October 2011

Advice: a practical, prudent approach

Setting a course for retirement security

The curious course of advice

The largest generation in U.S. history is moving into retirement. Indeed, according to the U.S. census, more than 10,000 Americans reach the age of 65 every day. This pattern is projected to continue for the next 19 years, according to the non-partisan Pew Research Center. This translates to approximately 70 million Americans gradually drawing down their accumulated savings. As this sweeping change is unfolding, American workers face continued uncertainty in financial markets, a recession and a weak economic recovery—all of which have contributed to an erosion in confidence about the ability to achieve financial security.

These developments also come against the backdrop of a number of other challenges that impact retirement income: higher healthcare costs, increased longevity, and government-provided guaranteed income that is rarely sufficient to maintain one's desired standard of living (for the average retiree, Social Security replaces only 40% of preretirement income).

The net effect has been a decline in Americans' retirement security. In 2009, research from McKinsey and Company found that the average American couple will face a savings gap of $250,000 at the time of retirement.[1] Retirement account balances continue to struggle to recover from the financial crisis. And by any measure, most American workers have simply not saved enough.

The savings gap is one reason a growing percentage of older Americans are staying in the workforce longer. The labor-force participation rate for men age 55 and older has increased from 37.7% in 1993 to 46.4% in 2010. Similarly, the labor-force participation rate for women 55 and older has increased from 22.8% in 1993 to 35.1% in 2010—the highest recorded level. Among those 65 and older, the participation rate increased from 13.7% in 1975 to 17.4% in 2010.[2]

There is a clear and compelling need to better prepare Americans of all ages—but particularly those 55 and over—for how to achieve financial security in retirement. Many different tools can be deployed to meet this objective, but the financial crisis provided a reminder that many, if not most, individual investors find it difficult to develop, and continually refine, a suitable retirement portfolio. The focus of this paper is how individualized advice can help American workers and their families overcome that difficulty and position themselves to achieve not just greater retirement savings, but also a comprehensive understanding of how to develop an income model that will lead to self-sufficiency in retirement.

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For individualized retirement planning advice to be effective, it must meet a number of criteria. It should be objective, free from conflict, come from a qualified source (such as an advisor that can act as a fiduciary), be reasonably priced and at all times represent the participant's best interests.

The paper highlights the traditional manner in which advice has been disseminated through vendors, and also examines the emerging methods for delivering advice in an age of rapidly changing technology and new consumer standards for personalized information. The topics covered include the integration of advice in today's education and communication curriculums, web-based advice models, and the growing use of qualified advisors, such as registered investment advisors (RIAs). The paper also examines the infrastructure needed to support the growing demand for the highly personalized advice service, as well as the challenge facing plan sponsors to implement best practices that result in advice that is appropriate and in compliance with the rigorous fiduciary standards set forth in the Employee Retirement Income Security Act (ERISA).

How advice has been used historically

For much of the 20th century, the dominant retirement planning model was centered on defined benefit pension systems, which promised a specified monthly benefit at retirement. But that model has become increasingly rare. Only 33% of private-sector employees had access to a defined benefit pension plan in 2008—down from 84% 30 years ago.[3] Replacing defined benefit plans has been a variety of different savings options, which require more responsibility and place greater risk for retirement income security on individual workers.

While greater autonomy and flexibility in retirement planning is aligned with employment trends, there is well-documented evidence that many Americans approach financial planning for retirement with a mix of intimidation and bewilderment.

This confusion underscores the need for reliable, independent, objective and personalized advice—particularly for everyday investors, who have not typically sought out customized financial advice. Unfortunately, less than 30% of Americans who have access to personalized financial advice make use of it.[4] A survey by the Center for Secure Retirement in 2011 revealed that many workers assume that personalized financial advice is too costly to utilize or that their accumulated savings are insufficient to engage the assistance of a professional advisor.

Individuals without access to personal financial advice (or those choosing not to use it) have typically resorted to group sessions at their workplace, or sought information online. This latter option is gaining in popularity, and while the long-term effectiveness has yet to be determined, studies have shown that when participants are left to their own means to create a retirement savings plan, their performance typically lags the market. One glaring deficiency in most online tools is that many of them provide recommendations that are based only on individuals' plan-related investments. In other words, outside savings earmarked for retirement (e.g., a spouse's retirement benefits, IRAs, previous employers' retirement savings plan) are often not part of the equation.

