The PFM Group
Public Financial Management, Inc.
PFM Asset Management, LLC
PFM Advisors

Two Logan Square
Suite 1600
18th & Arch Streets
Philadelphia, PA
19103-2770

215 567-6100
215 567-4180 fax
www.pfm.com

August 29, 2008

Memorandum

To: Steve Ezikian
Brian Marcel
Sharon Raschke
Teresa Zigman

From: Jim Link, PFM Advisors

Re: 403(b) Vendor RFP and Selection Process

This memorandum outlines the search process, observations from vendor interviews and PFM Advisors' recommendations relating to the recent 403(b) plan vendor services search for the Washtenaw ISD and Wayne RESA Consortium (the "Consortium") of school districts.

Background

Since the beginning of the 403(b) market place in the 1950's and 1960's, these "plans" have been less sponsor-oriented retirement plans and more individual compensation deferral arrangements. By definition, the K – 12 403(b) marketplace is not governed by the federal regulations promulgated by ERISA. With no "true" plan sponsor and no ERISA regulation, there existed little or no oversight over the products, their suitability and features. In fact, because of the genesis of the 403(b) regulations, the individual agent-based insurance industry effectively controlled the marketplace. Further, the typical K – 12 "plan" only authorized (or rather did not restrict) the availability of multiple vendors for each school district rather than organized the vendors. This fact, in and of itself, is not problematic except that the lack of any central control left the vendors, not the customers, in charge of the marketplace. Unfortunately, this has meant significant competition for the assets of each employee, products with numerous ancillary features not germane to saving for retirement, generally higher (sometimes significantly higher) fees than commensurate 401(k) investment options, and subjecting participants to sales pitches by a variety of vendors for multiple (non-403(b) related) services. The result has generally been a sense of security for school district employees created by the individual relationship with an agent, registered representation or broker, but substantially higher/less disclosed fees for this feeling.

Over the years there has been mild tweaking of the 403(b) regulations, but little substantial change. However, because of lax oversight and complicated rules there was generally poor compliance with the letter and intent of the rules. In 2007, the IRS, presumably desiring to close the loopholes and improve compliance, passed new rules designed make 403(b) plans more like their 457 and 401(k) cousins. The rules create more formality for the plan, requiring a documented plan, universal availability, and other features characteristic of defined contribution plans. The regulations also effectively changed 403(b) from series of payroll arrangements to an actual plan with the accompanying organizing documents. Additionally, the regulation has put more responsibility for plan compliance on the administrative staff of each school district. One of the outcomes of the new regulation is the desire of many school districts to take their new federally mandated responsibilities seriously and to implement more control over the plan. The most logical way to improve the district's ability to oversee the plan is to authorize only a single vendor to provide services the district employees. Interestingly enough, this single vendor strategy is also a mechanism to address the problems with product consistency and to improve pricing for participating employers and employees.

Process

The Consortium members (the "Committee") were generally charged by their respective Superintendents and Business Managers to "handle" the 403(b) issues pertaining to the new regulations. As an overarching philosophy, the Committee was reluctant to make any change that might undermine the ability of participants to benefit through better pricing, better performance or better services; all goals designed to allow for greater asset growth and more money for participants at retirement.

One way to solve the issues would have been to simply hire a lawyer to draft documents, hire a third party administrator ("TPA") to monitor compliance requirements, and then wash their hands of the situation. This process alternative may have been the easiest route, but it would also have added an additional layer of cost to participants without any tangible benefit. The simple alternative did not meet those previously described criteria since there would have been increased cost with no direct participant benefit. So, the Committee undertook a process of reviewing the issues, educating themselves on the alternatives, and determining the "right" way to approach the problem rather than simply taking the "easy" approach. After this education process, the Committee determined that the "right" alternative was to find a single vendor to provide services. This alternative, while new in many school districts, is the overwhelming model for all other defined contribution and deferred compensation plans. In fact, because of the typical cost differences in multi-vendor versus single vendor plans many pundits are expecting that most school districts will ultimately follow suit and hire single vendors to administer their 403(b) plans. The benefits of the single vendor alternative, which all focus on providing the best potential for participants to improve their retirement savings picture, are as follows:

- Leverage the assets of multiple districts to obtain lower fees;
- Provide participant investments and services for lower overall cost in this case no vendor competition for assets means lower cost for participants (no sales people involved);
- Have investment options selected and monitored by an independent fiduciary through a rigorous process;
- Regarding sales people, a single vendor will subject employees to a less onerous sales structure relating to the plans and other financial services (e.g., life, auto, home owners insurance, other investments);
- Generate a better, more organized and reviewed investment structure for participants; and
- Create an appropriate oversight structure for the districts to comply with the regulations.

