CHAPTER 1

Investment Sponsors

Individuals, households, businesses, governments, and nonprofit organizations have a number of motives for designing, developing and implementing saving and investment programs. Essentially, the savings component of these programs involves reducing current expenditures in order to set aside a portion of such things as current income, earnings, tax receipts, and contributions, while the investment component involves allocating these savings among seemingly ever-growing varieties and combinations of asset classes, investment vehicles and securities.

Individuals and households establish saving and investment programs, among other reasons, to provide retirement income security in order to maintain a desired standard of living during the portion of their lives when income is no longer being derived from work. Businesses and governments may be motivated to organize saving and investment programs as incentive devices to boost employee productivity, reduce worker turnover and take advantage of tax shelters in the case of businesses. Non-pofit organizations arrange saving and investment programs to support current operations, finance capital expenditures, and strengthen the financial basis of the organization. Clearly, there are numerous reasons for establishing saving and investment programs. These motives combined with the investment goals and processes of the investing entities in conjunction with the universe of investment alternatives determine the investment choices and investment portfolios of the saving and investing entities.

Regardless of the entity establishing it, assessing, analyzing and evaluating the performance of an investment program is a critical element in its success. Thorough, timely and accurate investment performance evaluation is a vital step in determining if the objectives of a saving and investment program are being attained, and in taking subsequent actions. Performance evaluation must be undertaken regardless of the decision to either manage the investment program internally or to employ outside investment professionals to manage all or parts of it.

While many entities have established their own saving and investment programs, for example roughly 4.6 million individuals have established their own retirement based saving and investment programs with assets totaling approximately $3.7 trillion, there are several reasons why certain organizations and individuals may be more effective and efficient in establishing programs for others, particularly those programs with long anticipated lives.[1] Individuals considering establishing retirement programs on their own as well as those who seek to contribute on their own to the viability and longevity of organizations such as universities, museums, hospitals and foundations confront difficult planning challenges and potentially high expenses. Specialized knowledge and skills, and substantial information in addition to initial and ongoing administrative costs are required. Moreover, sustained discipline is often necessary to implement such programs.

In contrast, some organizations and individuals may already possess the specialized knowledge and skills and be able to acquire information more easily. They may also enjoy the advantage of declining costs per participant in the development, maintenance, record keeping, compliance and the like for saving and investment programs. Besides economies of scale related to an existing knowledge base, information acquisition, and administrative costs, these organizations and individuals may have strong economic incentives, such as greater employee and contributor loyalty, for arranging saving and investment programs. They may also obtain for themselves and be able to offer tax benefits to participants in saving and investing programs.[2]

Investment sponsors is the term used to refer to organizations and individuals who undertake the responsibility for establishing, designing, developing, implementing, monitoring, and evaluating saving and investment programs on behalf of, and for the benefit of, other persons and groups. The number and variety of sponsored programs have soared over the last several decades. As illustrated in Table 1.1, the most recently available data show there are approximately 1.1 million tax exempt organization–sponsored investment programs with more than 100 million participants and total investments of roughly $12.1 trillion; more than 1.1 million taxable personal trusts with total assets of $1.0 trillion; and, as noted above, about 4.6 million IRA and Keough programs with investments of close to $3.5 trillion.

[1] The data are for the number and dollar amounts of assets in IRA and Keough accounts at year end 2004. See "Notes," *Employee Benefit Research Institute* 27, no. 1 (January 2006).

[2] The advantages possessed by some organizations and individuals allowing them to be more effective investment sponsors is discussed in greater depth in Zvi Bodie. "Pensions as Retirement Income," *Journal of Economic Literature* 28 (March 1990), pp. 28–49.

TABLE 1.1 The Variety of Investment Sponsors

Type of Plan Sponsor	Number of Plans	Number of Participants	Investment Assets (billions of $)
Retirement[a]	716,336[b]	109.1 million[c]	$10,927
Defined Benefit	30,336	44.1 million	$5,823[d]
Defined Contribution	686,000	65.0 million	$5,104
Charitable Organization[e]	365,000	NA	$1,212
501(c)(3)	212,000		$654
Foundations[f]	76,348	NA	$515
Trust[g]	1,100,000	NA	$1,000
IRA & Keogh	41,000,000	4.6 million	$3,667

[a] Includes private trusteed, federal government and state and local government plans.
[b] Includes only the number of private trusteed plans.
[c] Includes only participants in private trusteed plans.
[d] Assets of private defined benefit, federal government and state and local government retirement plans.
[e] Includes all 501(c)(3) through 501(c)(9) charitable organizations not classified as foundations by the Internal Revenue Service.
[f] Includes operating and nonoperating foundations.
[g] Includes only trusts at FDIC insured financial institutions.

Sources: Employee Benefits Research Institute, *Pension Investment Report: Fourth Quarter, 2005*; Board of Governors of the Federal Reserve, *Flow of Funds Accounts of the U.S., First Quarter, 2006*; Pension Benefit Guarantee Corporation, *Pension Insurance Data Book 2005*; U.S. Department of Labor, *Employee Benefits Security Administration: Private Pension Plan Bulletin*, July, 2006; U.S. Department of the Treasury, *Internal Revenue Service: Statistics of Income*; The Foundation Center: *Foundation Center Yearbook, 2006*; Federal Deposit Insurance Corporation, *Statistics of Depository Institutions*; and Investment Company Institute, *ICI Fundamentals* 15, no. 5.

The explosive growth in the number of sponsored investment plans indicates that the market for saving and investment programs has become significantly broader and deeper. Several factors appear to account for this robust growth. In terms of provision or supply, ongoing technological progress in communications and information processing combined with a wide range of product, investment management, market structure, institutional and regulatory innovations and changes in the financial sector have likely lowered the costs of establishing and maintaining saving and investment plans. Far reaching changes in the U.S. tax code and persistent, heightened competition for qualified employees have also enabled and motivated tens of thousands of midsized to smaller organizations to sponsor saving and investment programs. Sponsored programs are no longer the sole purview of organizations with large numbers of participants and large dollar portfolios—organizations that may experience economies of scale in operating such programs.

With regard to demand, healthy and sustained long-term growth in the U.S. economy has led to continuous increases in incomes and rising wealth, providing the necessary savings and net worth to fund such programs. Demographic trends, perhaps most notably the aging of the baby-boom generation, have spurred the desire to participate in retirement plans and stimulated the willingness for sizable increases in bequests, contributions, gifts and grants to charitable organizations, foundations and trusts.

THE INVESTMENT COMMITTEE

Organizations establishing saving and investment programs have ultimate fiduciary responsibility for the plans they sponsor. These substantial fiduciary responsibilities are vested in the governing body, such as the Board of Directors of a corporate sponsored pension plan and the Board of Trustees of a university endowment fund, of the organization sponsoring the saving and investment program. Governing bodies in turn frequently establish investment committees and delegate and entrust to them the responsibilities for fulfilling the investment mandates set forth by the sponsoring organization. These responsibilities may vary widely, ranging from placing a few thousand dollars of excess cash in a money market mutual fund to overseeing the investment of billions of dollars apportioned among a number of investment managers across several asset classes.

Committee Composition

The investment committee is chaired by a member of the organization's governing body, that is, a member of the Board of Directors or Board of Trustees, as it is a committee of the governing body. In those infrequent instances when a Board member does not chair the investment committee, at least one Board representative will nonetheless sit as a voting member of the committee. In addition the President, Chief Financial Officer and Chief Investment Officer—if one exists—of the organization will sit as *ex oficio* members of the investment committee.