Another obstacle to advice has been the reluctance of many plans to provide it for fear of fiduciary liability. This fear has existed historically due to a regulatory firewall between participant investment discretion and plan advice. In addition, cost inefficiencies associated with hiring multiple vendors—one for recordkeeping and one for advice—have precluded many plan sponsors from offering advice. And until enactment of the Pension Protection Act in 2006, there were no federal regulations governing the provision of advice, so few plan sponsors were incentivized to offer it.

Plan sponsors also have been reluctant to offer advice delivered through advisors on location for fear of fiduciary liability associated with results of the advice provided to their employees. This fear exists in spite of regulatory guidance by the U.S. Department of Labor that if the plan sponsor is acting as the plan fiduciary they are not liable for the investment results of any participant accounts if that participant has selected an investment manager.[5]

The fear of making a poor decision can lead to no decision at all.

However, the Pension Protection Act of 2006, coupled with advancements in technology, has led to an erosion of the firewall between participant investment discretion and advice. As a result, there has been an acceleration of defined contribution plans or self-directed plans adopting individualized investment advice options in recent years. Specifically, the percentage of self-directed plans offering investment advisory services increased from 37% in 2005 to about 50% in 2009.[6] Given the growth of self-directed retirement plans, the complexity of investment options, and the fact that participants have failed to achieve successful retirement incomes when left to their own accord, demand for individual advice is projected to continue rising.[7]

The impact of advice on retirement planning outcomes

The fact that more individuals are failing to make retirement-planning choices that result in successful outcomes, when coupled with the proliferation of investment options and savings vehicles, has increased the need and desire for individually tailored retirement planning advice. Having so many different choices can lead to "paralysis by analysis"—the fear of making a poor decision leads individuals to make no decision at all. The fear is legitimate, as a single mistake in the course of 30 years can severely depress one's retirement outcome.

Additionally, giving participants too many choices can often lead them to make poor choices. Recent research by Columbia Business School and the University of Chicago Booth School Of Business[8] indicates that workers who are faced with multiple investment options ultimately make decisions that can adversely impact their retirement—choosing asset allocations that are unbalanced, or choosing to do nothing and leaving their savings in cash and money markets.

This research highlights the need for participants to seek help from qualified advisors who can offer investment selection and asset allocation guidance throughout the accumulation phase. Using qualified advisors is even more important at a time when there is heightened anxiety about retirement security. Research has shown this anxiety triggers a number of emotions when individuals approach retirement planning, including fear and distrust. These emotions can serve as an obstacle to getting advice, and ultimately lead many individuals to either take foolish, risky and imprudent actions, or no action at all.[9]

As Olivia Mitchell and Stephen Utkus write in their book, *Pension Design and Structure: New Lessons in Behavioral Finance*, investors who have not received advice tend to use "a naïve heuristic—avoid extremes, pick the middle option—rather than maintain a consistent set of well-ordered risk preferences to select from the investments offered." Furthermore, according to the authors, "[M]any plan participants seem to lack well-formed investment preferences."

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A limited menu with diverse choices can facilitate rational investment selection.

A key part of the solution to this problem is objective, noncommissioned advice focused on building a diversified portfolio consistent with individuals' goals and risk tolerance. A 2009 survey shows that those individuals working in higher education who are approaching retirement age are focused on securing an income that can maintain their standard of living. And they're seeking advice. Nearly 9 in 10 (87%) said that advice about retirement income strategies is important to them. And in the two years preceding the survey, 60% of respondents had sought out objective retirement planning advice.[10]

It's clear that providing a limited menu that offers a diverse selection of investment choices, along with objective advice, can help facilitate rational investment selection and prudent portfolio construction. Indeed, high-quality individualized advice is a critical ingredient in the recipe for seeking retirement security, as it leads to more rigorous decision-making and improved savings outcomes. **According to a study published in the May 10, 2006 issue of BenefitNews.com, retirement plan participants who received personalized advice saved 140% more than those who had not received advice. The article pointed out that the recipients of advice, "save more, save smarter and take an overall greater interest in their financial health."**

But one of the challenges associated with advice is that even when participants receive it, they don't always act on it. A 2009 survey of higher education near-retirees found that among those who have consulted with a financial advisor within the past two years, 17% report always implementing the recommendations of their advisor(s) and an additional 52% implement their advisor's recommendations most of the time.[11] That still leaves a significant percentage that did not follow their advisor's recommendation. A likely reason for non-implementation among some is trust; 75% of those who typically do not implement an advisor's recommendations view the advice as biased compared with 55% of those who typically implement the advice. Addressing a trust issue is important given that concern over various aspects of retirement planning is lower for those implementing the advice they receive compared to those who receive but do not implement advice.[12]