The single vendor search process was conducted in a reasonable and technically sound manner. The Committee search process included the following steps:

- Generated an RFP to elicit vendor responses and expressions of interest;
- Posted the RFP on a state website, in the newspaper, etc. to provide broad access to any firms desiring to respond;
- Invited all current vendors to respond to the RFP;
- Received and assessed 28 vendor responses;
- Conducted calls and meetings to clarify responses with vendors (as necessary);
- Hired an independent consultant ("PFM") to review the vendor responses and to make a recommendation relating to vendors to interview;
- Interviewed 9 separate vendors (or vendor groups) in tandem with PFM; and
- Asked follow up and clarifying questions of select vendors.

The vendors who submitted responses were:

1. 403(b) ASP (principal bid) – Interviewed
2. AIG Retirement – Interviewed
3. AXA Equitable
4. Benefit Advisor Group (The Hartford)
5. The Capital Group – Interviewed
6. Chesme Capital Management (Charles Schwab) – Interviewed
7. Edward Jones (The Hartford)
8. Expert Plan – Interviewed
9. Fidelity Investments – RFP submission did not comply with requirements.
10. First Investors
11. GLP & Associates
12. Great American (403(b) ASP) – Interviewed
13. Horace Mann
14. ING
15. Kushner & Company
16. Lincoln Financial Planning
17. MEA Financial Services (Prudential) – interviewed
18. MEBS – Interviewed
19. MetLife Resources
20. National Insurance Services (The Standard)
21. OneAmerica – Did not meet RFP submission deadline.
22. Oppenheimer Funds, Inc.
23. Security Benefit
24. The Standard (principal bid) – Interviewed
25. TIAA-CREF
26. Tisch Investment Advisory Inc. (MEBS)
27. UBS-MDS Consulting
28. Wachovia Retirement Services

The organizations who were asked to interview were deemed by the Committee and PFM to have best met the key principles of low cost, broad access to funds, knowledge and expertise of plan compliance, and a general understanding of the workings of a plan versus the individual consent environment of the current 403(b) arrangement. For the most part, the organizations who were not asked to interview fell into one or more categories. Those organizations typically either proposed higher cost investments, less flexibility or access to funds, and/or did not generally exhibit an understanding or willingness to assist in organizing the plan according to the structure and goals outlined in the RFP.

Prior to the interviews, the Committee settled on a targeted investment menu style that included relatively low cost alternatives in four (4) categories. Each category provides a specific set of alternatives for participants to use in making investment decisions. The categories include: funds covering a wide range of asset classes, some form of lifestyle or target date funds, a managed account option, and potentially a mutual fund window (brokerage account).

Interview Results

403(b) ASP (principal bid) – 403(b) ASP is an internet-based retirement plan recordkeeping portal that enables access to the site by participants, plan sponsors, compliance vendors, and financial intermediaries. The bid was made in conjunction with three other firms:

- Means & Associates – plan and regulatory compliance;
- PIA – registered investment advisor; and
- Matthew Hutchinson LLC – independent fiduciary.

The 403(b) ASP platform allows for an integrated program that offers recordkeeping, compliance, and investment services. 403(b) ASP does not offer education or communication services, but does allow advisors to access the platform (if authorized by the participant) so that the services can be provided. The group is capable of offering all elements of the investment menu. The group is completely fund neutral with elements of hard dollar and basis point fees. Participant services would be handled primarily over the internet. The fees of the group included a $40 per participant + 0.20% fee for 403(b) ASP and Means & Associates, 0.15% for PIA, and 0.06% for Matthew Hutchinson in addition to any fund expense and any fee for advisors/education and communication services. In aggregate, the "minimum" fee totaled $40 per participant + 0.41% plus the fund expense with all revenue sharing credited back to the plan to reduce the stated fees. Portfolio management fees of 0.25% for model portfolios.

Assessment – group has not previously worked as a team in total. There was not a discernable leader or point of accountability, which made the group look disorganized. They did not do a good job of articulating how all of the pieces fit together and the overall value proposition. The investments menu can be constructed without limitation. Participant services could be a problem with no staff. 403(b) ASP offers strong compliance support. Fees seem a little high, but not out of line.

