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Comments on DOL's Proposed Regulation to Increase Access to High Quality Investment Advice.

THE MOST IMPORTANT ADVICE 401(K) PARTICIPANTS NEED--AND ARE NOT GETTING--IS HOW MUCH TO SAVE IN ORDER TO RETIRE.

SUMMARY:

Do employees need high quality advice? They definitely need to be protected from advisers who prioritize compensation from commissions over offering objective advice to their clients. On the other hand, if every employee had access to passively managed target date funds that included international holdings, no advice on choosing funds would be necessary. Unfortunately, mutual fund companies who offer managed funds are unlikely to offer this advice.

What's more, the advice regulations do not address the most important investment advice that participants need and most of them are not getting, which is how much to save. In addition, this advice could be generated by a computer model created by pension actuaries and would not require costly personalized advice.

In addition, the regulations appear to have exempted advice on target-date funds, which are rapidly dominating 401(k) assets. Even if target date funds were included in the regulations, the most important issue isn't advice to participants as to which funds to pick but ACCESS to mutual funds with a prudent asset allocation shift (also called glidepath) formula.

Finally, the Baby Boomers nearing retirement age are facing the biggest crisis--they are not only NOT being advised that they can't afford to retire, but the Obama Administration has sanctioned "automatic annuitization," which can't make empty nest eggs full.

PART ONE: THE MOST IMPORTANT ADVICE PARTICIPANTS AREN'T GETTING: HOW MUCH TO SAVE

1) While there are fiduciary duties to select and monitor the plans' investments, there are no requirements to communicate the necessary contribution rate to reach retirement adequacy, or the "minimum funding requirement," as pension actuaries would describe it.

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Background: More Americans are solely dependent on 401(k) plans for their nest eggs. Pension coverage has shrunk to 17% of the private sector and most pensions are either “frozen,” meaning that employers are not making any contributions to them, or are likely to be frozen. Even those Americans who are fortunate enough to work for a big company with an “unfrozen” plan are among the tiny minority; only half of Fortune 100 employers offers pension coverage to new hires.

Although 401(k) plans are called defined contribution plans, to my knowledge nobody in Congress has ever attempted to pass legislation to require that the contributions be defined based on the participant’s investment time horizon so that the participant can retire with a benefit as generous as that of a defined benefit plan. Or, more importantly, enact legislation that doubles or triples the employer contribution rate so that employees won’t have to bankroll most of their nest egg.

Few people outside of the actuarial community know that unless your income is so low that most of it is replaced by Social Security, if you’re not covered by a pension you need to have accumulated the equivalent of 10 times your “final pay”, or your salary before retirement, in your current 401(k) and rollover accounts in order to be able to retire. Given that the median income for Americans between age 60 and 65 is \$65,000, typical savings should be at least \$650,000. However, according to the Employee Benefit Research Institute (EBRI) and the Investment Company Institute, fewer than 10% of 401(k) savers have accumulated more than \$200,000. Even more startling data is revealed by EBRI’s 2010 Retirement Confidence Survey in which 43% of workers said they had less than \$10,000 in their accounts and 27% said they had less than \$1,000.

Among the few people in the retirement community who do know the rule of thumb for retirement security is David Wray, the president of the Profit-Sharing/401k Council of America, who put it this way: “Ten times final pay gets it done, The issue is the 40 years (of participation). You’ve got to start at 25 to retire at 65.”

Wray hit the nail on the head. Or if you don't start at 25 you've got to boost your contribution rate to make up for lost time. When I was asked to testify before the Department of Labor's (DOL) ERISA Advisory Council's Working Group on Financial Literacy and the Role of the Employer in 2007 my testimony disclosed that even workers who start contributing at age 25 must save 10% of their salary. The longer the participant postpones starting to contribute, the greater the required contribution. For example:

Waiting until age 35 increases the contribution rate to more than 17%.

Waiting until age 40 increases it to more than 23% of pay.

Finally, waiting until age 50 requires nearly a five-fold increase from the rate at age 25, to 48% of pay. Needless to say, this over-50 requirement flies in the face of the meager current \$5,500 limit on "catch-up contributions" currently allowed by the IRS.

Needless to say, these contribution rates are unaffordable for everyone who has postponed saving for retirement until their 30s or later, which is most Americans. The solution would be to boost the employer contribution rate so that they can afford to retire as is the case in other countries. However, that reform is beyond the scope of this paper.

