

- On 403 (B) Plans -

**Presented to Southwestern Illinois College
Academic and Support Staff
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Note: This web-based version of the seminar text does not contain graphs that were in the original paper.

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I. Introduction

Educational In Nature

This presentation is designed for academic and support personnel of the Southwestern Illinois College (SWIC). It is meant to be educational in nature, and the emphasis is on legal and financial aspects of the investment of assets, with attention being given to both individual and institutional concerns.

The presentation is not intended to give out investment advice on the selection of specific assets, and is not meant to be a recommendation to buy, trade, or sell any security or any type of investment device. Financial advisors should be sought out for such selection of assets, and well as for overall financial planning at both individual and institutional levels.

Qualifications and Affiliations

Kevin C. Kaufhold is licensed to practice law in the State of Illinois, is a member of the Illinois State Bar Association, local Bar Associations, and is past chair of the Labor Law Section Council for the Illinois State Bar Association.

Kaufhold has extensive experience in the representation of clients in the field of labor law, and represents or has represented several joint labor-management pension, health and welfare, and other associated trusts funds in the collection and / or representation of trust matters. Additionally, Kaufhold has widely authored and lectured on various topics of labor law.

Kaufhold is also a member of the International Foundation of Employer Benefit Plans (IFEBC), and has attended several of the Foundation's Annual Conferences.

Kaufhold graduated from Georgetown University Law Center in Washington, D.C., received his undergraduate degree from SIU-E, and an Associates of Arts Degree from Belleville Area College (now known as SWIC). Kaufhold has also recently taken graduate level courses in Economics and Finance at SIU-E, School of Business.

Disclosure as to Ownership of Investments and Philosophies of Investment

Kaufhold currently holds interests in actively managed mutual funds; passively managed index mutual funds (including Vanguard Funds); several publicly traded equities; and ownership and partial ownership of several local, private businesses (including the Law Firm).

As to his own investments, Kaufhold generally follows a value style investing philosophy, and believes in the long-term investment of assets and accumulation of net worth.

II. On Legal Considerations

- A 403 (B) is a tax deferred retirement plan available to employees of participating educational institutions and 501(c)(3) charitable organizations.
- Similar in style to a 401(k), except for employees of educational and charitable institutions.
 - o 401(k)'s are available to private sector employees.
 - o 401(k)'s can be limited to only certain employees; 403(B)'s generally require universal availability, subject to some exceptions.
- 403 (B)'s can act as a supplement to other pension and retirement plans.
 - o IRS treats 403(B)'s as Tax sheltered annuities (TSA's)
- Contributions are made on a pre-tax basis, through a voluntary salary reduction program with the employer.
- Investments grow tax deferred until withdrawal, at which time they are taxed as ordinary income.
- Typically, participants choose from investment providers offered by the employer, and can include:
 - o Fixed annuity and variable annuity contracts are allowed through insurance companies.
 - o Custodial accounts (i.e. mutual funds through a 403(B)(7)). Prior to 1974, 403(B)'s were available only as annuities with insurance companies. In 1974, ERISA was passed for private sector employees, and this allowed for mutual fund investments. At that time, 403(B)'s were expanded to include mutual fund investments.
 - o Retirement income accounts for churches.
 - o Employees can request for the employer to include additional investment providers to an approved list. (SWIC is very flexible on this, currently having 35 approved vendors).
- 403(B) contributions will not lower Social Security benefits or vested defined benefits from other qualifying private or public retirement plans.
- Participation in a qualifying defined benefit plan will not affect eligibility to participate in a 403(B) plan, nor the amount that can be contributed to a 403(B).

