# RETIREMENT Plan Trends

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## Disciplined Savings More Important Than Ever

Recently, employees have seen the value of their 401(k) savings decline dramatically. Now, convincing these employees to continue to contribute to their retirement plans creates new challenges for plan sponsors. Two recently published reports have advised plan sponsors to remind workers that failure to maintain their current savings levels could lead to even greater financial insecurity in the future.

According to a study released by human resources consultancy Hewitt Associates, the need for disciplined savings habits is more important than ever amid worsening economic conditions. Hewitt's projections of retirement income levels of nearly two million employees at 72 large companies made in July 2008 showed that employees would, on average, need to replace 126% of their final pay at retirement, after inflation and increases in the cost of medical care were taken into account. At the time, an analysis of employees' savings behavior found that most workers were on track to replace 85% of their income.

But, researchers said, after the effects of the recent market downturn are factored in, this same group of workers is on track to replace just 81% of their income, down four percentage points from mid-2008. This means, for example, that a typical 55-year-old employee with a current average 401(k) savings rate of 10% will need to save an additional 12% per year until age 65, or work an additional two years. Meanwhile, an average 40-year-old worker with a current savings rate of 7% would have to save an additional 1% of pay per year until age 65, or work an extra year to make up the shortfall.

Rob Reiskytl, Hewitt's leader of retirement plan strategy and design, acknowledged that, in today's economy, many employees are stretched to their limit. "But the key for workers is to keep saving, and to make sure they are using all the tools and resources they have at their disposal to maximize their retirement savings potential," he advised. "It also means that many employees—particularly

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Furr & Associates
Insurance and Investment Services

5575 Garden Village Way
Suite C-102
Greensboro, NC 27410

(336) 852-4554
(336) 698-3180 *fax*
(877) 273-7755

www.furrandassociates.com

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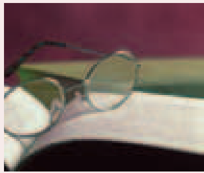

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baby boomers—may have to make some tough decisions about what retirement looks like. They may need to work longer, part-time, or find other ways to supplement income in retirement to make up for the shortfall."

The study recommended that employees concerned about retirement savings shortfalls take certain steps to maximize their earning potential even in difficult market conditions. These include contributing enough to receive the full company match, granting their employers permission to automatically increase their plan contribution rates on an annual basis, diversifying their investment portfolios, and taking advantage of investment advice offered through their employers.

Similarly, a report by financial research firm Greenwich Associates advised retirement plan sponsors to assist employees in making rational investment choices in light of the market conditions and encourage them to continue to contribute to their 401(k) accounts.

Even in periods when markets were generating strong investment returns, too many employees were underinvested in financial markets, the report said. Yet, by 2008, growing numbers of retirement plan sponsors were using automatic enrollment and default investment options to improve participation levels and increase workers' exposure to equity markets. Researchers noted that, from 2007 to 2008, the share of defined contribution plan sponsors using money market or stable value funds as their plan's default investment declined from 35% to 19%, while the percentage of plan sponsors using target retirement date funds—which frequently have equity exposures of around 50%—had increased from 35% in 2007 to 53% in 2008.

These choices made on behalf of employees may put plan sponsors in an awkward position, Greenwich Associates consultant Chris McNickle acknowledged. He observed that 401(k) participants may, given the downturn in the markets, feel particularly hard hit because the money in these plans often represents a large share of their personal savings, and possibly their entire retirement savings.

Plan sponsors should, therefore, "be working aggressively to make participants understand that the worst thing they can do is abandon their equity investments at the market bottom," the report said. Researchers advised sponsors to make the case for remaining invested in their company's 401(k) plan, reminding participants, for example, "that pre-tax contributions amount to a raise equivalent to the amount of the contribution multiplied by their personal income tax rate."

## Congressional Committee Assesses Retirement Security

The House Education and Labor Committee is conducting a series of hearings to explore the shortcomings of the nation's retirement system and to discuss ways to better ensure that Americans can enjoy a financially secure retirement, even as economic conditions become increasingly volatile. The first hearing, "Strengthening Worker Retirement Security," which was held on February 24, looked at the effects of the current financial crisis on the 401(k) retirement savings system.

In his opening statement, Rep. George Miller (D-CA) called upon Congress to find ways to improve defined contribution plans, while also exploring new ways to plan for retirement. "The 401(k) needs to be more transparent, fair, and operated on behalf of the account holder," Miller said. "But, we must also ask the difficult questions about the state of our nation's retirement system as a whole, and look to see whether we need to create a new leg of retirement security."

In his testimony before the committee, Paul Schott Stevens, president and CEO of the Investment Company Institute, agreed with Rep. Miller that 401(k) plans should be preserved and strengthened, but he rejected the notion that defined contribution plans require a complete overhaul.

"Congress should not mandate specific investment options or distribution methods or attempt to regulate exposure to investment risk," Stevens said. "Nor should Congress undermine the ability of plans to pay for services using asset-based fees. Finally, reliable data make it clear that the costs of 401(k) plans and mutual funds in those plans are very reasonable. Congress should reject attempts to scrap or undermine the existing system or fundamentally alter its structure."

