

THE SHERIDAN ROAD MAP

The Best Route to Financial Success



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COURT SAYS 401(K) PARTICIPANTS CAN SUE

The Supreme Court ruled individual participants in 401(k) retirement plans can sue under a pension protection law to recover their losses. The unanimous decision has implications for 50 million workers with \$2.7 trillion invested in such plans.

James LaRue of Southlake, TX says the value of his stock market holdings plunged \$150,000 when administrators at his 401(k) retirement plan failed to follow his instructions to switch to safer investments.

The issue in the LaRue case was whether the Employee Retirement Income Security Act permits an individual account holder to sue plan administrators for breaching their fiduciary duties.

The language of the law refers to recovering money for the "plan" rather than for an individual, raising the question of whether a participant can sue solely for himself.

Justice John Paul Stevens, in his opinion for the court, said that "Fiduciary misconduct need not threaten the solvency of the entire plan to reduce benefits below the amount that participants would otherwise receive."

The decision overturned a ruling by the 4th U.S. Circuit Court of Appeals in Richmond, VA.

Unlike people enrolled in traditional pension plans, employees in 401(k) plans choose from a menu of options on where to invest their money. That puts workers squarely in the middle of decision-making about their pensions and inevitably leads to the kind of disputes LaRue has with his plan's administrators.

"Defined contribution plans dominate the retirement plan scene today," unlike when ERISA was enacted in the mid-1970s, Stevens said.

Many traditional pension plans guaranteeing a fixed monthly benefit have either been frozen or terminated, and 401(k) plans are the main source of retirement income, said the Air Line Pilots Association, which represents 60,000 pilots.

The Bush administration argued in support of workers. The government said the appeals court ruling barring LaRue's lawsuit would leave 401(k) participants without a meaningful remedy from any federal, state or local court if plan administrators fail to live up to their duties.

Business groups supported LaRue's employer. They argued that ERISA is aimed at encouraging employers to set up pension plans, while guarding against administrative abuses involving the plan as a whole. The law doesn't

permit individual lawsuits, the business groups said.

Congress enacted ERISA after some widely publicized failures by companies and labor unions to pay promised pensions. Workers in class-action lawsuits have long relied on the law, most recently in the scandal-ridden collapses of companies like Enron and its 401(k) plan for workers.

Participants in 401(k) plans do not know how much money they will receive in retirement. Employees invest a certain amount each month and how much they get back depends on how well their chosen investments have performed.

The case is LaRue v. DeWolff, 06-856.



DESPITE COSTS, MORE PEOPLE RAID 401(K)S FOR CASH

Financially stretched workers are increasingly breaking into their retirement accounts to get cash. Over the past couple of decades, the 401(k) account and its brethren have become the main retirement savings vehicles for millions of Americans. But as the credit crunch and declining home values limit many types of consumer loans, a growing number of workers are tapping into these accounts.

Eighteen percent of workers had a loan outstanding from their retirement plan in 2007, up from 11% in 2006, according to a survey by the Transamerica Center for Retirement Studies, a nonprofit corporation funded by Aegon NV's Transamerica Life Insurance Co.

Major retirement-plan providers are reporting a similar trend. The number of participants taking a loan from their 401(k) plans rose by 7% at the end of last year from six months earlier, according to J.P. Morgan Chase & Co.'s analysis of 350 plans nationwide that cover 1.3 million people. Those results followed a period from January 2005 through June 2007 when loans from these 401(k) plans fell by 15%.

Similarly, in 2007, 401(k) plans administered by Fidelity Investments and T. Rowe Price Group Inc. posted increases in loans and so-called hardship withdrawals for people who demonstrate an immediate financial need, such as medical expenses, over the prior year.

There was roughly \$49 billion of 401(k) loans outstanding at the end of 2006, according to an estimate by the Employee Benefit Research Institute, a nonprofit research group in Washington.

For workers, a retirement-plan loan may seem like a quick and easy solution to a cash crunch. Borrowers don't need a good credit rating, interest rates are generally relatively low, and interest is paid to the borrower's account, not to the bank.

But the rise in retirement-plan loans is "an alarming trend," says Catherine Collinson, president of the Transamerica Center. "The real secret of building a retirement nest egg is saving over the long term on a consistent basis," she says.

There are other reasons why borrowing from your 401(k) can wreak havoc on your finances. A worker who leaves his job before the loan is paid off will have to pay the remaining balance in full, or else face taxes and potential penalties. What's more, given the stock market's recent declines, participants now borrowing from plans may be selling assets at depressed values to fund the withdrawals.

Now that home prices are dropping in many markets, more workers loaded with debt, struggle to make mortgage payments and are turning to their retirement plans. In Transamerica's study which surveyed more than 2,000 full-time employees, 49% of those who borrowed from their retirement savings said they took the loan to pay off debt, up from 27% in 2006.

