RETIREMENT
Plan Trends

A benefits update Volume 52, Number 3

Personal Retirement Accounts May Produce Better Returns Than Social Security

Despite recent volatility in the stock markets, investments in stocks and bonds using hypothetical "personal retirement accounts" have the potential to produce returns that exceed the amounts workers can expect to receive in Social Security benefits, according to a study published by the American Enterprise Institute (AEI) for Public Policy Research.

The report, "Social Insecurity? Personal Accounts and the Stock Market Collapse," was written by Andrew G. Biggs, a former principal deputy commissioner of the Social Security Administration (SSA). In light of the recent declines in the stock market, Biggs examined the issue of whether a proposal made by the Bush administration in 2005, which stated that Americans be permitted to divert a portion of their payroll taxes into personal retirement accounts, now appears more or less feasible.

Drawing upon historical returns from stock and bond markets, Biggs modeled a personal account plan that is designed to be representative of proposals considered by President Bush and Congress. For simulation purposes, Biggs assumed that a male worker would be allowed to voluntarily invest four percentage points of the 12.4 percent payroll tax in a personal retirement account, and that he would start making contributions at age 21 and retire at age 65. An earnings history for a typical worker, created by the SSA, was used to simulate the individual's annual earnings and account contributions.

Using historical market data updated through November 2008, Biggs assumed that the worker would invest in an S&P 500 index fund and long-term government bonds. He also assumed that the investment portfolio would be managed on a

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The calculations revealed that the average return earned by personal account holders over 44 years of working was 3.4% above inflation, while the average return on an all-bond portfolio was 1.4% above inflation.

life-cycle basis, with the proportion of stocks and bonds automatically adjusted as the worker aged. The account would, for example, hold 85% stocks through age 29, but only 15% in equities by age 65. Averaged annually, the account would hold 53% stocks and 47% bonds. The model further assumed that administrative costs would be equal to 0.3% of the managed assets.

Although this hypothetical worker would have retired in November 2008, during a downturn in the markets, his exposure to stock market losses would be limited by the fact that his portfolio held only 15% equities. According to Biggs, the end balance of the worker's personal account would amount to approximately $161,500, which, when converted into an annuity, would translate into an annual payment of $10,330. By contrast, he asserted, a "shadow account" reflecting the value of the bonds held in the Social Security trust fund that would be used to make payments to the worker would amount to around $122,380, or an annual annuity income of $7,830. Therefore, Biggs concluded, the personal account would increase annual benefits for this worker by a total of $2,500.

However, Biggs cautioned, this case is based on one set of market returns between 1965 and 2008, and better and worse returns from investments in personal retirement accounts are likely, depending on market conditions. To create models representing a broader range of potential outcomes, Biggs used historical data from 1871 through the present to simulate 95 cohorts of workers, retiring from 1915 through today. The calculations revealed that the average return earned by personal account holders over 44 years of working was 3.4% above inflation, while the average return on an all-bond portfolio was 1.4% above inflation.

"In all cases, returns on life-cycle portfolios exceeded those on an all-bond portfolio," Biggs observed. "This indicates that in all cases individuals holding personal accounts would have increased their total retirement benefits."

Biggs acknowledged that not all economists who have conducted historical simulations on the likely returns of personal retirement accounts have reached the same conclusions. Specifically, he noted, a 2005 working paper by Robert J. Shiller found that one-third of historical cohorts would fail to break even if they had invested in personal retirement accounts. Biggs attributed the discrepancy between his own and Shiller's findings to the fact that Shiller's simulations assumed that personal account holders would be charged an offset interest rate of 3% by the SSA, when the actual typical bond return rate was 1.4%. If the offset rate is adjusted to the realized return on government bonds, Biggs contended, then all of the 95 cohorts studied would see an increase in total benefits by holding a personal retirement account.

At the same time, however, Biggs warned that conclusions drawn from historical data should not be overstated, as the time period of 1871 to 2008 encompasses only three full, non-overlapping 44-year periods, which means that the data sample is relatively small. "That is to say, we cannot generalize from the fact that workers with personal accounts in the past would have fared very well to the inference that account holders in the future will do similarly well," he said. "They might, but our sample of data is not large enough to say with certainty."

Moreover, Biggs pointed out that workers who have access to equity investments outside of Social Security, such as through a 401(k) plan, already have the opportunity to supplement their Social Security benefits with investments in the stock market, with risk adjusted to the desired level. If Social Security accounts were invested in equities, the potential return on, but also the risk to, these benefits would increase.

Because these retirement savings alternatives exist, Biggs concluded, the workers most likely to see financial gains from personal accounts "would be low earners who currently are unable to invest in stocks, but wish to diversify their retirement savings portfolios. These individuals are currently constrained to invest only in a low-risk, low-return portfolio—Social Security—but might prefer a different mix of investments, including stock."

