

Target-Date Funds and Managed Accounts:
Are They the Modern Versions of Hans Christian
Andersen's Fairy Tale, "The Emperor's New Clothes"?

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A market is never saturated with a good product, but it is very quickly saturated with a bad one.

—Henry Ford

Had the plan fiduciaries deliberated, decided and documented their resolution of the issue, the class’ 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*

Amara also teaches a lesson that conscientious fiduciaries already know: sugar-coated, “feel-good” communications... will only lead to problems.

—McGuireWoods Legal Update on Supreme Court’s Decision in *CIGNA v. Amara*

Earlier this year, the GAO presented its report on target-date funds to Congress. The GAO’s analysis showed that (1) target-date funds—and presumably their next of kin, managed accounts—are quite messy; (2) funds targeting the same year have asset allocations all over the place; (3) the assumptions the funds’ managers make about participant contribution rates and withdrawal behavior are seldom in sync with reality; (4) the DOL’s regulations are inadequate, outdated, and encourage misuse of target-date funds; (4) all too many plan sponsors and fiduciaries are clueless as to how these funds operate.

This GAO study, along with some recent court cases, should encourage plan sponsors and fiduciaries to make sure that they do not “turn a blind eye” towards their fiduciary duties. If they do, they might find that the lack of a well-document process will put them in not only expensive litigation, but also at the mercy of a judge(s) who is (are) “legislating”.

Background

Congress sanctioned the use of Qualified Default Investment Alternatives (QDIAs)—including target-date funds (TDFs) and managed accounts—because it recognized that many, if not most, American workers do not, and probably cannot, use 401(k) plans effectively. Simply put, the average American probably lacks the educational skill necessary to plan, on his own, for his retirement.¹

The appeal of TDFs and managed accounts lies in:

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- their ease of use;
- the belief that their foundations rest on the highly quantitative (and presumably scientific) Nobel Prize winning ideas—particularly Modern Portfolio Theory—of William Sharpe and Harry Markowitz;
- highly regarded consulting firms routinely using Modern Portfolio Theory, modifications of it, and other quantitative techniques and strategies to arrive at the asset allocations of large public and corporate defined benefit pension plans.

Congress's comfort level with QDIAs was so great that it sanctioned the use of any type of QDIA for any 401(k) plan. Fiduciaries, however, must still justify why they picked one firm's product over another. Unfortunately, the regulations promulgated by the Department of Labor (DOL) offer little guidance as to the criteria fiduciaries should use in their due diligence process.

If TDFs and managed accounts are grounded in science, as both Congress and the DOL believed, having to justify why a sponsor picked a specific TDF fund series and/or managed account program was assumed to be a moot point. After all, how different could one product be from another? In any event, using any of these professionally managed products should put participants in much better positions than they would be in if they made their own naive asset allocation decisions.

The stock market crash in 2008 and its recovery in 2009 gave everyone—Congress, the DOL, sponsors, fiduciaries, and participants—a "rude awakening". In 2008, TDFs designed for workers retiring around 2010 suffered losses that professional investment management was suppose to prevent. In 2009, these same funds rebounded; however, their returns varied all over the place.

Since managed account programs are, practically speaking, personalized TDFs, they probably incurred losses of similar magnitude in 2008. Thus, these programs must be monitored to the same extent as TDFs even though their investment managers assume fiduciary responsibility for the recommendations each participant receives. If any fiduciary doubts the need to monitor co-fiduciaries, they should read *Phones Plus, Inc. v. Hartford Life Insurance Co.* (D.Conn., No. 3:06-cv-1835 (AVC)).

