

Monitoring Retirement Readiness:
The Need, Who Should Do It, and How to Avoid Pitfalls

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You have to see reality as it really is.

— A.G. Lafley, former CEO of Procter & Gamble¹

[A] surprising number of corporate leaders and companies continue to take positions that may seem credible internally but are totally incredible to outside observers.

— McKinsey Quarterly, June 2011²

...the fact that 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. Kravitz³

[T]he 401(k) industry—plan sponsors, participants, providers and advisers—are beginning to realize that the real purpose of 401(k) plans is—or at any rate should be—to provide monthly retirement income ... This is due to the simple truth that, in retirement...401(k) accounts need to generate a monthly “paycheck.”

— Fred Reish and Bruce Ashton⁴

- I. **The United States is in the midst of an economic crisis that greatly increases the likelihood that all large 401(k) plan sponsors will find themselves in messy 401(k) litigation.** After all, when dreams are dashed—through unemployment, inability to retire, or the inability to maintain one’s current standard of living—humans have a tendency to blame others—such as their employer—for causing their problems.

More Americans are reaching their 60s with so much debt they can’t afford to retire.

— E.S. Browning, *Older Americans Held Hostage by Mortgages*.⁵

In the wake of the worst recession in fifty years, there’s little doubt that the American middle class—the 40% of households with annual incomes between \$50,000 and \$140,000 a year—is in distress...In 2009, the income of the median family, the one smack in the middle, was lower, adjusted for inflation, than in 1998, the Census Bureau says...

To monitor the evolving American consumer market, P&G executives study the Gini index, a widely accepted measure of

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income inequality... “We now have a Gini index similar to the Philippines and Mexico—you’d never have imagined that,” says Phyllis Jackson, P&G’s vice president of consumer market knowledge for North America.”⁶

- II. **A guaranteed way of increasing health care costs is to have in the workforce a significant number of older, demoralized workers who can’t afford to retire.** This relationship between workers who cannot afford to retire and greater health care costs is often missed due to:
- A. the silos—health care in one and retirement programs in another—that often exist in benefit departments;
 - B. the reality that since few, if any, recordkeepers have automated the calculation of participant retirement readiness—let alone taken a holistic approach to this problem (such as including benefits from defined benefit pensions and non-qualified plans)—this statistic can’t appear in the annual reviews 401(k) sponsors and fiduciaries receive, thus leaving the sponsors’ senior managements without realistic assessments of their employees retirement prospects;
 - C. the widespread attitude among senior management that 401(k) plans should be presented as valuable benefits while simultaneously downplaying just how difficult it is for the typical employee to achieve a secure retirement.
- III. **Enabling hungry plaintiffs’ attorneys to quickly realize that your plan is not low hanging fruit is the first step in effective 401(k) risk management.** Effective and efficient 401(k) risk management also includes:
- A. recognizing that 401(k) litigation is perhaps more likely to originate from those in middle and upper management than from those in lower pay categories:
 - 1. Janice Amara—the lead plaintiff in *CIGNA v. Amara*, a case that ended up in the Supreme Court—was a compliance attorney with CIGNA.
 - B. monitoring the conflicts of interest that plague the 401(k) arena and are well documented in the GAO study, *Improved Regulations Could Better Protect Participants from Conflicts of Interest*.⁷
 - 1. Sponsors and fiduciaries often forget that law firms with significant ERISA practices typically represent both large sponsors and large providers. Further, the profit models of providers often conflict with the needs of fiduciaries and participants, thus raising the question: How does a law firm serve three masters simultaneously?

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2. Sponsors and fiduciaries ignore the fact that it is difficult to argue that their recordkeepers are fiduciaries. If recordkeepers aren't fiduciaries, they are then governed by the morals of the marketplace—whatever those may be.
3. Fiduciaries often don't realize that they have a duty to monitor the behavior of their co-fiduciaries. After all, these co-fiduciaries are usually for-profit businesses that have their own business and models. Thus, even if a recordkeeper or managed account provider is a co-fiduciary, the appointing fiduciaries' duties are not significantly decreased.

