THE SHERIDAN ROAD MAP

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DESPITE PESSIMISTIC OUTLOOK, PARTICIPANTS RENEWING RETIREMENT SAVINGS FOCUS

Results from the Mercer Workplace Survey show U.S. retirement benefit plan participants are dramatically more pessimistic about their economic expectations than just one year ago.

The percentage of participants expecting a recession has nearly doubled (42% versus 23% in 2010). Participants have internalized this gloomy economic outlook with a record number of participants fearing job loss (45%, up from 36% in 2010) and planning to delay retirement (44% up from 35% in 2010).

According to a news release from Mercer, there typically is a direct correlation between economic outlook and retirement behavior. This year, however, despite deep economic concerns, participants seem to be renewing their focus on retirement savings and gaining confidence in their ability to do so. "In 2010, most participants saw the economy improving but not their own personal situation – a highly unusual divergence," said Suzanne Nolan, Partner and Director of Marketing and Communications for Mercer's U.S. Outsourcing business, in the news release. "This year's results reflect a stunning reversal in terms of a highly negative view of the economy but a renewed commitment to and accountability for their own retirement planning."

Proof of this renewed focus and confidence on retirement savings is reflected in several data points from the Mercer Workplace Survey. For example, over the past year 41% of participants claimed to have increased their 401(k) contribution rate (up from 31%), 40% reallocated existing portfolios (up from 33%), and 38% reallocated their future contributions (up from 29%). In the coming year, participants also plan to contribute more to their 401(k) plans, and a slightly higher percentage expect to contribute the tax-deferred maximum (11%, up from 8% in 2010).

These positive actions mirror a corresponding shift in attitude, with participants becoming more accountable for their key retirement decisions. Eighty-five percent of participants feel confident in their 401(k) asset allocation, 83% in their investment selection, and 77% in their contribution amount. These results are all improvements over 2010 results and top some levels found in pre-recession responses.

"We believe this increase in personal accountability among retirement plan participants is 'good news' for plan sponsors and their on-going efforts to increase employee engagement levels," said Nolan. "Participants seem to be saying that they can no longer rely on market performance, their employer or the government to build their retirement savings for them, but must take control of every aspect they can in order to provide for a successful retirement. Employers and plan sponsors alike should see this as a unique opportunity to offer and promote tools and resources to assist participants in making informed retirement decisions."

The Mercer Workplace Survey tracks employee attitudes toward, and experiences with, employer-sponsored retirement, health and benefits programs. The survey represents a national cross-section of active 401(k) participants defined as those currently contributing to a 401(k) plan irrespective of balance or having a 401(k) balance of $1,000 or more with their current employer, whether or not they are currently contributing. Online interviews were completed with 1,507 participants between June 16 and July 1, 2011.

By Tara Cantore • PLANSPONSOR, November 2011

Study Finds Gen X Overlooked in Workforce

A new study by the Center for Work-Life Policy finds that despite being the smallest generation (46 million), Generation X might be "the most critical generation of all" for employers.

Gen Xers are of an age (33 to 46 years old) that should put them at the prime of their lives and careers, stepping into leadership roles and starting families. However, a recent study, titled "The X Factor: Tapping into the Strengths of the 33- to 46-Year-Old Generation," reveals that due to challenges and circumstances out of their control, Gen Xers are taking a different life path.

The study found a large number of Gen Xers are choosing not to have children. Their extreme work schedules (nearly a third of high earning Gen Xers work 60+ hours a week), strong career ambition, the current economic challenges, as well as changing mores, and life choices are all factors that contribute to their high level of childlessness compared to other generations.

Gen X, born between 1965 and 1978, might be called the "wrong place, wrong time" generation, says the Center for Work-Life Policy. They were hit by an economic triple whammy: college-related debt, multiple boom and bust cycles (including the 1987 stock market crash, occurring just as Gen X entered the work force), and the housing slump. As a result, Gen X is the first generation not to match their parents' living standards.

While these economic woes have impacted most generations, they have hit Gen X the hardest in their work lives, the study found. Due to their own financial concerns, Boomers are not retiring and are choosing instead to work an average of nine years longer than anticipated. This delays Gen X's career progression, resulting in their feeling stalled in their careers and dissatisfied with their rate of advancement.

Yet the turmoil and instability that have been an integral part of Xers' lives have yielded unexpected benefits in the work world. Having been front and center for every major economic crisis of the past 30 years, Xers possess exactly the sort of resilience that organizations need as they face an uncertain future.

