Improving 401(k) investment performance

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INSIDE

Introduction

Public policies toward private pensions reflect a fundamental tension between free choice and paternalism. When people act in their own best interest without harming others, government intervention is unwarranted. But a key motivation for public policies to subsidize retirement saving in the first place is the belief that, without such subsidies, people would fail to act in their own best interest in making saving and investment choices.

A striking example of this tension relates to employees' freedom to choose how their 401(k) accounts are invested. Self-direction of investments is a common feature of 401(k) plans, but it is not working as well as it could. Employees frequently fail to diversify their investments or rebalance portfolios over time. One of the most dramatic failures is that workers often overinvest in their employer's stock. These errors can prove costly, as demonstrated by the plight of Enron employees. Overinvested in employer stock, they lost not only their jobs but much of their retirement savings. But even when the plan sponsor does not collapse, poor investment choices impose unnecessary risk on workers, threaten the level and security of retirement income, and reduce the public policy benefits from 401(k) tax subsidies.

Given the prevalence of 401(k) plans, workers' widespread inability to make appropriate investment choices is a first-order concern. This brief summarizes the key conclusions discussed at the June forum on the nature and sources of the underlying problem and potential solutions. Emerging evidence shows that default choices can strongly influence — and, from the perspective of

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economic decision making, improve — participation and contribution behavior in 401(k)s. A similar approach for asset allocation and investment options, while still preserving employees' option to self-direct their accounts if they so choose, could be one solution to poor asset allocation choices.[2] Even without establishing such a default, conference participants generally agreed that encouraging employers to promote diversification (for example, by reducing concentrations in employer stock, allowing 401(k) participants access to diversified mutual funds and/ or making available independent investment expertise and management) could substantially improve 401(k) asset allocation. Plan sponsors that offer certain qualifying investment arrangements could receive a measure of safe harbor fiduciary protection. These types of solutions deal simultaneously with the frequently poor investment choices made in 401(k)s and the specific problem of overconcentration in employer stock.

BACKGROUND

On June 10, 2004, The Brookings Institution held a forum called "Improving 401(k) Asset Choices: Avoiding the Next Enron." This event, which was funded by the Social Security Administration through a grant to the Center for Retirement Research at Boston College, featured prominent experts from government, academia, and the private sector on how to promote more diversified 401(k) investments. The event attracted an attentive and engaged audience interested in emerging solutions.

William Gale, of The Brookings Institution, moderated the event. Alicia Munnell, of Boston College, discussed how certain types of investment choices can undermine 401(k) participants' retirement security. Richard Thaler, of the University of Chicago, picked up this theme, describing the drawbacks of employer stock and summarizing the results from a recent survey, which examines why many employees and employers like employer stock anyway.[1] Author David Wray, of the Profit Sharing/401(k) Council of America, took issue with Thaler's criticisms, saying that studies have shown that employer stock boosts productivity and, overall, has proven to be a positive economic force. Congressman Ben Cardin (D-MD) explained that the focus of legislative action on pensions in recent years has been on increasing contribution limits and making it easier for companies, to establish plans. Mark Iwry, of The Brookings Institution, outlined a variety of policy changes that could help encourage better asset allocation choices and accelerate the emergence of related private sector initiatives. Michael Henkel, of Ibboston Associates, discussed his firm's involvement in providing a professionally-managed 401(k) account option, an approach that is gaining popularity. John Kimpel, of Fidelity Investments, described two ways in which his company attempts to improve asset allocation: 1) by offering a number of diversified age-based mutual funds in which the asset allocation automatically changes over time; and 2) by offering professionally-managed accounts as described by Michael Henkel.

Sources of the problems

The current situation reflects two underlying trends. First, the current 401(k) plan, while similar in structure to the 401(k) of the early 1980s, has come to play a far more central and critical role in the pension system. Second, Congress has enacted rules encouraging self-directed investments and overinvestment in company stock, while doing little to help workers manage the responsibilities arising from the dramatic shift toward 401(k)s.

Twenty five years ago, defined benefit plans (together with certain types of traditional defined contribution pension plans — such as employer-funded profit-sharing plans and money purchase plans) were workers' primary source of private pension coverage. These plans require workers to make almost no important financial choices before retirement. The firm enrolls all eligible workers, makes contributions, and makes investment decisions (or retains professional investment managers). The worker's only real choices are when and in what form to collect benefits.

