DC Investment and Choice: Lessons from U.S. 401(k) Plans

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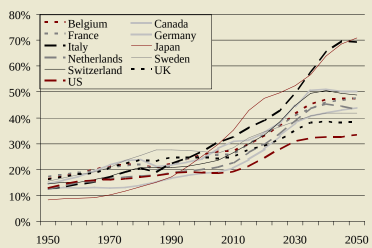
Pay-as-you-go pension costs are rising everywhere.

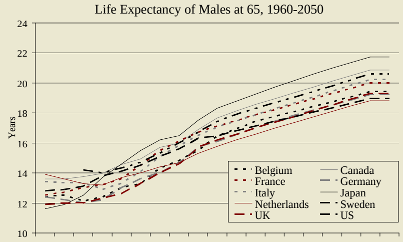
Ratio of the Population age 65 and over to the Population Age 15-64, 1950-2050



Source: United Nations Population Division. 2005. *World Population Prospects: The 2004 Revision Population Database*.

Rising public pension costs reflect increasing life expectancy

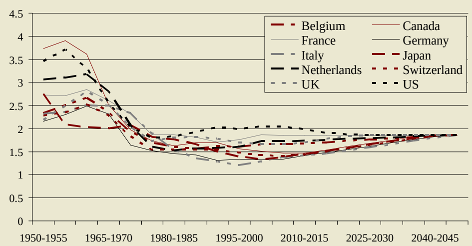
Life Expectancy of Males at 65, 1960-2050



Sources: Organisation for Economic Co-operation and Development. 2005. *Society at a Glance: OECD Social Indicators - 2005 Edition*. Table HE1. Life Expectancy; and United Nations Population Division. 2005. *World Population Prospects: The 2004 Revision*. File 5, Obtained via email.

and very low fertility rates.

Fertility Rates, 1950-2050



Source: United Nations Population Division. 2005. *World Population Prospects: The 2004 Revision Population Database.*

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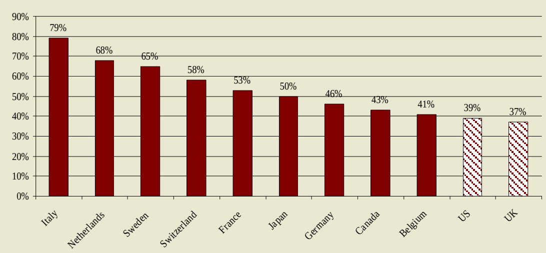
Problem is less serious in U.S. and U.K. because benefits are low.

Gross Replacement Rate at Average Earnings, 2002



Source: Organisation for Economic Co-operation and Development. 2005. *Ageing and Pension System Reform: Implication for Financial Markets and Economic Policies.*

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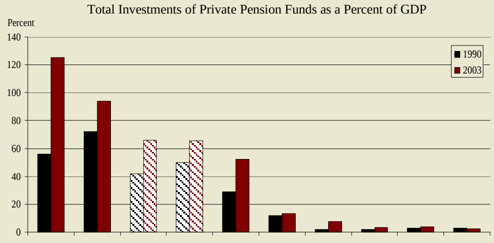
Rising pay-as-you-go costs have produced a shift to private funded plans.

Total Investments of Private Pension Funds as a Percent of GDP



Note: Switzerland data are 2002, not 2003.
Sources: Ignazio Visco. 2005. *Ageing and Pension System Reform: Implications for Financial Markets and Economic Policies;* and Jean-Marc Salou and Juan Yermo (Editors). 2005. Pension Markets in Focus. *OECD Newsletter* Issue 1.

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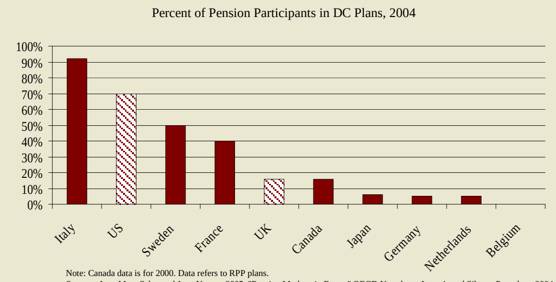
Within private plans, U.S. and Italy lead in shift to defined contribution.