2. Participants not only need to be advised how much to contribute to their 401(k) accounts, but they need to be told that if they were "automatically enrolled" at a 3% contribution rate--a practice that sanctioned by the Pension Protection Act, they need to be told to boost that contribution rate as soon as possible. At a minimum, most of them have to triple their contribution rate.

Unfortunately, it appears that not only is the Obama Administration unaware of the necessary contribution rate needed but it has sanctioned "automatically enrolling" new employees in their plan at a savings rate that is lower than what participants typically would have contributed on their own--3% versus 5%--and drastically lower than the rate that's needed. What's more, the administration's endorsement of "automatic escalation," which typically increases the contribution rate by only a percentage point each year, flies in the fact of the actual brute-force ratcheting up that's needed when you postpone saving.

The problem with a 3% starting contribution rate is that it's less than one-third of the rate required at a starting age of 25 and less than one-seventh for a starting age of 40--and these scenarios assume an employer match. Second, auto-enrollment keeps the default rate at the artificially low 3% rate for job changers. For example, workers who changed jobs every seven years who were automatically enrolled at a 3% rate would accumulate only 40% of what they'd need--and that's assuming an employer match at each job. Job changers working for companies without a matching contribution would accumulate less than one-third of what they need.

3. The problem with workplace 401(k) advice is that it's only relevant to the employee's current employer.

With the average worker holding eight jobs during a career, the majority of his or her savings is going to be at old employer plans or in rollover accounts. That's why the best advice should come from software that can track ALL household savings, not just current workplace savings.

4. Because employers aren't required to hire pension actuaries to communicate the communication rate, in the rare circumstances employees do get advice they may get seriously flawed assurances that they are on target.

For example, a retirement consulting firm claimed in a March 2010 press release that Americans are on track to meet 92% of their retirement income needs. In addition, the company's website features a "retirement readiness index" in which visitors can enter the name of selected companies and find out whether their employees can afford to retire. For example, those seeking information on the 401(k) plan at Johnson & Johnson will be informed that its employees are 93% ready for retirement and will receive income of \$28,800 a year or \$576,000 for life. It's unclear how the firm could make this one-size-fits-all assumption, given that the account balances of the company's employees will vary widely based not only on their salaries but their contribution rates and length of service.

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How did the firm arrive at such optimistic predictions? Through overly optimistic assumptions about investment returns and employer/ employee contributions. For example, while the company's CEO admits that participants in their 40s have only saved around \$50,000, he says, "if you project (\$50,000) to age 67 using our assumptions, it's worth \$670,000." The assumptions: the 45-year-old contributes about 8% a year, the employer matches 60 cents on the dollar and the investments generate an average 8 percent return.

However, in reality the typical employee contribution rate is 5% of pay, not 8%, and those employees who are "automatically enrolled" in their 401(k) plan save only 3%. Second, assuming 8% annual returns flies in the face of reality, especially given the "lost decade" of the 21st century: a \$1 investment in the S&P 500 at the end of 1999 was worth roughly 90 cents at the end of 2009--worse results than during the Great Depression. Finally, the notion that employers would match 60 percent of an employee contribution up to 8% of pay has little basis in reality. The most typical match is 50% up to 6% of compensation--in other words, a 3% match--and most small companies offer no match.

PART II: TARGET DATE FUNDS CAN AUTOMATE DECISION-MAKING BUT THE FORMULA MUST BE RIGOROUS AND THE ASSETS SHOULD BE IN INTERNATIONAL INDEX FUNDS, NOT JUNK BONDS

5. Target date funds can "automate" asset allocation, making advice on which investments to choose unnecessary, but some fund managers use the wrong formulas.

The Pension Protection Act of 2006 permitted employers to default 401(k) participants into a target date fund if they don't choose their own investments. As a result, the "automation" of asset allocation within the funds, called "target-date" funds, has eliminated the necessity for participants a) to be advised that they have to lower their concentration in stocks as they get closer to retirement and b) remember to make this shift. The bad news is that some target-date fund managers are imprudently putting a too-high allocation in stocks as employees near retirement, taking risky bets on short-term performance. The worse news is that target-date funds are exempt from the advice requirement, which makes no sense, given that they are rapidly becoming the favored choice among participants

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In the same fashion that automatic enrollment and automatic escalation gets passive employees to contribute to their accounts and raise their contribution rates--albeit insufficiently--target-date funds are essentially “automatic asset allocation shifters.”