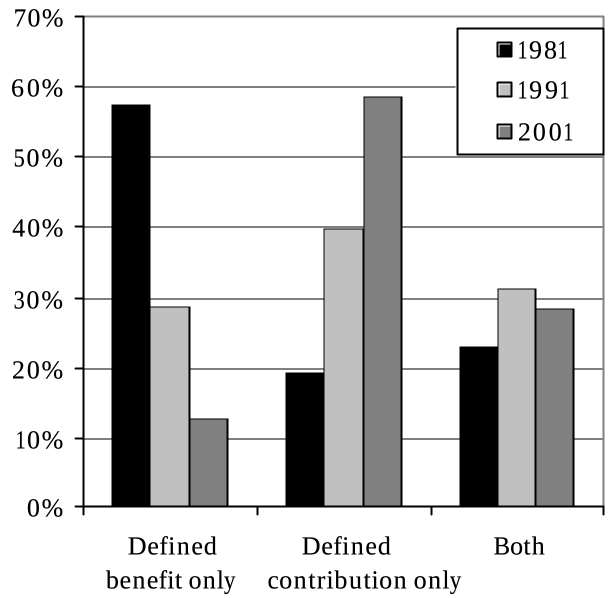
When 401(k) plans began to diffuse rapidly in the early 1980s, they were viewed mainly as supplements to employer-funded pension and profit-sharing plans. Since 401(k) participants were presumed to have their basic retirement income security needs covered by an employer-funded plan and Social Security, they were given substantial discretion over 401(k) choices, including whether to participate, how much to contribute, how to invest, and when and in what form to withdraw the funds. At the time, this arrangement reasonably balanced paternalism and choice.

Over the past 25 years, however, the pension landscape has changed dramatically. Most workers covered by an employer plan now have a 401(k) as their primary or only plan (see Figure). Yet 401(k)s still operate under the old rules. Workers continue to have almost complete discretion over whether and how much to contribute, how to invest, and how and when to withdraw the funds. While allowing workers to make such choices may have been relatively harmless when 401(k)s were smaller, supplemental plans with limited coverage, the risks of having workers make poor investment choices loom much larger when 401(k)s become the primary pension vehicle.

Policy design is partly responsible for this situation. First, the Employee Retirement Income Security Act of 1974 (ERISA) relieved employers of most fiduciary responsibility for investment losses if they allowed employees to direct their own investments, which likely encouraged the shift to 401(k)s. Second, the main exception to the pervasive use of employee-directed investment in 401(k)s has been plan sponsors' frequent decision to contribute employer stock. Although this tendency undermines diversification and also might normally be considered a conflict of interest, Congress actually granted special exceptions from the normal fiduciary standards to allow plans to be heavily invested in employer stock.

With the expansion of 401(k)s, employer stock has moved from a supplemental to a far more central place in the pension landscape. For example, in plans that allow employer stock as an investment option, 46 percent of participants (about 11 million employees) hold more than 20 percent of their account balance in employer stock, and one-sixth hold more than 80 percent of their account in employer stock.[3] Meanwhile, the rationale originally articulated for providing special exceptions for employer stock — encouraging worker ownership of equities — has already been addressed by the availability of diversified equity investments through 401(k)s. Other potential rationales — attempting to encourage productivity through worker ownership and encouraging employers to contribute to retirement plans — may not justify the full extent to which employer stock has come to dominate so many workers' 401(k) portfolios.

Figure. Percent of Wage and Salary Workers with Pension Coverage by Type of Plan, 1981-2001



Source: Munnell and Sundén (2004).

Inadequacy of Policy Responses

Congress has not acted on the specific problem of overinvestment in employer stock. The problems at Enron did create a flurry of discussion and some proposals aimed at reducing the influence of employer stock. But, while the current major legislative proposals would limit plan sponsors' ability to require participating employees to invest in employer stock (with broad exceptions for employee stock ownership plans), they would allow employees — with the effective encouragement of corporate management — to continue overinvestment of retirement funds in employer stock. As a result, the proposals would not prevent future Enron-type catastrophes, because most 401(k) overinvestment in employer stock is not literally required by employers. It stems instead from a combination of employee inertia, uncertainty, optimism, peer group reinforcement, concern about appearing disloyal to the company, and encouragement from management. Moreover, the current legislative proposal to require a notice to 401(k) participants regarding the virtues of diversification could likely prove ineffectual if it were seen as just required "boilerplate" language from the federal government.

Another proposal would relax current fiduciary standards to allow investment fund providers to offer advice on investing in their own funds (as well as their competitors') to workers. This approach raises concerns about new conflicts of interest for investment providers. In addition, evidence suggests that only a small share of 401(k) participants respond to offers of investment advice, at least when offered via a website. Finally, despite assertions that the proposed investment advice legislation is the answer to Enron, the legislation, as currently drafted, actually stops short of requiring investment advice to extend to employer stock, thus ignoring precisely the area where employees have the most serious need for independent professional advice.