*Well aware of the increasing but healthy paranoia felt by plan fiduciaries about their potential exposure to fiduciary breach lawsuits, an increasingly popular practice by consultants and other service providers to retirement plans is marketing their services as "co-fiduciary" in nature... **Some plan fiduciaries are under the impression that by assuming co-fiduciary status under ERISA, the service provider is actually assuming, or at the very least sharing, fiduciary responsibility for the particular activities being performed.** These plan sponsors believe that by hiring a provider to assist it in selecting, monitoring, advising, or otherwise providing expertise on plan investments, they will either be relieved of those fiduciary obligations or that their responsibility for complying with such obligations will be reduced by the provider's purported acceptance of shared responsibility. **Given the sophistication of such marketing programs, it is understandable why plan sponsors are led to such a conclusion. They are likely to be disappointed, however, if they engage a provider thinking that the provider's acknowledgment of "co-fiduciary" status has somehow reduced the plan sponsor's fiduciary obligations to the plan.**⁸*

- C. monitoring and managing participant expectations by comparing how the financial (particularly *Forbes* and the *Wall Street Journal*) and popular (*USA Today* and *Frontline*) press describes “hot” topics with what your participants receive—if anything at all—from your vendors on topics such as:

1. the failure of 401(k) plans to live up to expectations;
2. the varied asset allocations of target-date funds with the same retirement date;
3. the inability of most economists to accurately predict where the economy and capital markets are heading;

*An economist is an expert who will know tomorrow why the things he predicted yesterday didn't happen today.*⁹

4. “quants” and their poorly designed models wreaking havoc on Main Street while generating profits for Wall Street:

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- a. Fiduciaries will be hard pressed to argue that they weren't aware of either the pitfalls of financial models and the overconfidence and over-optimism that these models generated on Wall Street. After all, the financial press routinely discusses these issues and many books have been written on the subject and reviewed in the Wall Street Journal:
 - i. John Cassidy, How Markets Fail: The Logic of Economic Calamities;
 - ii. Justin Fox, The Myth of the Rational Market: A History of Risk, Reward, and Delusion on Wall Street;
 - iii. Andrew Ross Sorkin, Too Big To Fail: The inside story of how Wall Street and Washington fought to save the financial system—and themselves;
 - iv. Carmen M. Reinhart and Kenneth S. Rogoff, This Time is Different: Eight Centuries of Financial Folly.

- D. providing participants with sufficient materials needed to make informed decisions in easily understood language:
 1. Fiduciaries must be able to demonstrate that they factored into the participant communication pieces the knowledge level, capabilities, and attitudes of the typical American worker, and 401(k) participants in particular:

*...the majority of Americans lack basic numeracy and knowledge of fundamental economic principles such as the workings of inflation, risk diversification, and the relationship between asset prices and interest rates.*¹⁰

- E. making sure that documentation is readily available that enables your legal counsel to build a good, fact-based story that shows how the fiduciaries diligently fulfilled their duties of loyalty, prudence, and disclosure:
 1. If legal counsel for disgruntled employees requests plan information, fiduciaries must be able to respond to these inquiries without significant and expensive disruptions in workflow and in sufficient detail to discourage further consideration of litigation.
 2. If a lawsuit is brought against the plan, fiduciaries want to be able to maximize the likelihood it will be dismissed.

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3. If the case goes to trial, fiduciaries want the judge—regardless of whether he is a progressive, libertarian, or a conservative—to conclude that the fiduciaries:
 - a. made a sincere and intelligent effort—acted with procedural and substantive prudence—to help their employees achieve a financially secure and comfortable retirement;
 - b. earnestly tried to make their employees understand that achieving retirement security fell solely on their shoulders and theirs alone;
 - c. provided employees with communications that made it perfectly clear that achieving retirement security can be quite expensive, even requiring the forgoing of immediate wants, and that the vagaries of the capital markets can still upset the participants’ apperecars regardless of how much they contribute to their 401(k) plan.
- F. recognizing, given the scope of the current economic crisis, that it is risky, if not foolish, to try to predict how judges will react to a case based upon their previous decisions and published views:
1. *Jones v. Harris Associates* landed in the Supreme Court in large part due to the legal brawl between the highly regarded conservative Seventh Circuit judges Easterbrook and Posner.
 2. Judge Richard A. Posner, a devout believer in free markets, wrote two widely discussed books, A Failure of Capitalism and The Crisis of Capitalistic Democracy.
 3. Cass Sunstein, the current White House regulatory chief and a long time proponent for restraining the growth of federal rules, argues—along with Richard Thaler in their book, Nudge: Improving Decisions About Health, Wealth, and Happiness—that libertarian paternalism can make it easier for people to choose what is best for themselves, their families, and the nation.
 4. The dicta included in the Supreme Court’s decision in *CIGNA v. Amara* are proof that sponsors and fiduciaries should not assume that because a remedy for a wrong is not immediately apparent, judges—regardless of their political persuasions—will not try to help participants recover monetary damages.
- IV. **Do Congress’s cures for participants—managed accounts and target-date funds—significantly increase the likelihood of serious litigation for 401(k) sponsors and fiduciaries?**