The size of the investment committee is ultimately a decision of the organization's governing body. Factors such as the complexity of the investment mandate, the number of participants in the plan, the dollar amounts to be invested, and legal and regulatory compliance requirements appear to determine the size of the investment committee. For example, the California Public Employees Retirement System (CALPERS), the nation's largest public pension plan with roughly $210 billion in invested assets, has a 13 member Board of Administration and a 13-member investment committee comprised solely of Board members.[3] In contrast, the John D. and Catherine T. MacArthur Foundation, one of the largest philanthropic foundations in the country with about $5.5 billion in invested assets also has a 13-member Board of Trustees, but a seven-member investment committee comprised of four trustee and three nontrustee members.[4]

Trade-offs obviously exist in setting the size of the investment committee. Large committees may suffer from a diffusion of responsibilities, communications challenges, and tendencies to "group" decision making. Smaller committees may face responsibilities simply too daunting to adequately address. In recent years a trend towards reducing investment committee size from 10 to 15 members to five to seven members appears to have emerged.

While the size of the investment committee is important to its success, the qualifications and dedication of committee members are considerably more important. Individuals invited to serve on the investment committee should be selected based on their education, knowledge, experiences and background in a range of investment management and plan administration issues. Indeed, investment committee members of pension plans coming under the jurisdiction of the Employee Retirement Income Security Act (ERISA) are required to not just act in accordance with the "prudent man" rule but to act per the "prudent expert" rule; that is with the prudence someone familiar with investment management matters would exercise.

Prospective investment committee members should be clearly informed about their requirements, duties, responsibilities and expectations prior to joining the committee. Policies regarding potential conflicts of interest and disclosures should be fully addressed at this time. Orientation seminars for new members and ongoing education programs for all members will serve to keep the committee informed and current about important new developments.

Committee Responsibilities

The overarching responsibility of the investment committee is to design, develop and implement investment strategies and policies in order to achieve the investment goals of the saving and investment program. Effective committees focus on broad issues of strategy and policy rather than the micromanagement of the investment process.

[3] www.calpers.ca.org, accessed June 23, 2006.
[4] www.macfound.org, accessed June 23, 2006.

There are nine primary strategic and policy issues under the investment committee's purview:

1. *Determining investment goals*. Investment goals include specifying return objectives for the monies being invested; setting the risk tolerance(s) about the return objectives; and defining any constraints or limitations on the investment process.
2. *Identifying and monitoring asset classes and investment vehicles*. Determining investment goals will help direct the committee in selecting asset classes whose returns and risks are likely to be most consistent with its investment goals. As the number of asset classes and the variety of instruments for investing continue to rapidly expand the committee must also monitor the growing universe of asset classes and investment vehicles.
3. *Internal versus external investment management*. The committee must decide whether the day-to-day investment of the funds will be delegated to an in-house group of investment professionals and support staff under the direction of a Chief Investment Officer, or if external investment management professionals will be given this responsibility. If the decision is to build in-house capacity for investment management then the investment committee may have strategic and policy responsibilities for such things as its structure and organization. If the committee decides to employ outside investment professionals then procedures for hiring, monitoring, evaluating as well as terminating such firms must be established.
4. *Passive versus active investment strategies*. The committee must determine if monies should be invested such that returns and risks closely track those of relevant benchmarks—a so-called passive investment strategy or, instead, if monies should be invested to earn returns adjusted for risks and costs that consistently exceed relevant benchmarks—a so-called active strategy. Previous decisions regarding investment goals as well as anticipated results, expenses, and evaluation and monitoring costs play important roles here.
5. *Asset allocation guidelines*. The committee should specify permissible ranges for allocating funds among the identified asset classes. These ranges will be influenced by the committee's decisions on investment objectives, asset classes, and a passive versus active investment strategy.
6. *Establishing performance criteria*. In order to properly measure, assess and analyze success in achieving its investment objectives the committee must establish criteria and benchmarks against which actual performance results will be judged. The number and types of criteria have increased substantially in recent years in conjunction with the growth

in the number and variety of asset classes and investment vehicles. Consistency and appropriateness with investment goals, permissible asset classes, and investment strategy and portfolio composition are important in this regard.

7. *Performance evaluation*. The committee must decide how frequently actual investment performance results will be evaluated, the most useful methodologies for evaluating performance, and the parties responsible for undertaking the performance evaluation. The committee must be skilled in assessing and analyzing the performance evaluation data and information presented to it.
8. *Changes to the process*. A host of factors may cause the investment committee to reexamine the strategies and policies in items 1 through 7 above. For example, the tolerance for risk may diminish on a long-term basis; new constraints may emerge; new asset classes may be available for investments; the costs of maintaining an in-house investment department may be considerably increasing; fiduciary responsibilities may become more stringent; or the performance of outside investment professionals may be disappointing. The committee must decide when incremental changes as opposed to more fundamental changes to its strategies and policies need to be made.
9. *Communications and reporting to governing body*. As a committee of the Board the investment committee is responsible for periodically and regularly informing the Board on its progress in successfully implementing the mandates it received from the Board. Key reporting requirements include information on strategy and policy issues noted above; investment performance results and performance evaluations; and recommendations for substantial changes to investment strategy and policy which require Board approval.

Written Investment Policy Statements are the preferred and probably best device for the investment committee to communicate its investment strategy and policy to the Board, participants in the saving and investment programs and any regulatory officials. Investment Policy Statements are the subject of our next chapter.

THE VARIETY OF INVESTMENT SPONSORS

Taxable Status

The two primary types of investment sponsors are tax-exempt sponsors and taxable ones. Over the years the U.S. Congress has enacted, amended, and overhauled an array of laws under which organizations and individuals may sponsor saving and investment programs and qualify for either exemption or deferral from federal taxation. Qualified organization and individual sponsored retirement plans, public charities, and private foundations are the most prominent tax exempt—tax-deferred investment sponsors with trillions of dollars of invested assets. In contrast, individuals—except for their qualified retirement plans—corporations, partnerships and most trusts are taxable investment sponsors.

Qualified versus Nonqualified Retirement Plans

Qualified retirement plans meet certain requirements contained in the Internal Revenue Code to ensure they do not discriminate in favor of highly compensated employees. Sponsors of plans meeting these requirements receive tax benefits in that plan contributions are tax deductible and the investment returns on contributions are tax exempt. Depending on the type of qualified plan, participants' contributions—if any—as well as investment returns on participants' contributions are tax exempt until they are withdrawn by the beneficiary. Nonqualified retirement plans are generally targeted at highly compensated employees. These plans are not subject to the same Internal Revenue Code requirements as qualified plans. However, the broad types of nonqualified plans are similar to the qualified ones discussed below.

A wide variety of qualified retirement plans are offered by private sector, public sector, and nonprofit organizations. Table 1.2 reports the total dollar amounts of retirement plan assets in the U.S. from 1985–2005 by broadly defined plan sponsors. Retirement plan assets totaled almost $14.6 trillion dollars at yearend 2005, compared to about $2.4 trillion in 1985. This represents a compound annual growth rate of approximately 9%. Adjusted for inflation, retirement plan assets have expanded at a compound annual growth rate of close to 6%, roughly twice the pace of expansion of the U.S. economy.

Figure 1.1 illustrates the changing composition of retirement plan assets by broadly defined plan sponsor from 1985 to 2005. Four notable changes are apparent:

1. The share of retirement plan assets accounted for by private trusteed plans, that is private plans managed by a trustee, has fallen from 51% of the total in 1985 to just 34% in 2005.
2. The drop in private trusteed plans share has been exclusively in defined benefit plans, which have plunged from 34% to 14% of the total. Defined contributions plans share, in contrast, has inched up from 17% to 20% of the total.

