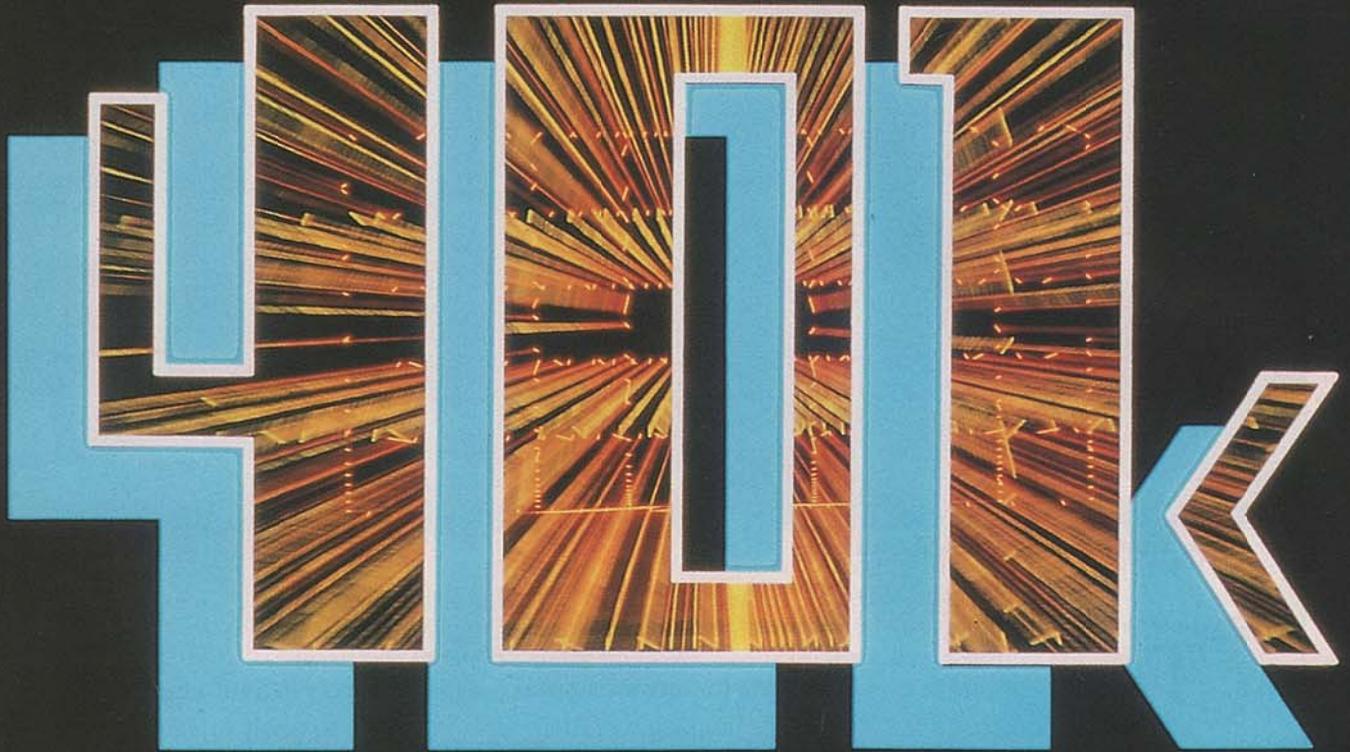


# IGNITE



## Pros and Cons of Daily Valuation

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**D**aily valuations of personal investments, a feature first offered by mutual funds to retail investors, is spreading quickly to defined contribution (DC) plans. Other money managers, third-party administrators and benefits consulting firms are scrambling to offer or support this high-tech service and all of its detailed record-keeping, administrative and regulatory demands.

But before plan sponsors jump on the

bandwagon, they should consider a fundamental question: Are daily valuations right for our plan? Their answers will help determine whether daily valuations remain a growing trend or become a passing fad.

### Background

The full package commonly called "daily valuations" carries several key administrative components:

# POWER

## In Plan Performance

- Daily account valuations of participants' accounts are accomplished by establishing daily unit prices for each investment fund in the plan, then applying those prices to each participant's holdings (i.e., number of units) in each fund. This unitization process permits investment income (dividends, interest and changes in market value) to be allocated to participants daily. The assets of a plan's funds must, of course, be valued every day.

The process is straightforward for publicly traded funds such as registered mutual funds, since the unit price typically will equal the fund's published "net asset value" or share price as of the close of business each day. For privately held funds (i.e., GICs, company stock funds with short-term cash components, separate accounts and bank commingled funds) and funds that are a composite of publicly traded funds, special procedures must be followed by the plan's service agents to calculate unit prices daily.