The study contends that most importantly, Xers are masters at mastering change—a skill set critical in every company today. They have been laid off, restructured, outsourced, reorganized and relocated more than any other generation in modern times—yet they are hugely hard-working and ambitious, eager to amplify their talents by learning new skills and garnering new experiences. However, employers must take warning: These strengths risk being nullified by diminished loyalty, declining engagement—and increasing apathy.

Key findings from the survey show:

- A large proportion of Xers are delaying or even opting out of parenting: 43% of Xer women and 32% of Xer men do not have children.
- Among non-parents, 60% of women and 36% of men feel their personal commitments are perceived as less important than those of colleagues with children.
- Despite having been nicknamed the "slacker generation," Generation X enrolled in higher education in record numbers. Over a third of Gen X hold bachelor's degrees and 11% have graduate degrees.
- Gen X is not only highly ambitious, but their ambition is nearly gender neutral: 75% of women and 72% of men consider themselves ambitious.
- Thwarted by Boomers who can't afford to retire and threatened by the prospect of leap- frogging Millennials, 41% of Xers are unsatisfied with their current rate of advancement and 49% feel stalled in their careers.
- Debt determines many Xer career choices, with 43% of Xers saying that their ability to pay off their student loans is an important factor in their career choices and 74% saying the same about credit card debt.
- The vast majority (91%) of X women and 68% of X men are part of a dual-earning couple. More than a third (36%) of Gen X women out-earn their spouses.
- Women and minorities made up 64% of graduates during the Gen X college years. Many Xer minorities are the first in their family to graduate from college: 49% for African-Americans and 54% for Hispanics, compared to 33% of Caucasians.

Gen Xers have been front and center for every major economic crisis of the past 30 years, Xers possess exactly the sort of resilience that organizations need as they face an uncertain future.

By Tara Cantore • PLANSPONSOR, November 2011

Current retirees receive income for sources that future retirees won't be able to count on.

"Seven thousand baby boomers are turning 65 every day, and will be doing so every day for the next 17 years," Putnam Investments President and CEO Bob Reynolds told advisors in his keynote presentation at the 4th annual Retirement Income Symposium on Oct. 17 in Boston (The event was sponsored by AdvisorOne and its sister publications at Summit Business Media's Investment Advisor Group.) The challenge, Reynolds said, will be closing the "assured income gap" they are beginning to face.

Two-thirds of retirement income now comes from sources that future retirees won't be able to count on, Reynolds pointed out. Defined-benefit (DB) plans are disappearing in the private sector and are under pressure in the government sector, while Social Security benefits are likely to shrink, especially for higher income beneficiaries. Defined-contribution (DC) plans will be the primary source of retirement income, but hardly any of them offer assured-income features. "Not yet," he added.

With retirement security increasingly dependent on personal savings, Reynolds said, an initial policy goal should be making workplace savings plans accessible to more Americans. Today, such plans are available to only half of U.S. workers.

In a Brightwork Partners survey of nearly 3,300 working Americans, Putnam found that workers who were best prepared for retirement (on track to replace 100% or more of their current income) differed from those who were least prepared (likely to replace 45% or less) not in how much they earned, but in having access to an employer savings plan and saving 10% or more of their income.

> **"Two thirds of retirement income now comes from sources that future retirees won't be able to count on."**

Reynolds, who led Fidelity Investments into the 401(k) market in 1989, would improve savings plan access by making universal IRAs mandatory for companies with 10 or more employees. Workers would be enrolled unless they opt out. Requiring this "negative option" in all DC plans would boost participation, the second goal he identified.

He defined the third policy goal as encouraging deferrals of 10% or more. Putnam believes this savings rate, in tandem with Social Security, will provide workers with what they need in retirement. The default deferral of 3% of income, Reynolds said, is "much, much too low" to fund a secure future.

Putnam addresses this issue by promoting "impulse saving" whenever a Putnam-provided retirement plan participant logs onto its website. (Putnam has also created a free iPhone app to encourage investors to save more for retirement.) The first screen they see gives an estimate of the income they'll need in retirement and urges them to review their current contribution level, asset allocation and retirement age to be more confident of making that number.

By recognizing these three essentials, Reynolds said, "we've nearly cracked the code" in the accumulation phase of retirement plans. The challenge now is creating lifetime retirement income from those accumulated assets. A number of unknowns, including market volatility, longevity and sequence-of-returns risk (the influence of a down market's timing on how long a retiree's savings last), can lead to nest eggs being eroded way too early.

Making a DC plan more like a DB plan

There's no single solution to this challenge, Reynolds said, although annuities and annuity-like products are an obvious tool. Longevity insurance, for example, eases the pressure on finances later in life, allowing a policyholder to leave a larger estate. However, annuities' perceived cost and complexity limit their appeal, while insurers' financial woes have made consumers wary of handing over large sums to a single company. "Today," he noted, "households own as many annuities as they do goldfish."

