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CORRESPONDENCE MEMORANDUM

DATE: August 2, 2004

TO: Wisconsin Deferred Compensation Board Investment Committee

FROM: Shelly Schueller, Director
Wisconsin Deferred Compensation Program

SUBJECT: Wisconsin Deferred Compensation Investment Spectrum and Direction

At the May 2004 board meeting, a Wisconsin Deferred Compensation (WDC) Board member raised the following question: "Should the WDC have anything beyond index funds in the core spectrum?" The WDC Board discussed the question and ultimately referred it to the Investment Committee for further study. This memo provides perspective on the current WDC investment spectrum and offers some insight as to what participants believe they want from the WDC.

The WDC Program presently offers a mix of passive index funds and actively managed funds in the core investment spectrum, as well as a self-directed option through the Charles Schwab Personal Choice Retirement Account (PCRA). This combination has provided WDC participants with investment options: a participant may elect to invest in index or active funds that are reviewed and monitored by the WDC Board or a participant may personally select and monitor mutual funds from the 2,000+ funds offered through the PCRA.

Department staff believes the WDC should continue to offer a mix of actively managed and index funds in the core spectrum. There are many reasons why offering only index funds in the core investment spectrum and providing access to active funds only through the PCRA may not be in the best interests of WDC participants.

1. Participants can conveniently defer funds on a bi-weekly basis into actively managed WDC funds. The PCRA does not permit easy, automated bi-weekly deferrals.
2. Participants must pay transaction costs through PCRA. There are no additional fees through the WDC beyond the normal participation fee.
3. Some funds may also charge sales and/or redemption fees. Many funds have short-term redemption fees that are charged if a sale occurs before a specified holding period is met. The holding period varies by fund company; it could be 30, 60, 90 or 180 days.
4. The PCRA requires participants to be conscious and active and monitor funds, as the WDC Board does not monitor any funds offered through PCRA.
5. The PCRA requires participants to remember to move their deposits from the PCRA money market to the specific fund in which they wish to invest. In addition, the time the transition from money market to fund causes a participant's money to be "out-of-the market" for two days.

Reviewed and approved by Pam Henning, Office of Strategic Services

Signature _____

Date _____

Participants could miss out on 52 or more market days per year and consequently miss some valuable days.

6. The WDC is reimbursed by the actively managed funds. In 2002, the WDC received \$162,000, which was used to offset administrative costs. Without that offset, participant fees might need to be higher.
7. Not all funds in the current WDC core investment spectrum are available through the PCRA. The T. Rowe Price Mid Cap Growth Fund, which is a current investment option in the WDC program, is not available through the PCRA, as the fund was closed to new participants by T. Rowe Price on 12/8/03. The DFA U.S. Micro Cap Portfolio Fund, which is a current investment option in the WDC Program, is not available through the PCRA.
8. Current actively managed funds in the WDC core investment spectrum are institutional class shares. WDC participants investing in these funds through PCRA would not have access to the institutional class shares and would have to pay higher expenses. Many of the funds in the WDC core investment spectrum are significantly cheaper when purchased through the WDC rather than PCRA.

FUND	WDC EXPENSE RATIO	PCRA EXPENSE RATIO*
T. Rowe Price International Stock Fund	0.95%	0.95%
DFA US Micro Cap Portfolio	0.56%	Not available in PCRA
T. Rowe Price Mid Cap	0.88%	Not open in PCRA**
Janus Fund	0.89%	0.89%
Calvert Social Invest. Fund-Equity Portfolio	0.70%	1.29%
	(Class I)	(class A)
Fidelity Contrafund	0.98%	0.98%
Vanguard Wellington Fund	0.23%	0.36%
	(Admiral Shares)	(Inv. Shares)
Vanguard Long-Term Corp. Fund	0.19%	0.28%
	(Admiral Shares)	(Inv. Shares)
Federated US Gov't Sec. Fund 2-5 (Inst. Class)	0.57%	0.81%
Vanguard Admiral Treasury Money Market Fund	0.14%	0.32%
		(retail)
<i>Average Expense Ratio</i>	<i>0.61%</i>	<i>0.90%</i>

* Expense ratios for appropriate share class available in the PCRA.