Other surveys reinforce these findings. According to a 2010 Hewitt/Financial Engines study, there is a 25% usage rate when participant advice is offered. Time, plan design (auto enrollment teamed with a qualified default investment alternative [QDIA]) and participant demographics did, however, play a key role in determining usage.[13]

The challenges of offering advice

For plan sponsors, delivering customized advice raises fiduciary and compliance concerns. Fiduciary responsibilities in particular have become a more prominent concern for retirement plan sponsors with the increase in regulatory and plaintiff attorney attention. A 2010 study of plan sponsors highlighted the challenge associated with compliance. The study found that while 74% of respondents believe they are fully compliant, 45% say they have difficulty even understanding the regulations.[14]

In a 2010 Deloitte survey, 653 plan sponsors were asked whether they provided individual financial counseling/investment advice. Fifty-one percent said they did, and an additional 16% said they were considering adding this feature in the next two years. But among those plans that do not offer financial counseling or investment advice, the potential fiduciary responsibility associated with offering advice was the top reason for not offering it, cited by 60%.[15]

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The sensitivity of advice and who is responsible for it prompted the U.S. Department of Labor to propose more rigorous standards under the Employment Retirement Income Security Act (ERISA) with respect to who is a fiduciary for providing plan sponsor and participant advice in order to hold more advisors and appraisers responsible under ERISA for the advice and appraisals they provide. The Labor Department, responding to criticism and pressure from Congress and the financial community, withdrew the proposal in September 2011. But, it will be reintroduced in early 2012, with the extra time being used to make the proposal "more straightforward and more clear." While it is unclear whether the proposed regulation will become law, advisors should be prepared to respond in the event these standards, if adopted, result in new compliance requirements.

Fiduciary responsibility and suitability aside, it is clear that more and more sponsors recognize the value of individualized advice and how it will benefit plan participants.

Fiduciary responsibility and participant advice

- ERISA Regulation 2550.404c-1(c)(4) provides that there is no obligation to provide investment advice to participants in an ERISA 404(c) plan.[16]
- Interpretive Bulletin 96-1 references the 404(c) provision that there is no obligation to provide participant advice.[17]
- Plan sponsors who offer advice must weigh the fiduciary risks when making independent advice available to their plan participants.
- Plan sponsors who elect to offer access to independent advisors in a 404(c) plan are not liable if the investment advisor is not designated.[18]
- Plan sponsors can minimize risk under ERISA Section 404(c) by allowing participants to choose among undesignated investment advisors or a broad universe of designated investment advisors while providing participants with the control to select their own investment advisor representative.

The new advice age

There are a number of drivers behind the demand for advice today.

Market volatility
Recent uneven market performance has triggered a decline in confidence about retirement security, and the lack of confidence has persisted. An Employee Benefit Research Institute survey released in March 2011 found that 27% of workers were not at all confident about having enough money for a comfortable retirement—the highest level measured in the survey's 21 years. And just 13% were very confident about having enough money to retire comfortably—a record low level that was also measured in 2009.[19]

Against the backdrop of this uncertainty, workers are determined to be better prepared in the event of a sustained market decline. This sentiment frequently translates to a search for professional help—particularly among baby boomers who are nearing retirement and can't afford sharp declines in their retirement savings. The corresponding shift in focus to retirement income—and guaranteed income in particular—to achieve retirement security creates a greater interest in seeking the advice of financial professionals who can help them make better asset allocation decisions among equities, fixed income and cash equivalents.

A recent survey by the TIAA-CREF Institute found that two-thirds of near-retirees (age 50–70) in higher education are concerned about outliving their savings and about choosing the best way to draw income from their retirement savings. In addition, 58% of higher education near-retirees considered it very important as they near retirement to receive advice regarding drawing income from retirement savings; an additional 29% viewed it as somewhat important.[20]

Regulatory environment
As regulations covering fiduciary responsibilities continue to evolve, the likelihood is there will be a greater focus on integrating advice into retirement offerings, especially once the definition of a fiduciary is further clarified.

There is a heightened awareness that retirement planning and readiness is an individualized experience.

