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401(k) Plan Participants Use Lifecycle Funds Unexpectedly

The introduction of lifecycle funds in 401(k) plans appears to be succeeding in reshaping individual portfolio choices in ways that were intended by plan sponsors, particularly among lower-income plan participants, according to a working paper published by the Pension Research Council of the Wharton School, University of Pennsylvania. In addition, the availability of these funds has led to the unanticipated creation of a new class of mainly middle-income investors who hold lifecycle funds as part of more complex portfolios.

The paper, "Default, Framing and Spillover Effects: The Case of Lifecycle Funds in 401(k) Plans," was written by Olivia S. Mitchell, Gary R. Mottola, Stephen P. Utkus, and Takeshi Yamaguchi. The authors noted that, since the initial introduction of an opt-out or automatic enrollment regime in the late 1990s was found to dramatically improve 401(k) saving among low-wage and younger workers, a broader discussion of the role that "choice architecture" might play in a range of domains has ensued.

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Building on these findings, researchers said, the Pension Protection Act of 2006 sanctioned a new class of default investments for defined contribution plans known as qualified default investment alternatives (QDIAs). Intended to improve portfolio allocations among defaulted participants, lifecycle or target maturity funds were often chosen by 401(k) sponsors as QDIAs. Based on each participant's expected year of retirement, a lifecycle fund's portfolio manager handles investment allocations, daily rebalancing, and portfolio adjustments over the lifecycle, with the asset mix becoming more conservative as the participant ages.

The authors observed that, when lifecycle funds are offered to 401(k) plan participants on a voluntary basis, they may be expected to appeal to

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The study found that in voluntary, non-default settings, lifecycle funds are chosen by participants with characteristics generally associated with low levels of financial experience, i.e., young, low-income, and low-wealth investors.

workers with little or no experience with portfolio asset decisions. This is referred to as the investment framing effect, as it reframes a potentially complex portfolio choice as a simpler one. Meanwhile, when lifecycle funds are designated by the plan sponsor as a default investment, these funds would be expected to alter portfolio allocations due to inertia, which may be called a default effect. However, according to the authors, "default and framing effects are an incomplete account of the behavioral impact of changing the 'choice architecture' in retirement plans."

Based on their analysis of nearly 250,000 participants in 258 defined contribution plans with a range of default and voluntary choice settings, the authors concluded that the introduction of lifecycle funds produces an unexpected result. It leads to the growth of a sizeable new class of investors who use these funds in unexpected ways. They refer to this unanticipated change in behavior as a "spillover" effect.

The analysis revealed that, as anticipated, a given choice architecture has certain default and framing effects. For example, the study found that in voluntary, non-default settings, lifecycle funds are chosen by participants with characteristics generally associated with low levels of financial experience, i.e., young, low-income, and low-wealth investors. Meanwhile, if an employer chooses a lifecycle fund as the default investment, the likelihood that plan participants will invest only in a single lifecycle fund was shown to be nearly 60% higher than in plans without a lifecycle fund as the default.

At the same time, however, researchers found that the introduction of lifecycle funds can also produce unexpected spillover effects. Specifically, the introduction of these funds leads to the creation of a large group of mixed investors who use the funds as part of what appears to be a more complex approach to retirement saving. The findings indicated that these "mixed" users of lifecycle funds are primarily middle-income and middle-wealth investors, who do not usually display the demographic characteristics or default behavior typically associated with low levels of financial sophistication. The authors noted, however, that it remained unclear whether these investors are engaged in "naïve diversification," combining lifecycle funds with other funds at random, or whether they are engaged in a more sophisticated approach to investing.

The authors said in conclusion that the results of the analysis "are directly relevant for retirement policymakers and plan sponsors seeking to influence investment patterns in 401(k) plans." Given that the simplified framing of lifecycle funds was shown to appeal to participants with characteristics indicative of low financial sophistication, the authors asserted that the choice of such funds as a default investment has the potential to enhance portfolio allocations for this group.

The findings also suggest that, while default and framing appear to play powerful roles in changing individual behavior, these effects alone fail to fully explain the impact of changing the decision environment. "Thus," researchers said, "when altering choice architectures, it is critical to understand the potential spillover effects that might occur, the magnitude of such effects, and whether their impact might be judged to be detrimental or benign."

Consider More Than Tax Rates When Choosing A Roth 401(k)

The conventional wisdom that retirement plan participants should consider mainly their current and post-retirement marginal tax rates when deciding whether to contribute to a traditional 401(k) plan or a Roth 401(k) plan may

be flawed in some cases, a study released by research firm Financial Engines, Inc. has warned.

In “Who Should Save in a Roth 401(k)? (It’s Not Just About Tax Rates),” investment analyst Wei-Yin Hu observed that, up to now, conventional wisdom has held that “savers who expect to face higher tax rates in retirement than today should save in the form of Roth contributions, while those facing lower tax rates in retirement would do better saving in the traditional pre-tax manner.”

Hu said it is still too early to judge the popularity of the Roth 401(k) feature, which allows participants to contribute to their employer-sponsored retirement plan up to the standard 401(k) limits, but in after-tax rather than pre-tax dollars. While 401(k) plan sponsors were first permitted to offer the option in January 2006, many plan administrators have only recently made the changes necessary to implement the Roth savings feature, and many employees remain uncertain about whether they should take advantage of the Roth 401(k) option when it is offered by their plan.