TABLE 1.2 Total Retirement Plan Assets in the U.S.: 1985–2005 ($ in billions)

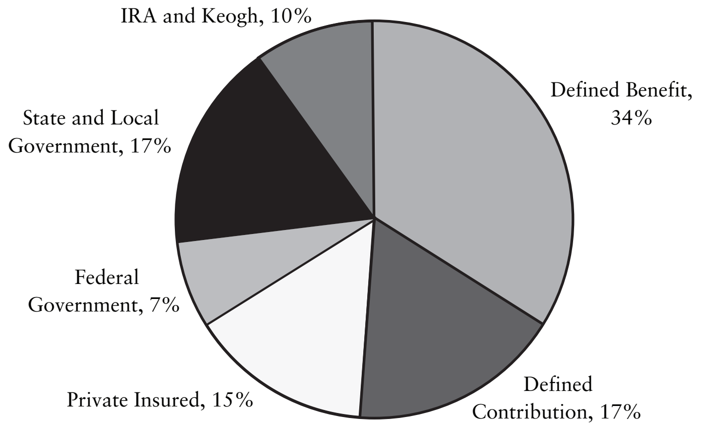
		Private Trusteed					
	Total	Defined Benefit	Defined Contribution	Private Insured	Federal Government Retirement	State and Local Governments	IRA & Keough
1985	$2,395	$814	$417	$355	$172	$402	$235
1986	2,778	885	478	418	202	477	319
1987	3,028	833	523	467	233	532	390
1988	3,272	883	549	525	267.5	597	451
1989	3,746	942	672	582	304	700	546
1990	3,928	896	676	649	340	730	637
1991	4,577	1,048	829	691	382	852	776
1992	4,878	1,043	892	706	426	937	873
1993	5,237	1,170	1,014	750	468	1,042	993
1994	5,722	1,193	1,076	794	512	1,092	1,056
1995	n/a	1,444	1,312	n/a	541	1,327	1,288
1996	7,524	1,542	1,520	880	606	1,509	1,467
1997	9,106	1,783	1,853	1,288	659	1,795	1,728
1998	10,365	1,945	2,105	1,418	716	2,031	2,150
1999	11,640	2,085	2,272	1,532	774	2,326	2,651
2000	11,531	1,945	2,295	1,571	797	2,293	2,629
2001	10,842	1,707	2,118	1,331	860	2,207	2,619
2002	9,928	1,404	1,820	1,310	894	1,931	2,533
2003	11,918	1,715	2,246	1,574	959	2,344	3,080
2004	13,259	1,869	2,554	1,765	1,024	2,572	3,475
2005	14,594	2,056	2,907	2,197	1,075	2,692	3,667

Sources: Employee Benefit Research Institute, *Pension Investment Report,* Fourth Quarter 2005; and Board of Governors of the Federal Reserve, *Flow of Funds Accounts of the U.S.*, Second Quarter, 2006.

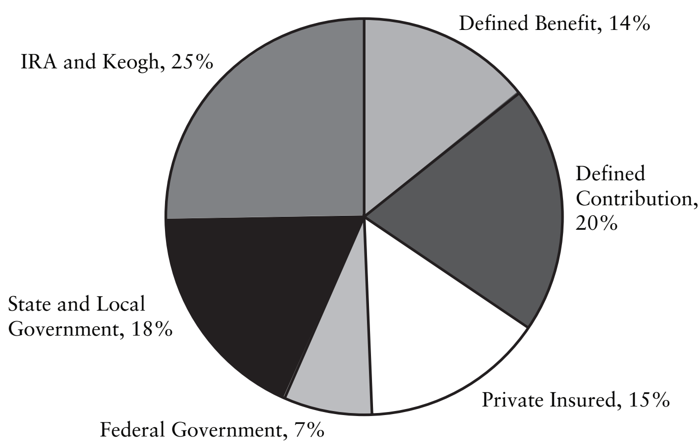
3. IRA and Keough plans proportion of total retirement plan assets has advanced strongly, rising from only 10% of the total in 1985 to 25% by 2005.
4. The proportions of retirement plan assets represented by private-insured plans, federal government plans, and state and local government plans have remained roughly constant from 1985 to 2005.

FIGURE 1.1

Panel A: Sponsor Shares of Retirement Plan Assets: 1985 (Total Assets: $2.395 trillion)



Panel B: Sponsor Share of Retirement Plan Assets: 2005 (Total Assets: $14.594 trillion)



Source: Employee Benefit Research Institute.

Private Sector Retirement Plans

Plans designed to provide income during retirement fall into one of two basic categories: defined benefit plans and defined contribution plans. Fundamentally, these two basic types of plans differ in how they are funded; how benefits are determined; how investment risks are borne; whether or not the invested funds are pooled; and regulatory and compliance requirements.

Defined Benefit Plans

Defined benefit plans are designed to provide participants' retirement incomes that are reasonably certain as the benefits are based on identifiable, specific, predetermined criteria. Most frequently these criteria include length of service to the sponsoring organization; a measure of the participant's wages and salary during a particular time period; and known minimum and maximum annual benefits. These criteria are embedded in a variety of formulas so that participants can estimate and understand the retirement benefits they are likely to receive.

Sponsoring organizations are responsible for funding defined benefit plans. Defined benefit plans require the sponsor to make annual contributions to the plan. Funding requirements are therefore a liability of the sponsoring entity. At the same time, annual contributions made to defined benefit plans by profit-seeking enterprises are a business expense and, like other business expenses, reduce the corporation's taxable income and tax liabilities. The present value of the ongoing decrease in tax liabilities provides incremental value to the enterprise's shareholders in the form of a so-called "tax shield."

Annual contributions made by sponsors should be invested according to the plan's investment policy statement. These invested, accumulated annual contributions combined with the cumulative investment returns on them represent the plan's assets. The plan's assets, in turn, are the source of payment to its retirees. Ensuring that annual contributions and the returns on these invested monies are sufficient to meet the predetermined, promised benefits to retirees is the obligation of plan sponsors. Investment risks of defined benefit plans are thus borne by the entity sponsoring the plan.

The value of a defined benefit plan's assets is generally measured as the fair market value of all the plan's invested securities at a point in time. This fair market value is generally considered to be the same as the liquidation value of the portfolio of assets on the valuation date. Alternatively, the Pension Benefit Guarantee Corporation, the federal government agency that insures participants' pension benefits, allows plan sponsors to calculate asset market values using a maximum five-year average of market values as long as the smoothed market value is not less than 80% or more than 120% of the current market value of assets.

The value of a defined benefit plan's liabilities is the present value of the lifetime stream of future benefits promised to participants and, in some cases, to their surviving beneficiaries. Measuring the value of this liability hinges on a host of assumptions. Assumptions are required for contingencies such as employee turnover rates; retirement ages and the mortality rates of participants; whether benefits are considered to be those accrued to date, projected, or actually vested; and interest rates used to calculate present values.

A defined benefit plan's funding status is based on a comparison of the market value of the plan's assets to the present value of its liabilities. Plans with a positive net asset value are said to be either over funded or fully funded, while those with a negative net asset value are considered under funded. The Pension Benefit Guarantee Corporation reports that for fiscal year 2005 the total assets of all pension plans whose participants it insures were approximately $57.6 billion while total liabilities were about $80.7 billion, representing a system-wide under funding of roughly $23 billion. About 73% of all plans were under funded in fiscal year 2005, with the bulk of the under funding concentrated in single-employer plans.[5]

The landmark Employee Retirement Income Security Act (ERISA) of 1974 and its several amendments—the most comprehensive being the Pension Protection Act of 2006—provides the regulatory and compliance framework for retirement plans in general and defined benefit plans in particular. For purposes of investment performance evaluation the key existing features of ERISA are:

1. The stipulation that sponsors operate plans solely in the interest of participants and beneficiaries and for the exclusive purpose of providing benefits and paying plan expenses.
2. The extension of fiduciary responsibilities, that is, the highest standards of care, to plan trustees, plan administrators, and plan investment committee members.
3. The exercise of fiduciary responsibilities by acting in accordance with the prudent expert rule; diversifying the plan's asset portfolio; developing and following a written investment policy statement; and avoiding conflicts of interest.
4. Disclosure to plan participants of the plan's rules, usually embedded in the Summary Plan Description; disclosure of information on the plan's management, operations, financial status and financial performance; and the provision of an Annual Report.
5. The establishment of the Pension Benefit Guarantee Corporation to ensure that participants in defined benefit programs receive pensions even if their plans terminate without adequate assets to pay promised benefits.[6]

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[5] The data are from page 2 and Tables S-1, S-20, M-1, and M-5 of the *Pension Insurance Data Book 2005*, Pension Benefit Guarantee Corporation, Washington, D.C. (Summer 2006).

