Will DC Automatic Programs Eliminate Need for Education and Advice in the Workplace?

by Stacy L. Schaus, CFP®

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American private workers increasingly rely on defined-contribution (DC) savings as the primary source of retirement income aside from Social Security. Today, 64 percent of companies consider their DC plan to be the primary company-sponsored retirement program.

Given the reliance on DC plans for creating adequate and sustainable retirement income, what are employers doing to make financial education available to plan participants? The majority—91 percent of plan sponsors—offer investment education programs, and 37 percent offer outside investment advice. Historically, plan sponsors cite three measures of success for their DC plans:

- Participation rates
- Contribution levels
- Asset allocation

Plan sponsors' highest priority has been participation rates. Most education efforts focus on simply getting workers into plans. Companies accomplish this by hosting savings fairs, educational seminars, providing online tools, and sending mailings to entice higher participation. Yet, despite the dollars and effort expended, participation rates have shown little to no improvement over the last decade, fluctuating tightly within a 74–79 percent rate (Hewitt 2005).

Similarly, companies have worked to increase the savings or contribution rates across their participant bases. Despite plan sponsor efforts, only a minor increase occurred between 1999 and 2005, from 6.7 percent to 7.0 percent (Hewitt 2005).

The impact of education and investment advice on asset allocation has been modest at best, with only about one in six participants (17.3 percent) reallocating their DC assets within a typical year, and one in five (20.1 percent) of participants holding half or more of their DC account balances in company stock (Hewitt 2006).

With results like these, many conclude that educational efforts have failed overall. While we can identify organizations that have done better, the composite shows the results of a large sample of plans that have been less than stellar. To explain such a disappointing outcome, academics and other behavioral analysts point to a flaw in human behavior. While we all have the best of intentions, we often fail to take action: “Why do today what can be put off until tomorrow?”

Take, for example, a study by Choi et al.,[1] which shows the outcome of a retirement planning seminar. While a high percentage of participants expressed their intentions to take action in one of the three key areas—participation, contribution rate, and asset allocation—only a small percentage actually followed through (see Table 1).

Table 1: Effect of Education Is Positive but Small

	Seminar Attendees		Non-attendees
	% Planning to Make Change	% Actually Made Change	% Actually Made Change
Those Not in 401(k) Plan			
Enroll in 401(k) plan	100%	14%	7%
Those Already in 401(k) Plan			
Increase Contribution Rate	28%	8%	5%
Change Fund Selection	47%	15%	10%
Change Asset Allocation	36%	10%	6%

Source: Choi, Laibson, Madrian, and Metrick, "Saving for Retirement on the Path of Least Resistance," 2001, 2004.

Pension Protection Act of 2006 to the Rescue

Fortunately, the Pension Protection Act of 2006 (PPA) helps us move in a positive direction. Influenced heavily by behavioral research, the PPA supports automatic enrollment and automatic escalation programs because the programs are likely to successfully circumvent participant inertia. “Auto” programs can address each of the three key measures of success.

1. Automatic enrollment can improve participation rates. One survey (Hewitt 2007) discovered that 36 percent of respondents have auto-enrollment programs, up from 24 percent in 2006. Of those remaining, 31 percent said they were “very likely” to auto- enroll, and 24 percent indicated they were “somewhat likely.” Only 27 percent stated that they were “very unlikely” to institute an auto-enrollment program.
2. Automatic escalation programs can raise contribution levels. Thirty-one percent of plan-sponsor respondents in the Hewitt survey said they already have some type of plan-contribution escalation, while about a third said they do not plan to auto-escalate. The PPA provides a safe harbor for auto-enrollment and auto-escalation, given an initial 3 percent of salary contribution, with escalation up to at least 6 percent. Many in the industry hope that companies eventually will go beyond 6 percent since most employees will need higher contribution rates to reach reasonable retirement-income replacement.
3. Defaulting to a target-date or managed-account approach that shifts to a lower risk level as a participant ages can improve asset allocation. The

PPA supports this type of auto-asset-allocation product or service. As of this writing the market is awaiting the Department of Labor's release of final regulations that define qualified default investment alternatives. Proposed regulations identify asset allocation strategies as acceptable, whether target date, target risk or managed account. For companies that offer auto-enrollment, we anticipate a continued shift from the use of stable value to an asset-allocation strategy, with target date the most prevalent. In fact, a 2007 PIMCO DC Consulting survey shows that 67 percent of firms expect target retirement-date strategies to become the most prevalent DC default in the future.

