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How Can Employers Improve Defined Contribution Plans?

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In 1980, more than 60% of American workers who had retirement plans at work enjoyed traditional pensions, with the employer providing fixed monthly payments throughout the former employee's retirement. Most other employees had "defined contribution" plans such as 401(k)s, which leave retirement investing to the employee.

Today, the numbers are reversed, with more and more companies scrapping traditional pensions and shifting the investing risk to their workers. But numerous studies have found that the typical worker saves too little, often invests too conservatively and doesn't manage the nest egg well after retiring. Millions could end up with too little to live on as they grow old.

If 401(k)s and similar plans are the main way Americans invest for retirement, how can employers improve them? By making enrollment automatic, minimizing the use of the employer's stock, expanding use of annuities and improving employees' financial knowledge, according to the Financial Economists Roundtable, a 13-year-old group of about 50 prominent economists. "As a social policy, we want people to have enough to live on when they are retired," says Wharton finance professor Marshall E. Blume (http://www.wharton.upenn.edu/faculty/blume.html). Unless these problems are remedied, Blume says, many 401(k) participants will run out of money and become burdens on society. "Currently, many employees do not participate in these plans, even when there's an employer match [to employee contributions]," he adds.

To address these problems, members of the FER met in Breton Woods, NH, in July. The result is a set of recommendations titled, "Best Practices for the Design of Defined Contribution Plans."

The FER was founded in 1993 and meets every year to address a key economic issue. Recent annual statements have dealt with subjects such as risks related to hedge funds, better accounting for corporate pensions and high executive compensation. Statements must be approved by a majority of members attending the annual meeting. The 52-member Roundtable includes three Wharton professors besides Blume: Richard Herring (http://www.wharton.upenn.edu/faculty/herring.html), Jeremy Siegel (http://www.wharton.upenn.edu/faculty/siegel.html) and Robert Stambaugh (http://www.wharton.upenn.edu/faculty/stambaur.html), all of whom were among the 33 members who signed the latest statement.

The paper endorses key provisions in the federal Pension Protection Act of 2006 passed last summer, such as the value of allowing employers to automatically enroll employees in 401(k)s. It also envisions further steps not included in that law, such as the development of low-cost annuities that 401(k) participants can buy to get steady retirement income guaranteed for life.

"The defined benefit plans were great," Blume says. "They removed investment risk. They removed longevity risk. People just got a lump sum every year for the rest of their lives. But that assumes you work for one company forever and ever. It also assumes the company is going to be around to make the payment."

Traditional pensions, or defined benefit plans, typically figure an individual's pension with a formula that multiplies the employee's years with the company times his final salary, or an average salary over the final few years. The result is multiplied by a percentage figure to calculate the annual pension payment. Thus, a $75,000-a-year employee with 30 years on the job would get a $36,000 annual pension, assuming the percentage was 1.6.

To get the most out of a pension, the employee must stay with the company many years and still be with the company when he or she retires. If he leaves earlier, he may still get a pension, but the formula would use fewer years, and it would use his salary upon leaving, rather than the higher one he might make just before retiring many years later.

In a defined contribution plan such as a 401(k), the employee can choose to contribute a portion of his salary, and he can choose from among a variety of investments offered by the plan trustee selected by the employer -- usually a mutual fund company. Many employers also match a portion of the employee's contribution, though they typically put in less than employers put into the average pension plan. Employee contributions are subtracted from the employee's taxable income, reducing federal income tax. There also is no tax on investment gains until the money is withdrawn in retirement, when all withdrawals are taxed as income. Generally, the employee cannot withdraw money from a 401(k) until turning 59.5 years, or else there is a 10% penalty on top of taxes.

Defined contribution plans are good for employees who change jobs, because they can take their 401(k) assets with

them and don't have to worry about the health of the employer's pension plan. But their income in retirement depends on how much they choose to put into the plans and whether the investments they choose do well. The typical 401(k) offers no more than a dozen mutual funds.

Poor Investors

The problem is that too many employees are poor investors.

In 2006, federal rules allow participants to put as much as $15,000 into their 401(k)s, or $20,000 if they are over 50. Many plans allow employees to put up to 20% of their salary into the plans as long as they don't exceed the federal limits. But a recent study by Fidelity Investments, which operates plans for 12,000 employers and nine million participants, found the average employee put in only 6.9% of annual salary. In many cases, that's not enough to get the entire match offered by the employer. Just over a third of eligible employees don't participate at all, and among those who do, the average account balance is only $62,500. Nearly half had balances of less than $20,000.

