

“Duty of Loyalty”: An Ambiguous Phrase that is Likely to Lead to a Minefield of Legal Uncertainty

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ERISA, and the regulations under it, are often lamentably obscure—to describe them as a tangled web does not do them justice.

—Judge Mark R. Kravitz; *Janice C. Amara v CIGNA Corporation and CIGNA Pension Plan*

Action in the absence of good intelligence can be a terribly expensive course.

—Warren Bennis, Daniel Goleman, and James O’Toole, *Transparency*, p.30.

Summary

Using Investment Horizons’ Plan Utilization Analyses (PUAs) is a major step in removing fiduciaries and providers from the realm of legal uncertainties and legal pragmatism generated by ERISA itself as well as the changing economic and political environment.

These analyses contain retirement readiness assessments by demographic groupings that show, for example, average suggested contributions, average percent of participants that are on-track for a financially secure retirement, and the average number of years it will take to deplete the participants’ retirement nest eggs. This knowledge enables fiduciaries to:

- assess the effectiveness of their plan design and communications programs;
- prioritize the issues that need to be addressed in each demographic segment and evaluate the effectiveness of the approaches used to tackle them;
- evaluate their provider’s delivery of its products and services;
- demonstrate that they are using evidence-based management techniques to run the plan and fulfill their fiduciary duties.

Background or Why Congress Endorsed “Libertarian Paternalism”

A common denominator in the current plethora of lawsuits against 401(k) fiduciaries and some providers is the assumption (on the part of corporate benefits attorneys and providers) that the fiduciaries fulfill their “duty of loyalty” to the participants, including providing participants with exceptional value for the fees they pay, by:

- selecting a large well-known provider that other employers of their size use;

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- giving the employees a broad selection of funds from which to create their allocations;
- providing the in-vogue “bells and whistles” that employees are presumed to want and need so that they can manage their accounts both efficiently and effectively.

This approach assumes that the average worker is not only willing and capable when it comes to planning for his retirement but will also enroll in the 401(k) plan when he becomes eligible. Unfortunately, there is no evidence to suggest that either assumption is true.

In fact, all the evidence suggests that those who are making good use of their 401(k) accounts are the “exceptions to the rule” and not the rule itself (see *The Great 401(k) Hoax* written in 2002 by *Business Week* magazine’s former editor and chief economist William Wolman and Anne Colamosca).

The obvious question, then, is: Shouldn’t “the duty of loyalty” incorporate the capabilities and mindset of the average American worker? Congress implicitly answered “yes” by enacting the Pension Protection Act of 2006 with its endorsement of auto-pilot programs, a design feature that Richard Thaler (its creator along with Shlomo Benartzi) and University of Chicago law professor Cass Sunstein call “libertarian paternalism” (in their 2008 book, *Nudge: Improving Decisions About Health, Wealth, and Happiness*).

The Neglected Issues

- I. Do the responsibilities of providers and fiduciaries (employees of sponsor) vary based on the sponsor’s size?
 - A. Can it reasonably be argued, regardless of what is written in the contracts, that the marketing materials of providers that cater to the small plan marketplace are written in such a fashion as to encourage unsophisticated buyers to believe that by hiring the providers and their “best of class” products and services, all of the fiduciaries’ responsibilities will be fulfilled?
 1. If the fiduciaries are expected (and they realistically are) to “rubber stamp” the contracts, service agreements, and communication programs, does the provider, by its representations (such as the two shown below taken from a Vanguard 401(k) sales brochure) become a de facto fiduciary?
 - a. “When others depend on you, turn to the retirement plan provider you can trust”.
 - b. “Trust us to help you deliver the best possible plan.”