Budget expectations
Offering individualized advice may help plan administrators address the dual challenge of cutting costs while also preserving entitlements. By helping to improve outcomes, advice may enable administrators to reduce the entitlements.

Economic climate and demographics
The weakness of the U.S. economy, which is reflected in the high unemployment rate, coupled with the depressed housing market, has led participants to intensify their focus on maximizing their retirement savings accumulations to generate future retirement income, while still meeting their current obligations. Obtaining quality advice is recognized as a tool to help individuals find this balance.

Demand for advice is also being driven by the aging of the U.S. population, coupled with increased longevity. As individuals grow older, and live longer, they need more income to achieve retirement security, and quality advice can help them meet this objective. Along the same lines, the potential for Social Security and Medicare benefits to be reduced, and for healthcare costs to continue to rise, deepens the retirement security challenge.

Encouraging good decision-making
Advisors tend to obtain a high deferral rate out of participants. Advisors also help prevent participants from taking rash actions during volatile markets, which makes it possible for these participants to realize the gains associated with a market recovery.

Sponsor expectations
Using an advisor to deliver communications, education and advice can create efficiencies for plan administrators—enabling them to keep their focus on their day-to-day responsibilities while reducing costs. Partnering with an advisor who assumes fiduciary responsibilities further helps the plan sponsor fulfill their own responsibilities as a fiduciary. Advisors also foster investment objectivity, which reinforces the choices that administrators are required to deliver as part of their fiduciary responsibilities.

Participant expectations
Participants are seeking personalized advice that is reasonably priced, objective and transparent, with the end goal of helping them to accumulate a larger pool of retirement savings to generate future retirement income. While retaining a personal investment advisor comes at a cost, participants can expect to see better results with professional guidance in their overall retirement planning effort.

There is a heightened awareness that retirement planning and readiness is an individualized experience. While mass marketing and communication can play a valuable role in reaching participants (and potential participants), the demand is for individualized planning that will enable participants to meet their retirement needs.

Emerging advice models

Even if retirement plans are designed to make it easier for workers to receive personalized advice, and to save appropriately, are these workers likely to take advantage of the advice offering? Developments in behavioral finance and technology, and the expanded use of registered investment advisors, provide hope for progress in more widespread retirement security.

Behavioral finance
Behavioral economists have been conducting extensive research to determine how the design of a retirement system can influence participant behavior. Much of the literature has focused on overcoming, or leveraging, apparently negative tendencies, such as inertia and risk aversion, with new plan features and approaches.

For example, when plan sponsors automatically enroll workers in a retirement plan, participation rates rise quite significantly, as do contribution levels. Sponsors often elect to utilize a qualified default investment alternative (QDIA) for auto-enrollment for fiduciary protection, thereby eliminating the need for individualized advice. But individualized advice remains a key component of such offerings, since research has shown that auto-enrollment services can also lead to inertia, as participants' lapse into a mindset of "set it and forget it."[21] Advice can help ensure that as retirement needs evolve, and as market conditions change, participants' portfolios can be adjusted accordingly.

With defined contribution plans, participation has historically been voluntary on the part of eligible workers. One-quarter of those eligible choose not to participate in a plan. Some choose not to participate for financial reasons; others for behavioral reasons, such as simple inertia, which seems to be a powerful influencer in retirement planning. Private and public efforts have been made to keep people on the right track through programs like auto-enrollment and auto-escalation, anticipating that just as investors are not motivated to move to retirement plan savings nor will they be motivated to move out of retirement plan savings.

Definition of an advisor

For purposes of this report, we focus on fee-based advisors. A fee-based advisor is someone who, at a minimum, has passed the Series 65 exam. The exam is administered by the Financial Industry Regulatory Authority (FINRA). Passing the Series 65 will qualify an investment professional to operate as an Investment Advisor Representative in certain states. Besides passing the Series 65, the Advisor must pay a fee and have a clean criminal record. For example, a felony prohibits someone from becoming an Advisor. This prohibition also appears in ERISA Section 411 which outlines those activities which prevent someone from serving as a fiduciary or service provider to a retirement plan. An Advisor is typically responsible for rendering investment advice to a retirement plan or plan participant for a fee. The challenge retirement plan sponsors and plan participants have is selecting an Advisor that has expertise they lack to justify the fee the Advisor charges. Expert Advisors are determined to be experts based upon the Daubert Supreme Court decision and the Federal Rules of Evidence under Rule 702. Both bodies of knowledge are supported by academia's research reflected in the Cambridge Handbook of Expertise and Expert Performance. In combination with a properly constructed vetting process and evaluated in accordance with the fiduciary standards of ERISA, an advisor's level of expertise can be determined to ensure they can achieve the objectives of the plan or plan participant.