Note: Canada data is for 2000. Data refers to RPP plans.
Sources: Jean-Marc Salou and Juan Yermo. 2005. "Pension Markets in Focus." OECD Newsletter Issue 1; and Silvana Pozzebon. 2004. "The Future of Pensions in Canada." *Pension Research Council Working Paper* 2004-15.

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The U.S. provides a cautionary tale on how choice affects DC outcomes.

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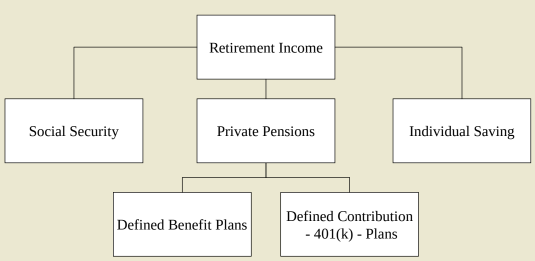
U.S. retirement income system is a three-legged stool.



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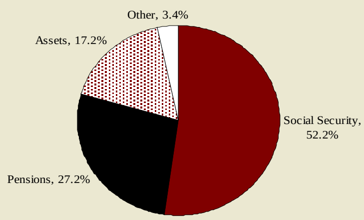
The private pension system plays an important role in the United States.

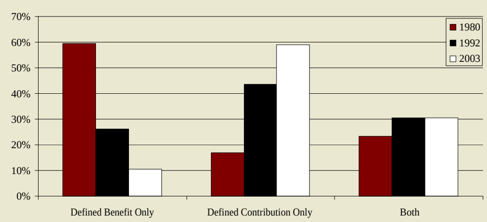
Percent of Non-Earned Retirement Income of those 65 and older by Source, 2004



Source: Bureau of Labor Statistics. 2005. *Current Population Survey* and Author's calculations.

But private pensions have changed; most now rely on individual accounts 401(k) plans.

Percent of Private Sector Wage and Salary Workers with Pension Coverage by Type of Plan from Form 5500, 1980-2003

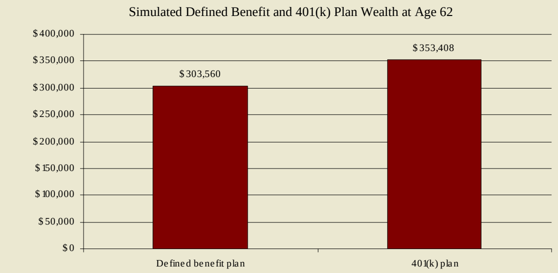


Source: U.S. Department of Labor. 2004. *Private Pension Plan Bulletin, Abstract of 1999 Form 5500 Annual Reports* and author s updates.

Why did private pensions change?

- Shift away from large manufacturing firms
- Employees like them
  - Benefits are portable
  - Control over investments
- Employers like them
  - Smaller contributions
  - Employee bears risk
  - Cheaper to administer

In theory, steady 401(k) contributions could produce a lot of wealth.



Source: Alicia H. Munnell and Annika Sundén. 2004. *Coming Up Short: The Challenge of 401(k) Plans*. Brookings Institution Press.

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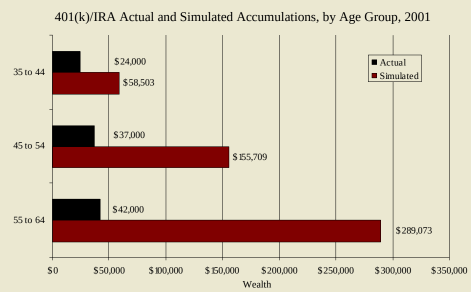
But, in practice, actual accumulations fall short.



Source: Alicia H. Munnell and Annika Sundén. 2004. *Coming Up Short: The Challenge of 401(k) Plans*. Brookings Institution Press.

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Why? Because 401(k) plans shift all decisions & risks to the individual.