In some instances, workers in fear of home foreclosure may be tapping retirement funds as a last-ditch measure, says Anne Lester, a senior portfolio manager at J.P. Morgan Asset Management. "We found a strong correlation between parts of the country where foreclosure rates were high and there was a rise in 401(k) loans or hardship withdrawals," she says. The South Atlantic, Midwest and Southwest regions have seen the highest increase in foreclosure rates with more than half of company 401(k) plans experiencing an increase in loans and withdrawals since 2006.

Defined-contribution plans such as 401(k)s held roughly \$4.4 trillion at the end of June. Most 401(k) plans allow participants to take out loans.

Generally workers can borrow the lesser of \$50,000 or 50% of their account balance.

Among participants with loans, the average unpaid balance at the end of 2006 was nearly \$7,300, according to the Employee Benefit Research Institute. Loans aren't taxed, but participants repay the loan, plus interest, with aftertax dollars. While interest rates vary, a typical rate is the prime rate plus 1%. General-purpose loans must be repaid within five years.

Some workers raid their 401(k)s without fully understanding the consequences. Joanna Bare, 40 years old, of Bethesda, MD, took a \$35,000 loan from her 401(k) in 2005 to cover a huge tax bill resulting from the sale of stock she had held since she was a child.

She didn't realize she would need to repay the loan with after-tax dollars even though the 401(k) account was funded with pretax savings, meaning the loan repayments would take a bigger bite out of her paycheck than she anticipated. While repaying the loan, Ms. Bare had to drop her monthly 401(k) contribution from \$900 to \$200.

Things get really ugly when 401(k) borrowers lose or change their jobs. In that case, the borrower must repay the entire outstanding loan balance right away. If the borrower can't pay off the loan, he'll owe income tax on the unpaid balance and, typically, a 10% penalty if he's under age 59. Such a scenario may be a particular concern at a time when the economy is slowing and layoffs may become more common, says Rick Brooks, a financial planner in Solana Beach, CA.

Workers taking loans also miss out on market returns on the money they've borrowed. A borrower may wind up paying himself less interest than his money would have earned if it had remained invested in his 401(k) plan.

Consider this example from T. Rowe Price: A participant with a \$20,000 account balance who contributes \$100 a month and earns an annual return of 10% would have \$624,681 after 30 years. But if that participant borrows \$10,000 from his plan and repays the loan at 7% interest over five years,

For workers, a retirement-plan loan may seem like a quick and easy solution to a cash crunch . . . but borrowing from your 401(k) can wreak havoc on your finances.

AUTOMATIC 401(K) PLANS MIGHT NOT SAVE ENOUGH



Automatic 401(k) plan enrollment, advocated by lawmakers, regulators and financial-services firms, isn't helping many workers save adequately for retirement, according to recent research.

While automatic enrollment helps many people start saving, it often excludes a large segment of workers and steers participants to a contribution rate that may be below the rate these employees would have chosen on

their own, the research shows. Nearly two-thirds of employers who use automatic enrollment apply it only to new hires, according to a survey of 5,490 plans by Plansponsor, a retirement-research firm in Stamford, CT. And the median participant-contribution rate decreases under automatic enrollment, according to a study of about 50 plans by mutual fund firm and 401(k) provider Vanguard Group Inc.

Participation in a 401(k) plan has become critical to many workers' retirement security as defined-benefit pension plans disappear. Defined-contribution plans such as 401(k)s held more than \$4.4 trillion at the end of June.

The 2006 Pension Protection Act made it easier for employers to automatically enroll workers in 401(k) plans. Nearly a quarter of employers now have automatic-enrollment programs, according to the Plansponsor survey, up from 17% a year ago.

Plan participants should recognize that the default contribution rates and investment selections applied in automatic-enrollment programs don't guarantee a secure retirement, 401(k) experts say. "There is responsibility on employees over time to recognize that if they're not saving enough money in the plan through automatic enrollment, they need to take the initiative and up the savings," said David Wray, president of the Profit Sharing/401(k) Council of America, of Chicago.

While research highlights some shortcomings of automatic-enrollment programs, it also provides evidence that the feature is helping many employees. Automatic enrollment increases plan participation in many demographic groups, with the

biggest benefits going to low-income and younger employees, according to Vanguard.

Automatic enrollment usually doesn't help existing employees because they are often excluded from these programs. If employers don't automatically enroll existing employees, "you're going to have a generation of 401(k) participants who will reach retirement with severely inadequate savings," said Charles Ruffel, Plansponsor's chief executive.

Companies may be slow to extend automatic enrollment to existing employees because that may cause them to spend more on matching contributions, said Stephen Utkus, director of the Vanguard Center for Retirement Research.