** Fund closed to new participants by company in 2003.

9. When purchasing funds through the PCRA, each fund company has minimum initial deposits of \$1,000 and subsequent purchases vary per fund from \$100 - \$500. Through the WDC, participants can invest as little as \$5 per pay period or as much as they like in a fund up to the contribution limits established by federal law.
10. Although there are no transaction or sales charges on OneSource Funds (which includes all WDC PCRA funds), there is an overriding minimum of \$19 per trade. There are also transaction fees for any non-OneSource Funds:

Charles Schwab PCRA Non-OneSource Funds Transaction Fees	
<u>Transaction Size</u>	<u>Transaction Fees</u>
\$0-\$14,999	0.7% of principal
\$15,000+	0.7% on first \$15,000 0.2% on amounts over \$15,000; maximum of \$149

PCRA participants who place transaction fee mutual fund trades through an automated phone service receive up to a 10% discount; those trades placed through an electronic channel receive up to a 20% discount off the stated commissions or transaction fees.

WDC Self-Directed Option

The PCRA option was opened to WDC participants in 2000, after approximately four years of research and discussion by the Board. It was added after the Board decided there was enough demand from more investment-savvy and sophisticated members of the WDC for such an option. The PCRA provides these participants with a broader selection of mutual fund options for an additional fee while not confusing the average participant by cluttering the core investment spectrum.

Adding the PCRA to the WDC required a contract amendment with National Deferred Compensation (now Nationwide Retirement Solutions or NRS). NRS receives an additional \$1,250 per month (\$15,000 per year) to administer the PCRA for the WDC. This breaks down to roughly a cost to the WDC of \$20.50 per each of the 732 current PCRA participants (or \$0.37 for each of the 40,593 WDC participants as of 12/31/03).

The table below provides data on WDC participant use of the PCRA from inception through the end of 2003.

WDC Schwab PCRA Accounts			
Year	Total PCRA Accounts	WDC Population	% WDC Population using a PCRA
2000	571	35,827	1.6%
2001	644	37,809	1.7%
2002	691	39,164	1.8%
2003	732	40,593	1.8%

What is the future investment direction of the WDC?

This question needs careful consideration. In recent years, the Board has added several new funds that “fill” a particular need or style box. For example, the poor investment performance of the Dreyfus Premier Third Century Fund, the WDC’s socially responsible offering, resulted in the replacement of that fund with the Calvert Social Investment Equity Fund. Most recently, the Board perceived a need to offer an option in the small cap style box and moved to add a small cap index fund. These changes have taken place on an ad hoc or as-needed basis. Before any other changes are made, the Board needs to consider questions such as:

- What is the underlying objective of the WDC?
- Who are the WDC’s target participants? What do these target individuals need or want?
- What role should the WDC Board play?

Although no concrete answers to these questions are immediately available, staff offer the following points for consideration and discussion:

WDC Objective

The stated objective of the WDC is to be a supplemental retirement savings program for public employees that provides participants with the ability to invest pre-tax income in a broad range of investment alternatives.

WDC Participants

WDC participants are a diverse group. The 2002 Cortex survey revealed that WDC participants can be categorized into three groups, based on their knowledge of investment concepts.

- High knowledge, high interest participants. Approximately 24% of WDC participants fall in this “Do-it-myself” group;
- Average participants. Roughly 53% of WDC participants are average participants, both in knowledge and in interest; and
- Low knowledge participants. About 23% of WDC participants indicated that they had either slightly poor or extremely poor investment knowledge.

The 2002 survey showed that women and younger participants also scored significantly lower in investment knowledge than did their male or older counterparts. These participants would benefit from a focused education campaign, which could include a renewed effort to market the existing WDC asset allocation service.

The 2002 survey demonstrated that participants want and need additional education materials targeted to them. To be effective, information and education efforts must be targeted to specific types of participants. As a result of the survey, NRS has been developing new interactive workshops designed for specific groups, such as women or lower-compensated public employees. These workshops will be rolled out to participants in the latter half of 2004.

The WDC Board's Role

The Board's stated role is to select appropriate investment options for offering by the WDC and to monitor the selections to ensure they continue to be acceptable for long-term retirement savings. This is an appropriate role and one the Board should continue to perform for WDC participants.

While the data analysis from the 2004 participant survey is not yet complete, initial results indicate that the majority of WDC participants responding to the survey want the Board to continue to select and monitor active funds as well as passive index funds.

Conclusions

The following conclusions are based upon the observations summarized in this memo:

1. WDC participants are a diverse group that rely on the Board to offer a variety of investment options that are appropriate for the WDC. Accordingly, the Board should focus on maintaining a core investment spectrum consisting of both actively managed funds and passive index funds. The Board should also continue to provide alternative investment options through the PCRA.

2. Department staff should work with NRS to develop and distribute additional educational materials targeted to participant groups identified as having a greater need for knowledge and understanding of investments.