- Same-day processing and trading, a service standard in the daily valuation environment, refers to the provider's ability to act on participants' elections for deposits, disbursements, or transfers using end-of-day unit prices. For these expectations to be met, both record-keeping and trade execution at the trust level must act in the same-day time frame, using identical unit prices.

Adhering to this standard requires close communication between the fund man-

ager(s) and service agent(s). It also requires operating agreements from fund managers and their transfer agents, confirming their acceptance of trading instructions collected by the service agent before the market closes but submitted to the managers after the market closes. To make this possible, the service agent should be registered as a transfer agent or a broker/dealer with the SEC.

- Transaction processing frequency generally would be daily, however plan sponsors can choose to collect certain transactions (e.g., loans or withdrawals) daily but price and/or process them weekly or monthly. The greater the processing frequency, the faster participants' distribution requests can be paid fully.

### Consistency with Sponsor Objectives

One aspect of daily valuations that attracts plan sponsors is the outsourcing of administrative duties to service agents. Coupled with varying degrees of investment choice and focused employee education programs (figures 1-3), daily valuations seem to meet four human resource objectives: improved responsiveness to employee needs; greater employee self-sufficiency; increased employee satisfaction; and perceived value.

Daily valuations let participants control their DC accounts like they control their personal savings accounts. When this responsiveness is viewed alongside the con-

venience of payroll deductions, tax advantages and the company match typically found in 401(k) plans, remarkably high levels of satisfaction and perceived value can result.

Daily valuations also can be used to reach the management objective of improved policy control of the program and, especially when considering the potential for direct subsidies from retail managers, two financial objectives:

- Increased productivity of internal staff;
- Lower internal and external costs.

It is important to note that these objec-

service agent(s) responsible for the plan's administration and trust/custody functions, plan sponsors may be unable to use their preferred investment managers or offer as much investment flexibility as they would like.

- Daily valuations likely will require a transactional blackout period upon start-up, which can raise operational and employee relations issues. Daily valuations require that record-keeping totals match trust assets precisely. Non-daily valuations function in an accrual mode, with payables and receivables to the trust existing as of any valuation date. Each of these accrual items must be cleared before the daily valuation process and its associated voice-response and on-line data access systems can be activated. Generally, this period will span several weeks, certainly contingent upon the turnaround time of the final non-daily valuation.

- Daily valuations may require a restructuring of the plan's GIC portfolio. Daily trading requires daily availability of cash from the plan's GICs to cover distributions and inter-fund transfers. Ordinary cash flow almost surely will prove inadequate. Providing the extra liquidity will reduce the overall rate of return available to plan participants, whether more of the assets are held in cash or if current and/or future contracts are (re)negotiated to provide more frequent in-flow and out-flow.

- Daily valuations may require a review of company-stock liquidity. Daily trading requires the daily availability of cash in a company stock fund. Two troublesome questions arise: What percentage of the fund should be held in cash? How can the plan ensure liquidity if the cash reserve is exhausted? Given the potential volatility of share prices, the impact on returns of holding part of the fund in cash can be much more conspicuous in a company stock fund than, for example, in a GIC fund.

Ideally, no stock-fund assets would be held in cash, ensuring participants the "true" performance of the underlying investment. Subject to ERISA and SEC requirements, particularly for "adequate consideration" in the pricing of stock transactions, some plan sponsors attempt to guarantee overnight liquidity by establishing procedures with corporate treasury or other financial intermediaries. The interest of financial institutions in this approach varies according to the plan size, the expected transaction volume, and the size of the plan's stake in the sponsoring company. Note that this overnight guarantee of liquidity may place additional constraints on plan participants, such as earlier deadlines on the voice-response system for same-day withdrawals or transfers.

Figure 1

### Administrative Features

Objective	Voice Response	Client On-line	Dedicated Benefit Reps	Daily Valuation	Utilization Analysis
Improved Responsiveness	✓	✓	✓	✓✓	
Improved Employee Self-sufficiency	✓		✓		
Improved Employee Satisfaction	✓	✓	✓	✓	
Increased Productivity	✓	✓	✓		
Lower Cost	✓	✓			
Improved Policy Control					✓

tives can be addressed without daily valuations, although employee satisfaction levels likely will not be as high.

