The Sheridan Road Map

The Best Route to Financial Success

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The Fight Over Who Will Guard Your Nest Egg

A power struggle in Washington will shape how investors get the advice they need. On one side are stockbrokers and other securities salespeople who work for Wall Street firms, banks and insurance companies. On the other are financial planners or investment advisers who often work for themselves or smaller firms.

Brokers are largely regulated by the Financial Industry Regulatory Authority, which is funded by the brokerage business itself and inspects firms every one or two years. Under Finra' rules, brokers must recommend only investments that are "suitable" for clients.

Advisers are regulated by the states or the Securities and Exchange Commission, which examines firms every six to 10 years on average. Advisers act out of "fiduciary duty," or the obligation to put their clients' interests first.

Most investors don't understand this key distinction. A report by Rand Corp. found that 63% of investors think brokers are legally required to act in the best interest of the client; 70% believe that brokers must disclose any conflicts of interest. Advisers always have those duties, but brokers often don't.

Brokers can sell you any investment they have "reasonable grounds for believing" is suitable for you. Only since 1990 have they been required to base that suitability judgment on your risk tolerance, investing objectives, tax status and financial position.

A key factor missing from Finra's suitability requirements: cost. Let's say you tell your broker that you want to simplify your stock portfolio into an index fund. He then tells you that his firm manages an S&P-500 Index fund that is 'suitable' for you. He is under no obligation to tell you that the annual expenses that his firm charges on the fund are 10 times higher than an essentially identical fund from Vanguard. An adviser acting under fiduciary duty would have to disclose the conflict of interest and tell you that there are cheaper alternatives.

If brokers had to take cost and conflicts of interest into account in order to honor a fiduciary duty to their clients, their firms might hesitate before producing the kind of garbage that has blighted the portfolios of investors over the years.

Richard G. Ketchum, chairman of Finra, says, "It's time to get to one standard, a fiduciary standard that works for both broker-dealers and advisers." When asked whether Finra should be that single regulator, Mr. Ketchum replied: "Do we have the infrastructure and would we do a good job? We think yes."

Others disagree. "It would be lethal if Finra becomes the only regulator," retorts Tamar Frankel, a professor of securities law at Boston University. "Finra has an inherent conflict of interest, because it's the same people regulating themselves."

In testimony to the Senate, SEC Chairwoman Mary Schapiro said the agency is considering "whether to recommend legislation to break down the statutory barriers" that impose different regulations on brokers and advisers.

Ms. Schapiro stepped down earlier this year as head of Finra to lead the SEC. In 2005, when she was vice chairwoman of Finra's predecessor, she wrote a scathing letter to the SEC. When asked if she still held that view, Ms. Schapiro replied: "I wear a new hat now...so my perspective has changed. I think investors would rationally say that they prefer fiduciary duty as the standard of care. And they are entitled to have their interests come first, always." She said it is too early to say who should be the lead regulator if brokers and advisers are brought under the same set of rules.

By Jason Zweig • Wall Street Journal, March 28, 2009

Advisors are reassessing two primary ways to provide income to clients in retirement.

In the quest to generate retirement income for their clients, many advisors relied on their investing-for-accumulation roots, and therefore were not focused on retirement income planning. "True retirement planning first begins with an assessment of the ultimate risk a retiree faces, which goes beyond pure capital risks," says David Macchia, president and CEO of Wealth2K. "When advisors fail to recognize or manage these risks properly, clients' retirement security can be extremely harmed." Macchia says retirement income investing begins with creating a retirement income floor—a guaranteed income floor—to handle that client's essential expenses. When you're using a systematic-withdrawal-type methodology to produce returns, that's not accounted for."

Advisors latched on to the systematic withdrawal method back in the go-go stock market days of the 1980s and 90s, when it was typical for people to "retire at 65 and be dead at 72," James Dew president of Dew Wealth Management in Scottsdale, AZ says. In those days, advisors started creating portfolios of stocks and bonds for retiree clients and then, in order to generate income, the advisor would just set up a certain amount to be automatically withdrawn each month and deposited into the client's checking account. So the client's portfolio was concentrated in "conservative investments that generated income." Anything left over was placed in growth stocks. That approach works well when the overall markets are doing well. "When the markets don't cooperate," says Dew, "you may be spending principal which dramatically impacts a portfolio." Plus, nowadays people are retiring at age 50 or 60 and living to 80 or 90.