[6] The PBGC pays pension benefits according to plan provisions up to specified, maximum amounts. For 2006 the maximum is $48,000 per beneficiary, with the annual maximum tied to the national increase in wages.

The wide-ranging Pension Protection Act of 2006 was designed, among other things, to better ensure that defined benefit plans are adequately funded and to improve the Pension Benefit Guarantee Corporation's insurance reserve. Noteworthy provisions of the Act include:

- A revamping of funding rules for single employer plans beginning in 2008 pertaining to minimum funding requirements, funding requirements for severely under funded plans as well as increased limits on maximum contributions.
- Changes to the interest rate assumptions plans may use to determine the present value of liabilities. These changes will be phased in over two years starting in 2008. Different interest rates will be applied to different groups of benefits based upon when the benefits will be received.
- The time period for averaging plan asset values will be shortened beginning in 2008 to 24 months and the range for averaging will be reduced to no less than 90% and no more than 110% of current market value.
- Mortality assumptions used in calculating the present value of liabilities will be prescribed by the U.S. Treasury.
- Additional changes to the rules for Pension Benefit Guarantee Corporation insurance premia will be instituted, and limits on its exposure to plan benefit increases put in place just before an under funded plan is terminated will be implemented.

Notwithstanding the intent of the Pension Protection Act of 2006, the long-term decline in private sector defined benefit plans is likely to continue unabated. Table 1.3 contains data on the number of Single Employer and Multi-Employer (collective bargaining) defined benefit plans insured by the Pension Benefit Guarantee Corporation as well as the number of participants in these plans from 1985 to 2005. As can be seen in the table the total number of plans has plunged from more than 114,000 in 1985 to slightly more than 30,000 in 2005. Continuous declines have been registered in the numbers of both single- and multi-employer plans, but the fall-off has been most severe in the number of single-employer plans.

The long-term downtrend in the number of single employer plans had been concentrated in smaller plans, that is, plans with less than 100 participants. However, the Pension Benefit Guarantee Corporation reports that the number of larger plans (those with more than 5,000 participants) has also started to decline in recent years.[7] High administrative and operating costs, the concentrations of funding and investment risk with plan sponsors, and the relative attractiveness of defined contribution plans likely account for the downward spiral in the number of private-sector-defined benefit plans.

[7] *Pension Insurance Data Book, 2005.*

TABLE 1.3 Private Defined Benefit Pension Plans: Number of Plans and Participants, 1985–2005

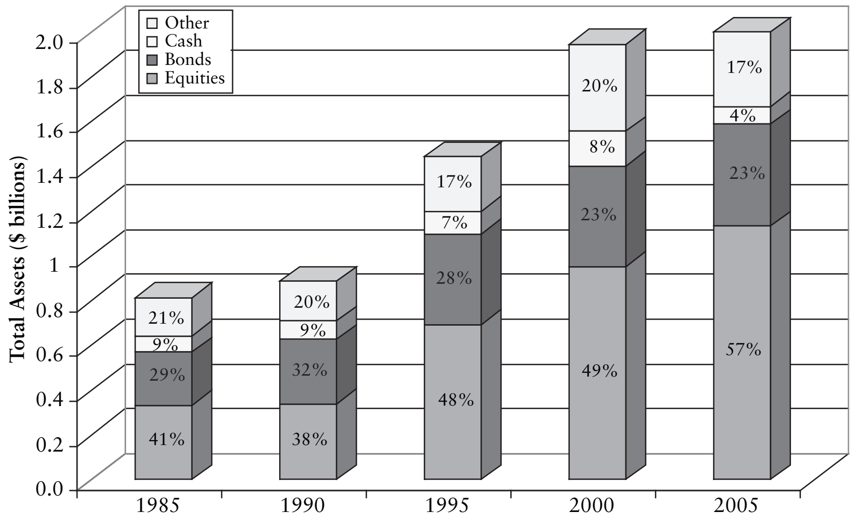
	Number of Plans (PBGC Insured)			Number of Participants (in thousands)		
	Single Employer	Multi-Employer	Total	Single Employer	Multi-Employer	Total
1985	112,208	2,118	114,398	29,809	8,209	38,018
1986	111,944	2,153	114,097	30,043	8,154	38,197
1987	111,351	2,098	113,449	31,200	8,256	39,456
1988	108,279	2,081	110,360	31,461	8,294	39,755
1989	101,724	2,060	103,784	31,574	8,426	40,000
1990	91,899	1,983	93,882	31,633	8,534	40,167
1991	82,717	1,926	84,643	31,851	8,710	40,561
1992	71,589	1,936	73,525	32,056	8,780	40,836
1993	63,778	1,900	65,678	32,271	8,657	40,928
1994	57,010	1,880	58,890	32,372	8,559	40,931
1995	53,589	1,879	55,468	32,634	8,632	41,266
1996	48,748	1,876	50,624	32,724	8,649	41,373
1997	43,902	1,846	45,748	33,214	8,740	41,954
1998	41,462	1,817	43,279	33,545	8,876	42,421
1999	37,538	1,800	39,336	33,804	8,991	42,795
2000	35,373	1,744	37,117	34,108	9,132	43,240
2001	32,954	1,707	34,661	34,342	9,423	43,765
2002	31,229	1,671	32,900	34,248	9,630	43,878
2003	30,611	1,612	32,223	34,407	9,699	44,106
2004	29,651	1,587	31,238	34,617	9,826	44,443
2005	28,769	1,567	30,336	34,200	9,900	44,100

Source: Pension Benefit Guaranty Corporation, *Pension Insurance Data Book*, 2005.

And, although the number of plans has plummeted, the number of participants continues to modestly advance—rising from about 38 million in 1985 to 44 million in 2005 or at a pace of less than 1% per year.

Assets of defined benefit plans, as presented in Table 1.2, have also experienced only modest growth since 1985. In current dollar terms defined benefit plan assets have risen about 4.50% per year. Adjusted for inflation the growth in assets has only been at a 1.40% annual rate. Assets per participant have doubled from $21,000 in 1985 to $42,000 in 2005, but adjusted for inflation have moved up by only 16% or at roughly the same annual growth rate as the number of participants.

FIGURE 1.2 Defined Benefit Plans Asset Allocations, 1985–2005



Source: Employee Benefits Research Institute.

The declining numbers of defined benefit plans in concert with sluggish increases in the number of participants and assets as well as the serious under funding challenges may be influencing the asset allocation choices of the investment professionals charged with implementing investment strategy and policy. Figure 1.2 depicts the broad asset allocations among equities, bonds, cash equivalents and other assets of defined benefit plans at five-year intervals from 1985 to 2005. A clear and pronounced shift of assets to equities and from the other asset classes has occurred. The asset allocation to equities has moved from about 40% of all assets in the 1985–1990 time periods to roughly 50% by the 1995–2000 timeframes to approximately 57% by 2005. Allocations to bonds, cash equivalents and other assets have trended downward during this period.