- Participation
- Contributions
- Initial asset allocation
- Company stock
- Asset allocation over time
- Cashing out when changing jobs
- Withdrawing funds in retirement

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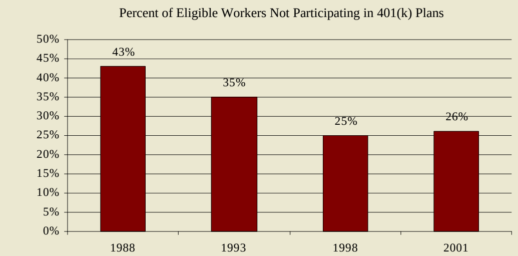
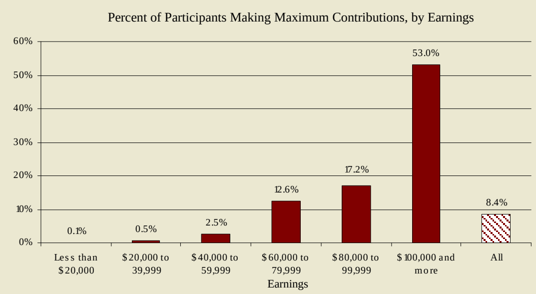
Despite improvement, 26 percent of eligible workers fail to participate.



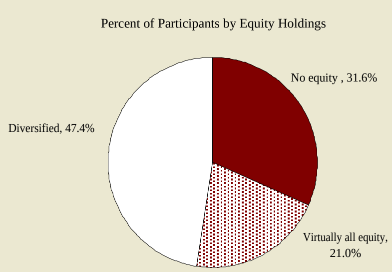
Sources: Bureau of Labor Statistics. 2003. *Current Population Survey*; and Board of Governors of the Federal Reserve System. 2003. *2001 Survey of Consumer Finances*.

Only 8 percent of 401(k) participants contribute the maximum.



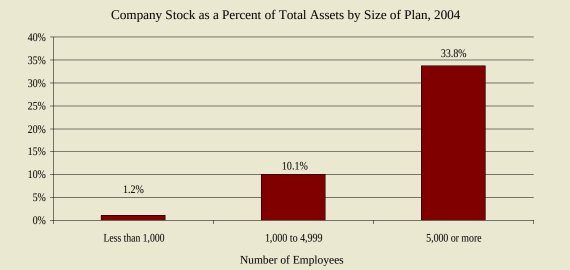
Source: Authors calculations based on Board of Governors of the Federal Reserve System. 2003. *2001 Survey of Consumer Finances*.

More than half of 401(k) participants fail to diversify.



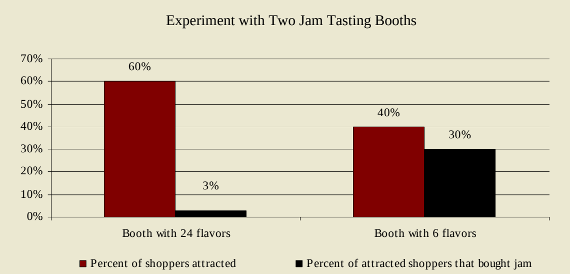
Source: Sarah Holden and Jack VanDerhei. 2005. Employee Benefit Research Institute Issue Brief 285: *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2004*.

401(k) participants over-invest in company stock.



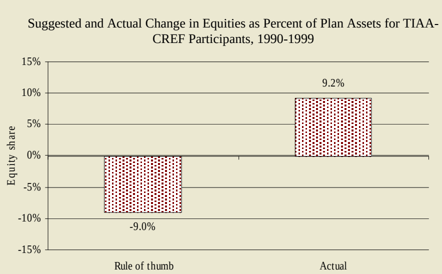
Source: Profit Sharing/401(k) Council of America. 2005. *Forty-Eighth Annual Survey of Profit Sharing and 401(k) Plans.*

Bad investment decisions could be result of too much choice.



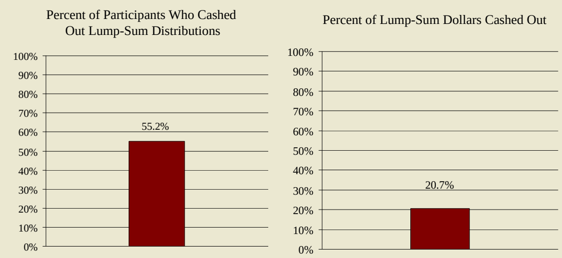
Source: Sheena S. Iyengar and Mark R. Lepper. 2000. When Choice is Demotivating: Can One Desire Too Much of a Good Thing? *Journal of Personality and Social Psychology* 79(6): 995-1006.

401(k) participants don t re-balance their accounts.