Promising Developments in the Private Sector

While the federal government has largely failed to promote better asset allocation choices in 401(k) plans, the private sector has begun to respond. While efforts to educate 401(k) participants through websites and informational materials have had limited success, more active and comprehensive approaches have generated a larger response. For example, some financial services firms have begun offering managed accounts as an option for the companies that hire them to provide investment advice to workers. Under this approach, professional financial advisors will, with an employee's permission, take charge of all the investment decisions. Initial reaction to this option by 401(k) participants has been promising.

Poor 401(k) investment choices threaten retirement security.

Another approach to improving asset allocation is through diversified "life cycle" mutual funds. Several companies offer such funds, which vary by the year of one's expected retirement. Each fund has a specific asset allocation that changes over time so that an individual's portfolio will automatically move away from equities and toward bonds as the individual ages. These funds are already widely available and have proven increasingly popular among investors.

Potential Ways to Improve Asset Allocation Choices

Policymakers might help further the goal of diversified 401(k) investments in general and less exposure to company stock in particular through a number of approaches.[4] For the most part, these actions would encourage employers to promote widespread adoption of balanced portfolio choices.

General Approach

A key step to improving overall asset allocation choices would be to grant employers relief from selected fiduciary liabilities if they offer participants alternatives to mandatory self-direction — through either standard investments or professionally-managed accounts. This strategy would improve 401(k) asset allocation and investment choices while protecting employers and preserving employees' rights to self-direct their accounts if they so choose.

<u>Standard Investments</u>. Congress could prescribe certain standardized, broadly described types of investments that would receive a measure of fiduciary safe harbor treatment, i.e., would be immune from certain challenges for imprudence and lack of diversification under ERISA. In addition to stable value investments, these would include balanced, prudently diversified, low-cost

funds with a range of permissible allocations representing a mix of equities and bonds. Plan sponsors would not be required to offer such investments, but would be permitted to impose standard investments on all participants or include standard investments among participants' investment options.

Plan sponsors would have an incentive to use standard investments to the extent that doing so would provide "safe harbor" fiduciary liability protection against charges of imprudent asset allocation or lack of diversification. Indeed, the market might come to view the types of investments that receive such favorable treatment as, in effect, enjoying a "presumption of prudence." Use of "presumptively prudent" balanced or life cycle funds as the default investment in lieu of money market, stable value funds and employer stock seems likely, in turn, to improve investment returns for participants.

The private sector offers ways to improve 401(k) investment performance.

Managed Accounts. Congress could also make clear that plan sponsors seeking protection from fiduciary liability could designate an independent professional investment manager to invest participants' accounts. This would free participants from having to manage their own accounts (although they could retain the option to do so). The plan sponsor and trustee would be protected from fiduciary responsibility for investments appropriately delegated to an independent investment manager (except for the continuing responsibility to prudently select and monitor the manager). Such guidance from policymakers would likely accelerate the expansion of professional management services that are an emerging trend in the financial services industry.

Like standard investments, managed accounts generally would ensure reasonable asset allocation and adequate diversification, two key factors in raising expected returns and reducing risks. Accordingly, an important byproduct would likely be the divestiture of excessive amounts of employer stock in the interest of diversification. And Congress could give managers a fiduciary safe harbor or exemption for investing up to 10 percent of each account balance in employer stock, if desired.

Policy Strategies Targeted More Specifically to Employer Stock

The authors of this brief believe that some specific policy changes relating to employer stock are also warranted. The goal should be to reduce the concentration in employer stock that exposes millions of 401(k) participants to unnecessary risk. Ideally, 401(k) plans would not include employer stock as an option (leaving purchases to an ESOP plan or to employee's own initiative). However, the authors of this brief do not advocate an outright ban on including employer stock in the plans. Some companies apparently believe that making contributions in stock is somehow less expensive than cash contributions (contrary to both economic theory and common sense). Thus intermediate steps, such as a rule that says that companies can either match in their own stock or offer it as an option in the plan, may be appropriate. This section discusses several specific strategies for reducing employer stock concentrations.

Crowdout. The minimalist strategy to diversifying employer stock is to note that exposing employees' 401(k) accounts to professional investment management (or standardized default investments) as described above seems likely to reduce the concentration in employer stock sooner or later. The gospel of sound asset allocation and diversification will be more pervasive and obvious, and professional expertise will permeate the system far more readily once employees are no longer the only or primary managers of their plan portfolios.