- Tax credit of up to 50% of the first \$2,000 in contributions to a 403(B) are allowed on individual tax returns, on a sliding scale basis.
 - o The full 50% credit is available to joint filers with \$30,000 or less in AGI; 20% credit allowed for AGI of \$30,000 to 32,500; 10% for joint filers between AGI of \$32,500 to \$50,000.
 - o For single filers through 2006, eligibility is currently ½ the threshold of joint filers (50% of the 1st \$2,000 for single filers with AGI of less than \$15,000).
- 403(B)'s are universal in their availability, and apply to part-time and full-time employees.
 - o Exceptions include: employees contributing \$200 or less annually; employees or students working less than 20 hours per week (employers may elect to allow employees working less than 20 hours per week the ability to participate); participants in another TSA, 457 or 401(k).
- For 2005, workers can contribute the smaller of:
 - o \$14,000 (in 2006, \$15,000 plus COLA adjustment);
 - o Or up to 100% of includable compensation;
 - o For employer matches, limits are up to \$42,000 or 100% of compensation, whichever is smaller, but the employee is still limited to an elective deferral limit of \$14,000, and the employer can then match up to an additional \$28,000. This would be a Title I Plan (SWIC does not match, which would be considered a non-Title I Plan).
 - o Catch-up provisions allows for employees who are 50 or over to contribute an additional \$4,000 for 2005, and \$5,000 plus COLA in 2006 and thereafter.
 - o Another catch-up provision: If the employee has 15 or more years with the same employer, and has not contributed more than an average of \$5,000 to 403(B)'s in prior years, the employee can elect to increase contributions by up to an additional \$3,000 per year, to an lifetime maximum of \$15,000.
- On withdrawals / penalties / distributions:
 - o Please note that annuities are private contracts developed with insurance companies, and these contracts may provide for a penalty on early withdrawal, or even transfer to another participating employer. The specific contract document needs to be referred to.

- Distributions taken prior to 59 1/2, or other qualifying events (see below) are subject to a 10-1/2% early distribution penalty, and may be subject to a 10% additional tax on the distribution (with some exceptions).
- Generally, penalty-free distributions can occur for certain triggering events:
 - 59 1/2 years of age;
 - Or separates from service at 55 years of age and then retires;
 - Or retires before age 55 and is eligible for substantially equal periodic payments (SEPP);
 - Or becomes disabled;
 - Or through an approved loan (qualifications and limitations to this);
 - Or suffers financial hardship loan (qualifications and limitations to this);
 - Or dies (designated beneficiaries receive the money distributed over the beneficiary's life expectancy, or by the year following the participant's beginning eligibility date for retirement distribution depending upon whether the beneficiary is receiving retirement benefits when the employee's death occurs).
- Distributions do not have to be made when the employee becomes eligible for distributions (generally at 59 1/2), but distributions are mandated from a 403(B) no later than the April 1 of the year following the year in which the employee turns 70 1/2.
- Money contributed prior to Dec. 31, 1986 is not subject to age 70 1/2 age distribution requirement (more qualifications to this).
- On changes to the contribution rate, many employers will limit the number of changes allowed per year. Often, employers will provide for only one change per year. (SWIC allows multiple changes per year).
 - At any time, employees can stop contributing altogether, however.
- Contributions must be credited to a 403 (B) no later than the 15th business day of the month immediately after the month in which contributions are withheld (the maximum is therefore 45 days).
- Rollovers to other participating plans of other employers may possibly be allowed, even to 401(k)'s, but there are limitations with annuity contracts and as to employers not allowing such transfers, so check with all parties concerned before attempting.
 - Do not merely take a lump sum payment. This may be treated as an early withdrawal, subject to a stiff penalty. Make sure it is an approved rollover transfer.

- On divorces, QDRO (qualified domestic relations order) rules for alternate payees apply.
- Employees can contribute to both 401(k)'s and 403(B)'s, simultaneously, but cannot exceed the annual contribution limit (\$14,000 in 2005).
- Employees can contribute to 403(B) and Roth IRA, but are still subject to Roth AGI limitations.
- Employees can participate in 403(B)'s and SEP IRA's, but generally employers make the SEP contributions.

III. On Personal Finance Considerations

Investor Education. Learning anything and everything about savings and investment leads to a more informed investing public.

Keep it simple. Many professionals have suggested that simplicity is itself an effective strategy for long-term investing. Numerous writers have suggested over the years to keep it simple.

Live below your means, and save. Whatever a person's income level, even modest savings can accumulate to become significant sums. An example: after 40 years of dutifully saving \$25 a month, one person had developed a \$1 Million + portfolio. *Investing for Life*, NAIC, at 82.

Saving more, and the power of compound returns. The mere act of increasing your savings even by small amounts will do more for one's net worth than most other investment decisions can, including the adoption of an aggressive allocation strategy.