What's more "if you're taking no money out of a portfolio, you can sit and wait for the market to come back," Dew says. "But if you're withdrawing from a portfolio, you're doing reverse dollar-cost-averaging and selling a large number of shares at lower dollar values, and that's just a spiral downward."

Right after the market crash of 2001 and 2002, Dew set up a retirement planning strategy in which he sets at least a 10-year time frame on equities—meaning a client won't need to touch the money in equities for at least 10 years. Then for the first 10 years of a client's retirement plan, it's essential to have "reliable, dependable income from safe, conservative sources," Dew says, "even if that means having three to five years of cash." While the rate of return on that cash isn't going to be good, he argues that "you have to have somewhere to get the income in a reliable, predictable fashion" without relying on the markets cooperating. That means turning to money market funds, laddered Treasuries, laddered high-credit-quality corporate bonds or laddered munis, and CDs, he says.

A Closer Look at Risk. Macchia says, "Advisors have to have a greater sensitivity to the multiple risks retirees face. They have to manage those risks more efficiently than they have, and that includes more than products—it includes assessment of the client's human capital opportunities, social capital opportunities, and investing capital by only exposing the appropriate portion of that to upside potential, but first establishing an income floor. That's much different than the way many advisors have been approaching [retirement income planning]."

Before totally throwing a wrench into the automatic withdrawal approach, however, there are retirement experts who say that the universe of advisors performing retirement income planning are actually pretty evenly split in their opinions about whether retirement income planning strategies can successfully mirror accumulation strategies.

Howard Schneider, president of Practical Perspectives, a consulting firm to the asset management industry in Boxford, MA, says research his firm conducted found two schools of thought among advisors when it comes to retirement income planning.

One group looks at delivering retirement income using the same approach they use for clients in the accumulation phase: "building a risk-adjusted total return portfolio, and following the classic rule of thumb within the financial planning industry to take down between 4% and 6% of the portfolio each year which becomes the income stream. If you do that for the client, the portfolio should last for an extended period of time," he says. The second school of advisors—almost equal in size to the first—believe that a strategy that works for accumulation doesn't work for retirement income. "These advisors gravitate to what is called the 'pooled' or 'bucket' approach," says Schneider, "where they are trying to bulletproof the income, at least over the short term, by allocating specific assets to income-generating securities or vehicles and then progressively investing the other assets in riskier securities or buckets that go out over time."

Advisors who use the "bucketed" approach for their clients say "they're able to keep their clients invested in the equity market over time because the clients stay calm during periods of volatility," Schneider says. Schneider says the jury is still out on which strategy is better—the consensus is that it really depends on the type of client.

Target Date Funds Exposed. While advisors are busy doling out advice to their clients now that their retirement accounts have been hammered, what about retirement plan sponsors? Are advisors taking just as much time to give them advice and help them understand what they should be doing now?

Fred Reish of Reish Luftman Reicher & Cohen in Los Angeles, which specializes in employee benefits law, says that given the poor performance of target date funds, advisors need to be "talking with plan sponsors much more about their target

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date funds, how they performed last year, and see if that's what the plan sponsor wants." Target date funds, on average, were down 25% last year, with 2010 funds dropping 25% to 30%. Target date funds, Reish says, "have to be reviewed from a retirement perspective—what are the goals and aspirations of the plan sponsors and fiduciaries for their participants?"

Reish wonders if the goal is to have the most participants contribute the highest possible amounts while leaving some participants with substantial losses before they retire, or is it "in the last five or ten years before retirement, to conserve principal and to make a substantial effort to conserve principal? Those are directly conflicting objectives."

If it's the highest possible account, he says, "then some people are going to get hurt. If it's to have preservation of capital be the dominant factor in the last five or ten years before retirement, then those who retire in an up market, will have been invested conservatively and will have missed out on some potential gains." Did the advisor educate the plan sponsor on these issues? Were they all vetted a year or five years ago? Did the plan sponsor make an informed decision based on the advice of the advisor?