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2. Is it reasonable to assume that small employers, such as those with a workforce that numbers less than 250, would establish a 401(k) plan if they would have to find qualified benefit attorneys and consultants and pay them thousands of dollars to investigate their fiduciary liabilities and explore and then implement the best approach to running their small plans?
 3. What will be the effect on a judge once he recognizes the asymmetry of knowledge (how much the providers know versus the ignorance of the typical small plan fiduciaries) that effectively produces a poker game (the hiring of a qualified provider) in which the “the deck is stacked” against the fiduciaries of small plans?
- B. Should 401(k) fiduciaries of Fortune 500 companies, with all the resources (such as sophisticated in-house treasury, risk management, marketing, legal, and advertising expertise) that are available to them, be able to differentiate (as suggested by Keller Rohrbach in their lawsuit against Wal-Mart) a provider’s sales hype from actual substance and thus be held to a higher standard of conduct than fiduciaries of small plans?
- II. ERISA is ambiguous as to the meaning of “duty of loyalty” as well as to what it entails.
- A. Without a clear definition of “duty of loyalty”, is it possible for fiduciaries to know with certainty what is expected of them and thus anticipate the standards by which they will be judged?
1. Without a clear definition of “duty of loyalty”, can it be argued that, in the past, both the duty of loyalty and prudent process were defined by Andy Warhol’s definition of art:

“Art [duty of loyalty and the prudent process for running a 401(k) plan] is what you can get away with”?

In the future, whether or not this definition will hold will be determined by the courts.
 2. Since ERISA was enacted to safeguard the welfare of pension participants, doesn’t it follow that 401(k) fiduciaries and their providers should make available (and encourage the use of) all the tools needed for the employees to maximize the benefits of participating in a 401(k) plan?
- B. Is the “duty of loyalty” an evolving concept?
1. 401(k) plans were not in existence when Congress enacted ERISA.

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2. The original intent of 401(k) plans was to enable employees to supplement (rather than replace) their retirement income from defined benefit pensions.
 3. How does the fact that 401(k) plans are nothing more than tools for employees to use in creating their own retirement security affect the meaning of “duty of loyalty” (as contrasted with the duties of fiduciaries’ of defined benefit plans)?
 - a. If the fiduciaries felt that their employees did not understand the challenges of providing for a financially secure retirement, would it be incumbent on them to provide employees with personalized shortfall (gap) reports that lead them in the right direction?
 - i. “When 401(k) Investing Goes Bad” describes in detail what happened to West Virginia’s teachers when they participated blindly in their 401(k) plan. (Jennifer Levitz, Wall Street Journal, August 4, 2008, B1.)
 - ii. Perhaps the lengths companies go to in order to provide valuable executive compensation packages will be used by the courts to set the minimum standards for 401(k) fiduciary conduct. (see Ellen E. Schultz and Theo Francis, “Companies Tap Pensions Plans To Fund Executive Benefits”, Wall Street Journal, August 4, 2008, A1.)
- C. Is the “duty of loyalty” affected by whether or not the design of a 401(k) plan is a fiduciary or settlor function?
1. Was the passage of the Pension Protection Act of 2006 (PPA), with its sanctioning of full-blown autopilot programs, a recognition by Congress that since American workers have not embraced retirement planning on their own, providers, fiduciaries, and sponsors should take a much more proactive approach to plan design and their communication programs?
 - a. Fiduciaries should take a much more proactive role, including the use of behavioral economics, in getting their employees enrolled in the 401(k) plan and encouraging them to recognize that default contributions aren’t adequate.
 - i. PPA recognizes that plan design is never neutral. Choice architecture either makes it easy for employees to start using the plan wisely or it doesn’t.

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- b. Fiduciaries and sponsors should reevaluate their participant communications since they are not working as judged by:
 - i. the increase in participation when auto-enrollment is implemented;
 - ii. contribution levels (often combined with asset allocations) that will most likely lead to drastically lower lifestyles during retirement, especially if Social Security and Medicare benefits are reduced and if the estimated cost (ranging from \$300,000 to \$500,000) of post-retirement health care is factored in.
 - c. Fiduciaries and providers should factor into their communications the constantly growing body of research that shows the average American likely lacks the educational skills and knowledge of investing/retirement planning to effectively manage his own 401(k) account.
- D. Is it wise for fiduciaries to assume that since plan design is a settlor function in the defined benefit arena (where a financially sophisticated sponsor defines the benefit and then assumes the risk of funding it), it is also a settlor function for 401(k) plans?
- a. Is it really such a “long shot” that judges will rule that plan design is a 401(k) fiduciary responsibility since:
 - unsophisticated employees are blindly assuming all the responsibilities and all the risks of funding their own retirement;
 - plan design substantially impacts the risks and potential rewards for participants?
 - i. Cognitive science, including behavioral economics, has shown that people often don’t act in their own best interests.
 - ii. To overcome the inertia that overwhelms many people when it comes to retirement planning, Richard Thaler and Shlomo Benartzi pioneered auto-enrollment and escalation of contributions (the SMarT feature) and James Choi, Daivid Laibson, and Brigitte Madrian studied easy (quick) enrollment.