The growth in assets in target-date funds has been exponential; as of 2008, 75% of 401(k) plans offer these funds as an investment option. According to the Vanguard Group, one of the three largest providers of these funds, the percentage of 401(k) plans it manages that use these funds as the default investment option mushroomed from 42% of them in 2005 to 87% in 2008.

Unfortunately, since there currently aren't any guidelines on the most prudent asset mix for target-date funds, some fund companies have taken irresponsible bets on short-term gains. For example, not only is T Rowe Price's 2010 target date fund--aimed at folks who are scheduled to retire this year--nearly 60% in stocks, but the allocation only decreases to 20% at age 85.

Not surprisingly, as a result of this too-high allocation in equities, in 2008 the average return of the four largest target date funds--holding 87% of all assets--was minus 25.8%, almost as bad as the overall market slump for the S&P 500 that year of minus 38%.

What's more, T Rowe's 2010 fund holds 16% of its assets in junk bonds and Fidelity Investment's 2010 fund is 20% in junk. Owning junk bonds is risky because while interest rates are higher, producing solid investment returns as long as the bond is repaid, they are higher for a reason--the debtor is a bad credit risk and may be unable to repay the loan, increasing the risk of loss.

6. 401(k) participants should be advised to invest in target date funds that are passively managed; i.e., index funds--advice that is unlikely to be given by advisers employed by mutual fund companies with actively managed funds-- regardless of whether the advisers are compensated for giving advice. What's more, while Congress is considering legislation to disclose the fees charged on mutual funds, disclosure is meaningless unless the participants can use this information to shift their investments to low-fee index funds.

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Despite the fact that paying “only reasonable plan expenses” is a fiduciary duty under ERISA there is no requirement that every plan offer index funds, a measure that Rep. George Miller endorses. Unfortunately, only about 10% of 401(k) plan assets are in index funds.

There are several reasons the performance of most managed funds is inferior to that of index funds over the long run. The first reason is that many fund managers have made reckless short term bets on certain sectors rather than taking a buy-and-hold approach as index funds do. For example, between 2000 and 2009 Janus Capital Growth suffered a loss of \$58.4 billion, Putnam Investments lost \$46.4 billion and Alliance Bernstein Holdings lost \$11.4 billion, for the most part as a result in bets on sectors such as technology and growth stocks.

Secondly, even when these money managers pick the right investments, they too often dump them rather than holding onto them, whether these managers run retail funds or pension funds. According to Morningstar, mutual funds with the highest portfolio turnover rates have underperformed the slowest-trading funds by an annual average of 1.8 percentage points over the past decade. In addition, a study of pension fund stock portfolios found that on average, investment returns would have increased by nearly a full percentage point annually if the managers had gone on a “12-month vacation.”

Fund managers used to be more prudent a few decades ago, when long-term results were valued more than year-to-year four-star ratings Morningstar ratings. Turnover in managed funds was 65% in 2006, suggesting an average holding period of 18 months, versus 30% in 1976, suggesting a three-year holding period.

Believe it or not, Berkshire Hathaway, the conglomerate holding company run by Warren Buffett, might as well be an index fund--albeit one that cherry-picks winners from the get-go. The reason? Buffett doesn't just make good picks--he keeps most of what he picks. For example, comparing the holdings in Berkshire Hathaway's 1995 annual report with those in the 2009 report reveals that Berkshire still owns the seven companies that accounted for 79% of consolidated revenues in 1995. As a result, shareholders are laughing all the way to the bank. If you invested \$10,000 in Berkshire Hathaway in 1964

your stash would be worth about \$80 million in 2010-- compared to about \$9.1 million for investors in Fidelity Magellan and \$2.9 million for Templeton Growth, two highly ranked mutual funds.

Why can't managed funds beat their passive counterparts? Because investors not only can't beat the market, they can't time it, either. What's rarely discussed about the stock market is not only is it impossible to predict the winners and losers but you can't predict when the winners' shares are "on a roll" because double-digit returns only occur during a tiny percentage of the time. Here are some mind-boggling statistics that are rarely discussed: investors who were out of the market during the best 90 days out of the 30-year period from 1962 to 1992 would have lost 95% of market gains. To put it another way, a dollar would have been worth \$24 for the buy-and-hold investor but only \$2.10 for the investor who "timed it wrong."