About 72% of assets in the Fidelity plans were in stocks, showing that participants do understand these are more profitable long-term investments than bonds or cash. But about 14% of all holdings are in the employer's stock, which many experts think is too many eggs in one basket.

"Defined contribution plans are designed for well-informed people who take active interest in planning for their retirement and who can evaluate longevity risks, portfolio allocation, and saving decisions," the FER statement said. "But the large number of people who are prone to error, including spouses who can suffer from their partner's errors, is of social concern."

One remedy: automatic enrollment. That means automatically signing new employees up to participate in the 401(k). Employees would have the right to opt out, but studies have shown that they tend to stick with plans once they discover the payroll deductions are not so onerous. "If they're in, they tend not to get out," says Blume. "If they're out, they tend not to get in."

Fidelity found that with automatic enrollment, 76% of eligible employees participated in their plans, compared to 54% for plans that did not have automatic enrollment. People in automatic-enrollment plans also contributed more. Among plans that did have automatic enrollment, the most common "default deferral rate" -- the percentage of income put into the plan unless the employee changed it -- was 3%.

While many automatic enrollment plans put the employee's contribution into a money market fund unless he or she designates something else, the FER suggested plans use low-cost, low-risk diversified portfolios that include stocks and bonds. One option is the life-cycle fund that puts most of a young employee's contributions into stocks, and then gradually shifts to bonds as the employee approaches retirement age.

Don't Rely on Company Stock

Many states have long had laws that prevented automatic enrollment by requiring that employees approve any payroll deductions. But the Pension Protection Act of 2006 lifted this barrier and protects employers from lawsuits if automatic investments do poorly, so long as those investments are prudently diversified.

In the Enron collapse of 2001, many employees saw their retirement savings virtually wiped out because they were heavily invested in the company's stock. Although many experts subsequently warned about the dangers of having both one's paycheck and retirement savings dependent on one company, about 14% of all 401(k) assets are in employer stock, according to the Fidelity study.

One reason is that many companies use their own stock to match employee contributions. "Company stock exposes an employee to a lot of additional risk," Blume says. "If the company does poorly, it may well be that the employee loses his or her job and at the same time sees the stock go down." While not suggesting that this be banned, the FER statement noted that a good defined contribution plan should avoid use of employer stock.

One of the biggest problems retirees face is "longevity risk" -- outliving one's money. Even a substantial nest egg can be built through a 401(k); however, many people do not know how much they can withdraw each year while still assuring there's enough left to last them well into their 80s or 90s.

The FER said that good plans should therefore offer annuities, using the plan's bargaining clout to reduce fees. One type is the immediate annuity which guarantees a fixed income for life in exchange for a lump-sum payment. Upon retiring, for example, an employee might pay $150,000 to get an income of $1,000 a month. By paying more, the employee could get an income that rises with inflation and continues after the former employee dies, providing income for a spouse. The disadvantage: The money paid for an annuity is gone forever, even if the employee dies after receiving only a few payments.

"The FER concluded that annuities can play a major role in eliminating longevity risk, and employers should offer at retirement the default option of joint life annuities that protect both employees and spouses," the statement said. "An employer can obtain annuities at group rates and may be in a better position than an individual employee to

evaluate different annuities." The Pension Protection Act makes it easier for employers to offer various types of annuities, Blume says.

Even if employers adopt automatic enrollment, eliminate use of their own stock and provide annuities and other innovative investing options, the employee remains in control of the defined contribution plan. So improving employees' financial education is key to making these plans work better, the FER said.

Many employers have been reluctant to offer employee education, fearing lawsuits if employees have poor investment results. The Pension Protection Act protects employers from liability so long as their investment advice relies on accepted principals, such as the need to diversify among various types of holdings. Although many employers are likely to turn employee education over to subcontractors, the FER noted potential conflicts of interest if education is done by the fund companies or brokerages that manage their plans. Employers therefore should still bear "primary responsibility" fsor the content of any investor education programs they provide, the FER statement said.

"You want people to understand the risks and rewards of different investment strategies," Blume says. "At this point, people with large amounts of money can obtain this education through financial advisors. The problem is how to provide this understanding to people with a limited amount of money, and to do it cheaply."

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