In the subsequent Q&A with attendees, Reynolds said that equities also play a role in helping retirees cope with inflation and political unpredictability, but Putnam recommends an allocation of no more than 20%. (This summer, the Putnam Institute released a study recommending that to minimize sequence-of-returns risk, retirees' equity allocation should be on the low side of 5% to 25%.)

Reynolds advocated two reforms to better regulate the "multitrillion-dollar" assured-income market:

- A national insurance charter. The 50 state charters that now apply are a big hurdle for any employer considering annuities as part of a retirement savings plan.
- A new regulatory body to vet assured income products. This national insurance pool—the "Lifetime Income Security Agency" (LISA)—would be funded with risk-based fees paid by insurance companies. Offered inside retirement plans, a LISA-approved product could provide confidence to participants that the insurer would keep its promises.

Also, noting that deficit hawks are circling hungrily over the tax break for retirement plans, Reynolds urged financial advisors to "tell Congress to keep their hands off retirement savings," most of which are taxed at full rates when withdrawn.

The need to create assured retirement income is "a tremendous challenge for our society, but an opportunity for our industry," he said. "We Americans, when we think our country is off track, we don't just worry. We fix things."

Later that day, Bob Pozen addressed attendees in a session titled "The Fund Industry: How Your Money Is Managed." But by the time the chairman emeritus of MFS Investment Management wrapped up, he had galloped through the federal budget deficit, underfunded state pension plans, target-date funds as default 401(k) plan investments, challenges of income distribution in retirement and the future of retirement itself.

(continued on page 4)

Some highlights of his speech, which raised the consciousness, and sometimes ire, of the 200 RIS attendees:

The budget deficit

Prozen, now a senior lecturer at Harvard Business School, senior research fellow at the Brookings Institute and former economic advisor to President George W. Bush and then-Governor of Massachusetts Mitt Romney, considers it vital to shrink a federal debt-to-GDP ratio that now exceeds 60%. However, he warned, big spending cuts should be phased in over time in order not to damage the frail economy.

That may not be a problem. We should aim for $5 trillion in reduced spending, he said, but "it's pathetic how little we've agreed to cut"—just $0.9 trillion so far. The deficit supercommitte is supposed to carve out another $1.2 trillion by Nov. 23, but with every special-interest group hollering, "Not me," Pozen said he doubts whether enough cuts will be found to meet that target.

Underfunded pension plans

The distorted accounting used to determine pension plan funded rates is coming to light as states grapple with budget shortfalls, Prozen said. Plans can assume future rates of return without regard to realistic benchmarks. The higher the assumed rate, the less funding is needed. When Prozen reported that the average annual rate of return assumed by state pension plans is 8.5%, an incredulous laugh went up from the audience of financial advisors.

A potential rule requiring pension administrators to use a more realistic rate would, of course, put even more pressure on state budgets. "I'm not asking for full funding right away," he insisted, "just honesty at the state level." He suggested that putting new workers into a defined-contribution plan would find favor with taxpayers who realize their state's defined-benefit plan is unaffordable.

Asked if states should be required to balance their budget every year, Prozen said there may be times when a state would need to overspend. When he mentioned that nearly every state requires a balanced budget except Vermont, one attendee shouted out, "What do you expect from a socialist state!" Prozen recommended a less rigid requirement, such as no more than a 2% to 3% loss over 10 to 20 years.

Target-date funds as default investment options

Prozen is against 'em. He said, "Target-date funds purport to say, 'OK, you were born in 1950'"and group you with other investors of the same age in a one-size-fits-all asset allocation. However, it's highly unlikely, he argued, that everyone of the same age would retire at 65 or have the same plans for what to do with their money once they are retired.

Another concern with target-date funds is that plan participants don't know what they're getting, he said. In 2008, 50% to 60% of funds maturing in 2010 were at least 35% invested in equities, exposing investors on the brink of retirement to the market downfall of 2008-2009.

The larger issue, as Prozen sees it, is that target-date funds encourage plan participants to put retirement investing on autopilot. "You have to think about retirement at least once in your life," he argued. "When will you retire? What's the time horizon for your investments? What will you have for assets?" He would prefer to see a balanced fund with 50/50 stocks and bonds as the default DC plan investment. Expenses would be lower, transparency would be improved and investors would be kept alert by the need to adjust portfolio allocations as they approach retirement.

> **"Target-date funds encourage plan participants to put retirement investing on autopilot."**

The principal value of a target fund is not guaranteed at any time, including at the target date. Investing in mutual funds involves risks, including possible loss of principal.