Defined Contribution Plans

In contrast to defined benefit plans, defined contribution plans are not structured to provide specific, predetermined retirement incomes to participants. Instead, the amount contributed by the plan sponsor for each participant is defined at either the discretion of the sponsor or via a fixed formula. Participants may augment the sponsors' contributions in certain types of plans. Retirement incomes for plan participants will be based on accumulated contributions, the length of time these contributions are invested and returns on the invested funds.

Since defined contribution plans do not guarantee benefits to retired workers investment risks are shifted to plan participants. Nonetheless, sponsors of defined benefit plans are not necessarily exempt from all liability, especially in the case of 401(k) plans. In addition to the prudent expert rule, ERISA requires plan sponsors to choose appropriate asset classes and investment vehicles for plan participants; to regularly evaluate the investment performance of the selected investment alternatives; and to provide participants sufficient information so that they can make informed investment decisions and thus assume responsibility for investment outcomes.[8] Moreover, the Pension Protection Act of 2006 contains provisions pertaining to defined contribution plans. Beginning in 2010 small employers, those with at least two but not more than 500 employees, can establish combined defined contribution and defined benefit plans. Temporary changes enacted in 2001 regarding increased contributions and portability of plans have been made permanent.

Unlike the pronounced two-decade downtrend in defined benefit plans, the number of defined contribution plans, participants, and plan assets have experienced strong, sustained advances. Between 1985 and 2002 the number of defined contribution plans surged from approximately 346,000 to 686,000 while the number of plan participants accelerated from approximately 11.2 million to in excess of 65 million.[9] The overwhelming majority of plans, about 74%, had less than 100 participants. And, as illustrated in Table 1.2, assets of defined contribution plans have soared from roughly \$420 billion in 1985 to approximately \$2.9 trillion in 2005. In inflation adjusted terms defined contribution plan assets have expanded at a solid annual rate of 6.67 % during this period. However, a different perspective emerges when the assets of defined contribution plans are looked at on a per participant basis. Assets per participant stood at \$37,500 in 1985 and increased to almost \$45,000 by 2005—an annual growth pace of roughly 1%. This rate of expansion fell short of the average inflation rate of approximately 3%, implying that inflation-adjusted assets per participant contracted by about 2% per year.

Table 1.4 presents a summary of the primary types of defined contribution plans for 2002, the latest year for which such data are available. A brief description of each plan type is presented together with the number of spon-

[8] The responsibilities of 401(k) sponsors are more fully described by Jay G. Sanders, "401(k) Plans and Liability Exposure for Plan Sponsors," *The CPA Journal* 75, no. 12 (December 2005), pp. 37–42.

[9] The data are from Chapter 11 of the *EBRI Databook on Employee Benefits*, Employee Benefit Research Institute, Washington, D.C. (May 2005).

sors for each plan type, the number of participants in each plan and the total assets of each plan. Internal Revenue Code 401(k) plans, first established in 1978, have come to dominate all other types of defined contribution plans. They now account for approximately 75% of all defined contribution plans; 82% of all plan participants; and 81% of all plan assets.

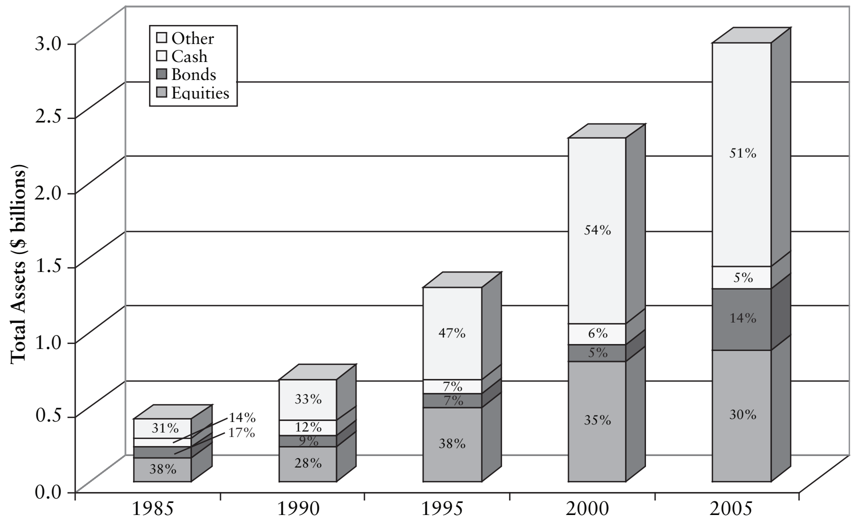
In a similar fashion as Figure 1.2, the asset allocations of defined contribution plans at five-year intervals from 1985 to 2005 are shown in Figure 1.3. At first glance the striking differences between the asset allocations of defined benefit and defined contribution plans are the sharp uptrend and concentrated allocation of defined contribution plan assets to the "Other Assets" class of investment vehicles. "Other Assets" have come to represent more than 50% of all defined contribution plan assets in recent years compared to about 30% in the 1985–1990 timeframes. Closer inspection, however, indicates roughly 75% of these "Other Assets" are mutual fund

TABLE 1.4 Primary Types of Defined Contribution Plans

Plan Type	Description	Number of Plans	Number of Participants	Assets (billions)
Profit sharing	Employer determined contributions to participants accounts.	193,238	5,200,000	$181
Money purchase	Like (1), but contributions fixed percentage.	77,444	4,115,000	$111
Stock bonus	Employer determined contribution of company stock.	2,875	1,559,000	$50
Target benefit	Contributions target a specific benefit.	2,519	79,000	$37
Cash benefit/ 401(K)	Matched employer—employee contributions.	388,204	53,300,000	$1,570
Cash benefit/ 403(B)	401(K) plan for employees of tax-exempt organizations.	16,309	137,000	$1,200
Cash benefit/457	Supplemental plan for state and local government employees.	NA	NA	$143
Other		4,966	924,000	$32
Totals		685,943	65,275,000	$3,324

Source: Employee Benefit Research Institute, *EBRI Databook*.

FIGURE 1.3 Defined Contribution Plans Asset Allocations, 1985–2005



Source: Employee Benefit Research Institute.

shares—reducing the allocation to alternative investments closer to 13%.[10] Moreover, 2004 data for 401(k) plans reveals about 70% of their assets were held as mutual fund shares with roughly 46% held as equity mutual fund shares; 10% each held in balanced and bond mutual fund shares; and 4% in money market mutual fund shares.[11] When these factors are accounted for, it appears the 2005 asset allocation of defined contribution plans was roughly 59% to equities; 17% to bonds; 6% to cash equivalents; and 18% to other assets. Overall, the asset allocation of defined contribution plans is reasonably close to that of defined benefit plans.

Individual Retirement Plans

Self-employed persons can establish their own tax-deferred, saving-investment programs for retirement, as can individuals regardless of whether they are participating in a sponsored defined benefit or defined contribution plan. Several such individual retirement programs exist, with the Individual Retirement Account by far being the most popular. Traditional IRAs were es-

[10] These data are from the *Flow of Funds Accounts of the United States, Table L118. c*, Board of Governors of the Federal Reserve, Washington, D.C., first quarter 2006.
[11] The data are from Chapter 13 of the *EBRI Databook on Employee Benefits*, Employee Benefit Research Institute, Washington, D.C. (May 2005).

tablished by the ERISA legislation of 1974 and followed by Roth IRAs in 1997.

