RETIREMENT Plan Trends

A benefits update

Volume 52, Number 9

Older Retirement Savers May Need To Take Action To Recoup Losses

While younger defined contribution plan participants may remain on track for building retirement savings, the recent volatility in the markets means that older plan participants may have to take additional action to recoup losses in account values before entering retirement, an analysis conducted by human resources consultancy Mercer has found.

Researchers studied account data for defined contribution plan participants over the age of 55 and under the age of 30 to determine what hypothetical investment returns would be needed to recover any investment losses experienced by these groups of savers between January 1, 2008 and April 30, 2009. Results showed that, over this period, participants over age 55 lost an average of 16% in account value, while participants under age 30 saw an average account balance gain of 24%.

Explaining this wide gap in returns, researchers observed that younger participants with smaller balances can more quickly recover their losses through new contributions and a potentially more aggressive investment strategy. However, older participants face a huge challenge in saving enough for retirement when markets are unstable.

Also In This Issue

"The overall improvement in market conditions has certainly helped account balances to start heading in the right direction," said Eric Levy, business leader of Mercer's retirement outsourcing business. "But near retirees do not have time on their side. Based on our data, it is evident that these participants are not adjusting their portfolios as quickly to capture the recent market upswing as they were to move into more conservative investments in late 2008."

Levy noted that a comparison of the portfolio diversification of those 55 and over in April 2008 and in April 2009 showed that capital preservation has gone from 30% to 39% of assets, compared to 22% for those under age 30.

To recoup the average investment losses experienced by participants

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over age 55 between January 1, 2008 and April 30, 2009, the analysis found that hypothetical future investment returns would have to reach 13.64% annually over a two-year period, 5.44% annually over a five-year period, 2.72% annually over a 10-year period, and 1.81% annually over a 15-year period.

Because the level of investment returns required for a recovery of losses may be hard to achieve, participants over age 55 should consider either substantially increasing contributions or significantly delaying retirement, researchers said. The study found, however, that older participants reduced their average pre-tax contribution rates from 9.2% in September 2008 to 8.8% in April 2009, while only 8% of participants eligible to make catch-up contributions took advantage of this option in 2008.

Results of the analysis indicated that, to make up their losses over the period studied through higher contributions—assuming the current rate is 8.8%—participants over age 55 would have to increase their average contribution rates by an additional 16.5% over two years, 6.6% over five years, 3.3% over 10 years, and 2.2% over 15 years.

Given these findings, researchers advised plan sponsors to use recent market activity to encourage employees to become actively engaged in retirement planning and to take advantage of the tools and resources available. They further recommended that employers remind participants nearing retirement that they face serious decisions regarding catch-up contributions, current spending levels, and possibly even postponement of retirement.

401(k) Loans And Household Wealth

Despite frequent warnings that taking loans from a 401(k) account generally represents a risky financial move for workers who are saving for retirement, a study published by the Federal Reserve Board has suggested that taking out a 401(k) loan can help some plan participants build household wealth over time, especially those who would otherwise carry consumer debt at high interest rates.

In "New Evidence on 401(k) Borrowing and Household Balance Sheets," Geng Li and Paul A. Smith of the Federal Reserve Board noted that, according to the 2007 Survey of Consumer Finances, about 15% of eligible households had outstanding 401(k) loans in 2007. While loan conditions can vary, the tax code limits 401(k) loans to the lesser of $50,000 or 50% of the plan balance. With the exception of loans for the purchase of a principal residence, most loans must be repaid within five years, and within 90 days of separation from an employer. Provided the repayments are made on schedule, no taxes or penalties apply. Interest is paid on the loan, usually at the prime rate or slightly above, but the interest is added to the account.

"The key advantage of a 401(k) loan is that it reduces the need for paying interest to outside lenders," the authors pointed out. "Indeed, since the 'borrowed' assets are already owned, a 401(k) loan is really just a withdrawal coupled with a schedule of replenishing contributions (with interest). A secondary advantage is that the transaction costs are typically quite low."

Yet, despite these advantages, Li and Smith observed that many financial advice publications discourage 401(k) borrowing, partly because asset returns on the borrowed amount are foregone while the loan is outstanding, and also because borrowers who quit or lose their jobs may be forced to pay taxes and a 10% penalty on the loan amount if they fail to pay it back within 90 days. But for some households, the authors contend, a 401(k) loan may still be a better option than other types of borrowing.

Based on an analysis of the 2007 Survey of Consumer Finances, the authors found that the percentage of eligible households with 401(k) loans has remained roughly the same since 1995. However, the share of 401(k) borrowers who report taking out their loan for debt consolidation has grown. The study found that the best predictors of 401(k) borrowing are the presence of liquidity or borrowing constraints and the size of 401(k) balances relative to income.

But, Li and Smith assert that a more fundamental finding of their study "is that many 401(k)-loan-eligible households carry relatively expensive consumer debt that could be more economically financed via 401(k) borrowing." According to the authors' estimates, these households could have saved as much as $5 billion, in aggregate, by paying off expensive consumer debt with 401(k) loans. For individual households, this would mean an annual savings of $275 per household, or more for borrowers who carry a large amount of high-interest consumer debt.