In an attempt to understand the implosion of 2010 TDFs, Congress, DOL, SEC, and others launched investigations. These analyses found that TDFs come in "all sizes, shapes, and forms" because they are created using different assumptions and methodologies.² For example, TDFs with the same target date can have dramatically different asset allocations and glide paths (how the asset allocations change over time).³

Thus, Congress's belief that both TDFs and managed accounts are constructed using widely accepted and scientifically developed principles is nothing more than the modern

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version of Hans Christian Andersen’s fairy tale, “The Emperor’s New Clothes”.⁴ In fact, 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.*⁵

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.*⁶

Even the validity of Modern Portfolio Theory—the bedrock for both TDFs and managed accounts—is being challenged. Quantitative finance guru, Nassim Nicholas Taleb, puts it this way:

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

To make matters worse, the Government Accountability Office (GAO), in its recently released report to Congress, reported that the assumptions regarding participant contribution rates and withdrawal behavior used in designing TDF glide paths don’t jibe with reality.⁷ Investment managers assumed that participants would be contributing at much higher rates than they do. Other studies have shown that contribution rates are way too low.^{8,9} In fact, several years ago Fidelity reported that its average participant was not on-track for a comfortable and financially secure retirement.¹⁰

Action Steps and Preventive Medicine

It should be apparent that sponsors and fiduciaries must monitor and benchmark their TDF/managed account providers. So, how should fiduciaries benchmark the performances of their TDFs (and managed accounts)? ERISA attorneys Fred Reish and Bruce Ashton have suggested a commonsense approach. Fiduciaries should monitor—and they usually do not¹¹—whether or not these products are enhancing the retirement readiness of their employees:

*But, the 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 income in retirement... This is due to the simple truth that, in retirement... 401(k) accounts need to generate a monthly “paycheck.”*¹²

Morningstar’s methodology in constructing TDFs and managed accounts also supports this approach to benchmarking TDFs:

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Earlier, we established that the core goal of most individuals' investment plans is to provide an adequate retirement income. Put somewhat differently, the primary reason individuals convert a portion of their human capital into financial capital is to fund their retirement. Once in retirement, individuals prefer reliable, inflation-adjusted real income.

Retirement expenses form the retiree's retirement liability. Optimal strategic asset allocation plans must consider the investor's total portfolio, including liabilities as well as assets. More specifically, the difference between the value of the assets and the value of the liabilities is crucial, because this difference will determine whether the investor can pay for retirement.¹³

(Morningstar has also pointed out that a major disadvantage of TDFs 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.¹⁴)

Why don't recordkeepers monitor the retirement readiness of participants? According to Reish, few plan sponsors and fiduciaries are interested in this service. Thus, recordkeepers, with their own budget constraints, haven't and will not invest in analytical tools that have little appeal to their plan sponsor and fiduciary clients.¹⁵

Appendix A provides an example of a commercially available *Retirement Readiness Assessment*. Using this analysis, fiduciaries and plan sponsors can determine whether or not they and their participants are getting their "money's worth" for the fees they are paying. They will learn how the participants are using, misusing, or simply not using the 401(k) plan.

For example, fiduciaries will be able to compare current participant contribution rates with suggested ones (using the projected investment growth rates of the appropriate TDFs). They will also learn how long, on average, their participants' nest eggs are projected to last. Fiduciaries, then, will be able to determine what issues they should address to minimize both participant rude awakenings and the likelihood that their plan will look like low hanging fruit to knowledgeable class action attorneys.

An examination of the communications that the participants have received over the past few years will enable knowledgeable class action attorneys to easily spot 401(k) plans that are likely low hanging fruit. For example, these plaintiffs' attorneys will know that a plan is not a good target if each year participants are given personalized gap (or shortfall) analyses (see Appendix B) along with other communication pieces that discuss the performance of the TDF that each participant is using. If participants who are investing in more than one TDF or a TDF along with non-TDF funds also receive communication

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pieces that remind them of the TDF's purpose, it will be apparent to a plaintiffs' attorney that the fiduciaries have implemented a process that is both procedurally and substantively prudent.

In the past, most fiduciaries felt they could fulfill their duties of loyalty, prudence, and disclosure without making their participants aware of the challenges involved in achieving a financially secure and comfortable retirement. After all, since the DOL did not mandate the distribution of gap analyses, fiduciaries felt they had nothing to gain by being bearers of bad news: that achieving a financially secure retirement is a costly proposition, assumptions will have to be periodically (and perhaps significantly) revised, and achieving retirement security involves a lot of luck.