Invest regularly. On a related topic, methodical and regular savings will certainly accumulate over time. In one study, families with fairly low earnings patterns were found to accumulate massive amounts of savings and retirement accounts. What mattered most was the simple choice of certain families to consistently and regularly save and invest versus the choice of other families to consume and spend. "You Don't Have to be Rich to Save a Big Nest Egg", *St. Louis Post Dispatch*, Sept. 1, 2000, p.c12.

Dividends and Dividend Reinvestment. Since 1926, dividends have accounted for 42% of the S&P 500's annual return. *Better Investing*, Feb. 2005, at 23. Dividend reinvestment and the power of compounded returns are such powerful investment tools that returns can be magnified many times over by dutiful investment of assets. The following graph provides a wonderful example. *Better Investing*, Feb. 2005, at 10.

--- Insert dividend graph here ----

Dollar Cost Averaging. Regular additions to capital will allow the individual to take advantage of the downs or dips of any stock, as well as getting hit with times of relatively high valuation of the same stock. You end up seeing the average of all the lows and the highs in prices. By regular investment, your average price of a stock will in all probability be lower than if you bought the same stock at any one particular time. Andy Tobias, at 133-137.

Keep Costs, Expenses, and Taxes Low. The costs of management of an asset portfolio are critical to the overall success and rate of return of that portfolio. Always remember that transaction and trading fees, administrative and management expenses, and the turnover of assets with the resultant tax impact on capital gains will all act as a drag against performance of an investment portfolio. It is therefore prudent to keep expenses to a minimum.

Cost, Expenses, and Taxes: A Discussion of Mutual Funds. Many mature individual and institutional portfolios contain one or more mutual funds, so the following comments are tailored to the mutuals. Actively managed mutual funds charge much higher expense fees than index funds and generate higher turnover costs.

The higher expenses of the actives are the chief reason that actively managed mutual funds will underperform their benchmark indexes. In any one year, up to 70 % of all actively managed funds under-perform the Wilshire 5000 index. *Refresher for Trustees on Investment Concepts*, International Foundation of Employees Benefits Conference, Orlando, Fl, Nov. 1, 1999, chart at 70-8; *A Random Walk*, at 215. Over five-year periods, 90 % of all mutuals may end up trailing the S&P. In fact, one source indicates that only 1.20% of all actively managed funds have outperformed the S&P Index in each of the five years between 1994 to 1999! “Refresher on Investment Concepts”, IFEBC Annual Conference, Nov. 2000, Sandy Lincoln, speaker. And as of the end of 2004, only one known active mutual fund manager has outperformed the relevant benchmark index for last 14 consecutive years (Bill Miller, manager). After tax impacts are figured in, index funds may outpace 86% to 97% of all actively managed mutual funds. Bogle, at 286-287.

Coupled with an inability to outperform the indexes, active mutual funds suffer from a lack of consistency in performance. There is little or no long-term relationship between mutual performance in a past period and investment returns in a future period. Even the *Forbes* Honor Roll of Mutual Funds has under-performed the Wilshire 5000 over a 16 year test period. *A Random Walk*, at 443-444. And, a Morgan Stanley Dean Witter study in 1998 showed that repeat superior performance by the mutuals is as probable as results obtained randomly. *Common Sense on Mutual Funds*, John Bogle, at 214.

Invest in the Long-Term. A simple, long-term buy and hold type of strategy takes advantage of compounded returns, reversion to the mean tendencies of assets, and allows

for the accumulation of assets in a tax-deferred status, with capital gains being paid (at the reduced, long-term tax rates) only when a sale occurs. Coupled with dollar cost averaging and dividend reinvestment, additional investments of even an incremental nature can develop into a solid, long-term asset portfolio.

Formal studies also support long-term investment patterns. In a computer run of 1,200 companies over an 18 year period, the correlation of earnings to price steadily increased from a short-term 3 years of .131 to .360, up to an 18 year incidence of .688. *The Warren Buffett Portfolio*, p.74-76, and Appendix B. In another study reviewing the S&P 500 long-term performance from 1964 to 1999, two primary things became evident: First, the trend of earnings is strongly upward; Second, stock price advances over long time periods are closely aligned to earnings and dividend growth. See, *Winning the Investment Marathon*, at 10-15. A simple long-term investment strategy takes advantage of this alignment, and does so in an automatic manner.