Among employers using automatic enrollment, the median default deferral rate is 3% of salary, according to Plansponsor. For most workers, that isn't enough to generate adequate retirement savings, 401(k) experts say. An individual who starts saving at age 25 and receives a 3% employer match should sock away at least 10% of his salary to save adequately for retirement, said Jane White, president of Retirement Solutions LLC, a retirement-plan education-and-advocacy firm in Madison, N.J. "I like auto enrollment," Ms. White said. "It's the default rate which makes no sense."

Employers could probably increase the initial default employee-contribution rate without causing more employees to opt out of their plans, Vanguard's research suggests.

Simply adding automatic enrollment to a plan doesn't necessarily increase retirement savings, according to Vanguard. Under automatic enrollment, the median participant contribution rate is 2.9%, versus 5% under voluntary enrollment, Vanguard found. One Vanguard client plan saw its new-hire savings rate fall to 3%, from 7% or 8%, when it introduced automatic enrollment, Utkus said. That employer plans to automatically increase participants' contribution rate each year, Utkus said. 401(k) experts say that is a critical feature excluded. Just 11.5% of employers include automatic deferral increases in automatic-enrollment programs, according to Plansponsor, though the feature is becoming more popular.

By Eleanor Laise • Wall Street Journal, January 9, 2008

DESPITE COSTS, PEOPLE RAID 401(K)S (CONTINUED FROM PAGE 2)

halting contributions while he repays the loan but making \$100 monthly contributions for the next 25 years, he would have only \$523,502 at the end of the 30-year period.

If participants decide they must take out a 401(k) loan, they should aim to pay it off as quickly as possible and continue making new plan contributions while paying off the loan, taking full advantage of any employer-matching contributions. "As long as you keep contributing, the long-term negative impact isn't nearly as significant," says Pamela Hess, director of retirement research at Hewitt Associates.

The 401(k) loans are increasing despite some employers' efforts to discourage them. More plans are adding fees on loans or limiting the number of loans that participants can take, aiming to deter excessive borrowing, Ms. Hess says. Nearly 80% of plans charged loan-origination fees in 2007, up from 63% in 2001, and the average fee was \$55, according to Hewitt.

Some plans also charge annual loan-servicing fees, and many plan providers educate participants about the potential pitfalls of taking loans. Fidelity spokeswoman Jennifer Engle says "A retirement savings plan is a funding source of last resort."

By Eleanor Laise and Craig Karmin • The Wall Street Journal, February 28, 2008

HOW DIVORCE HITS YOUR 401(K)

If your marriage is breaking up, here's one more thing to think about: The major effect it'll have on your employer-sponsored retirement plan.

You've worked hard over the years and have set aside a big nest egg for your retirement through your company's 401(k) plan. Or perhaps your spouse has been the breadwinner while you've taken care of the kids, but you know the "family" 401(k) is sizable.

What you might not have anticipated are the consequences divorce could have on an employer-sponsored retirement plan. Here are some commonly asked questions and answers:

Q: *Is a 401(k) marital or separate property in the case of divorce?*

A: Typically, the amount in a 401(k) accumulated during a marriage is considered marital property.

Q: *I know my spouse has a large 401(k), and I'm afraid that if he thinks I might file for divorce, he'll borrow from the plan or make withdrawals. How can I protect myself?*

A: This is a potential problem for dependent spouses. Some plan sponsors or employers require spousal consent for an employee to take out a loan or make a withdrawal from his or her 401(k).

But this depends on the plan document of the employer. Most employers do not require spousal consent. Once a divorce is pending, you can call the plan's record keeper and ask him or her to flag the account so your spouse cannot take out a loan or withdraw from the account. Some record keepers will do so.

Q: *By what mechanism is a 401(k) divided in divorce?*

A: It's split up through a qualified domestic-relations order, or QDRO. That's a decree, order or property settlement under state law relating to child support, alimony or marital property rights that assigns part or all of the participant's benefits to an alternate payee. Generally the alternate payee is the spouse, but it could be a child or another dependent.

Q: *Can I avoid an early-withdrawal penalty if I cash out part of my share of a 401(k) that I receive during divorce proceedings?*

A: Yes. When the 401(k) is divided, you, as the alternate payee, have a one-time opportunity to take out 401(k) money without paying the normal 10% income tax

penalty for withdrawing before age 59?. However, it is likely that you would have to pay income tax on any distribution.

Q: *If I'm the alternate payee, what can I do with my share of the 401(k)?*

A: If you want to keep your share of the 401(k) in a tax-deferred account, you can roll it into an individual retirement account. The benefit to this option is that you can continue to contribute to the account, and you'll have a wide range of investment options.

Alternatively, you could stipulate in the QDRO agreement that you'd like to leave your share in the existing 401(k) plan. The plan's administrator would create a separate account for you. However, your ability to add and withdraw from this account might be tied to your ex-spouse's retirement plan. You may find that by rolling your share into an IRA, you'll have more autonomy over your money.



By Elizabeth Cox • divorce360.com, February 27, 2008



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