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- b. Is it likely that judges will ignore the fact that a workforce that is not able to retire is not only a tragedy for the workers, but a serious socio-economic problem for the nation as a whole?
 - E. Even if plan design is determined to be a settlor rather than a fiduciary function, is it safe for fiduciaries to assume that their “duty of loyalty” does not require a well thought-out effort to help their employees achieve a comfortable retirement?
- III. Is it possible for fiduciaries to implement a prudent process without defining their goals and how (strategies and tactics) they wish to accomplish them?

“Strategy without tactics is the slowest route to victory.

Tactics without strategy is the noise before defeat.”

—Sun Tzu, *The Art of War*

- A. Without clearly defined goals, how will fiduciaries be able to evaluate a provider’s capabilities (both strengths and weakness) for helping them to implement and then monitor their strategies and tactics?
 - 1. If providers are not fiduciaries, is there any rationale for sponsors and fiduciaries to believe that a provider will put its desire to maximize profits behind the interests of both fiduciaries and employees?
 - a. There is no duty on the part of non-fiduciary providers to disclose third party payments made to them, and:

“Claiming to be transparent is not the same as actually being transparent.”

(Warren Bennis, Daniel Goleman, and James O’Toole, *Transparency*, 2008, p.2)
 - b. If fiduciaries don’t know all the fees (direct and indirect) that the provider is receiving, how can they determine if the overall fees the provider receives, let alone the individual ones, are in the “ballpark” of being reasonable?
 - 2. To what extent, if any, is a non-fiduciary provider obligated to:
 - a. emphasize that it is not assuming any of the fiduciaries’ responsibilities;
 - b. explain the limitations of its technology;

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- c. clarify its willingness or unwillingness to deviate from its “off-the-shelf” products, services, and procedures that make it efficient (from its “manufacturing” perspective) and, as a by-product of efficiency, oftentimes ineffective (from the customer’s standpoint);
 - i. Fidelity’s Retirement Income Indicator analysis (see Building Futures VIII, p.114) demonstrates this ineffectiveness in effecting desired employee behavior.
 - d. demonstrate that it offers good to exceptional value for the fees that both the sponsor and the participants pay (that is, it is meeting the specified needs of both parties)?
3. At what point could a strong argument be made that the provider’s omissions were intentional material misrepresentations that either led or contributed to the fiduciaries’ failure/inability to fulfill their responsibilities to their participants?
- B. Do the goals of the employer—creating benefit programs that are appreciated by their employees—conflict with the employees’ goal of having a financially secure and comfortable retirement?
- a. The Deloitte 2008 401(k) Benchmarking Survey found that employers view 401(k) plans as important tools for recruiting, motivating, and retaining employees and that they want their plan to be competitive with those of their peers.
 - b. This survey found that sponsors used the following criteria, listed in order of importance, for judging the success of their plans:
 - participation;
 - investment returns;
 - employee appreciation;
 - cost effectiveness;
 - easy accessibility to technology.
 - c. The glaring omission from this list of criteria is the quantification of the extent to which most employees on are target to achieve a specified replacement ratio and, if they are not on target, by how badly are they missing the mark.

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a comfortable retirement for fear that if he finds out, he will have to curtail his current expenditures (that is, sacrificing immediate gratification for deferred gratification 20 or 30 years later, assuming he is still alive).

2. Framing can be defined as presenting (more specifically, carefully choosing the words and pictures that are used) an idea or concept in a manner that will elicit the right connotations and result in the creation of the desired attitude or action. The “right connotations” are “our body-and-brain-based understanding of that reality” (idea or concept) and one person’s understanding of that reality can be quite different than another’s.

a. In Figure 1 (shortfall report), for example, the picture of the collapsing barn, the wording, and the chart showing the employee outliving his retirement nest egg by quite a few years reinforce the message—don’t wait any longer to increase your contribution rate because if you do, your retirement dreams will fall apart.