Tax Issues. Low turnover of assets is a great and easy way in which to manage and contain the capital gains taxation of assets. Selling capital assets with losses to offset capital gains of other assets is another way to lower taxes. Buying tax-exempt bonds is a tried and true approach. There are numerous other tax issues involved in financial planning, many of which may be inter-generational in nature. Advice from financial advisors, accountants, and estate lawyers versed in the nuances and complexities of taxation of assets and income is highly recommended.

Insurance Issues. No investment plan is complete without considerations of insurance coverage. Term life, whole life, disability, AD&D, homeowners, automobile, health, and umbrella policies should all be evaluated for coverage and effectiveness. Sufficient coverage is necessary at all times to protect capital assets and net worth patterns. Advice from an insurance agent is highly recommended.

Investment Policies and Practices. Charles Ellis, in *Winning the Loser's Game*, strongly recommends the development of stated, written investment policies and plans that guide the investor towards a methodical and consistent investment of assets. The above concepts can be incorporated into an investment policy. Such an investment plan is mandatory for ERISA types of investment trust funds, but is also a standard practice in the investment community for larger portfolios. Thus, structured investment policies and plans have a definite place at both the institutional and individual levels.

IV. Finance Theory

The Risk – Return Trade-off. Standard economic theory indicates that a trade-off exists between risk and return. In order to increase the rate of return on investments, there must be a corresponding increase in basic risk levels. This is demonstrated in the following graph (generated by Kevin Kaufhold, using Ibbotson data, 1926-2002).

--- Insert risk and return trade-off here ---

Balancing of Risk and Return through Optimization. Risk can never be eliminated entirely, only managed, reduced and “optimized”. Return cannot accelerate indefinitely, and is limited to gains flowing from economic productivity. The following graph shows the means variance optimization process for a one-year holding period, and is derived from econometric equations of the Markowitz Portfolio Theory and the Capital Asset Pricing Model. Ibbotson data between 1926 and 2002 was again used.

The intersection of the capital market line (in red) and the Markowitz efficient frontier (in blue) is the optimized point between risk and return, and is represented as a red diamond. With Ibbotson’s historical data sample, and assuming an historical average of 4% risk free rate of return, the optimized level of stocks to bonds with a one-year hold was 52% stocks, 48% bonds (the red dot on the curve). The box on the curve is 100% bonds; The blue dot on the curve is the minimum level of risk; and the x on the curve represents 100% stocks.

--- Insert 1 year frontier and CML graph here ----

While the above graph is based on complex equations and investment theories, the principle behind the graph is straight-forward: risk and return can be managed and optimized simply through an appropriate mixture of various asset classes. That is a key investment concept for any trust fund manager to understand and utilize, and is also very useful at the individual level.

Reduction of Risk through Diversification. Fluctuations in the rate of return can be reduced by holding a broad grouping of investments within each asset class. For example, the following graph (taken from *Investment Analysis & Portfolio Management*, at 293), demonstrates that as the number of stocks held in an equity portfolio increases, the risk that the rate of return will deviate from expected levels of return substantially decreases.

--- Insert diversification graph here ----

Reduction of Risk through International Diversification. Risk can also be reduced by adding international investments into an investment portfolio, as the following graph demonstrates. From, *Investment Analysis and Portfolio Management*, at 78.

--- Insert international diversification graph here ---

On the Reduction of Risk through Time. Traditionally, economic theory has assumed that the intended period of investment is unitary in nature, with all investors having the same “timeless” holding period. Once that assumption is relaxed however, economic textbooks indicate that the definition of risk and return must change in accordance with the longer investment time horizons. See, *Investment Analysis and Portfolio Management*, supra, at 287. This is due to the traditional measure of risk (standard deviation of expected returns) becoming meaningless in long-term time frames, as shown in the following graph. Through reversion to the mean tendencies inherent in almost all assets classes, the volatility of the expected rate of return is greatly reduced in long-term time periods to almost insignificant levels.

The following graph is based on MPT and CAPM equations using the same Ibbotson data as before, but now includes longer holding periods of (left to right) 30 years; 25 years; 20 years; 15 years; 10 years; 5 years; and 1 year. The red diamonds are optimized levels of risk and return for each holding period. A very similar graph is found at *Stocks for the Long Run*, 2nd ed., 1998, Jeremy Siegel, at 36.