7. 401(k) participants should be advised to choose target date funds that contain international stocks, reflecting an investment strategy that reflects the fact that "The World is Flat" when it comes to investing, not as a currency hedge.

While there is no doubt that the first decade of this century has been the worst on record for the U.S. stock market, the best "fix" for 401(k) accounts is not to switch to "safe" investments, as some have proposed, but to have more international exposure, given that two thirds of the world's largest publicly held companies are based overseas. What's more, mutual funds that invest in companies in emerging markets such as Brazil, India, Russia and China have delivered greater than 10% annual returns for the past decade. The good news is that target-date funds are more likely to have more international holdings--estimates range from 17% to 30% of assets. What's yet to be determined is whether the fund managers are choosing the investments because of their vital role in the global economy or as a "currency hedge," which means they are likely to dump these funds if they just happen to have a bad year or if currency values head in the wrong direction.

PART III: THE SAVINGS SHORTFALL IS ESPECIALLY CRITICAL FOR BABY BOOMERS APPROACHING RETIREMENT AGE

8. While younger workers who are automatically enrolled in prudently run target date funds probably don't need investment-picking advice, older workers do because it is less likely that their investment strategy is on "autopilot" with a target-date fund since these funds weren't around when they entered the workforce. For that reason, employers should be required to include 401(k) education at annual "open enrollment" meetings, in which employees typically only select what kind of health coverage they want, i.e., high or low deductibles or copays.

Why is education so vital when it comes to the older workforce? While to my knowledge there have been no rigorous studies on asset allocation by age groups, a 2006 Fidelity Investments survey of its participants showed that investors in their 70s had more than 50% of their investments in equities, a highly risky investment approach for people with a short time horizon.

Furthermore, while 43% of retirement-plan participants in their 20s owned target-date funds in 2008, up from 29% in 2007, only 22% of savers in their 60s did. This is not surprising because the age cohort that is more likely to be auto-enrolled in target date funds is young people entering the workforce, as opposed to long-service employees who are already enrolled in the plan and who probably only shift a portion of their 401(k) investments to a target date fund--or more likely, put new contributions in one.

9. In addition, workers over 50 need to be advised that catch-up contributions don't cut the mustard AND be allowed to contribute more, as is the case in Australia.

The notion that a mere \$5,500 addition contribution (the catch-up limits for 2010) will enable anyone to "catch-up" flies in the fact of common sense--especially those workers who have waited until their 40s to start contributing. Assuming a 3% matching contribution, waiting until age 40 to contribute to a 401(k) account increases the required employee contribution rate to more than 23% of pay and waiting until age 50 requires nearly a five-fold increase from the rate at age 25, to 48% of pay. Unlike in the U.S., the political leadership in Australia understands that Boomers need to dramatically boost their nest eggs to make up for lost time in order to retire from its version of our 401(k) plan. Baby Boomer Australians can sell a home or other asset and add the proceeds to

their accounts; workers over 50 can make after-tax contributions of \$150,000 a year or \$450,000 over three years.

10. Employees approaching age 65 who have not accumulated 10 times their final pay in their 401(k) savings--which includes current account balances, balances at old employers and in rollover accounts--that is, most Americans, should be advised that they need to stay in the workforce for AT LEAST another decade if they do not have a generous pension.

Unfortunately, the final challenge for 401(k) participants is not only that they can't afford to retire but as a result of the Obama Administration's support of "automatic annuitization" older participants may not only be lulled into thinking that they can but sold a high-fee product that very likely will be "churned" by an unscrupulous insurance broker.

What's more, even if automatic annuitization doesn't get embraced by employers, the annuity industry has apparently lobbied Congress to incentivize workers to buy them with tax breaks. Legislation has been introduced that would exclude 25% of taxable distributions under a life annuity; the total exclusion is limited to \$10,000 annually for joint filers.

At a minimum, any company or individual selling an annuity, managed payout account or similar investment product should be required to disclose how the monthly payout from the product compares to the amount needed to meet living expenses based on their pre-retirement income--so that potential buyers can choose to remain in the workforce and continue to accumulate assets until they can afford to retire.