This report often elicits a 4% to 6% increase in the contribution rate by 7% to 12% of the participants.

b. In today’s society, fast food franchises conjure up two dramatically different reactions:

i. a quick, tasty, almost effortless, and satisfying meal that both parents and children enjoy;

ii. alternatively, just one more step towards the coronary care unit, assuming the heart attack doesn’t kill you first.

The second example explains why one-size-fits-all communications have not succeeded in increasing participation and contribution levels.

(*Don’t Think of An Elephant* and *The Political Mind*, both by George Lakoff, provide excellent discussions of how framing is used today in politics.

Although the neurological foundations of framing were discovered relatively recently, framing has been used for a long time in both propaganda and advertising. An excellent discussion of this topic can be found in *Modernism, Media, and Propaganda* by Mark Wollaeger.)

B. The hypothetical participant discussed in Figure 1 will have accumulated by age 65 just 60% of the nest egg he needs to provide his desired income until age 90. His nest egg will be consumed by age 79. In the real world, depleting

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the retirement nest egg eleven to 15 years before anticipated life expectancy is not at all unusual (based upon the analyses we have run) for participants who are age 40 and older.

- C. If participants and eligible non-participants receive easy to read communications containing the all the material information that is necessary for them to make informed decisions, it will be difficult for anyone to argue that the fiduciaries and providers caused them to incur damages. After all, the employees made an informed decision not to act in their own best interests.

On the other hand, if fiduciaries and providers focus on cultivating “happy campers”, some judges will have a field day arriving at damages.

Investment Horizons’ Plan Utilization Analyses Show Fiduciaries and Providers What They Have Done Well and What Is Not Working

- V. Investment Horizons’ PUAs can document whether or not the fiduciaries, along with their provider, implemented a prudent process that responded to how the participants were using, misusing, or simply not using the 401(k) plan.
 - A. Using sponsor and provider data, PUAs can be created that establish a baseline against which all further fiduciary actions can be evaluated.
 - 1. The PUAs can be run for the plan as a whole or by employee segments or groupings, many of which can be created without customized programming (see Figure 4, Group Definition Screen).
 - 2. The PUAs contain retirement readiness assessments by demographic groupings that show, for example, suggested contributions, percent of participants that are on-track for a financially secure retirement, and the number of years it will take to deplete the participant’s retirement nest egg.
 - 3. The calculations use the assumptions that the provider and fiduciaries suggest. This flexibility allows the fiduciaries and providers to do modeling.
 - 4. The findings of the initial analysis enable fiduciaries to assess the effectiveness of their plan design and communication programs. With this knowledge, they can refine, if need be, both their strategies and tactics in a systematic manner and then implement the necessary changes.
 - i. Investment Horizons can also help implement the new tactics using proprietary technology that makes it easy to create, deliver, and then evaluate targeted personalized communications.

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5. The process is repeated to evaluate whether the new approaches are creating the desired changes in employee behavior.
 6. The net result of the PUA process is a paper trail that demonstrates that the fiduciaries had implemented and then monitored a prudent process whose goal was to help employees achieve a financially secure retirement.
- B. In today’s litigious environment, it is quite likely that fiduciaries and providers will find themselves on opposite sides of the table:
1. The initial PUA will enable the fiduciaries to evaluate if their provider’s representations as to their “best of class” products and services are in sync with reality.
 2. The initial PUA also enables providers to demonstrate how good a job they have done—that they delivered what they said they would and more—and to justify the recommendations they made even though the fiduciaries may have decided not to implement them.
- C. The final benefit of Investment Horizons PUAs is that it provides both fiduciaries and providers the opportunity to show that employees were not only encouraged to help themselves, but were guided in the process. If they elected not to do so, or if they could not afford doing it, it was not the fiduciaries or the provider’s fault.

FIGURE 1
(See next page)

Don't let your retirement dreams collapse!

John,

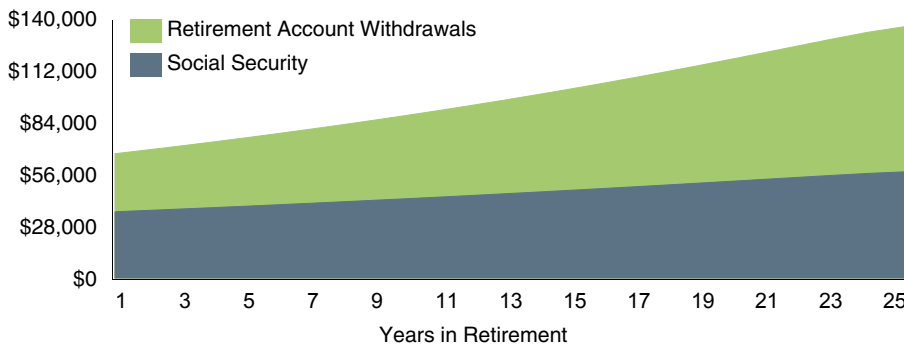
You are responsible for your own retirement security. If you don't start contributing to your 401(k) plan, your retirement dreams might fall apart.