Are We Done, Then?

Given that the Pension Protection Act addresses plan sponsors' primary concerns, do we still need to offer education and advice to employees? Can't we simply auto-enroll, auto-escalate, and auto-allocate, and call it a day—or a decade?

David Wray, president of the Profit Sharing Council of America, predicts that the auto-enrollment programs, including all plans (even those that do not add automatic enrollment), will raise current participation levels from around 70 percent to over 83 percent. Contribution levels can escalate above current levels, but how much they increase depends on the auto-escalation-rate ceiling set by individual plan sponsors. Ideally, plan sponsors will increase to 10 percent, offering plan participants the choice to go even higher. Finally, sponsors will rebalance participants' asset allocations more frequently since, over time, most will participate in target-date or other automatic strategies.

Despite all the advances—especially with the PPA—there still is room for considerable improvement in helping American workers prepare for retirement. Professor Richard Thaler, behavioral economist at the University of Chicago, said, "I don't know whether we want to declare victory yet. We've made substantial progress, yet we still have other issues."(PIMCO DC Dialogue™, June 2007.) He specifically notes, for instance, the need to reduce exposure to company stock, as well as plan for elder care.

What More Can Employers Do?

Today, employers are able to extend valuable financial planning services to their workforces. As plan sponsors increase participation levels, contribution rates, and appropriate asset allocation through automatic programs, sponsors are free to focus on higher objectives. In the past, we defined a retirement plan's success as maximizing the accumulation of wealth for the plan overall, which left some participants as winners and some as losers. As more American workers rely on their DC plans as the primary employer-provided sources of retirement income, the new definition of DC-plan success is to create "retirement-income adequacy”—maximize the number of people who can retire comfortably. Many plan sponsors ask whether their plans will be able to provide sufficient real retirement-income replacement for workers.

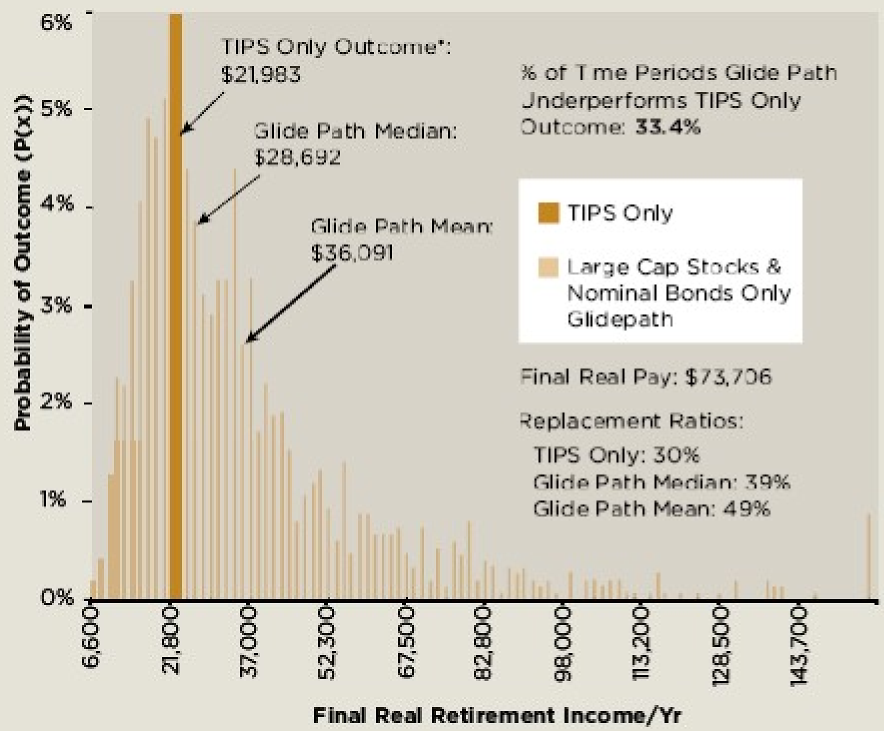
Clearly this is the right question. To answer it, plan sponsors must evaluate the probable accumulation of DC assets and the percentage of final pay these dollars will replace. To elevate the pay-replacement percentage, many plan sponsors are increasing plan funding via a higher match or non-matched contribution; this may include adding a supplemental plan such as a money purchase or profit-sharing.