There's nothing wrong with using tax breaks to incentivize Americans to make sensible investments, whether we're talking about the roof over their heads or their nest eggs. However, even if most Americans had accumulated sufficient retirement savings, many sellers of annuities have acted irresponsibly, either by misleading potential investors about the product's potential investment returns or by generating commissions through selling a new product. In 2006 the Financial Industry Regulatory Authority (FINRA) issued an investor alert regarding annuity salespeople who conducted workplace seminars in which they convinced employees to retire early, cash out of their 401(k) accounts--causing them to pay "penalty taxes" if they were under 59 1/2--and buy a variable annuity. In another workplace disciplinary case, a broker told employees that he could generate annual investment returns of 18%.

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Unfortunately, even if employees get objective advice when they are in the workplace, once they are retired they are vulnerable to annuity salespeople who have no compunction about generating commissions by selling the retiree a new annuity. For example, in 2008, Florida Governor Charlie Crist signed a law increasing penalties on annuity salespeople to as much as \$150,000 for deceptive practices such as “twisting,” in which a salesman lies about the benefits of his annuity to get clients to sell their current annuity, or “churning,” which involves replacing the annuity with a new product from the same company. In 2006, New York Attorney General Eliot Spitzer announced an agreement in which the Hartford Financial Services Group would pay \$20 million in restitution and fines and implement reforms designed to bring transparency to the marketing of retirement products.

There are lower-fee alternatives called managed payout accounts offered by mutual fund companies that don't subject buyers to the same risk of being churned because they are not sold by sales representatives who earn a commission on new products.

Unfortunately, these products do not generate as generous a payout as annuity products because of the need to withdraw money conservatively to cover the “risk” of living to a very old age – a risk that is pooled in annuity products, thereby permitting higher rates of withdrawal.

However, even the more generous annuity payout is very likely insufficient to meet living expenses and, if anything, Baby Boomers are likely to have bigger financial burdens than their parents did. For example, many of them are still paying off college loans for their kids because Pell Grants no longer cover most of the cost of a college education as it did many decades ago and many Boomers are still paying off mortgages. Here's an example of income generated by an annuity purchased with a low-six-figure nest egg. If a 65-year-old with a \$100,000 variable annuity (reflecting the typical 401(k) account and rollover balances at retirement) only withdraws 4% a year, the typical recommendation, the most he/she will be paid is \$8000 a year, or about \$650 a month. If that 65-year-old were paying off a \$100,000 mortgage he or she would not be able to afford the monthly payments of \$665, much less to meet other living expenses.

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It's bad enough that Boomers are still making mortgage payments but the money is likely going towards a depreciating asset that is needed to meet retirement expenses. The decline in housing prices between 2006 and 2008 alone has led to the loss of more than \$4 trillion in real housing wealth, more than \$50,000 for every homeowner. The slump doesn't just mean they will get less for their homes than when the market had peaked but they may not be able to sell them at all. What's more, Boomers may be relying on smaller assets from their parents' estates than previous generations; according to the National Bureau of Economic Research, children of parents born before 1930 will receive bequests of only about \$45,000 per child.

Conclusion:

As critical as I am of some of the Obama Administration's approaches to 401(k) reform, I believe that all Americans should be grateful that at least he is addressing it. However, we not only need to make sure that Americans are getting advice but consider requiring employers to contribute enough to their accounts so that their employees CAN AFFORD to take their advice.

Thus far, the best Congress has proposed is to tell most Americans the bad news that they can't afford to retire. For example, Senators Jeff Bingaman, Herb Kohl and Johnny Isakson recently introduced the Lifetime Income Disclosure Act in December of 2009, which would require administrators of 401(k) plans to provide, at least annually, a "lifetime income disclosure," setting forth the "annuity equivalent" of the participant's account based benefit. Explained Sen. Bingaman, "It is estimated that half of American households will lack sufficient retirement income to maintain their pre-retirement standard of living. Yet many Americans are unaware of their financial vulnerability. Our bill is a common-sense approach to empowering Americans, and helping them determine whether they are on a path to a secure retirement."

However, simply informing people approaching retirement that their annuity payments won't help them pay their mortgage, much less enable them to stop working, doesn't sound like empowerment to me. Currently America is the only country in the advanced world in which most of its citizens employed in the private sector are not only forced to

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bankroll their own retirement but are not educated on the “cost” of how much to save. As a result, most Boomers may have to stay in the workforce for another two decades--a necessity that is not only stressful for them but bodes ill for their children’s employment prospects. We owe Americans financial security, not merely to tell them the “inconvenient truth” about their looming pension poverty.