Reassessing the Relationship. Now that pre-retirees and retirees' portfolios have lost roughly 20% to 30%, and advisors' assets under management and revenue are down, there's no doubt that advisors are reassessing how to manage the relationship with clients moving forward. A recent Spectrem study on the affluent found that only 30% of the clients polled felt advisors did a good job through the market turmoil. What's more, a recent Cerulli study polling advisors on how the market environment is affecting their clients' retirement plans found that 67% of advisors said their clients were postponing retirement, while another 57% said their clients were still planning on retiring at the same age, but had lower expectations for their lifestyle during retirement.

As for the kind of retirement planning help they need from the Obama Administration and elsewhere, a survey conducted in January among 1,200 Schwab Advisor Services' RIAs found no lack of suggestions. (See chart - *Making An Impact*)

No matter how an advisor's clients have fared during the market upheaval, it's crucial that advisors maintain contact with them. A recent poll performed by Russell Investments found that "advisors that are connecting with their clients, that are proactive and calling them and getting them to come in, are by far doing the best," says Tim Noonan, managing director for private client services at Russell. "Don't hide from your clients," he counsels. Advisors who hide from their clients, he says, "are the ones that have suffered the most client defections and are least able to keep their clients invested.

Noonan says clients are relying on advisors to bring them "back to a position of confidence," not to wallow together in despair. To that end, Russell recently launched a Web site called Helpingadvisors.com (russell.com/helping-advisors), which is designed exclusively to assist advisors in creating a constructive dialogue with their clients. The site provides "tools and scripts and an advice framework to allow advisors to have a conversation with confidence with their clients again," Noonan says. "Most investors left to their own devices without an experienced advisor don't do the right thing when markets go sideways, and they did it again last year," he says. "The biggest outflows in equities last year coincided with the third week in November, the market bottom."

Redefining Your Value to the Client. To be sure, those advisors who helped their clients weather the market downturn without getting clobbered and who've created a more holistic relationship with their clients will be able to hang onto existing clients and compete more effectively for new ones. Going forward, advisors are going to have to broaden their services to satisfy clients, predicts Dennis Gallant, President of GDC Research in Sherborn, MA. Clients are now asking, according to Gallant, "What is the value of the advisor?" He says clients are looking for a broader array of services, "and given the [Bernie] Madoff scheme, I think there's going to be a lot more scrutiny" from clients and prospects.

So for advisors to convey their value to clients, Gallant believes they will need to address a wider range of retirement issues including longevity, wealth transfer, and income.

The challenge for advisors whose client portfolios have seriously underperformed will be to ask themselves where they go from here, and for many, the answer may be to actually stop doing asset management, Gallant says. "Some will say it's become too complex and they don't have the time or expertise" and will outsource that function, he argues, while others will expand their asset management capabilities.

Regardless of how their pre-retiree and retiree clients have fared through the market gyrations, every advisor wants to put their best foot forward and help their clients navigate what's going to be a tougher road to retirement. The bottom-line reality, says Gallant, is that there will be many advisors "who probably won't be around given the performances of their portfolios," while others will "reinvent themselves."

MAKING AN IMPACT

Proposed actions that Schwab-affiliated advisors said would have the biggest impact on American's ability to retire.

Action	%
Raise ceiling on maximum voluntary contributions allowed for all participants in defined contribution plans	61%
Continue the temporary halt or adjust mandatory withdrawal rules for people age 70.5 or older beyond '09	48%
Make investment advice for 401(k) plans more available in the workplace	35%
Allow employers to create automatic IRA accounts for employees	35%
Mandate that all employers offer a 401(k) or other retirement savings benefit in the workplace	25%
Allow people to borrow from a 401(k) up to a certain limit without penalty	10%
Create a government-run mandatory guaranteed retirement plan system	9%
No changes to the current system are necessary	7%

Source: Charles Schwab Advisor Services Independent Advisor Outlook Study of 1,240 advisors: Survey conducted January 2009

How to help clients calculate and maximize the amount of money available to pay for higher education expenses by encouraging parents to apply for financial aid.

What your clients do with their earnings and assets before and during their children's college years is important and can have a huge effect on the amount and type of aid they receive. Here's how to make sure your recommendations don't inadvertently cost your clients the needed financial assistance.