Keep your dreams intact. Enroll in the 401(k) plan today!



Projected retirement income if you make the suggested contribution*

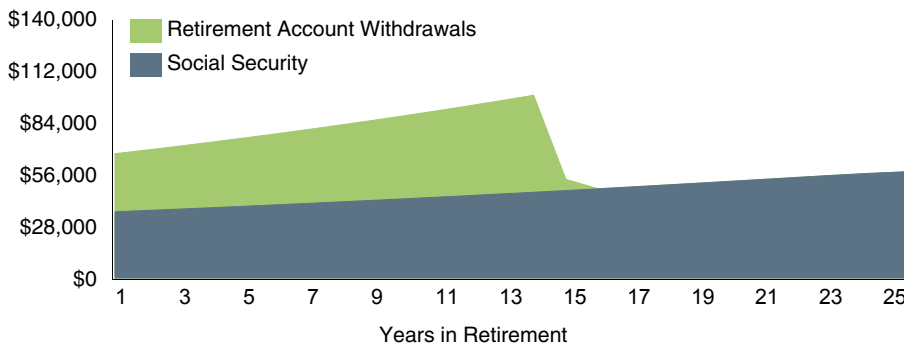
Projected account balance at retirement: \$642,062



Your contribution	15.0%
Your employer's contribution	3.0%
Total contribution	18.0%

Projected retirement income if you contribute less than suggested*

Projected account balance at retirement: \$392,371



Your contribution	8.0%
Your employer's contribution	3.0%
Total contribution	11.0%

*The charts above show the retirement income you are projected to need versus how much you are projected to have. The bottom portion shows the projected income provided by Social Security. The top portion shows the projected income provided by your 401(k) plan if the contributions shown above are made and the assumptions listed below turn out to be accurate.

Given the assumptions below, you are projected to need \$67,001 of income in your first year of retirement. Social Security is projected to cover \$35,692 of this amount. Thus, it is projected that you will need to withdraw \$31,309 from your nest-egg in your first year of retirement. In subsequent years, you will need to increase your withdrawals to keep up with inflation.

Assumptions

Current age	40	Social Security benefit at retirement	\$35,692	Pre-retirement investment return	7%
Current balance	\$0	Annual increase in Social Security benefit	2%	Post-retirement investment return	6%
Current salary	\$40,000	Post-retirement life expectancy	25 years	Employer match	50% on the first 6% of pay
Salary growth rate	3%	Inflation rate	3%		
Replacement ratio	80%				
Retirement age	65				

Although this report is based on information about you provided by your plan, it is only preliminary in nature and should not be treated or interpreted as an exhaustive, comprehensive analysis of your total financial situation. In addition, all the assumptions used in this report are for illustrative purposes only and are not guaranteed. You should not consider them predictive of the future. It is up to you to periodically review where you are along the road to retirement. You might find that you have more or less money than you had anticipated.

FIGURE 2
(See next page)

Retirement Security

John,
it's within your grasp
if you start now.