A. Congress endorsed managed accounts and target-date funds because it:

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1. recognized that average American workers, including 401(k) participants, were not seriously addressing—and possibly could not address—their retirement challenges;
 2. incorrectly assumed that highly regarded investment consulting and advisory organizations, with their quantitative models for optimizing investment portfolios, would get—and keep—participants on-track towards a financially secure and comfortable retirement.
- B. Congress assumed that these models would work because they are based upon the Nobel prize winning (and highly mathematical) works of Harry Markowitz and William Sharpe, the founders of the advisory services Guided Choice and Financial Engines, respectively. Unfortunately, Congress—possibly with the encouragement of lobbyists for the financial services industry—either discounted or ignored the following realities:
1. Economists who are Nobel laureates often disagree. Milton Friedman, Paul Krugman, Paul Samuelson, Joseph Stiglitz, and George Akerlof won Nobel Prizes and the latter four have serious disagreements with Friedman (the father of the deregulation of American financial institutions).
 2. Winning the Nobel Prize does not guarantee that an economist can capture the vagaries of the capital markets. After all, it was the financial innovations of Myron Scholes and Robert C. Merton that necessitated the bailout of Long Term Capital Management.

*Financial economics, as a discipline, is where chemistry was in the sixteenth century: a messy compendium of proven know-how, misty folk wisdom, unexamined assumptions, and grandiose speculation. Most of it focuses on practical aims, such as making money or avoiding loss for whoever is paying for it...it does mean—especially in the field of financial market analysis—that the flow of scientific information is sharply curtailed by self-interest.*¹¹

3. Historical data cannot be used to reliably model future capital market behavior.

As much as we'd like to say history is a good guide to what the future holds, it simply is not true...

— Christopher L. Jones, Financial Engines' Chief Investment Officer¹²

4. Diversified portfolios do not provide protection in market crashes and prolonged downward trends.

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*Although diversification is most effective in extracting risk premia over reasonably long investment horizons and is a key component of sound risk management, it is ill-suited for loss control in severe market downturns.*¹³

5. The demise of defined benefit plans was, in large part, due to the effect that the capital markets' volatility had on pension funding ratios. This occurred despite the fact that these pensions were routinely run with the aid of models similar to those used for the creation of target-date funds and managed accounts.
- C. Although Congress endorsed the concept of target-date funds and managed accounts, DOL regulations make it clear that selecting vendors—and thus flavors of these products—is a fiduciary duty.

*The selection of a particular qualified default investment alternative (i.e. a specific product, portfolio or service) is a fiduciary act and... A fiduciary must engage in an objective, thorough, and analytical process that involves consideration of the quality of competing providers and investment products, as appropriate.*¹⁴

Fiduciaries, unfortunately, must determine what is “an objective, thorough, and analytical process”. This process might be much more complicated than fiduciaries imagine as is suggested by ERISA litigator James Baker’s discussion of a letter sent by the DOL’s Boston office to a pension plan’s fiduciaries (Appendix A). The DOL maintained that the fiduciaries were in violation of ERISA since they had not performed their own independent valuation of a hedge fund’s investments.

To protect themselves, fiduciaries and sponsors must now document that they are not only aware of the following issues, but also how they have addressed and arrived at decisions regarding them:

1. Is economics a “hard” science like physics or chemistry?

- a. In his 1974 Nobel prize lecture, Friedrich August von Hayek said:

It seems to me that this failure of the economists to guide policy more successfully is closely connected with their propensity to imitate as closely as possible the procedures of the brilliantly successful physical sciences – an attempt which in our field may lead to outright error. It is an approach which has come to be described as the "scientific" attitude – an attitude which, as I defined it some thirty years ago, "is decidedly unscientific in the true sense of the word, since it involves a mechanical and uncritical application of habits of thought to fields different from those in which they have been formed." I want today to begin by

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explaining how some of the gravest errors of recent economic policy are a direct consequence of this scientific error...

- b. Thirty years later, the highly regarded physicist turned financial quant, Emanuel Derman stated:

*Trained economists have never seen a first-class model... “[E]very financial axiom I’ve ever seen is demonstrably wrong... The real question is **how** wrong is the theory, and how useful is it regardless of its validity. Everything you read in any theoretical finance book, including this one, you must take with a grain of salt.¹⁵*

- c. The following excerpt from a recent discussion between two highly respected economists, Martin Feldstein and Austan Goolsbee, on the merits of the tax aspects of the President Obama's *American Jobs Act* supports the viewpoint that economics is not based in science, regardless of the use of equation-filled models.