AIG Retirement – AIG Retirement, previously known as VALIC, has historically been a leading vendor of 403(b) services. AIG is a large current vendor of services to the Consortium districts. The K – 12 marketplace is AIG's largest market. Their services are fully bundled with all aspects of the plan are provided through AIG. These services include recordkeeping, compliance, investment and communication/education services. AIG was generally capable of providing all elements of the investment menu. The investments offered were from their Profile product consisting of roughly 90 funds. Presumably, if enough assets transfer into the new plan, there would be availability to total open fund architecture. Participant services would be handled by the advisor staff existing in the area. The fees for services were somewhat complicated in that AIG presented a maximum tiered fee schedule with the ability of individual districts' to gain better fees. AIG also retained all revenue sharing without offset to its fees (estimated at 0.25% to 0.35%). AIG minimum fees for the Consortium begin at 0.68% and reduce in 0.10% increments down to 0.48%. Portfolio Advisor is an additional $25 per participant per year with Portfolio Manager starting at 0.60% and trending down based on portfolio assets.

Assessment – dominant player in the 403(b) market. The investment menu can be constructed, but is limited by AIG in some respects. AIG was not prepared to offer or provide a solution for the mutual fund window (a/k/a self directed brokerage). Participant services could be easily handled, but cross-selling other services could be an issue. AIG seemed to be the most wedded to service model as usual. AIG offers very strong compliance support. The guaranteed fees are the highest of any interviewee, but AIG is willing to review fees on a district by district basis and annually as a group.

The Capital Group – The Capital Group ("TCG") is a local advisory practice with six (6) core representatives and access to as many as 75 additional affiliated representatives. They would use 403(b) ASP as the record keeper and compliance. TCG assumes that the employers will handle approval of all hardship withdrawals, etc. TCG is fund neutral and can offer all aspects of the investment menu. Participant services would be handled by the core representatives and, if necessary, the additional affiliated representatives. TCG fees were $20 per participant + 0.50% with any fund revenue sharing credited back to the participants. There would also be an additional fee of 0.25% for the creation of model portfolios/managed accounts.

Assessment – small, local service provider using a TPA to provide services. The investment menu can be constructed without limitation. Participant services would be handled by the core and affiliated representatives. This could introduce a loss of control over participant services and cross selling. TCG compliance services seem weaker than competitors. The fees are in line with competitors and the market. The presentation was somewhat disjointed with principal presenter seemingly making up parts of the program up as he went along.

Chesme Capital Management (Charles Schwab) – Chesme is very similar to The Capital Group in services and investments. However, Chesme's seven (7) partners have no access to affiliated representatives. Chesme is TPA neutral, but Schwab is a partner who was included in the RFP. The fees begin at 0.15% and reduce in 0.025% increments down to 0.10% + approximately $90 per participant for recordkeeping through Schwab. No additional fees for model portfolios.

Assessment – small, local service provider using a TPA to provide services. The investment menu can be constructed without limitation. Participant services would be handled by the core representatives. Because Chesme is focused only on retirement, there is no problem with cross selling. However, with a small staff that is not generally located in or contiguous with the Consortium district locations, servicing of the Consortium could be a problem. Chesme compliance services seem weaker than competitors. The fees are among the best compared to competitors and the market.

Expert Plan – Technology is clearly the key to Expert Plan ("EP"). They have some experience with K – 12 schools. Investment menu is open and can be structured as desired in conjunction with Morningstar. EP is fund neutral. Participant services would be handled via the internet with no real access to on the ground personnel. The ability of EP to provide compliance seems satisfactory, but perhaps not robust. EP fees were $45 per participant + 0.15% with revenue sharing to offset fees. Managed portfolios would range from 0.10% to 0.50% in additional fees based on portfolio size.

Assessment – small, technology oriented service provider. The investment menu can be constructed without limitation. Participant services would be handled over the internet. The lack of "feet in the street" could cause significant transition issues in moving from an advisor-based model to a 401(k) style plan. EP compliance services seem in line with competitors. The fees are among the best compared to competitors and the market. While EP seemed to have a very sound model, it would provide the most abrupt changes for participants.