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More providers are focusing on covering participants to, and through, retirement.

One innovative program is the Save More Tomorrow program, which was developed by The University of Chicago's Richard Thaler and UCLA's Shlomo Benartzi.[22] It is based on two sample plan amendments in IRS Notice 2009-65 that enable employers to add automatic contribution features to their 401(k) plans. In Thaler and Benartzi's first case study of the Save More Tomorrow program, participants increased their set-aside rate from 3.5% to more than 13%. Dr. Benartzi has written that more than half of large employers in the United States now offer the program.

Harnessing the emerging breakthroughs in behavioral finance can help plan sponsors deliver advice more effectively, and ensure it is more accessible to participants.

Technology
Technological progress will also influence advice. Online discussions, video chats and podcasts are just a few of the innovations that will make delivery simpler and more cost effective for plan sponsors and their participants. And individuals will be able to access more comprehensive information about their investment portfolios and do so in more ways—all at a time and on a device of their choosing. The simplicity and accessibility afforded by technology will also help to mitigate fear and anxiety about retirement planning and foster the understanding that is a key to long-term retirement security.

Plan providers
More and more retirement plan providers are focusing attention on delivering a retirement model for plan participants that cover them to, and through, retirement. While the model continues to evolve, it generally calls for leveraging technology to provide improved access to tools that forecast income needs at retirement, based on current savings accumulations. These forecasts help participants understand shortfalls in their current accumulation efforts when compared to income needs in the future. Communication and education curriculums, along with on-site retirement planning professionals supplied by the service provider, can also make a dramatic difference in establishing the appropriate contribution level to meet future retirement income needs for participants.

Providers have also made significant improvements in linking the investment options within a plan to retirement income objectives, helping plan participants align their personal risk/reward tolerance with available investment choices. A few providers have gone a step further and designed a "to and through" retirement model that integrates communication and education with wealth management expertise. This model affords participants a level of holistic financial advice tailored to their unique circumstances, and accounts for all of their assets that may contribute to meeting retirement income needs.

Registered Investment Advisors (RIA)
As demand for personalized advice has expanded, the registered investment advisor role has been gaining increased favor among plan sponsors and providers.[23] While RIAs have a long history of offering advice, there is heightened recognition of the important role they can play in helping participants achieve their retirement objectives. RIAs are particularly well equipped to provide sponsors and participants with a level of service that other financial professionals find difficult to provide. This service includes assistance with budgeting, fulfilling fiduciary obligations, and crafting participant education and communication materials focused on increasing retirement savings.

Sizing the advice offer

Best practices
For plan sponsors, a number of different tools can be used to enhance retirement planning offerings, and the advice that accompanies them. These include calculators, PowerPoint presentations, risk assessment models, goal assessments, and Monte Carlo simulations, which are used to replicate market certainty to derive a projected value of select portfolios.

Partnering with plan providers can lead to advice being integrated with plan communication and education curriculums. Quarterly statements can reflect how acting on customized advice has shaped participants' returns. Statements can also include estimates and projections of retirement readiness based on participants' current contribution levels and selected plan investments.

Partnering with those plan providers and registered investment advisors that have demonstrated expertise in designing and delivering individualized advice is critical to ensuring that plan participants have access to high-quality advice and counsel.

These "best practices" aren't simply a loose collection of administrative tasks but rather a cohesive set of policies and processes that support an overarching goal: reducing risk for plan sponsors while increasing the likelihood of successful outcomes for participants.

Service provider selection and due diligence

The need for plan sponsors to properly fulfill their fiduciary responsibilities underscores the importance of due diligence on their part when selecting any service provider. General criteria to consider when choosing service providers should include:

1 Can this service provider meet the special considerations needed for your plan?

2 Checklist for objective qualifications:

- Size of staff (be sure to identify individual(s) who will be handling your account)
- Professional certifications and/or registrations
- Relevant training and experience
- Performance record
- References
- Technical capabilities
- Financial condition and capitalization
- Insurance/bonding
- Litigation
- Termination by other clients and reasons

3 Make a comparison of fees to industry standards.

4 Have a written agreement documenting the services to be performed and the related costs.

5 Does your plan have a **conflict of interest policy** that governs business and personal relationships between fiduciaries and service providers and among service providers? Does your plan require disclosure of relationships, compensation and gifts between fiduciaries and service providers and among service providers?