Not only are these comments typical of the viewpoints that fill the financial press, they make it perfectly clear that trying to successfully model the U.S. economy is like searching for the Holy Grail:

AUSTAN GOOLSBEE: *I think those three things are what you want to do. You don't want to just pick one because what — your view of the world might not be correct.*

You want to try cutting taxes for hiring people, cutting taxes to put in people's pockets, cutting taxes for investment, and try to do that as a package. I think it could be pretty positive.

JUDY WOODRUFF: *So, Martin Feldstein, so what if you put them all together, you look at it all as a package? Does that make it any more helpful?*

MARTIN FELDSTEIN: *So, I have looked at what the various forecasters say this might do. And the most optimistic ones say that it will add between one and two million jobs over the next two years. And that sounds like a lot, until you realize that that's about \$200,000 per job, \$200,000 per job.*

So it's just not a good use of money that — of course, it has to be paid for. And we haven't talked about that yet, but it's not a good use of money to spend \$200,000 to create a single job.¹⁶

V. Are fiduciaries violating ERISA’s duties of loyalty and prudence—in spite of Congress’s endorsements—when they encourage their participants to use managed accounts and target-date funds if these products aren’t based upon scientific models?

A. Fiduciaries must be able to document that they understand what makes a model scientific rather than a mere reflection of how a particular economic school of thought hopes the world works. The internationally known mathematician, Stephen Hawking, and Caltech physicist, Leonard Mlodinow, define a well-thought-out scientific model as one that:

1. *is elegant;*
2. *contains few arbitrary or adjustable elements;*
3. *agrees with and explains all existing observations;*
4. *makes detailed predictions about future observations that can disprove or falsify the model if they are not borne out.*¹⁷

B. Perhaps Modern Portfolio Theory (MPT) is an exception to the general rule that economics is not a science. Is there any evidence to support that MPT can create target-date funds and managed accounts that can put participants on track for a financially secure retirement and also weather the storms of volatile capital markets?

a. *We learn from crisis to crisis that MPT [Modern Portfolio Theory] has the empirical and scientific validity of astrology (without the aesthetics).*

—Nassim Nicholas Taleb, quantitative finance guru and author of Foiled by Randomness and The Black Swan

b. Morningstar has pointed out that:

*Little rigorous work has been done to answer how and why the equity-bond glide path should evolve throughout an investor’s lifetime, and even less work has been done to answer how and why intra-stock and intra-bond splits should evolve over time.*¹⁸

c. Others have concluded that:

*...trying to predict market movements is just gambling. It’s not even a theoretically controllable form of gambling, like playing blackjack or picking football games, where there’s some degree of skill involved. It’s tossing dice or flipping coins—sheer chance.*¹⁹

- d. The implosion of 2010 target-date funds in 2008, as well as the large amount of variability in their returns, makes it difficult for anyone to believe that their foundation is grounded in solid science:

In addition to losing substantial amounts of assets, the returns of 2008 revealed significant variability in the performance of target date funds with the same target date.

For example, for 2008, the returns of 2010 target date funds ranged from negative 9% to negative 41%. While the returns turned positive in 2009, the variability continued, with 2010 target date fund returns ranging from 7% to 31%.

Much of this variability in returns is the result of variations in asset allocations among target date funds with the same target date. Based on a staff review, equity exposure of target date funds at target date has ranged from 25% to 65%.²⁰

—SEC chairman Mary L. Schapiro

VI. Why is our recordkeeper partnering with Financial Engines and recommending that our participants use this advisory service if the foundations for managed accounts (and target-date funds) are so shaky?

- A. The answer to that question—assuming there is a satisfactory one—will likely be found in the answers to the following questions:
 1. For your average participant who has few assets outside of his home, why is a managed account, with fees that can significantly reduce his 401(k) account balance over the long term, a better value than a target-date fund?
 - a. Morningstar, another provider of managed accounts, argues that a major disadvantage of target-date funds is that participants use them blindly:

This highlights a major weakness of target maturity funds relative to managed account solutions: managed account solutions identify saving shortfalls while target maturity fund do not.²¹
 - b. A GAO study, *Defined Contribution Plans: Key Information on Target-Date Funds Should Be Provided to Plan Sponsors and Participants*, came to the same conclusion.²²
 - c. For the cost of less than one small cappuccino at Starbucks, this problem can easily be solved with a personalized gap analysis.