The Supreme Court's recent decision in *CIGNA Corp. v. Amara* (No. 09-804) should force all 401(k) fiduciaries to rethink their duty of disclosure:

*Because litigation and monetary remedies are now more likely where errors occur in plan administration and communications, employers and plan fiduciaries need to devote more time and energy to ERISA compliance and careful participant communications.*¹⁶

Fiduciaries should now realize that significant omissions and misleading statements may come with a high price tag. After all, the Court ruled that plaintiffs do not necessarily have to show detrimental reliance to win. A showing of "likely harm" may be sufficient to entitle participants to recover benefits.

(It's worth noting that Janice Amara was a lawyer in CIGNA's compliance department.)

Fiduciaries should not be surprised if clever class attorneys now start to argue that since the average participant lacks the skills needed to plan for his own retirement, fiduciaries should use a small fraction of the fees participants pay to provide gap analyses. By emphasizing asset allocation (TDFs) and not contribution rates (not distributing gap analyses), these litigators will argue (especially when they represent auto-enrolled employees) that the fiduciaries were trying to hide the reality that:

*Asset allocation is irrelevant if you have no money to allocate.*¹⁷
—Dallas Salisbury

Fiduciaries should also keep in mind that their fiduciary duties are a matter of facts and circumstances and, as such, can evolve over time. The recent decision in *Tibble v. Edison International* illustrates this point. In that case, the judge ruled that blindly relying on a highly respected consulting firm was not prudent.¹⁸

Likewise, the recent decision in *George v. Kraft Foods Global, Inc.* also illustrates the need for fiduciaries to dot their "i's" and cross their "t's". Dotted "i's" and crossed "t's" is synonymous with thoroughly documenting that they are running the plan in a manner that is procedurally and substantively prudent:

[Although] the Parties also cite various e-mails and other correspondence among the Kraft plan fiduciaries and [the record keeper] regarding the cost, and benefits of various solutions to investment and transactional Drag. . . we can find nothing in the record indicating that defendants ever made a decision on these matters—i.e., that they actually determined whether the costs of making changes to the [company stock funds] outweighed the benefits, or vice versa.¹⁹

Summary

The GAO’s recommendations to the DOL regarding TDFs, along with its other reports to Congress discussing providers’ conflicts of interest and fiduciaries’ unawareness of or willingness to “turn a blind eye” to them²⁰ also increases the likelihood that even more 401(k) litigation will occur. 401(k) fiduciaries can protect themselves while simultaneously helping their participants by implementing the GAO’s recommendations:

We recommend that the Secretary of Labor direct the Assistant Secretary of the Employee Benefits Security Administration to:

- 1. amend the QDIA regulations so that fiduciaries are required to document that they have considered, to the extent possible, whether other characteristics of plan participants, in addition to age or target retirement date, are relevant factors in choosing a QDIA;*
- 2. provide guidance to plan sponsors regarding the limitations of existing TDF benchmarks and the importance of considering the long-term TDF investment allocations and assumptions used in developing the TDF asset allocation strategy; and*
- 3. in its final regulation on target date disclosure, expand the requirement that plan sponsors provide information regarding key assumptions concerning contribution and withdrawal rates by requiring that participants receive a statement regarding the potential consequences of saving, withdrawing, or otherwise managing TDF assets in a way that differs from the assumptions on which the TDF is based.²¹*

¹ See Annamaria Lusardi, *Americans’ Financial Capability*, Pension Research Council Working Paper, PRC WP2011-02, January 2011; 2003 *National Assessment of Adult Literacy* conducted by the U.S. Department of Education; ING’s *Retirement Number Study*, <http://ing.us/about-ing/newsroom/press-releases/ing-releases-findings-retirement-number-study>.