According to Hu, the conventional wisdom regarding Roth plans can be changed, or even turned around, by two “real-world complexities:” employer matching contributions and the IRS-imposed limit ($16,500 for participants under age 50 and $22,000 for those over age 50 in 2009) on 401(k) contributions. Generally, modest savers tend to do better by saving pre-tax dollars because employer match formulas are expressed as a percentage of employee contributions, regardless of whether those contributions are made with pre-tax or after-tax dollars. If, for example, an employee who wishes to maintain the same take-home pay contributed 6% of his salary to a traditional plan, but only 4% of his pay to a Roth plan, the loss of the employer match on the incremental 2% may outweigh the effects of a higher tax rate in retirement.

“Each individual considering switching to Roth saving (with the intention of maintaining the same take-home pay) needs to weigh the potential future tax benefits of that move against the possible loss of free money,” Hu said. “The simple conventional wisdom does not apply across all people. In practice, financial advisors should play a significant role in guiding individuals through these considerations.”

For participants who are in a position to contribute up to the IRS limit, other considerations apply, Hu pointed out. The contribution ceiling equally applies to both pre-tax and Roth dollars, despite the fact that after-tax dollars represent more savings than pre-tax dollars. Thus, even for individuals who expect to pay lower rates in retirement, the ability to save more in a Roth account could tilt the decision in favor of a Roth.

To illustrate these points, the study includes an example of a hypothetical 401(k) plan participant who faces a marginal tax rate of 33% today and 28% in retirement. Following conventional wisdom, this individual would be advised to save in pre-tax dollars, an approach that would be expected to beat the Roth savings strategy by almost 8%. However, if the participant is affected by the $16,500 limit, he may benefit more from a Roth strategy, especially if his time horizon is longer than 15 years. If the participant contributes the maximum over 30 years, the assumed advantage of 8% for pre-tax saving is reversed to become an advantage of 4% or 5% in favor of an after-tax saving strategy. Moreover, a participant who expects his tax rate to fall from 35% to 33% in retirement, and who contributes up to the limit each year, would benefit more from saving in after-tax than in pre-tax dollars after only five years.

The results of the analysis appear to indicate that more moderate savers, who stand to forfeit employer matching contributions, should continue to save with pre-tax dollars as conventional wisdom would suggest. On the other hand, savers who contribute at or near the 401(k) limits may wish to calculate

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whether they would benefit more from saving in after-tax dollars, even if they expect to face lower marginal tax rates in retirement.

Retirement Assets Declined Less Than Stock Market Values In 2008

U.S. retirement assets fell 22% in 2008, driven largely by falling investment returns, according to a report released by the Investment Company Institute (ICI), a national association of investment companies. Over the same period, however, the Standard & Poor's 500 total return stock index was down 37%, while bonds returned 7%, researchers noted.

The findings included in the annual ICI report, "The U.S. Retirement Market, 2008," were based on data collected by ICI, government agencies, and trade associations. The study found that total U.S. retirement assets amounted to $14 trillion at year-end 2008, down $3.9 trillion from year-end 2007. Assets held in individual retirement accounts (IRAs) fell $1.1 trillion, or 24%; assets in defined contribution plans declined $985 billion, or 22%; state and local pension plan assets fell $858 billion, or 27%; and private-sector defined benefit plan assets lost $734 billion, or 27%. However, total Federal government pension assets, which were primarily invested in government securities, rose 2% in 2008.

Researchers noted that retirement asset growth has historically been correlated with stock and bond market returns, and 2008 was no exception. Large capitalization domestic equities experienced negative total returns of 37%, small capitalization domestic equities lost 34% of their value, and corporate bonds fell 6%. The only asset class that showed strong returns in 2008 was Treasury bonds, which showed a positive total return of 23%.

According to the report, the largest types of retirement savings vehicles in the U.S. in 2008 were IRAs and employer-sponsored defined contribution plans, which held $3.6 trillion in assets and $3.5 trillion in assets, respectively. Meanwhile, private-sector defined benefit plans held $2.0 trillion in assets, state and local government employee retirement plans held $2.3 trillion in assets, Federal government defined benefit plans held $1.2 trillion in assets, and annuity contracts outside of retirement plans held $1.4 trillion in assets.

IRAs and defined contribution plans have become an increasingly large portion of U.S. retirement assets, the report said. In 2008, defined contribution plans and IRAs made up 51% of all retirement assets, compared with 39% in 1990.

As of May 2008, 40.5% of U.S. households had some type of IRA, with 32.1% of households owning a traditional IRA, 15.9% owning a Roth IRA, and 8.6% having an employer-sponsored IRA, such as a SIMPLE IRA or SEP. According to data from the Federal Reserve Board, the largest sources of IRA assets are employer-based plans: 46% are held in traditional rollover IRAs, and 7% are held in employer-sponsored IRAs. Meanwhile, traditional contributory IRAs account for 43% of all IRA assets, and Roth IRAs account for 5% of all IRA assets.

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