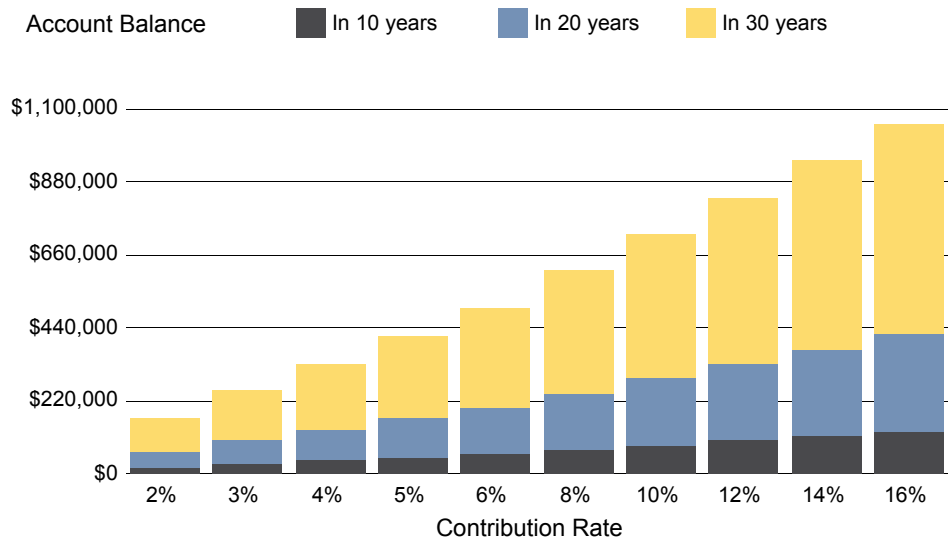
How much your account will be worth in the future depends on how much you contribute, the rate of return your investments earn, and how long your money is invested.

The chart at the right shows the nest-egg you will have at various times in the future and at different contribution rates.

It's in your best interest to start your retirement savings program as early as possible, so don't put off until tomorrow what you can do today. Join the 401(k) plan now.

The Power of Long-Term Investing

The chart below shows the power of a long-term investment program and the reason to start sooner rather than later.



Assumptions

Current Salary	\$40,000	Investment Return	7%
Current Balance	\$0	Employer Match	50% on first 6% of pay
Yearly Raise	3%		

To learn more about your 401(k) plan or to access tools that will help you invest wisely, visit the plan website at www.planwebsite.com or call 1-800-000-0000.

Although this report is based on information about you provided by your plan, it is only preliminary in nature and should not be treated or interpreted as an exhaustive, comprehensive analysis of your total financial situation. In addition, all the assumptions used in this report are for illustrative purposes only and are not guaranteed. You should not consider them predictive of the future. Federal law and possibly your plan limit the amount you can contribute to your account and you may not be able to invest as much as shown above. It is up to you to periodically review where you are along the road to retirement. You might find that you have more or less money than you had anticipated.

FIGURE 3
(See next page)

John,

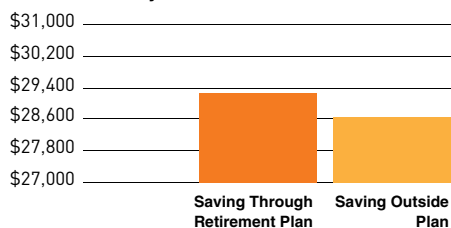
Achieving financial independence does not take place overnight. Growing your retirement savings, like raising a little one, takes time and nurturing.

Enroll in the 401(k) plan today.



Why is the 401(k) plan a good place to invest for retirement?

Take Home Pay



Gross Annual Salary	\$40,000	\$40,000
Retirement Contribution	\$4,000	\$0
Taxable Income	\$36,000	\$40,000
Federal Taxes*	\$6,716	\$7,316
After-Tax Savings	\$0	\$4,000
Take Home Pay	\$29,284	\$28,684
Increase In Take Home Pay	\$600	

Because you don't have to pay current income taxes on your 401(k) contributions, your take home pay can actually increase as compared to investing outside of the plan.

Let's look at your situation. If you invest \$4,000 in your 401(k) plan, you pay taxes on only \$36,000 instead of \$40,000.

The chart at the left compares investing in the 401(k) plan to investing outside of the plan. You can see how take-home pay is affected.

*This chart takes into account only Federal taxes and does not consider state or local taxes. Taxes are based on the IRS 2008 Tax Rates for a single filer plus 2008 OASDI and Medicare taxes. The 2008 standard deduction of \$5,450 and one exemption (\$3,500) have been applied in calculating the Federal taxes. Withdrawals made prior to age 59½ may be subject to a 10% Federal tax penalty and are subject to plan restrictions. Taxes are due upon withdrawal from a tax-deferred account.