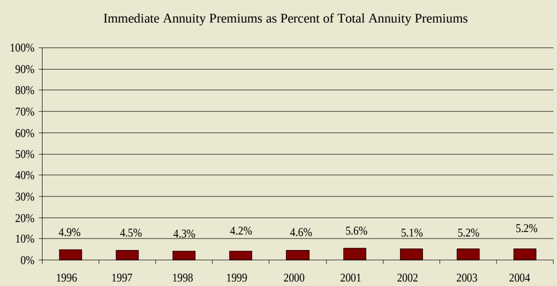
Source: John Ameriks and Stephen P. Zeldes. 2001. "How Do Household Portfolio Shares Vary with Age?" Working Paper 6-120101. *Employee Benefits, Compensation, and Pension Law* 2 (22): November 29. TIAA-CREF Research Institute.

Most 401(k) participants cash out when they change jobs.



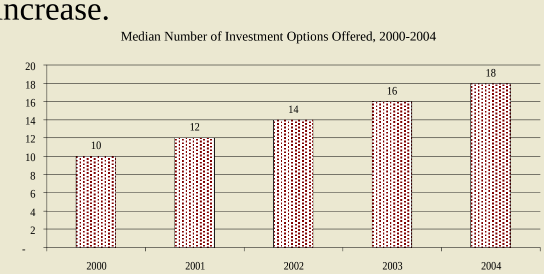
Source: Authors calculations based on Board of Governors of the Federal Reserve System. 2003. *2001 Survey of Consumer Finances*.

And people don t annuitize.



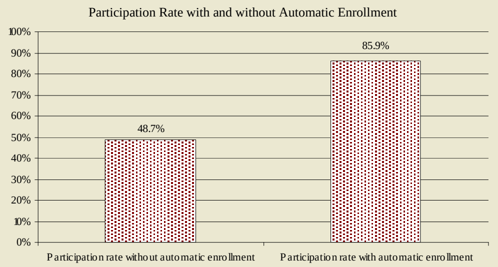
Source: LIMRA International. 2002. *The 2001 Individual Annuity Market: Sales and Assets* and updates from LIMRA International.

So how could these accounts work better? Limiting choice would help, but options increase.



Source: Fidelity Investments. 2005. *Building Futures Volume VI: How Workplace Savings are Shaping the Future of Retirement.*

Putting them on auto pilot is also important.



Source: Brigitte C. Madrian and Dennis F. Shea. 2002. "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior." *Quarterly Journal of Economics* 116(4).

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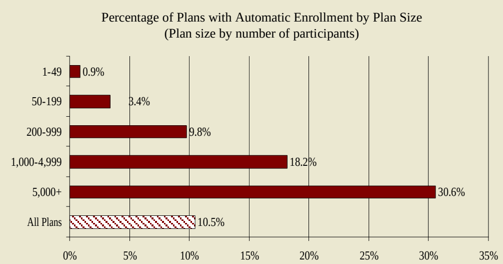
To date, more than 30 percent of large plans have adopted automatic enrollment.



Source: Profit Sharing/401(k) Council of America. 2005. *48th Annual Survey of Profit Sharing and 401(k) Plans.*

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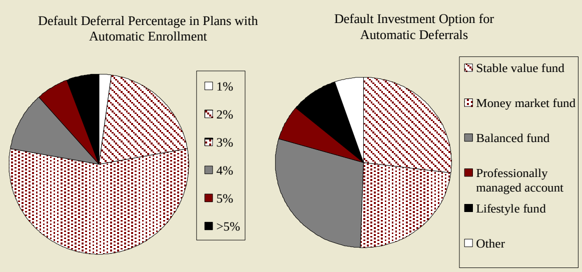
But default contribution typically 3 percent and default investment typically low yielding.



Source: Profit Sharing/401(k) Council of America. 2005. *48th Annual Survey of Profit Sharing and 401(k) Plans.*

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Need a comprehensive solution to improve 401(k) outcomes.

Problem	Default
Too few participants	Automatic enrollment
Too low contributions	Automatic increase in default rate
Lack of diversification	Automatic asset allocation
Too much company stock	Automatic allocation
No re-balancing	Life-cycle funds
Too much cashing out	Automatic rollover
Too little annuitization	Automatic annuitization

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Conclusion:

- Rising public pension costs lead to search for alternatives.
- Funded individual accounts relieve government budget.
- U.S. experience shows too much choice produces too little retirement income.

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