First, you shouldn't let financial aid-boosting strategies take priority over more important investment, tax, and financial planning issues and goals. Second, although some of the increased aid might come in the form of grants, a good portion will be subsidized loans or work-study programs. The family may decide to forgo that tepid help, and tap income or assets instead. Finally, honesty is the best policy. A person convicted of lying on a financial aid form can be subject to fines and/or a prison term.

IM or FM? There are two basic formulas schools use to calculate the "expected family contribution" (EFC), which, when subtracted from the total cost of attending the school in question, leaves the amount that could potentially be offset by financial aid.

The Federal Methodology (FM) is used to award federal and state financial aid, such as Pell grants, Stafford loans and PLUS loans. Roughly 600 (mostly private) schools use the Institutional Methodology (IM). Some schools may also have their own specific forms. It's a good idea for your clients to find out the method used by the schools they are targeting, as the numbers can vary widely.

Parent Income (0 to 47%). Although it might be difficult for working parents to manipulate their salary to minimize the EFC, they should at least try to arrange any bonuses to be paid in years before or after the base years.

As to your financial planning moves—if the parents are selling any assets on which they have larger capital gains, try to get the sale completed before or after the "base year" of the financial aid process (the year before they'll need any money).

Clients nearing their Golden Years might be disappointed to find out that contributions made to retirement plans (like an IRA or 401k) in any base year are added back into the EFC. From a financial aid standpoint, it's better for them to maximize retirement savings before their children go to college, and then plan on redirecting the otherwise deferred amounts toward paying college costs.

Parents who are retired when their children go off to college may be able to minimize pension payments and retirement plan withdrawals so this portion of the EFC is as small as possible.

Clients in the lower income brackets may get special treatment by the FM. If the parents meet certain criteria and have income of less than $50,000, the family can qualify for the "simplified EFC," where assets are not considered in the formula. Those who meet the same criteria with less than $20,000 in adjusted gross income qualify for "zero" for their EFC.

Parent assets (0 to 5.6%). Savings and investments held in the parents' names get much more favorable treatment, with an initial amount based on the age of the older parent that is completely free from inclusion. Less than 6% of the rest of their money will be included in the EFC, and assets in retirement plans may not be counted at all.

Clients who have substantial investments held outside of retirement accounts may want to place a portion into an annuity, which, under the FM, is considered a "retirement" plan and not counted in the EFC. Of course, there are other factors to consider, such as the costs, benefits and drawbacks of annuities, as well as any capital gains that might be realized when liquidating assets to fund the annuity.

Families considering tapping IRAs or 401ks to help pay for college costs should think twice, as the withdrawals will count as "income" for both tax and financial aid purposes. Instead, they should take out a loan against their at-work retirement plans. Or, if they only have IRAs, borrow enough from traditional sources of education loans to cover current college expenses, and repay the loan with IRA withdrawals after the child graduates.

Clients who have both liquid assets and consumer debt should consider paying the debt down or off, as they will remove the assets from the EFC, and save money on interest. This is especially true under the FM, as home equity is not considered in the formula. So paying down a mortgage will reduce the available assets without decreasing the family's net worth.

That said, before parents begin shifting assets around to get a more favorable EFC, they should make sure that they can still get at the money with relatively little friction if the financial aid awarded comes up short.

Student Income (0 to 50%). For the 2009-2010 school year FM, typically the first $3,750 of a student's earned income will be sheltered from inclusion in the EFC. After that, up to half of the earnings will be taken before any aid is awarded.

Student Assets (Up to 25%). 20% of the money held in the student's name (like in an UTMA/UGMA account) will be added to the EFC each year under the FM, and up to 25% under the IM. Families can try to spend down these accounts for purposes that benefit the child, such as braces or a car.

Another technique is to place the money into a student-owned 529 college savings plan. The family will shelter future gains, income, and qualified withdrawals from taxation. And they may get much more aid under the FM, as UTMA 529s owned by a dependent student will be counted as a parental asset, with no more than 5.6% going toward the EFC (the IM may still count an UTMA 529 as a student asset).

If neither of these solutions applies, then families should tap the students' assets for the first education expenses, and only use other family money or loans when the kid's money runs out.

