benefits staff to verify the status of the account and its association to MUS, thus protecting the tax status of these dollars transferred.**

-Paul Bogumill

The bottom line is that all 403(b) participants must be extremely careful in making transfers from one tax-deferred plan to another. Transfers among the MUS vendors: Montana Deferred Comp, Aetna, Metlife, Scudder, T. Rowe Price, TIAA-CREF and Valic should pose no problems. If you wish to transfer to another vendor not on this list, you should contact the MUS Benefits office and seek an "exception" **before you make the transfer.** Otherwise you could face serious tax consequences: **you will likely be required to pay income taxes on the total amount transferred in a single tax year and, if you are younger than age 59 and a half, you will be assessed a 10% penalty besides.** If you leave MUS employ, you may wish to consolidate all of your 403(b) funds under a single vendor. That is still allowed, as are rollover transfers made after age 59 1/2. The bottom line: contact your payroll/benefit office and be absolutely certain of the tax consequences **before** any transfers are made. ■

CHOICES NEWSLETTER

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Since each individual and family situation is unique, you should always consult your family physician before taking action on any medical advice given here and you should consult your personal financial advisor before acting on any financial advice in the Newsletter. Consult plan documents for complete information.

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