Additional issues in *monitoring* a service provider

1 Define the process for monitoring the service provider and determine who is responsible.

2 Review written reports and determine the frequency with which you need them.

3 Are the reports consistent with the contract?

4 Do the written reports provide sufficient information to evaluate performance when compared to benchmarks of the industry?

5 Establish a process to either (a) correct any non-conformance with guidelines/ contract, or industry standards; or (b) to terminate the service provider and retain a successor.

6 If the responsibility to monitor the service provider has been delegated, have the individual(s) acknowledge the accepted fiduciary responsibility in writing.

Advice and consent in summary

As plan sponsors develop advice offerings, they should ensure these offerings are integrated into plan communication and education materials. Sponsors can also provide participants with estimates and projections of retirement readiness, based on current contribution levels and selected plan investments.

To ensure continued satisfaction among plan participants, sponsors should monitor and measure outcomes connected to their advice offerings. This can take the form of surveying the participant base to gauge the level of confidence in retirement planning and whether it has changed. Another important data point to monitor and continually review is contribution levels. A high percentage of participants maximizing their contributions can suggest confidence in the plan and its offerings. Conversely, low contribution levels can be a signal that participants are dissatisfied.

If sponsors discover low participation rates and/or low contributions, one place to look for improvements is the advice offering. Is it failing to meet the needs of plan participants? If so, why? Similarly, plans without an advice offering can handicap the ability of participants to invest with confidence—a factor that is likely to lead to lower contribution levels and, in the long run, undermine their ability to meet their retirement income needs.

Conclusion

The economic and market volatility of the past few years has underscored the retirement security challenge facing millions of Americans. With an expanding segment of the baby boom generation beginning to move into retirement, frequently with inadequate savings, the challenge is even more daunting.

One of the keys to meeting this challenge will be ensuring that workers have access to retirement information and advice that is tailored to their individual needs. Individualized advice can help individuals develop a plan for achieving not just increased saving, but also an income model that will enable self-sufficiency in retirement. And with demand for advice projected to continue growing, its delivery will become more sophisticated and more personalized, and will be accessible to a broader segment of retirement plan participants.

Another challenge connected to retirement security is the "inertia" that frequently sets in when individuals are planning their retirement. To overcome this inertia, individuals must not only receive advice—they also need to be able to implement it free of unnecessary obstacles. An advisor's role in the implementation of advice can make a big difference in the final outcome. Objectivity on the part of the investor is necessary when considering investment advice, but just as important is the willingness to act decisively on that advice.

Expanding access to individualized advice, ensuring it is easy to implement and focused on developing a comprehensive plan to generate income, can help to usher in a new era of retirement security, and create a new generation of retirees who are informed, confident and capable of achieving lifetime financial security.

Advisor Services

Rob Rickey
Director, Advisor Services
TIAA-CREF Financial Services
730 Third Avenue, 13th floor
New York, NY 10017
Telephone: 212 916-4504
Cell: 917 861-3294
Fax: 212 916-6025
rrickey@tiaa-cref.org

Consultant Relations

Tony Cox
Vice President, Head of
Consultant Relations
TIAA-CREF Financial Services
Six Concourse Parkway, Suite 2600
Atlanta, GA 30328-6104
Telephone: 770 512-3546
Cell: 678 296-7783
Fax: 770 399-5469
tcox@tiaa-cref.org

Strategic Sales

David B. Ray
Vice President of Strategic Sales
TIAA-CREF Financial Services
2850 Lake Vista Drive, Suite 200
Lewisville, TX 75067
Telephone: 214 626-8321
Cell: 972 768-6432
Fax: 214 488-3214
dray@tiaa-cref.org

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[16] No obligation to advise. A fiduciary has no obligation under part 4 of title I of the Act to provide investment advice to a participant or beneficiary under an ERISA section 404(c) plan. 29 CFR 2550.404c-1(c)(4)

[17] Compliance with this condition, however, does not require that participants and beneficiaries be offered or provided either investment advice or investment education, e.g., regarding general investment principles and strategies, to assist them in making investment decisions. 29 CFR 2550.404c-1(c) (4).

[18] "In addition, F also has no duty to determine the suitability of G as an investment manager because the plan does not designate G as an investment manager." 29 CFR 2550.404c-1(f)(9)

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