When I talk to the 401(k) providers that don't offer the service [gap analyses], they tell me that they use their budget...to meet the demands

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*and requests of plan sponsors...Plan sponsors aren't giving a high priority to providing participants with information about benefit adequacy and needed deferrals.*²³

—Fred Reish

2. How does Financial Engines fit into the recordkeeper's business plan? What is the value proposition that Financial Engines will deliver to your recordkeeper?
3. What is the financial arrangement that exists between them? According to a GAO study, there probably is one:

*The sponsors of 401(k) plans face conflicts of interest from service providers assisting in the selection of investment options because of third-party payments and other business arrangements.*²⁴

4. What are the value propositions that your recordkeeper believes Financial Engines can and will deliver to sponsors, fiduciaries, and participants?
5. Does your recordkeeper's perception of Financial Engines' value propositions jibe with Financial Engines representations of its value propositions?
6. Can Financial Engines provide sufficient evidence—such as its past performance with actual participant money—that confirms that it is capable of delivering that value proposition?
 - a. Can Financial Engines demonstrate that it minimized losses for its participants during both the dot-com bust and the current economic crisis?
7. How does Financial Engines determine the input data for their portfolio optimizer and why is it so confident that these inputs will enable it to capture where the market is heading? After all, most economists and money managers—including those of hedge funds—often miss the mark and must revise their forecasts?

*The truth is that there are no fundamental laws in finance. And even if there were, there is no way to run repeatable experiments to verify them... To confuse the model with the world is to embrace a future disaster driven by the belief that humans obey mathematical rules.*²⁵

- a. How often must your participants' portfolios be reoptimized so that they are in sync with current market conditions?

- b. What evidence can Financial Engines provide that confirms their choice of intervals between reoptimizations?
8. How does Financial Engines define successful account management for its clients?

Based on Financial Engines' inflation-adjusted projections, three out of four workers are going to be unable to replace 70% of their pre-retirement income with the combination of their 401(k) plan and Social Security if the markets perform typically.²⁶

VII. Since Financial Engines' profit model likely conflicts with your fiduciary duties—as well as the goal of reducing the company's health care costs—does it make sense for the fiduciaries to rely on Financial Engines' evaluation of its success at putting your employees on the road to a financially secure and comfortable retirement?

- A. Allowing the **fox to guard the hen house** is not only a challenge no fiduciary should ever attempt to justify, but it is an open invitation for unwanted and unnecessary litigation.
- B. If participants don't enroll in Financial Engines' managed account program, who will monitor their retirement readiness? Perhaps those participants will be more successful in achieving their retirement goals than those who use Financial Engines.

Had the plan fiduciaries deliberated, decided and documented their resolution of the issue, the class's breach of fiduciary duty claim alleging \$83 million in losses probably would not have been remanded for trial.

—Dorsey & Whitney Update on the Seventh Circuit Decision in *George v. Kraft Foods Global*

Difficult, time-consuming, and expensive litigation with uncertain results...is assuredly not a sensible way to manage the Nation's retirement system for either employers or employees. Sadly, at least for now, litigation appears to be the only option available to them.

—Judge Mark R. Kravitz²⁷

If changing judges changes law, it is not even clear what law is.

—Judge Richard A. Posner²⁸

Whether you're dealing with terrorism or securities fraud, it's better to be in the prevention business than the cleanup business.

—Robert Khuzami²⁹

Appendix A: James Baker's Discussion of DOL Letter³⁰

Hedge Fund Valuations?

On August 8, 2008, the US Department of Labor's Boston Office sent a letter to an ERISA-regulated pension plan stating that the plan was in violation of ERISA because it had not performed its own independent valuation of its hedge fund holdings. According to the Department of Labor:

It is incumbent on the Plan Administrator to establish a process to evaluate the fair market value of any hard to value assets held by the Plan. Such a process would include a complete understanding of the underlying investments and the fund's investment strategy. In addition, the Plan Administrator must have a thorough knowledge of the general partner's valuation methodology to ensure that it comports with the fund's written valuation provisions and reflects fair market value. A process which merely uses the general partner's established value for all funds without additional analysis may not ensure that the alternative investments are valued at fair market value.

The Department of Labor's bottom line appears to be that the buck stops with the ERISA plan fiduciary. It is his or her duty to properly value hard-to-value assets. The Department of Labor has made it clear that relying on a hedge fund's own valuation is not enough.

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