² Ibbotson Associates Research Paper, *Lifetime Asset Allocations: Methodologies for Target Maturity Funds (Summary)*, May 2009, see panels A and B on p. 8; see also Bill

Ralls, *Beyond benchmarking — building blocks of a target date fund*, Fidelity, March 2011; Grant W. Gardner and Yuan-An Fan, *Russell's approach to target-date funds: Building a simple and powerful solution to retirement saving*, January 2008.

³ *Benchmarking Target Date Funds*, The S&P Target Date Index Series, March 2011, tables 1 and 2.

⁴ For some additional background information, see Richard D. Glass, *Target Date Funds: A Wonder Drug for Participants or a Pandora's Box for All Concerned*, Investment Horizons, March 2010,

http://www.investmenthorizons.com/Papers_Target_Date_Fund_Pandoras_Box.pdf;

Richard D. Glass, *Target-Date Funds and Managed Accounts: All that Glitters is not Gold*, August 2010, http://www.investmenthorizons.com/Papers_TDFs_Not_Gold.pdf.

⁵ Tom Idzorek, *Lifetime Asset Allocations: Methodologies for Target Maturity Funds*, Ibbotson Associates Research Paper, February 11, 2008 p. 48.

⁶ Joe Flood, *Playing the Right Game*, ai5000, May/June 2010.

⁷ GAO-11-118, *Defined Contribution Plans: Key Information on Target Date Funds as Default Investments Should Be Provided to Plan Sponsors and Participants*, January 2011, p. 16.

⁸ Olivia S. Mitchell, the executive director of the Pension Research Council and a professor at The Wharton School, told PIMCO's Stacy Schaus: "[T]he bottom line was that [in auto-enrollment programs] starting at 3 percent and escalating to 6 percent was a good start but much too low. As a solution she suggested 'more education to help people understand that this isn't even a floor. It's a basement...' She also said that even contributions as high as 15 to 20 percent might still leave people falling short." Stacy Schaus, *Designing Successful Target-Date Strategies for Defined Contribution Plans*, John Wiley & Sons, 2010, p. 18.

⁹ 2010 edition of *The Financial Engines National 401(k) Evaluation* found (p. 5) that [a]cross the entire sample, three out of four participants are not on track to comfortably retire by age 65. In addition, 34% have inefficient portfolios and/or inappropriate risk levels, 23% of participants with company stock as a plan option hold too much of it, and 39% of participants are not contributing enough to their 401(k)s to receive the full employer match...a significant majority of Americans (72%) are not on track to reach retirement income goals by age 65. 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. If the markets perform poorly, those same participants could be unable to replace even half (50%) of their pre-retirement income.

¹⁰ Fidelity, *Building Futures, Volume VIII: A Report on Corporate Defined Contribution Plans*, 2007, p. 114: *The average RII score for all active participants was 23% income replacement, far below the 40% suggested income replacement for defined contribution plan savings.*

¹¹ Fred Reish, *The 401(k) Destination: If you don't know where you are going...*, Out of Reish, PLANSPONSOR, June 2010, p. 72.

¹² Fred Reish and Bruce Ashton, *401(k) Account Balances as Monthly Retirement Income*, Reish & Reicher Bulletin, March 15, 2011.

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¹³ Tom Idzorek, *Lifetime Asset Allocations: Methodologies for Target Maturity Funds*, p. 30.

¹⁴ Tom Idzorek, *Lifetime Asset Allocations: Methodologies for Target Maturity Funds*, p. 40.

¹⁵ See endnote 13.

¹⁶ See endnote 2.

¹⁷ *How to Build an Effective 401(k) Education Program*, Managing 401(k) Plans, June 2004, p. 3.

¹⁸ For a discussion of this case, see Richard D. Glass, *New Challenges for 401(k) Fiduciaries: Are Judges Telling the Plaintiffs' Bar How to Sue 401(k) Fiduciaries and Sponsors?*, September 2010,

http://www.investmenthorizons.com/Papers/Judges_Telling_Plaintiffs_Bar.PDF.

¹⁹ *George v. Kraft Foods Global, Inc.*, No. 10-1469 (7th Cir. April 11, 2011).