Great American (403(b) ASP) – Great American ("GA") provides services through subsidiary firms and 403(b) ASP. GA will select funds based on a sound protocol using FI360. Three elements of the investment menu are available with the mutual fund window (brokerage window) is not generally available. GA will provide most participant services via the internet, but can supplement with ground personnel. GA offers full compliance services provided by a subsidiary. GA fees were quoted at $15 per participant + 0.90% trending down to 0.70% at $25 million. GA did comment that they would negotiate if more assets rolled into the plan. Revenue sharing would be used to offset fees. All managed portfolios are included in the existing fee structure.

Assessment – investment advisory oriented service provider. GA will create an investment menu without limitation. Participant services would be handled primarily, but not exclusively over the internet. GA seems to still be fixated on 403(b) being a participant driven arrangement versus an employer organized plan. GA compliance services seem in line with competitors. The fees were slightly high compared to competitors and the market. Being heavily asset-based, the fees would ultimately become untenably high.

MEA Financial Services (Prudential) – MEA provides services through its own staff and Prudential Retirement Services. Prudential provides most of the investment, recordkeeping, and compliance services. MEA provides participant communication services through a team of 25 advisors. The investment menu is open based on Prudential's trading relationships. It seems that all aspects of the investment menu can be provided, although Prudential was not sure about how the mutual fund window would work. The interview was fragmented, so who is accountable was not entirely clear. The fee quoted was the least clear given that apparently there is no fee other than the investment expense. Finally, there is no fee for a managed account in addition to the revenue sharing.

Assessment – it was difficult to understand the accountability of MEA and Prudential. There is no real limitation on the investment menu; however, based on the fee structure it seems impossible to have access to the lowest cost funds. Further, disclosure of revenue sharing, while seemingly addressed, would require extreme vigilance over time and would necessitate consistent renegotiations as asset grow. MEA is focused on servicing their "members" rather than organizing service for the plan. Their fees are invisible; therefore don't seem to be supportive of complete transparency. As such, it is impossible to determine how they stack up. Further, the "no cost" alternative has the danger of morphing into a high cost alternative, because of the lack of overt exchange of services for fees.

MEBS – MEBS offers recordkeeping and compliance services with an advisor partner for investment services. MEBS would provide most education services via the internet, but could supplement that mode with group meetings. The investment platform could be constructed in accordance with the Committee's desires. MEBS seemed capable of handling the recordkeeping and compliance. The MEBS structure and fee were entirely different than the RFP.

Assessment – complete change of position between RFP and interview including partners. MEBS is clearly putting the program together on the fly. Impossible to assess what is right or best because the story has changed and, in fact, continued to change during the presentation.

The Standard (principal bid) – The Standard is the retirement subsidiary of StanCorp and was created with the acquisition of Invesmart (a TPA rollup firm). The Standard's RFP response was the best in matching the Committee goals of improving cost and benefits for participants and inserting the compliance controls required by the new 403(b) regulations. The Standard can provide all investment menu alternatives. The firm committed to providing a variety of communication services including internet, push email for enrollment presentations, up to 80 days of group meetings either as train the trainer or enrollments (at hotels or during in-service days). The firm offers full compliance services including plan documents. The fee quoted are $40 per participant + 0.38% for the adopting members of the Consortium, however they are willing to negotiate. Revenue sharing will be used to offset fees. A managed account would cost an additional $10 per month.

Assessment – After the interview, The Standard was clearly the best match for the RFP requirements. They seemed to have the most fully developed ideas on education and investments. The overall cost was among the best on a net basis and most importantly the fee was easy to understand and transparent. They also met a goal of leveraging the Consortium assets to obtain lower costs.

Recommendation

Based on our review of the RFP responses and the nine detailed interviews, our recommendation would be to select The Standard and negotiate a few items with them during the formal engagement process. Those items would include finalizing the fee schedule, determining the proposed investment lineup of funds, determining the final structure of the initial 80-days of rollout meetings, and creation of the 403(b) plans from their standard document. In concluding, The Standard seemed the most prepared and focused on what the Consortium was trying to provide; a relatively low cost, full service, fully compliant 403(b) plan to benefit participants and employers. No other vendor provided a truly credible alternative based on the criteria and goals of the Consortium. As such, based on our assessment of the services and fees in combination, The Standard is clearly the best choice for further dedicated negotiations and selection as the Consortium districts' new 403(b) vendor. Because there is no other vendor that provided as well structured program with the relatively low level of fees, we would not recommend that any additional firms be included in the negotiations at this time.