Employers also are beginning to evaluate the risks in their DC plans, looking not only at the volatility of their investments, but also at inflation and potential retirement-income shortfall. For instance, they may ask, “Given this default target strategy, how likely will participants achieve these various retirement income-replacement rates?”

Academics such as Professor Zvi Bodie of Boston University have performed similar work by evaluating the shortfall risk within DC plans. Bodie is concerned that the industry isn’t conveying risk sufficiently. He states, “What they are doing in their education materials, as well as [in financial advice] models, is truncating the tail. So, they’re throwing out all the risk”(PIMCO DC Dialogue, June 2007). Bodie’s point is that, when we talk with DC participants about risk, we often only talk about volatility rather than the likelihood of meeting a set retirement-income goal.

He notes that financial models may show 95 percent of possible outcomes, yet fail to show the 5 percent tail risk or that spells disaster for the worker. He argues that participants need the full story and they need investment alternatives such as Treasury inflation-protected securities or insurance products to provide more certainty that workers will have sufficient retirement assets. Bodie is concerned about the auto-default to target-date strategies that are heavily weighted in equity investments. As illustrated in Figure 1, a third of the time the typical target-date strategy falls short of TIPS alone. Clearly, participants need to understand this risk.

Figure 1: Probability Density of Basic Glide Path Outcomes

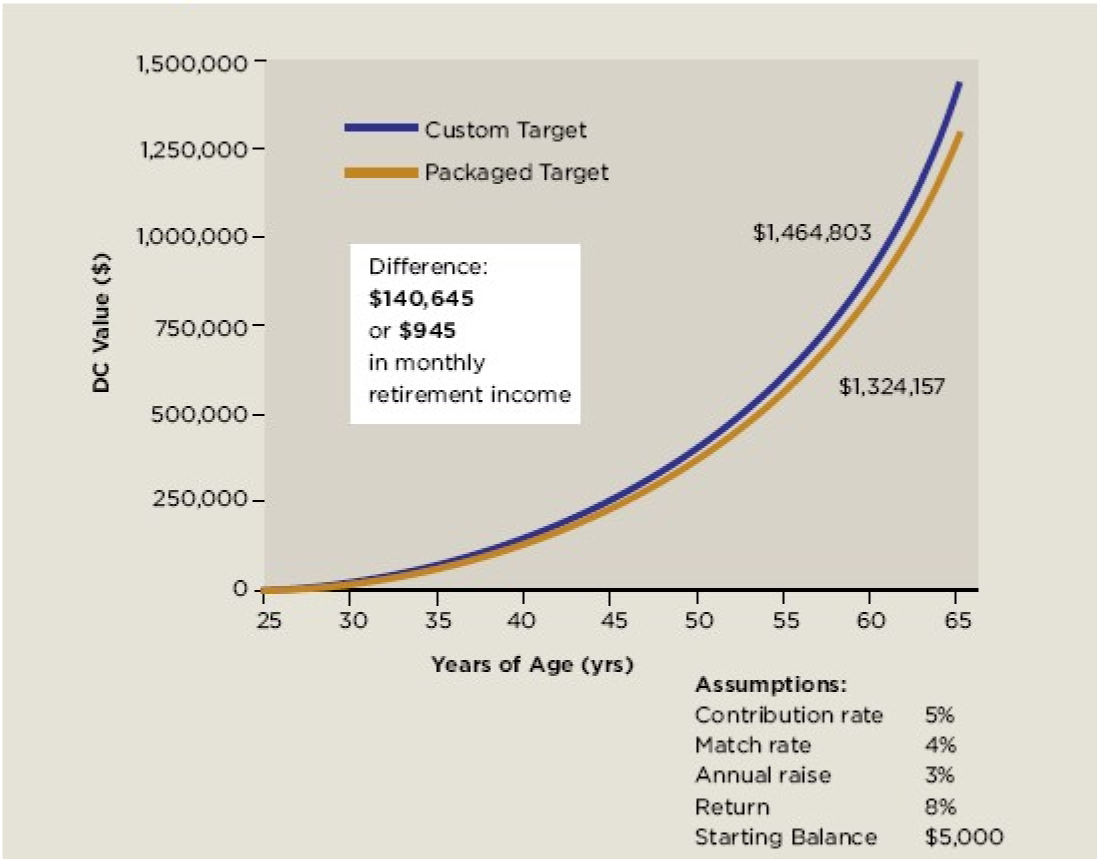


*Assumes a 2.0% TIPS Yield
Source: PIMCO with assumptions from Zvi Bodie

We also hear more talk about shifting from retirement-saving accumulation to income drawdown. In other words, plan sponsors are considering plan changes, including products or services designed to help retirees effectively manage their retirement incomes. Products may include in-plan or distribution annuities as well as insurance products that provide a guaranteed minimum withdrawal benefit. In large part, these types of products are designed to address the lower-tail risk that Bodie identifies. The products also address other risks such as longevity.

Employers can bring significant value to their workers by evaluating the risks in their plans as well as the ways to address and communicate the various types of risk. What's more, the employer or plan sponsor has leverage in the marketplace to negotiate fees and payout rates that may benefit employees significantly over time. For instance, annuity payouts may be up to 9 percent higher via the group programs, and investment product fees generally decline as a plan's assets grow. We all know that fees, indeed, matter. As shown in Figure 2, a 40-basis-point cost reduction may produce a monthly raise of over $900 for a retiree.