The authors considered several reasons why plan participants may avoid 401(k) loans, despite the lower costs associated with such loans relative to most other types of credit. For example, borrowers may be rationally averse to the risk of losing their jobs and having to pay back the loan in a short time frame; they may expect higher 401(k) returns than the after-tax interest they are paying on outside loans; or they may have walled off their 401(k) in a "separate mental account" that they deem unavailable for current consumption.

To help plan participants determine whether they might benefit from 401(k) borrowing, the authors recommended that plan participants be educated about the advantages of 401(k) loans in some situations and, when possible, be presented with a checklist of questions that can help them analyze the pros and cons of different kinds of borrowing, given their specific circumstances.

At the same time, however, Li and Smith acknowledged that the threat of unexpected separation from employment can represent a large risk for borrowers, particularly as households are less likely to have the income needed to pay off the loan in 90 days immediately after a job loss. To reduce this risk, the authors recommended that 401(k) plans be redesigned to make these loans "portable" across employers or that former employers be required to continue to service the loans of unemployed workers following separation.

Racial Disparities Shown In 401(k) Savings Patterns

Controlling for factors such as age, salary, and job tenure, a study conducted by the Ariel Education Initiative and human resources consultancy Hewitt Associates found quantifiable disparities in how successfully 401(k) plans are used by participants of different ethnic groups.

The findings summarized in the report, "401(k) Plans in Living Color: A Study of 401(k) Disparities Across Racial and Ethnic Groups," are based on an analysis of 401(k) plan savings behaviors by race and ethnicity within an employee population of nearly three million across a wide range of industries and sectors. The 57 401(k) plans included in the study provide an employer match on employee contributions and offer various forms of investment education. For the analysis, researchers collected data for year-end 2007 on participants' race, ethnicity, gender, salary, age, job tenure, 401(k) balances, and other account information. The retirement plan participants studied were categorized as white (65.1%), African-American (15.3%), Hispanic (10.6%), Asian (6.1%), and mixed or other (2.9%).

Results showed that, in general, African-American and Hispanic workers have lower participation rates and contribute less to their 401(k) plans than their white and Asian counterparts. While acknowledging that salary level is a much more accurate predictor than race or ethnicity in determining whether

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workers will enroll in their company's 401(k) plan, results revealed an overall gap in participation levels of around 10 percentage points between whites and Asians on the one hand, and blacks and Hispanics on the other: 77% of white employees participated in their company's plan, compared with 76% of Asians, 66% of African-Americans, and 65% of Hispanics.

The study also revealed that, regardless of salary levels, African-Americans and Hispanics have significantly lower contribution rates than whites and Asians. Whites were found to have an average savings rate of 7.9%; Asians, of 9.4%; African-Americans, of 6.0%; and Hispanics, of 6.3%. Furthermore, when controlled for factors such as salary, job tenure, and age, African-Americans were still found to contribute 11% less, and Hispanics, to contribute 6% less, than white 401(k) plan participants.

In addition, the study looked at what percentage of 401(k) participant accounts are held in equity investments. Researchers noted that, historically, equities have been the highest-yielding investments over the long term. Results showed that, on average, whites hold 72% of their account funds in equities; Asians, 73%; African-Americans, 66%; and Hispanics, 70%.

The findings further indicated that African-American plan participants are far more likely to take a hardship withdrawal from their 401(k) account. During 2007, 7.8% of African-Americans made hardship withdrawals, compared with 3.4% of Hispanics, 2.1% of whites, and 2.0% of Asians. As of year-end 2007, 39% of the African-American 401(k) participants had an outstanding loan against their retirement account balances, compared with 29% of Hispanics, 21% of whites, and 16% of Asians. The study's authors observed that, while men and women of most ethnic groups are equally likely to take money out of their accounts prior to retirement, African-American women take hardship withdrawals at a much higher rate than African-American men.

Finally, the study looked at average account balances. At all salary levels, the account balances of African-American and Hispanic participants at year-end 2007 significantly trailed those of whites, though the gap with Asians was not as large. For example, the average account balances of participants earning $60,000–$89,999 were estimated to be $79,018 for whites, $70,393 for Asians, $60,782 for Hispanics, and $51,594 for African-Americans.

While these findings clearly indicate the presence of a significant gap in retirement savings behaviors between different groups of employees, the study's authors emphasized that there are actions plan sponsors can take to improve participation and contribution rates among specific ethnic groups, as well as increase the total savings of all employees over time. They advised employers to add automatic features, such as automatic enrollment and default contribution rates, to their plans and to modify loan requirements to decrease the chances of default when an employee leaves an employer.

The authors also suggested that plan sponsors take additional steps to provide information to participants about investment choices and the costs and consequences of the decisions they make in managing their accounts. Moreover, researchers said, employers should urge policymakers to mandate financial literacy education for all American schoolchildren to provide future generations with a better understanding of sound money management, saving, and investment.

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