²⁰ GAO-11-291, *401(k) Plans: Certain Investment Options and Practices That May Restrict Withdrawals Not Widely Understood*, March 2011 and GAO-11-119, *401(k) Plans: Improved Regulation Could Better Protect Participants from Conflicts of Interest*, January 2011.

²¹ GAO-11-118, p. 40.

Appendix A: Retirement Readiness Assessment

Retirement Readiness Assessment

	Entire Group	Under 30	30 - 39	40 - 49	50 - 59	60 and older
Number of employees analyzed	370	56	67	119	98	30
Participants*	220	33	46	67	60	14
Non-participants*	150	23	21	52	38	16
Projected required nest-egg withdrawal, average						
All employees	\$45,435	\$71,801	\$61,893	\$46,064	\$27,073	\$16,947
Participants*	\$50,618	\$74,652	\$67,450	\$51,210	\$30,667	\$21,336
Non-participants*	\$37,832	\$67,709	\$49,720	\$39,433	\$21,399	\$13,107
Participant contribution rate, average						
Current	4.9%	5.2%	4.5%	4.8%	5.0%	6.1%
Suggested**	15.8%	5.5%	6.8%	14.1%	28.1%	24.3%
Non-participant contribution rate, average						
Current	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Suggested**	19.7%	3.6%	6.7%	17.2%	34.4%	33.5%
Participant nest-egg at retirement, average						
Projected (at current contribution)	\$828,242	\$1,921,685	\$1,188,208	\$644,005	\$295,725	\$232,025
Needed	\$981,049	\$1,453,263	\$1,303,080	\$986,077	\$599,872	\$419,427
Non-participant nest-egg at retirement, average						
Projected (at current contribution)	\$48,021	\$11,064	\$119,188	\$54,363	\$42,548	\$125
Needed	\$742,182	\$1,325,690	\$973,552	\$767,415	\$427,606	\$264,830
Participant retirement income security, percentage of group						
Projected to be on track	26.4%	72.7%	34.8%	16.4%	8.3%	14.3%
Non-participant retirement income security, percentage of group						
Projected to be on track	0.7%	0.0%	0.0%	0.0%	2.6%	0.0%
Number of years nest-egg projected to last at current contribution rate						
Participants	15	23	19	14	10	9
Non-participants	2	1	2	2	3	1
All projections are based on:						
Retirement age: 65			Post-retirement investment return: 6.0%		Employer matching schedule:	
Annual salary increase: 3.0%			Post-retirement inflation rate: 3.0%		100% on first 3% on of pay contributed	
Pre-retirement investment return: 8.0%			Post-retirement life expectancy: 25 years		50% on next 2% on of pay contributed	
Replacement ratio: 80%						

See notes on next page.

Appendix B: Gap Analysis

John,

Planning can prevent your retirement dreams from collapsing!



The press's coverage of the current economic crisis and the stock market's dismal performance over the last decade, including its effect on the retirement prospects of us baby boomers, makes our heads spin. The pundits are predicting that, for many of us, our retirement dreams simply won't come true.

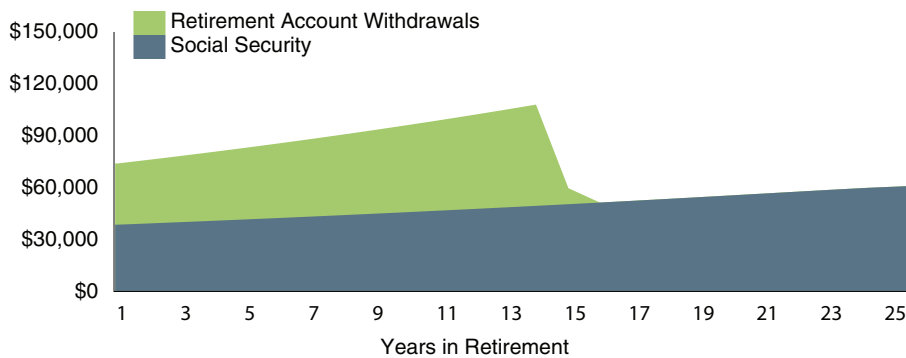
Research has found that most of us have neither calculated our likely retirement income needs nor what our 401(k)

contributions should be in order to achieve them. In short, we never evaluated what we would have to do to have a good chance of making our retirement dreams come true.