Figure 2: Return Comparison



Hypothetical example for illustrative purposes only
Source: PIMCO

Employers are evaluating DC plan costs carefully, working to reduce fees and find ways to communicate costs to participants more effectively. Given recent class-action lawsuits related to DC fees, people are focusing on fee management more now than ever in the past.

The Need for Full Financial Planning

Despite advancements in DC-plan auto-program success, plan sponsors acknowledge that we all have more work to do. Many plan sponsors show great interest in providing broader financial education and advice to participants. For example, in a recent survey, 80 percent of employers said they were “very likely” or “somewhat likely” to communicate to participants about retirement-income adequacy (Hewitt 2007). Employers may offer programs to help with financial questions ranging from “How can I afford to save in my plan?” to “How much will I need for retirement?” to “Does it make sense to pay for long-term care insurance?” DC plan providers and sponsors alike will increasingly help employees weigh both the value of participating in their retirement plans, as well as the trade-off and value of buying health and insurance programs.

Retirement advice needs to move beyond the basic questions of asset allocation to the more complex ones of creating sufficient and sustainable retirement income. Workers need help understanding how to reach retirement safely and how to remain there with adequate income to cover ongoing and often escalating costs such as health care.

Where Can Employers Go for Help?

To offer more effective educational assistance, employers may turn to benefit providers, their own professional staffs, or outside consultants. Yet, for most employees, the level of advisory services provided via these channels may fall short of what's needed as employees approach and enter retirement. Most will want personal meetings and an ongoing relationship with a competent financial planner. Many will need this level of personal support to manage their life's needs and to help them get it done.

Connecting workers with competent financial planners via the workplace helps both employers and employees. Further, collaborating with employers to offer online education and tools to employees, as well as a database that enables employees to search for financial planners in their communities also benefits everyone. As a financial planning community, we all can help.

Endnote

1. James J. Choi, David Laibson, Brigitte C. Madrian, and Andrew Metrick, "Saving for Retirement on the Path of Least Resistance," originally prepared for Tax Policy and the Economy 2001 under the title "Defined Contribution Pensions: Plan Rules, Participant Choices, and the Path of Least Resistance"; revised in 2004 to include additional data and analysis. Original draft: November 9, 2001; updated draft: July 19, 2004.