Government Neutrality. Currently, employer stock has preferential treatment under both federal tax and fiduciary law. The tax preference allows companies that earn a dividend to take an additional tax deduction at the corporate level. The fiduciary law incentive is the exemption of employer stock from ERISA's diversification requirements. A simple reform would be to eliminate these preferences and treat employer stock just like any other investment. This simple change might solve the employer stock problem, since firms might conclude that the fiduciary risk is not worth bearing.[5]

Diversification Safe Harbor for Plan Sponsors. Congress could also give a fiduciary safe harbor to plan fiduciaries that follow a systematic employer stock divestiture program. This approach would facilitate divestiture by plan sponsors that recognize they might have gotten in too deep but are still hesitant to divest themselves of employer stock. Employers fear litigation for fiduciary breach if plans sell employer stock or sell it too quickly (in the event the stock value rises) or too slowly (in the event the stock value falls). A safe harbor "glide path" for systematic, gradual diversification would also help address employers' other legitimate concerns — that large sales of company stock from the plan might depress the market or, more commonly, might be perceived by the market or by employees as a signal that management lacks confidence in the company's future.

Policymakers could spur the creation of "automatic" 401 (k) plans.

"Sell More Tomorrow." Plan sponsors could offer employees the option of participating in a systematic program of gradual employer stock divestiture over a period of years. Consistent with the employer-level safe harbor "glide path" approach suggested above, this creative employee-level approach (which its primary advocates call "Sell More Tomorrow") could encourage individuals to take a step that might be difficult by arranging to do most of it in the future, and as a way to spread out the sale of the shares over time to avoid potentially depressing the market and to mitigate the employee's risk of remorse for having sold at the wrong time.[6]

Threshold Approach. Another possible way to reduce the overconcentration in employer stock would be to permit employees to invest in employer stock only after they have reached some saving threshold — for example, 7 percent of pay. Under this approach, employees could only buy employer stock with plan contributions in excess of the threshold level.

Conclusion

As the private pension system continues to shift from traditional employer-funded pensions to 401(k)s, a guiding principle for policy design should be to make the new system as easy and safe for workers as the old one. Under traditional pensions, workers could avoid making most financial choices relating to their pension until retirement. In current 401(k) plans, however, workers face many financial choices (as well as the risk associated with those choices) but many lack the expertise to choose soundly. In response, policymakers and employers could reform the system to save employees from having to be financial experts, while continuing to allow self-direction for employees who want it.

The underlying policy goal should be to create "automatic 401(k) plans." At each stage of the plan cycle — contribution, accumulation, and distribution — these plans would program pro-saving behavior and prudent management as the default or automatic mode. While this approach points individuals in the right direction, it does not constrain them — they would have the freedom to ignore the default selections and make their own choices instead. The "automatic investment" approaches described here — particularly managed accounts or standard investments as the default investment mode — would improve 401(k) investment performance generally while working in concert with other methods described here to reduce overconcentration in company stock.

The integrated strategy of using default or automatic arrangements to promote saving without sacrificing individual choice was originally formulated — and began to be implemented — between 1998 and 2000 by the U.S. Treasury Department. Automatic enrollment raised participation rates. Automatic rollovers reduced leakage from the pension system. And both laid the groundwork for automatic investment by requiring plans to prescribe default investments that apply unless employees choose differently.

Now that automatic enrollment and automatic rollover have been authorized by law, a possible next step is 401(k) automatic investment.[7] This approach would serve to promote these policies' unifying objective — enhancing retirement security particularly for the moderate- and lower-income households that comprise the majority of the nation's working families.

Endnotes

1 Benartzi, et al. (2004)

2 Munnell and Sundén (2004). For background on the general policy approach of guiding individuals in a specific direction while allowing them full freedom to choose, see Sunstein and Thaler (2003).

3 VanDerhei (2002).

4 For more details, see Iwry (2003a).

5 Benartzi, et al. (2004).

6 Benartzi and Thaler (2002).

7 For more details, see Iwry forthcoming.

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About the Center

The Center for Retirement Research at Boston College, part of a consortium that includes parallel centers at the University of Michigan and the National Bureau of Economic Research, was established in 1998 through a grant from the Social Security Administration. The goals of the Center are to promote research on retirement issues, to transmit new findings to the policy community and the public, to help train new scholars, and to broaden access to valuable data sources. Through these initiatives, the Center hopes to forge a strong link between the academic and policy communities around an issue of critical importance to the nation's future.

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