- Insert multiple year cml – frontier graph here ---

On the Reduction of Risk over Time for all Asset Classes. Longer holding periods not only greatly reduce the risk levels of an optimized asset portfolio, a long-term investment pattern also reduces volatility risk of all asset classes. This is again due to reversion to the mean tendencies of investment assets. The graph uses Ibbotson data and probability equations.

--- Insert probability distribution here ---

The above graph clearly demonstrates that volatility risk, shown here as the range of probable returns at any one point in time, decreases as a function of the holding period, so much so that one writer has noted: “The holding period becomes a crucial issue in portfolio theory when data reveal the mean reversion of the stock returns”. See, *Stocks for the Long Run*, at 37.

V. On the Allocation of Assets

Allocation versus specific stock selection. Determining the percentage of asset allocation that fits an investor’s own risk pattern is by far the most important investment decision that anyone can make. Everything else may be secondary. Only 10% of a return of an investment may be due to individualized security selection decisions, with some studies showing that asset allocation accounts for 91.5% to 93.6% of a portfolio’s return. *Common Sense*, at 67. Standard academic texts also note similar findings: 85 to 95% of

overall investment returns arise from asset allocation decisions. *Investment Analysis and Portfolio Management*, at 54. Another source indicates that from 1970 to 1995, buying a broad based measure of stocks on the peak day of each year would have generated 8.5% annualized returns. Buying on the lowest point of any one year in the same time period would have generated a 10.1% return rate. There is therefore not much difference between great timing and the world's lousiest stock picking. *Learn to Earn*, Peter Lynch, at 200.

The Simplest Approach to Asset Allocation. For those investors who want immediate allocation and diversification but do not have the inclination or interest to delve deeply into matters of finance, lifestyle funds or balanced funds are available from both active and index fund families. These funds will typically maintain a fixed asset allocation between domestic and international equities, bonds, and cash, based upon your overall investment objectives (i.e., income versus growth). The investor simply makes a selection of one fully diversified mutual fund, and the managers of the fund then stay within that lifestyle choice for the selection of investments. Owning one single balanced fund is a recommendation of John Bogle in *Common Sense On Mutual Funds*, at 86-87.

To factor in intended holding periods, a number of active and index fund families have developed target retirement funds. These mutual funds will automatically decrease equity allocation percentages as one approaches a desired retirement age, while still maintaining full diversification in bonds, equities, and international arenas.

A Simple and General Approach, Recently Recommended. S&P has recently recommended (as of end of 2004) a portfolio of 45% US stocks, 15% foreign stocks, 25% bonds, and 15% cash. See, *The Outlook*, Dec. 15, 2004, at 13. The model portfolio can be adjusted from there for holding period considerations, income objectives, and risk tolerances (see below). The recommended allocations are:

US Stocks		
Large-Cap Blend	37%	
Mid-Cap Blend	4%	
Small-Cap Blend	4%	
...Subtotal...		45%
Foreign Stocks		
International EAFE	9%	
Pacific	4%	
Emerging Markets	2%	
...Subtotal...		15%
Bonds		
US Debt	15%	
US ST Debt	10%	
...Subtotal...		25%
Cash		
...Subtotal...		15%

An Investment Objective / Risk Tolerance Model. Portfolios with certain investment objectives or risk tolerances can also be easily designed. An investor objective model with additional features for size, type of bond, and type of cash investment is contained below. The international component can be further delineated with investments from European, Asian, and emerging countries, if an investor so desires. The percentages are roughly based upon an International Foundation seminar, *Refresher for Trustees on Investment Concepts*, Orlando, FL, Nov. 1, 1999, Eugene Burroughs, speaker.

	Income	Equity Inc.	Growth	Aggr. Growth
Inc. Equity	10%	10%	10%	--
Lrg Dom.	10%	10%	10%	15%
Med Dom.	--	10%	15%	15%
Sml Dom.	--	10%	20%	25%
International	--	10%	20%	35%
Govt Bond	20%	10%	5%	--
Corp Bond	20%	10%	5%	5%
CD	15%	10%	5%	5%
T-Bill	15%	10%	5%	--
MM	10%	10%	5%	5%

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