To help you size-up your situation, the Plan Administrator has prepared for you three personalized gap (shortfall) analyses. In creating them, he used what he considered to be reasonable assumptions, and these are shown after the third chart. Keep in mind that assumptions are just predictions. Only time will tell just how accurate (or inaccurate) they turn out to be.

Projected retirement income making your current 7.0% contribution

Projected account balance at retirement: \$469,076



Your contribution	7.0%
Your employer's contribution	3.0%
<hr/>	
Total contribution	10.0%

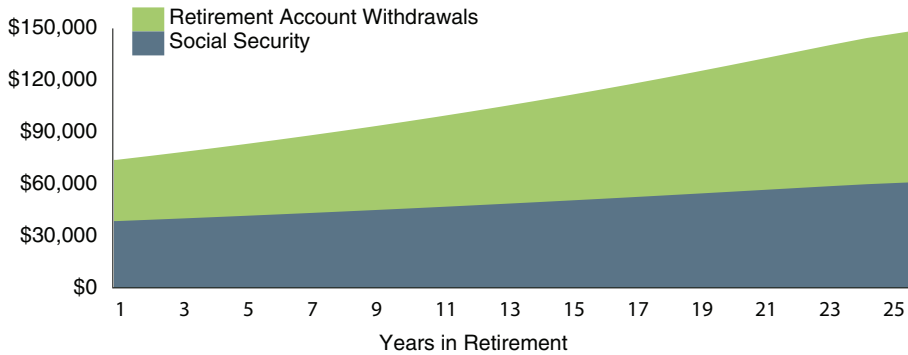
The first gap analysis (above) is based upon your current contribution rate (and the assumptions shown on page 3). It shows the number of years that withdrawals from your 401(k) account, combined with Social Security (based upon a single person), will provide you with an inflation-adjusted retirement income of 80% of your final pay (80% replacement ratio). Once the 401(k) account is depleted, your retirement income will be reduced to what you will receive from Social Security.

You are probably shocked by how quickly your 401(k) nest egg is projected to be used-up. You are also probably asking: Will I really need 80% of my final pay to live comfortably for the rest of my life? The candid answer is: No one really knows what you will need. If your mortgage is paid-off and you aren't sending kids to college, maybe you won't. If you are paying for nursing home care for parents and/or supporting children and grandchildren and/or stuck with huge medical bills, an 80% replacement ratio may not be enough.

You now probably want to know what contribution rate is suggested to provide an 80% replacement ratio if you have a long life, such as to age 90. This contribution rate is shown in the gap analysis chart below.

Projected retirement income making the suggested 20% contribution

Projected account balance at retirement: \$790,845



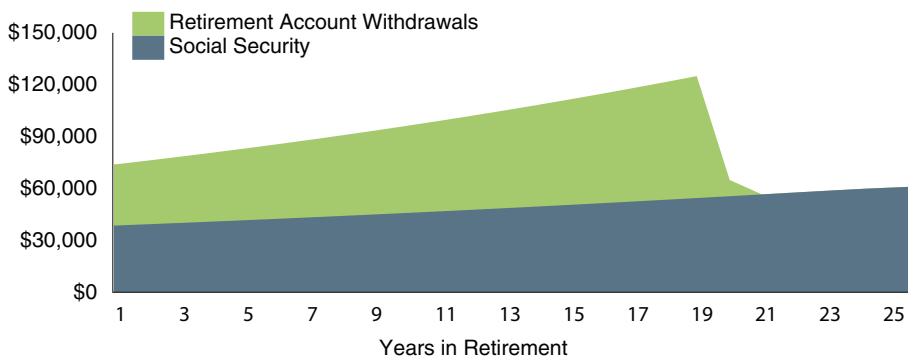
Your contribution	20.0%
Your employer's contribution	3.0%
Total contribution	23.0%

Admittedly, the suggested contribution rate is large—in fact, probably too large to be affordable. The Plan Administrator is showing you this rate so that you can make decisions based on a realistic picture of where you are on the road to retirement rather than blindly hoping for the best. (Remember, the calculations are based only on Social

Security and your 401(k) plan and don't reflect any of other sources of income, like IRAs, rental property, and retirement benefits from previous employers. If you will have other sources of retirement income, they will help close your gap. You must consider them in your decision making as well.)