More Workers Rolling Over Lump Sum Retirement Plan Distributions

According to a study by the Employee Benefit Research Institute (EBRI), growing numbers of employees are rolling over their retirement assets to tax-qualified accounts when changing jobs. However, many retirement plan participants choose to use at least some of these funds for consumption, home purchases, starting a business, or paying down debt.

Written by EBRI economist Craig Copeland, the study, "Lump-Sum Distributions at Job Change," was based on an analysis of the most recently available data from the U.S. Census Bureau, including data on recipients of lump-sum distributions through April 2006.

Copeland observed that, with defined contribution plans now the dominant form of retirement saving, and defined benefit plans offering lump-sum distributions at retirement, employees increasingly have to decide what to do with assets held in their workplace retirement plans when they move to another job. When exiting a job, workers who participated in an employer-sponsored retirement plan have three options for their retirement accounts: leaving the funds in the plan, rolling the funds over to another tax-qualified savings plan, or cashing out the assets.

Through April 2006, about 16.2 million working-age Americans reported having received a lump-sum distribution from a retirement plan when changing jobs. According to the analysis, the average amount of these distributions was $32,219 (in 2006 dollars), while the median amount was $10,000.

Results further showed that the percentage of employees who rolled over their most recent lump-sum distribution to another tax-qualified retirement plan rose to 44.3% through 2006, compared with 19.3% of those who received their most recent distribution through 1993. In addition, the study found that just 9.2% of workers who received lump-sum distributions through 2006 used the funds entirely for consumption, compared with 22.7% of those who received distributions through 1993.

The analysis also revealed that around 60% of those who took a lump-sum distribution did not roll all of the funds into tax-qualified savings accounts. While some of these assets were spent purely on consumption, some were also used to buy a home, start a business, or pay down debt. The findings indicated that behavior varied significantly depending upon the ages of the workers and the amount of the distribution, with older people and those with higher balances more likely to roll over their assets into another account.

In addition, the study found that the lump-sum distributions were relatively small in some cases: 21% of the lump sums were less than $2,500, while just over 16% amounted to $50,000 or more, and the remainder of the distributions were between $2,500 and $50,000.

Copeland observed that some plan participants, particularly younger workers, do not appear to understand or fully appreciate that even a small amount of savings can have a signifi-

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cant impact on retirement assets over time, due to compound interest. "By cashing out even small amounts, younger participants are sacrificing a potentially important asset for their retirement," he said.

To significantly reduce the number of retirement plan participants who cash out their lump-sum distributions, more education or incentives designed to help employees understand the importance of preserving these assets for retirement may be needed.

Fewer 401(k) Plan Sponsors Offer Company Stock As Investment Option

Most sponsors of defined contribution retirement plans now allow participants to choose how they wish to invest both their own and any matching contributions, according to a U.S. Bureau of Labor Statistics (BLS) study that appeared in the November 2008 *Monthly Labor Review*. But the number of sponsors that include employer stock among retirement plan investment choices has fallen dramatically in recent years.

Written by BLS economist William J. Wiatrowski, "401(k) plans move away from employer stock as investment vehicle" presented an analysis of trends in 401(k) plan investment options since 1985, when BLS started tracking data on defined contribution plans. Results showed that 90% of participants in 401(k) plans were allowed to select the investments made with their own contributions in 1985, but only 48% were permitted to choose how employer funds were invested. Yet, by 2005, the percentage of participants who were also allowed to elect how to invest matching contributions by employers had risen to 76%.

The study also found that the number of plan sponsors that offered employer stock as an investment option declined substantially between 1985 and 2005. Whereas 70% of employees were given the option of investing their own contributions in employer stock in 1985, that figure had declined to 25% by 2005. Over the same period, the percentage of participants who were allowed to invest in employer stock using employer funds fell from 61% to 19%.

Wiatrowski cited several reasons for this sharp decline. First, 401(k) plans were typically offered as supplements to traditional pensions when they first came into widespread use in the 1980s. Therefore, they were not seen as the employee's primary source of retirement income. Instead, 401(k) plans were often used by employers to serve other purposes, including building company loyalty through employee ownership. But, as 401(k) plans came to play a bigger role in retirement planning, sponsors became more concerned about the lack of investment diversity and the potential for financial improprieties associated with investment in company stock.

This downward trend in offering company stock as an investment option is likely to continue, Wiatrowski predicted, especially in light of new regulations implemented by the Pension Protection Act of 2006. Under this legislation, which seeks to expand participation in 401(k) plans through auto-enrollment and other automated features, plans are permitted to use a qualified default investment alternative, but this default portfolio is generally prohibited from including employer securities among its holdings.

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