Individual Retirement Accounts

Employees establish these accounts with financial institutions and they are generally funded with payroll deductions. Contributions to IRAs are capped, with the maximum contribution to Traditional IRAs for 2006–2007 being $4,000 to $5,000 depending upon the individual's age.[12] Contributions to Traditional IRAs may be tax deductible in whole or in part, depending upon the individual's tax filing status and adjusted gross income. Investment returns on Traditional IRAs are tax exempt until they are distributed.

Roth IRAs are a variation on the Traditional IRA. The most notable differences are that contributions to Roth IRAs are not tax deductible, and distributions are not taxed. While the maximum allowable contributions to Roth IRAs are the same as for Traditional IRAs, the employee's tax filing status and adjusted gross income may further constrain the maximum allowable contribution to Roth IRAs. Like Traditional IRAs, the investment returns on Roth IRAs are not taxed. Finally, Keogh plans are IRAs for self-employed persons. In all of these three types of individual retirement plans the individual account holder bears the full investment risk.

As shown in Table 1.2, the approximately $3.7 trillion of total assets in IRA and Keogh accounts as of 2005 are by a sizable margin the largest of all the types of retirement plan assets. IRA and Keogh assets have expanded at a roughly 14% compound annual rate since 1985. Adjusted for inflation the growth rate has been roughly 10% per year. Growth has been especially rapid since 1997.

The median asset value of IRA and Keogh accounts stood at $40,000 in 2005 versus $20,000 in 1992. It is estimated that slightly more than 40% of all households representing about 41 million people owned either an IRA or Keogh account in 2005 compared to 26% in 1992, with Traditional IRA accounts comprising 80% of the total.[13] At the same time the total number of IRA account holders seems to have flattened out after declining throughout the 1990s, while the number of Keogh accounts has been rising. The Employee Benefits Research Institute reports that individual IRA accounts shrank to about 3.4 million in 2003 from roughly 5.2 million in 1990, and the number of Keogh accounts stood at approximately 1.2

[12] The Pension Protection Act of 2006 provides for allowable contributions to increase to $5,000 to $6,000 beginning in 2008.

[13] Sandra West and Victoria Leonard-Chambers, "The Role of IRAs in Americans' Retirement Preparedness," *ICI Fundamentals* 15, no. 1, pp. 1–12. Copyright 2006 by the Investment Company Institute (www.ici.org). Cited with permission.

million in 2003 compared to 825,000 in 1990.[14] Self-employed individuals with Keogh accounts may be the driving force behind the total asset growth in these types of retirement plans.

Sharp shifts in the allocation of IRA and Keogh assets among financial institutions may also lie behind their rapid asset growth. In 1985, Commercial Banks and Thrifts held 60% of all IRA and Keogh assets, with the remainder roughly equally apportioned among mutual funds, life insurance companies, and security broker-dealers. By 2005, the market shares of IRA and Keogh assets had dramatically shifted. Mutual funds and security broker–dealers now hold 45% and 38%, respectively, of all IRA and Keogh assets, with commercial banks and life insurance companies holding roughly 7% and 9% each.[15]

While Traditional and Roth IRAs have come to dominate tax advantaged individual retirement accounts, there are several additional individual retirement plans worth noting. These include the Simplified Employee Pension Plan, SEP for short, where the employer makes contributions to their own IRA account as well as employees' IRAs. Contributions to employees IRAs are made at the employer's discretion. Simple IRAs are like SEPs in that employers make contributions to employee's IRA accounts and employees also make contributions to their IRA accounts. These plans are thought to be less expensive to administer than most defined benefit and defined contribution plans, allowing the extension of retirement saving and investment programs to smaller organizations.

Qualified Tuition Programs

Qualified tuition programs, also known as IRC Section 529 plans, allow individuals to contribute to state-sponsored prepaid tuition and college saving programs for eligible institutions of higher education. Contributions to such programs are not capped, but are also not tax deductible for federal income tax purposes. In about 25 states, however, contributions are deductible for state income tax purposes (in states with individual income taxes) if the contributor is a resident of the state sponsoring the program. If the contributor is not a resident of the state sponsoring the program, the contributor may nonetheless qualify for a tax credit in their state of residence.

Earnings on the contributions to qualified tuition programs are exempt from federal income taxes. Additionally, distributions to the designated ben-

[14] Craig Copeland, "IRA and Keogh Assets and Contributions," *EBRI Notes* 27, no. 1 (January 2006), pp. 2–9.

[15] Peter Brady and Sarah Holden, "The U.S. Retirement Market in 2005," *ICI Fundamentals* 15, no. 5, pp. 1–12. Copyright 2006 by the Investment Company Institute (www.ici.org). Cited with permission.

eficiary of qualified tuition programs, as long as such distributions are for normal and reasonable higher education expenses, are tax exempt.

Public Sector Retirement Plans

Federal, state, and local governments provide qualified retirement plans to their employees. These plans are primarily defined benefit plans although the federal government through the Thrift Saving Plan and state and local governments via IRC 457 plans also provide supplemental defined contribution plans for qualified employees. Assets of these supplemental defined contribution plans still remain relatively small proportions of total retirement plan assets. They account for about 6% of all federal government retirement plan assets and represent roughly 6% of all state and local government plan assets.

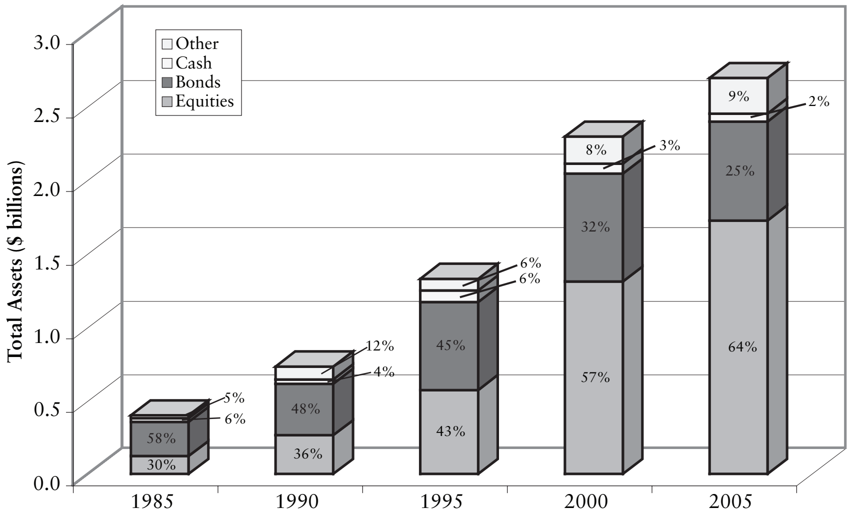
Assets of federal, state, and local government retirement programs totaled more than $3.7 trillion in 2005, with the federal government share accounting for roughly 29% and the state and local share being about 71% the total, respectively, as depicted in Table 1.2. Federal government retirement program assets have been advancing at close to a 9% compound annual rate since 1985 (6% adjusted for inflation) while assets of state and local government retirement programs have been rising at a hefty 9.5% annual pace (6.5% adjusted for inflation).

Assets of the federal government retirement program are almost exclusively invested in nonmarketable U.S. government securities. Between 2000 and 2005 the allocation to this asset class averaged 86% of all assets. After peaking at 89% of all retirement assets in 2001, the allocation to nonmarketable U.S. government securities has diminished steadily and stood at 82% in 2005. Equities represented 11% of retirement plan assets and bonds—primarily U.S. Treasury securities—accounted for 7% of all federal government retirement plan assets.[16]

State and local government retirement plan assets are allocated across the same broad assets classes as are defined benefit and defined contribution plan assets. However, there are some notable differences in the investment mix for state and local government retirement assets. Figure 1.4 shows the asset allocations for state and local government retirement plans at five-year intervals from 1985 to 2005. The rising share of assets invested in equities and the declining share allocated to bonds are the most notable changes over the 21 year time period. Equity investments have steadily trended upwards and now account for 64% of all assets compared to only 30% in 1985. State and local governments now invest considerably more in equities, as a per-

[16] *Flow of Funds Accounts of the United States, Table L.120*, Board of Governors of the Federal Reserve, Washington, D.C., second quarter, 2006.