### Service Implications

"Going daily" can have several administrative and philosophical implications the plan sponsor should recognize:

- Daily valuations may encourage employees to "play the market" and damage investment results over the long term, counter to the primary intent of the plan as a retirement-savings vehicle. Experience shows, however, that participants in daily valued plans generally wait out short-term market swings. Knowing they can make transfers at any time seems to make participants feel less compelled to do something than they do when month-end or quarter-end decisions need to be made.

- Daily valuations may restrict flexibility in investment providers. Record-keeping and trust processes should be evaluated carefully for pricing procedures and liquidity sufficient to support same-day processing and trading. Depending on the

Otherwise, the amount of cash to hold in a company stock fund is best determined by careful analysis of historical transaction activity, recognizing the potential for future volatility in both stock performance and transaction volume. Plan sponsors can exercise some degree of control by restricting the frequency of certain stock-related transactions.

- Daily valuations pre-empt retroactive error corrections. In non-daily valuation environments, administrative errors can be corrected

The day-to-day balancing between record-keeping totals and trust assets in a daily valuation environment leaves no

**Figure 2**

<b>Investment Features</b>					
Objective	Fund Choice	Manager Choice	Manager Cost Sharing	Passive vs. Active	Retail vs. Institutional
Improved Responsiveness	✓	✓			
Improved Employee Self-sufficiency					
Improved Employee Satisfaction	✓	✓			
Increased Productivity					
Lower Cost			✓ <sup>1</sup>	✓ <sup>2</sup>	✓ <sup>2</sup>
Improved Policy Control	✓	✓			

<sup>1</sup> Lowers employer's direct cost  
<sup>2</sup> Lowers total cost

**Figure 3**

<b>Investment Education Features</b>					
Objective	Standard Passive	Custom Passive	Standard Interactive	Custom Interactive	Personalized
Improved Responsiveness					
Improved Employee Self-sufficiency	✓	✓	✓	✓	✓
Improved Employee Satisfaction	✓	✓	✓	✓	✓
Increased Productivity					
Lower Cost					
Improved Policy Control					

place from which to draw corrective income, since all income to date will have already been allocated to participants' accounts through the daily re-calculation of their assets' unit values. As a result, the plan sponsor would have to fund income adjustments from its general assets or instruct the service agent to adjust income crediting to participants (i.e., daily changes to unit prices) prospectively.

In the daily environment, the legality of corrective techniques using subsequent investment earnings as a funding source is also unclear, and should be the subject of discussion between the plan sponsor and its counsel during the development of ongoing administrative procedures. Daily valuations thus add to the pressure on payroll, human resource and administrative systems to produce clean data, and on plan administrators to communicate and enforce transaction deadlines in order to minimize record-keeping adjustments.

### Cost Implications

Daily valuations alone do not improve plan sponsors' staff productivity or lower their external cost for administration. These are achieved through other facets of the advanced service model — the voice-response system, the on-line data access system and benefit service representatives. Productivity improvements will be greater and external costs will be

retroactively as additions or subtractions to the affected accounts. These inevitable problems, and their implications on the investment income credited to all participants in prior valuations, often are funded through a combination of payroll adjustments and the current valuation period's investment earnings not yet allocated to participants' accounts.

However, the legality under ERISA of accessing current period earnings for this purpose is unclear, even where the amount involved is insignificant or if it is the result of an innocent payroll error.

even less if the service agent's record-keeping system can interface directly with the sponsor's payroll system for electronic submission of participant data and contributions, as well as with the trustee's disbursement system.

In theory, all of these service components can be used independent of daily valuations. In reality, however, it is the rigor of daily valuations and transaction processing that has precipitated these service upgrades. Furthermore, the demands of the daily valuation environment will push a plan sponsor toward a "zero defects" standard for payroll and human resources data transmission. Clearly, a reduction in data errors goes hand-in-hand with increased efficiency and reduced external costs.

The additional costs of daily valuations are connected with more frequent transaction processing, additional trades and daily unit value calculations. These addi-

tional expenses are offset somewhat by improvements in efficiency and enhanced automation of the reconciliation process between record-keeping totals and plan assets.

The net result: A good rule of thumb would be to assume a 5% to 15% increase in administrative costs as a result of moving from monthly to daily account valuations. If transactions also are processed daily, rather than less frequently, the increase likely will be at the upper end of this range.

This relatively modest cost difference does not compel plan sponsors to employ daily valuations, but it certainly invites them to consider them. Every day, the costs and benefits of DC plan design and delivery alternatives are being evaluated on both economic and philosophical grounds. With decisions on issues like daily valuations, the future of DC plan administration is being shaped now. □