At the same time, however, Stevens called for improvements in 401(k) plans, including better disclosure about all key information relating to the plan, such as fees, risks, and historical returns. Stevens also suggested that required minimum distribution rules be relaxed to reflect change in life expectancy and help retirees manage their assets more effectively. He further advocated allowing employers to diversify plan participants out of company stock as they approach retirement. In addition, Stevens asked lawmakers to consider requiring plan sponsors to incorporate automatic features into every 401(k) plan and to make less complex savings plans available to workers. Finally, Stevens called upon Congress to take the steps necessary to place Social Security on sound financial footing.

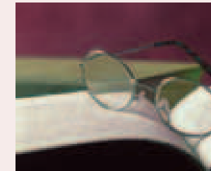
Dean Baker, co-director of the Center for Economic and Policy Research (CEPR), observed in his testimony before the committee that, even prior to the recent economic downturn, large numbers of baby boomers were not well prepared for retirement. "Most members of these cohorts had been able to save far too little to maintain their standard of living in retirement," Baker said. "They would have found it necessary to work much later into their lives than they had planned, or to accept sharp reductions in living standards upon reaching retirement."

According to Baker, the sudden decline in house prices has been especially devastating for baby boomers, both because their homes were by far the largest source of wealth for most people of this generation, and also because of the high leverage in housing.

As a potential solution to these problems, Baker recommended offering workers the option of contributing to a government-run, universal pension system that would provide a modest guaranteed rate of return. The plan would have a default contribution from all workers of 3%, up to a modest amount, such as $1,000 a year. Workers would also be permitted to make additional contributions of a similar amount that would earn the same guaranteed rate of return.

Alicia Munnell, director of the Center for Retirement Research at Boston College, also testified before the committee. Munnell observed that, when 401(k)s were first introduced in the early 1980s, they were seen primarily as supplements to traditional pensions and profit-sharing plans, and they were not intended to cover employees' basic income needs in retirement. But by 2007, she noted, 63% of workers participating in employer-provided retirement plans were covered by defined contribution plans only.

"Yet, 401(k)s still operate under the old rules," Munnell noted. "Workers continue to have almost complete discretion over whether to participate, how much to contribute, how to invest, and how and when to withdraw the funds. Evidence indicates that people make mistakes at every step along the way. They don't join the plan, they don't contribute enough, they don't diversify their holdings, they over-invest in company stock, they take out money when they switch jobs, and they don't annuitize at retirement."



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In recognition of these problems, Congress enacted the Pension Protection Act of 2006 (PPA), which encouraged automatic enrollment and automatic increases in deferral rate, and broadened default investment choices. While these measures have been helpful, they do not provide a "cure-all" for the issues associated with 401(k)s, Munnell added.

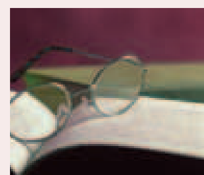
Munnell pointed out that too many 401(k) plan participants have accumulated relatively small balances. In 2007, the median 401(k) holdings for people aged 55–64 were only around $60,000. She stated that this problem has been worsened by the recent financial crisis, which has caused the value of participants' investments to fall, growing numbers of companies to suspend their matching contributions, and many workers to make fewer and smaller contributions to their accounts.

In response to the recession, Munnell suggested that older workers prolong their time in the labor market, and that lawmakers avoid further reductions in Social Security. In addition, she urged lawmakers to consider creating a new tier of retirement income designed to replace around 20% of pre-retirement income. Participation in this system would be mandatory, withdrawals prior to retirement would be banned, and benefits would be paid out as annuities. While this tier would be funded and managed largely by the public sector, the system could be modeled on the Federal Thrift Savings Plan, which is based on relatively conservative target date funds.

John C. Bogle, founder and former chief executive of the Vanguard Group, told the committee that long-term reforms in America's current retirement system are needed. Bogle attributed the system's problems in part to the recent decline in stock market prices, but also to a general overvaluation of stocks during the late 1990s and early 2000s, which "proved unjustified by corporate intrinsic value." This issue has been exacerbated, Bogle said, by the inadequacy of workers' contributions to retirement plans, the unsound and often speculative investment choices made by individuals and pension plan managers, conflicts of interest that arise when mutual fund managers hold the shares of companies that belong to their clients, and excesses of the financial system.

Generally, Bogle said, the shift from defined benefit to defined contribution plans is not just inevitable, it is necessary if U.S. corporations are to compete internationally. Yet, despite the worthy objectives of 401(k)s and similar plans, he asserted that "the deeply flawed implementation" of defined contribution plans have subtracted substantially from the value of this system.

To help get defined contribution plans on track, Bogle outlined a number of possible reforms. These include simplifying the defined contribution system by offering a single plan for tax-deferred retirement savings that would be made available to all citizens, thereby consolidating the wide range of plans currently available. Participants would be required to use at least a portion of their savings in these plans to purchase an annuity. Bogle also proposed the creation of a Federal Retirement Board, which would establish sound principles of asset allocation and diversification that could be tailored to meet the needs of individual participants. Finally, Bogle suggested that the existing ERISA-mandated fiduciary requirements for plan sponsors be extended to plan providers and money managers.



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