FIGURE 1.4 State and Local Government Retirement Plans Asset Allocations, 1985–2005



Source: Employee Benefit Research Institute.

cent of their total assets, than do either defined benefit or defined contribution plans. At the same time state and local government allocations to bonds have continuously slid from close to 60% in 1985 to just 25% in 2005.

Public Charities and Private Foundations

Sections 501(c)(3) through 501(c)(27) of the Internal Revenue Code specify the types of organizations that may be exempt from federal income taxation and the criteria that must be met to obtain and maintain federal tax exempt status. The types of organizations run the gamut from Civic Leagues to Charities to Chambers of Commerce to Cemetery Companies to Credit Unions Chartered by States to Cooperative Organizations to Finance Crop Operations. According to the Internal Revenue Service in 2003 there were more than 365,000 organizations of the 501(c)(3) to 501(c)(9) types, and their combined security investments totaled almost $1.2 trillion.[17]

By far, 501(c)(3) organizations, commonly referred to as charitable organizations, are the largest of all the types of tax-exempt organizations. In 2003, there were 288,206 such organizations, with investments in securities of roughly $998 billion, comprising close to 80% of the total number

[17] www.irs.gov/taxstats/charitablestats, accessed June 29, 2006. The data include private foundations but exclude most religious organizations.

of tax exempt organizations and almost 83% of all their security investments.[18] Organizations are eligible for exemption from federal taxation and to receive tax deductible contributions from donors as 501(c)(3) entities if they are established and operated solely for one of the following purposes: charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competition, and the prevention of cruelty to children or animals. Furthermore, the organization must be a corporation, community chest, fund or foundation.

All 501(c)(3) organizations are further categorized by the IRS under Internal Revenue Code section 509, with perhaps the most important distinction being between public charities and private foundations. In order to be classified as a public charity the purposes and operations of the organization must be for the benefit of the public interest. Moreover, the organization must receive a substantial part of its income from the general public or government, and this public support must be broad-based and not limited to a few individuals or families. Public charities account for some 74% of the number and about 70% of total security investments, respectively, of all 501(c)(3) organizations. Both the number of public charities and their assets invested in securities have grown rapidly in recent years. The number of public charities has risen from about 124,000 in 1988 to almost 212,000 in 2003. Security investments accelerated from approximately $175 billion to roughly $654 billion between 1988 and 2003, representing a compound growth rate of close to 9% per year (7% adjusted for inflation).

501(c)(3) organizations that do not qualify as public charities are classified as private foundations. A narrower base of control and financial support are two characteristics of private foundations. In order for an organization to qualify as a private foundation, receive exempt status from federal income taxation, and be eligible to receive tax deductible contributions the IRS imposes several restrictions and requirements. These include:

1. Restrictions on self-dealing between the private foundation and its substantial contributors.
2. Requirements that the foundation annually distribute income for charitable purposes.
3. Limits on the foundation's holdings in private businesses.
4. Provisions that investments must not jeopardize the carrying out of the foundation's exempt purpose.
5. Provisions to ensure that the foundation's expenditures further its exempt purpose.

[18] www.irs.gov/taxstats/charitablestats, accessed June 29, 2006. The data include public charities and private foundations but exclude most religious organizations.

In addition, an excise tax is imposed on the net investment income of most domestic private foundations.[19]

The total number of private foundations exceeded 76,000 in 2003 and the market value of their security investments was slightly more than $344 billion. Like public charities, the number and security investments of private foundations have soared in recent years. For example, in 1991 only 41,348 private foundations existed and their security investments totaled about $139 billion. The value of security investments rose at a compound annual growth rate of close to 8% from 1991 to 2003 (almost 7% adjusted for inflation). Typically, private foundations have allocated a substantial portion of their security investments to corporate equities. Between 1991 and 2003 equities averaged 73% of the total security investments of private foundations, with government and corporate bonds holdings representing the balance.[20]

Private foundations, in turn, are additionally subclassified as either private operating or private nonoperating foundations. The former expend their incomes, including returns from investments, on the operations of the foundation. Libraries and museums are often organized as private operating foundations. In contrast, private nonoperating foundations allocate their incomes and earnings from investments to make grants to other organizations and individuals. Private nonoperating foundations also face a federal requirement that each year they must payout an amount equal to 5% of the value of their investments in the previous year adjusted for total givings in that year and operating, administrative and investment expenses.[21] Private nonoperating foundations account for about 90% of the total number of private foundations and roughly the same share of total security investments.

The IRS also classifies charitable trusts as private foundations. These organizations are usually supported and controlled by either an individual or family. However, they are not exempt from federal income tax. In 2003 there were 3,125 charitable trusts holding security investments with a fair market value of approximately $3.9 billion.

TAXABLE INVESTMENT SPONSORS

Saving and investment programs sponsored by trusts, corporations, partnerships and individuals are subject to federal income taxation. Federal tax policies may affect a range of investment choices made by these sponsors such as the choice of assets classes, portfolio composition, and the timing of

[19] www.irs.ustreas.gov/charities, accessed June 29, 2006.

[20] www.irs.gov/taxstats/charitablestats, accessed June 29, 2006.

[21] *Foundation Yearbook: 2006*. The Foundation Center, New York, N.Y.

security sales and purchases. In addition, tax considerations are an element in evaluating the performance of their investment portfolios.

Trusts

A trust is a legal agreement under which assets are held and managed by one entity for the benefit of another. The entity creating the trusts and providing the assets goes by several legal names including trustor, grantor, and settlor. The individual(s) or organization that holds legal title to the trust assets and has fiduciary responsibilities for administering the trust agreement and managing the trust's assets is known as the trustee. The beneficiary is the person or organization who receives the benefits (such as income) of a trust.

Trusts are established for a variety of reasons. The most prevalent reasons for establishing a trust include:

- Providing financial support for others.
- Postponing or reducing taxes.
- Controlling assets.
- Achieving social goals.

There are a variety of types of trusts, varying according to their purpose, how they are created, the nature of the assets included in the trusts, and their duration. Each type of trust offers varying degrees of flexibility and control. Most commonly, trusts are classified as either living trusts (*inter vivos*) or testamentary trusts.

Living trusts are established during the trustor's lifetime. In most states the assets held in a living trust are not subject to probate and therefore need not be disclosed in court records. This confidentiality may be an important motivation for creating living trusts. Moreover, the beneficiaries receiving income from a living trust may be in lower tax bracket than the trustor, resulting in tax savings for the trustor.

Living trusts may be "revocable" or "irrevocable." With the former, the trustor may change the terms of the trust or even cancel it altogether. Revocable Living Trusts thus provide flexibility to the trustor. Irrevocable Living Trusts, in contrast, can not be altered or canceled by the trustor once they have been established. However, they offer the advantages that the income earned on the trust assets may not be taxable to the trustor, and the trust assets may not be subject to death taxes in the trustor's estate.

Testamentary trusts, the second common type of trusts, are established as part of a will and become effective upon the death of the person making the will. These types of trusts give trustors substantial control over the distribution of the assets in their estates. Since a will may be altered or even canceled prior to death a testamentary trust can be changed or canceled up to the time of the trustor's death.