More Help. Parents with children nearing college age should visit fafsa.ed.gov to learn more about the federal financial application and award process. Those with a few more years can visit finaid.org. The site offers several calculators that can provide an idea of what your clients' EFC might be.

By Kevin McKinley • Registered Rep, February 1, 2009

Hecker v. Deere Ruling Good News for Plan Fiduciaries

Decision not in line with DOL's proposed fee structure and previous position.

There was a bright spot for 401(k) plan fiduciaries when the Seventh Circuit Court of Appeals dismissed a class action lawsuit against John Deere & Co. *Hecker* was the first 401(k) plan excessive fee class actions to reach the appellate level. The decision is clearly a victory for plan sponsors.

The plaintiffs in *Hecker* sued Deere, the trustee/recordkeeper for Deere's 401(k) plans and its investment advisor affiliate for breaching their fiduciary duties by (a) failing to adequately disclose the plans' fee structure and (b) providing participants with investment options that charged excessive fees. The lawsuit included the trustee/recordkeeper and its advisor affiliate on the theory that they were "functional fiduciaries" of the plans. The federal district court dismissed the suit for failure to state a claim and the plaintiffs appealed to the Seventh Circuit Court of Appeals.

The Court first addressed the issue of "functional fiduciaries." The Court held that limiting investment options to the trustee/recordkeeper's affiliated funds was not a fiduciary exercise of discretion and that playing a role in the selection of a plan's investment options was not the same as exercising final authority over the selection. Because Deere retained final authority to approve or disapprove the investment options under the plans, the Court concluded that the trustee/recordkeeper did not exercise discretion over plan assets and was not a fiduciary.

The plaintiffs alleged that the investment advisor exercised discretion over plan assets because the trustee/recordkeeper's fees were paid solely from an internal revenue sharing arrangement with the advisor and the advisor determined how much revenue it would share with the trustee/recordkeeper. The Court rejected this argument because it concluded that fees that had been collected at the mutual fund level were no longer plan assets under ERISA.

The Court then analyzed the allegation against Deere, focusing on (1) Deere had disclosed to participants the total fees for each investment option offered under the plans and directed participants to each fund's prospectus for a specific breakdown of its expense ratio; (2) in addition to the direct investment options, the plans offered a brokerage window providing access to outside mutual funds; (3) each of the mutual funds direct investment options was a retail fund that was also available to the general public at the same expense ratio and therefore, in the Court's view, the expense ratios for those funds were subject to competitive market pressure to keep expense ratios low.

In concluding that Deere did not breach its fiduciary duty by failing to disclose the revenue sharing arrangement, the Court held that there was no breach of a specific disclosure obligation because Deere provided participants with information on the funds' total expense ratios. It also found that there was no material omission or misrepresentation that gave rise to a breach of Deere's fiduciary duty, because "The total fee, not the internal, post-collection distribution of the fee, is the critical figure for someone interested in the cost of including a certain investment in her portfolio and the new value of that investment."

The Court also rejected the argument that Deere acted imprudently in limiting the plans to investment options with excessive fees. In reaching this conclusion it relied heavily on the existence of the plans' brokerage window which provided access to outside mutual funds with a wide range of expense ratios and the fact that the plans' other investment options were retail funds. Further, it did not find that Deere had been imprudent to limit the plans' investment options to a single fund family because "many prudent investors limit themselves to funds offered by one company and diversify within the available investment options."

The Court further stated that even if it had erred in the above analysis, the lower court's ruling would have to be upheld because the Deere plans complied with the requirements of Section 404(c) of ERISA. Departing from the Department of Labor's long-held position, the Court declined to apply a separate prudence analysis to Deere's selection of the investment options under the plans, holding, "Even if §1104(c) does not always shield a fiduciary from an imprudent selection of funds under every circumstance that can be imagined, it does protect a fiduciary that satisfies the criteria of §1104(c) and includes a sufficient range of options so that the participants have control over the risk of loss."

Having found that Deere had met the specific requirements enumerated in the regulations under Section 404(c), the Court affirmed the lower court's dismissal of the *Hecker* suit.

By Ian Kopelman • Defined Contribution Insights, March/April 2009

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