Projected retirement income if you increase your contribution to 13%

Projected account balance at retirement: \$617,585

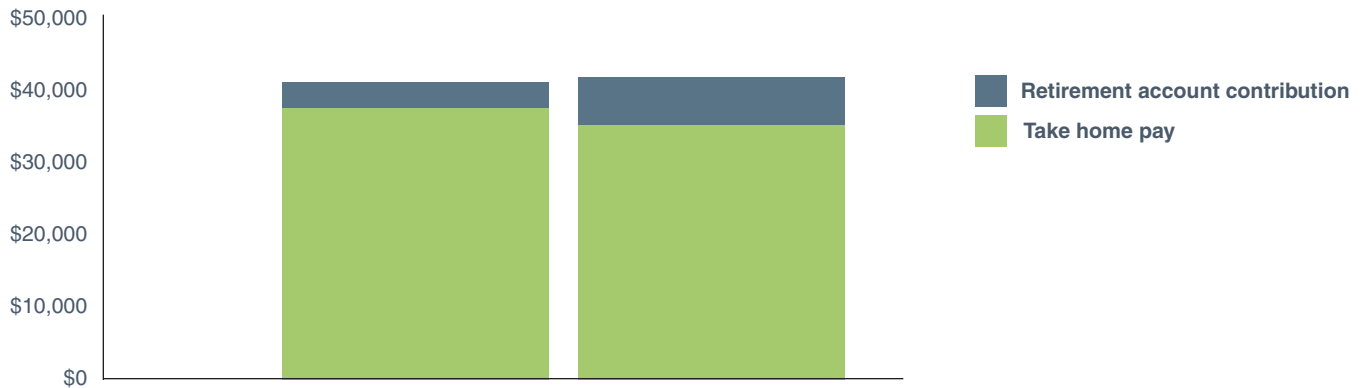


Your contribution	13.0%
Your employer's contribution	3.0%
Total contribution	16.0%

The third gap analysis (above) utilizes a contribution rate halfway between your current one and the suggested rate. The chart on the next page gives you an idea of how your take-home pay will be affected if you decide to increase your contribution from your current level to this rate.

We hope this report will give you a better perspective on how to approach retirement planning. We encourage you to take full advantage of the educational components of the Plan's website and explore the use of target-date funds or the managed account service.

Take home pay and contribution at a 7% vs. 13% deferral rate*



Deferral rate	7%	13%
Gross annual salary	\$50,000	\$50,000
Retirement contribution	\$3,500	\$6,500
Taxable income	\$46,500	\$43,500
Federal taxes*	\$9,294	\$8,544
Take home pay	\$37,206	\$34,956

*This chart takes into account only Federal taxes and does not consider state or local taxes. Taxes are based on the IRS 2010 Tax Rates for a single filer plus 2010 OASDI and Medicare taxes. The 2010 standard deduction of \$5,700 and one exemption (\$3,650) 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.

Act now! Increase your 401(k) contributions and get back on the road to a comfortable and financially secure retirement.

Assumptions used in the charts in this report

Current age	45	Social Security benefit at retirement	\$36,912	Pre-retirement investment return	6%
Current balance	\$69,084	Annual increase in Social Security benefit	2%	Post-retirement investment return	5%
Current salary	\$50,000	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.

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It's easy to increase your deferrals or change your asset allocation.
You can call the Plan Hotline at 1-800-000-000 or visit the plan's
website at www.planwebsite.com.

Department of Human Resources, ACME Company