At yearend 2005 FDIC insured financial institutions held slightly more than $1.0 trillion of assets in almost 1.1 million personal trust accounts. Approximately 74% of the total number of personal trust accounts comprising 74% of total trust assets were managed, fiduciary accounts by financial institutions, with the balances being non-managed accounts. At yearend 1996, by contrast, FDIC insured financial institutions held about $858 billion in some 904,000 personal trust accounts. About 92% of all personal trust accounts and 80% of assets in these accounts were managed, fiduciary accounts by financial institutions.[22]

For tax purposes, trusts are treated by the IRS as separate, taxable entities. Income distributed to beneficiaries, unless the beneficiary is tax exempt, is taxed at the beneficiary's individual or organization tax rate. Income earned on trust assets that is not distributed to beneficiaries may result in a tax liability for the trust. For 2006, the tax rates range from a low of 15% on undistributed income up to $2,050 to a maximum tax rate of 35% on undistributed income of $10,500 and above.

The IRS also provides special tax treatment for what are known as split-interest trusts. In these types of trusts, trustors designate as beneficiaries both charitable organizations and noncharitable individuals or groups. The trustor receives tax benefits from establishing the trust. There are four primary types of split-interest trust, differing by the methods and timing of payments to beneficiaries, with the charitable remainder unit trusts being, by a substantial margin, the most prevalent type.

When a trustor establishes a charitable remainder unit trust, the trustor obtains a tax deduction for the assets provided to the trust. The trustee makes payments to non-charitable, taxable beneficiaries per the terms of the trust for a specified length of time. IRS rules stipulate that these annual payments can not be less than 5% of the net fair market value of the trust assets. When the defined period of time expires the remaining assets are transferred to a charitable organization. In 2004, charitable remainder unit Trust accounted for 73% of the 123,204 split-interest trust and 73% of the $65.3 billion of assets held in split-interest trusts.[23]

Corporations

While corporations are the primary issuers of marketable debt and equity securities, they also invest in financial assets. For example, in 2005, U.S.

[22] "Total Fiduciary and Related Assets of All Financial Institutions," *Statistics of Depository Institutions,* Federal Deposit Insurance Corporation, Washington, D.C. www2.fdic.gov/SDI, accessed June 30, 2006.

[23] www.irs.gov/taxstats/charitablestats, accessed June 30, 2006.

nonfinancial corporations held approximately $83 billion of longer-term maturity debt instruments issued by other corporations, state and local governments, and the U.S. government. The tax rates corporations face on income and capital gains from investments in financial assets are not the same across assets classes, and these different tax rates may affect their investment choices; the compositions of their financial asset portfolios; and the net performance of their investments.

Corporations face the same capital gains tax rates on investments in stocks and bonds. These tax rates are the corporation's marginal tax rates, which are depicted in Table 1.5. As illustrated in Table 1.5, corporate tax rates vary with a corporation's taxable income from a low of 15% on taxable income up to $50,000 to a high of 39% on taxable income between $100,000 and $335,000. Deductions are allowed for capital losses, to the extent they offset capital gains, and can be carried back three years or carried forward five years to apply against prior or future capital gains. Although individual tax rates on capital gains have been reduced to 15% for most individual tax payers, they have not been lowered for corporations.

Interest income corporations receive from investments in fixed income securities is also taxed at the corporate marginal tax rate. However, dividends corporations receive from equity investments are taxed differently. Corporations investing in equities are entitled to deduct at least 70% of the dividend income that they receive. Moreover, if the corporation owns at least 20% of another domestic corporation's stock then the deduction increases to 80% of the dividend income received from the corporation. In those cases where a corporation owns at least 80% of another corporation's equity, then the deduction is 100% of the dividends received from the corporation. The differential taxation of capital gains and interest income on bonds on the one hand versus dividend income from equity ownership on

TABLE 1.5 Corporate Marginal Tax Rates, 2006

Taxable Income Range	Tax Rate (%)
$0–$50,000	15
$50,001–$75,000	25
$75,001–$100,000	34
$100,001–$335,000	39
$335,001–$10,000,000	34
$10,000,001–$15,000,000	35
$15,000,001–$18,333,333	38
$18,333,334 and above	35

the other may be a powerful incentive shaping corporate investment decisions in financial assets.

Individuals and Partnerships

In addition to tax-deferred retirement based and trust-type saving and investment programs, individuals may establish taxable saving and investment programs for a host of reasons. Diversifying income and wealth from a job or occupation and from a small number of assets in order to smooth consumption expenditures may be one motive. Accumulating wealth to finance future expenditures may be another. Regardless of the motive, individual taxable saving and investment programs are substantial. In 2005, individuals directly owned (not in retirement programs) some $5.5 trillion in equity securities.[24] However, the individuals' investment goals and objectives along with their choices of asset classes, investment vehicles, investment strategies and tax considerations will shape their investment decisions, portfolios, and the performance of their investments.

Individual tax rates on financial asset investments are often based on complex and, at times, baffling aspects of federal and state tax laws. Tax rates on interest income from investments in interest yielding, short-term maturity debt instruments (often referred to as *cash equivalents*) as well as corporate and U.S. Treasury and agency bonds are the same as the individual's marginal income tax rate. These tax rates currently vary from 10% to 35%, excluding the alternative minimum tax, with the income they apply to depending on the individual's tax filing status. Tax rates on qualified dividends from investments in equity securities, in contrast, currently stand at 15%. There is already research indicating the 2003 tax rate reduction on dividends has influenced investor's decisions.[25]

Capital gains on investments in debt and equity securities also currently stand at 15%. Moreover, capital losses can be used to offset capital gains. Deductions for capital losses up to a maximum of $3,000 per year, if losses exceed gains, are currently allowed.

Partnerships, noncorporate businesses of at least two individuals established for the purpose of conducting business to make a profit, also may invest in financial assets. For tax purposes, partnerships are treated like individuals. In general partnerships there is only one class of partner and each partner has liability for the debts and obligations of the partnership. Limited

[24] *Flow of Funds Accounts of the United States, Table B.100.c.,* Board of Governors of the Federal Reserve, Washington, D.C., second quarter, 2006.

[25] Jennifer L. Blouin, Jana Smith Raedy, and Douglas A. Shackleford, The Initial Impact of the 2003 Reduction in the Dividend Tax Rate, working paper (October 2004). Available at SSRN: http://ssrn.com/abstract = 4462542.

partnerships have two classes of partners; general and limited. General partners carry out the business of the partnership and often are the motivating force behind establishing it. General partners usually face unlimited liability. Limited partners often provide the equity capital for the partnership. They are not usually involved in the day-to-day activities of the partnership. Their liability is usually limited to their investment in the partnership.

SUMMARY

Large numbers of organizations and individuals sponsor saving and investment programs for significant numbers of participants for a wide range of purposes. These organizations include businesses, governments, and nonprofit entities. The saving and investment programs they sponsor run the gamut from retirement support to profit sharing to assisting charitable organizations and foundations to providing income to others. Many sponsors obtain tax deferral and tax exempt status for the saving and investment programs they establish, while others are not eligible for tax deferral or tax-exempt status.

Investments of sponsored saving and investment programs totaled more than $20 trillion in 2005. The market value of investments, adjusted for inflation, has been growing faster than the U.S. economy's growth rate for the last 20 years. These investments reflect not only the contributions made to sponsored programs—the savings part of saving and investment programs—but countless investment decisions made by investment committees, trustees, professional investment managers, and private individuals—the investment part of saving and investment programs. These investment decisions and the resulting portfolios of securities reflect the investment goals, objectives and investment processes established by investment committees. As well, ongoing innovations and changes in the national and global financial sectors are shaping portfolio choices.

Regardless of the sponsor of the saving and investment program and the sponsor's goals the performance of the investment portfolio must be regularly and properly evaluated. Portfolio performance evaluation, however, must be carried out within the context of the goals and objectives of the saving and investment program.