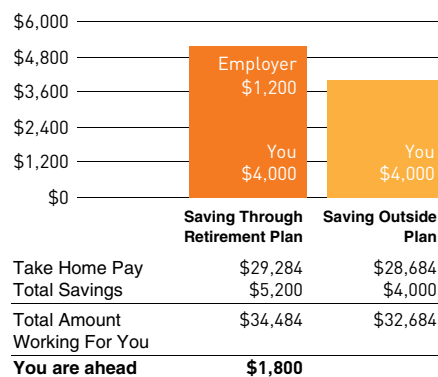
Does my employer's contribution really give me more "bang for the buck"?

Absolutely. When you invest in your 401(k) plan, your employer may match all or part of your contributions. When your employer's match is combined with the tax savings described above, you can see the power of the 401(k) plan (see chart at right).

Employer Match Schedule:

50% on the first 6% of pay contributed

Total Contribution



(continued on back)

FIGURE 4
(See next page)

CampaignManager's "Employee Group Definition" Screen

Assumptions

Select Content

Save Group

Done

Instructions:

1. Define below what type of employees should be in this group.
2. Click *Assumptions* above to enter the assumptions (investment return, etc.) to be used for this group.
3. Click on *Select Content* in the menu above to specify (and configure) a report, letter, or multipage piece to send to this group.
4. Click *Done* above when you are finished defining and specifying content for this group.

Employee Group: (Participants)

Enter the criteria for selecting employees to include in this group below.

Participation

- Include both participants and non-participants
- Include participants only
- Include non-participants only

Retirement income shortfall projection

- Include employees who are projected to have a shortfall as well as those who are on track
- Include only employees with projected shortfalls
- Include only employees who are on track

How long nest-egg is currently projected to last

- Do not limit the group based on how long the employee's nest-egg is projected to last
- Include only those whose nest-eggs are projected to last between years and years

Current contribution percentage

- Do not limit the group based on how much they are contributing
- Include only those contributing between % and %

Suggested contribution percentage

- Include all employees regardless of their suggested contribution
- Include only employees who have a suggested contribution of less than the maximum allowable
- Include only employees who have a suggested contribution of the maximum allowable
- Include only employees with a suggested contribution between % and %

Age range

- Do not limit the group based on age
- Include only those between the ages of and

Salary range

- Do not limit the group based on salary
- Include only those with salaries between and

Gender

- Do not limit the group based on gender
- Males only
- Females only

Location

- Do not limit the group based on location
- Include only this location:

(continued)

Job classification

- Do not limit the group based on job classification
- Include only this job classification:

Date-of-hire

- Do not limit the group based on date-of-hire
- Include only those with dates-of-hire between and (MM/DD/YYYY)

Custom data field 1

- Do not limit the group based on custom data field 1
- Include only employees with a value of in the data file field called "CustomField1"

Custom data field 2

- Do not limit the group based on custom data field 2
- Include only employees with a value of in the data file field called "CustomField2"

Number of (any type of) funds used

- Do not limit the group based on the number of funds used
- Include only those using between and funds

Number of pre-packaged funds (lifecycle, lifestyle, etc.) used

(These are funds which are intended to be used as the sole investment option.)

- Do not limit the group based on the number of pre-packaged funds used
- Include only those using between and pre-packaged funds

Allocation to pre-packaged funds (lifecycle, lifestyle, etc.)

(These are funds which are intended to be used as the sole investment option.)

- Do not limit the group based on the amount invested in pre-packaged portfolios
- Include only those with between % and % of their portfolios in pre-packaged portfolios

Allocation to other hybrid funds (balanced, asset allocation, etc.) funds

(These are funds which are not necessarily intended to be used as the sole investment option.)

- Do not limit the group based on the amount invested in hybrid funds
- Include only those with between % and % of their portfolios in hybrid funds

Allocation to stock funds

- Do not limit the group based on the amount invested in stock funds
- Include only those with between % and % of their portfolios in stock funds

Allocation to company stock

- Do not limit the group based on the amount invested in company stock
- Include only those with between % and % of their portfolios in company stock

Allocation to bond funds

- Do not limit the group based on the amount invested in fixed-income funds
- Include only those with between % and % of their portfolios in bond funds

Allocation to stable value funds

- Do not limit the group based on the amount invested in stable value funds
- Include only those with between % and % of their portfolios in stable value funds

Allocation to cash/money market funds

- Do not limit the group based on the amount invested in cash funds
- Include only those with between % and % of their portfolios in cash/money market funds

Content: (Gap Analysis (Barn))