The distribution phase of retirement investing

Life expectancy has been rising about 2 1/2 years every 10 years since 1900, Prozen said. Why don't important actuarial projections assume that this trend will continue? He suggested that Social Security's estimated life expectancies of 79 years for men and 83 years for women may be too low in both cases by six or seven years.

He went on to note four ways that retirees can convert savings into an income stream: systematic withdrawals, a managed distribution fund, partial annuitization at age 65 or annuitization at age 80. With longevity risk on the rise, why do fewer than 10% of pension recipients choose lifetime annuity income? He speculated that people want more flexibility to leave their money to their kids or keep it for a health care emergency.

Solutions for the future of retirement

Traditionally, retirement meant withdrawing from work. Cushioned by a pension and Social Security, previous generations had more flexibility to retire when they wished. Now people expect to live longer, most DB plans have gone away and DC balances have deflated. The upshot, he said, is that 49% of baby boomers expect to work past age 65 and 72% anticipate continuing to work after they reach retirement age.

Given this situation, Prozen advised companies and lawmakers to make some changes:

- Create more flextime and part-time jobs
- Allow partial retirement plan withdrawals for participants working part-time
- Provide health care benefits to age 65
- Move the normal retirement age back
- Offer financial incentives for Social Security recipients to work longer
- Address disability issues for those performing physical labor

Sherry Christie • Investment Advisor, December 2011

"Class" Actions

Class-action litigation concerning expenses and revenue-sharing

Illustration by Kyle T. Webster

Over the past few years, there has been a lot of publicity about class-action lawsuits filed against major corporations concerning the expenses and revenue-sharing for 401(k) plans.

More recently, there have been a number of procedural decisions in those cases—primarily concerning whether the lawsuits could go forward and whether they could be certified as class actions. However, there is no uniform pattern to those decisions and so, in many ways, we are still at the beginning.

We do know that the failure to understand and evaluate revenue-sharing can cause fiduciaries to be sued and may result in liability. Even without liability, spending several years in litigation is an unpleasant and expensive proposition.

With that in mind, this article discusses the lessons learned and steps that fiduciaries can take to minimize the risk of being sued—much less being liable. In that regard, plan committees should:

Learn about revenue-sharing paid from the investments (or from any other source) to the plan's service providers—for example, to the recordkeeper. This applies to both bundled and nonbundled arrangements.

In bundled arrangements that involve affiliated mutual funds, consider both revenue-sharing from funds and credits for the use of internal funds. For example, an unaffiliated mutual fund (or its investment manager or an affiliate) may pay subtransfer agent fees to the recordkeeper. For affiliated funds, there may be monetary payments to the recordkeeping division or there may be internal credits. Regardless of whether the arrangement is affiliated or unaffiliated, or involves payments or internal credits, it has the same effect—it becomes part of the analyses for determining the reasonableness of the revenues, both direct and indirect, of the recordkeeper.

The payments and credits should be evaluated (i) relative to the plan and participant services provided by the record-keeper and (ii) relative to the cost of similar services in the marketplace. For example, if the recordkeeper receives $150,000 of payments and credits, but those services could be purchased for $100,000 in the open marketplace, the plan appears to be overpaying by $50,000 per year. Fiduciaries need to benchmark the compensation of the provider to the cost of comparable services from other providers. This is difficult for most plan sponsors—primarily because they lack the benchmarking information. As a result, plan sponsors should work with consultants who specialize in 401(k) plans and who are familiar with their market segment.

If a plan is overpaying for services, fiduciaries must act to protect the interests of the participants. That can be done in a couple of ways. For one, fiduciaries can change to lower-cost investments. In some cases, it may be appropriate to switch to an even lower-cost collective trust or separate account. Alternatively, fiduciaries can negotiate with the provider to create an expense recapture account for the plan (sometimes called an ERISA budget account). ERISA accounts often are used for the payment of plan expenses during the year and, then, as of the last day of the year, the remaining balance is allocated to participants' accounts in proportion to the account balances.

As a word of warning, if you don't know the mutual fund share classes in your 401(k) or 403(b) plan, you may have serious fiduciary issues. Once you learn the share classes, look at the expense ratios and revenue-sharing of the share class and make sure that it is appropriate for a plan of your size.

While we must wait to see how the court cases ultimately are resolved, fiduciaries can have a high degree of confidence that, if they follow these procedures, they have significantly reduced the likelihood of being sued, and if sued, they have taken meaningful steps to insulate themselves from liability.

Fred Reish • PLANSPONSOR, November 2011

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