

BRIEF ANALYSIS

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401(k) Reform: Doing It the Right Way

by **Matt Moore**

401(k) retirement savings plans have been popular over the past three decades. However, the Enron debacle and the recent stock market slump are spurring Congress and the Bush administration to propose changes in the law. Wise reform could lead to higher returns and safer portfolios for the vast majority of workers. On the other hand, unwise reforms could induce employers to drop these plans altogether.

The Evolution of Private Pensions. Prior to 1978, private pension plans were predominantly defined benefit plans. Under these plans workers are promised a specific pension benefit (e.g., 60 percent of their final pay). However, because workers who switch employers suffer substantial pension losses, defined benefit plans are not well suited to the needs of a mobile labor market.

Since 1978, defined contribution plans — primarily 401(k) plans for for-profit firms and 403(b) plans for nonprofits — have taken the nation by storm. Essentially created by accident from a loophole in the Revenue Act of 1978, defined contribution plans are often better for workers who change jobs frequently or experience gaps in employment. Employers usually match employees' contributions, and the funds that accumulate in the account are the employees' property.

Defined contribution plans make workers responsible for choosing among investment options. The average 401(k) plan offers employees nine actively managed investment choices, according to the Employee Benefit Research Institute (EBRI), although some offer unlimited choices.

Today, more than 42 million workers participate in defined contribution plans, with total assets exceeding \$2 trillion. However, in 2000 the average 401(k) account lost money for the first time in recent years. From 1999 to 2000, the average account shrank from \$46,740 to \$41,919.

401(k) Problems: Poor Returns. The consulting firm Watson Wyatt conducted a recent survey of 503 employers sponsoring both a 401(k) defined contribution plan and a defined benefit plan during 1990-95:

- The survey found that defined benefit plans averaged an annual return 1.9 percentage points higher than 401(k) plans — 10 percent versus 8.1 percent.

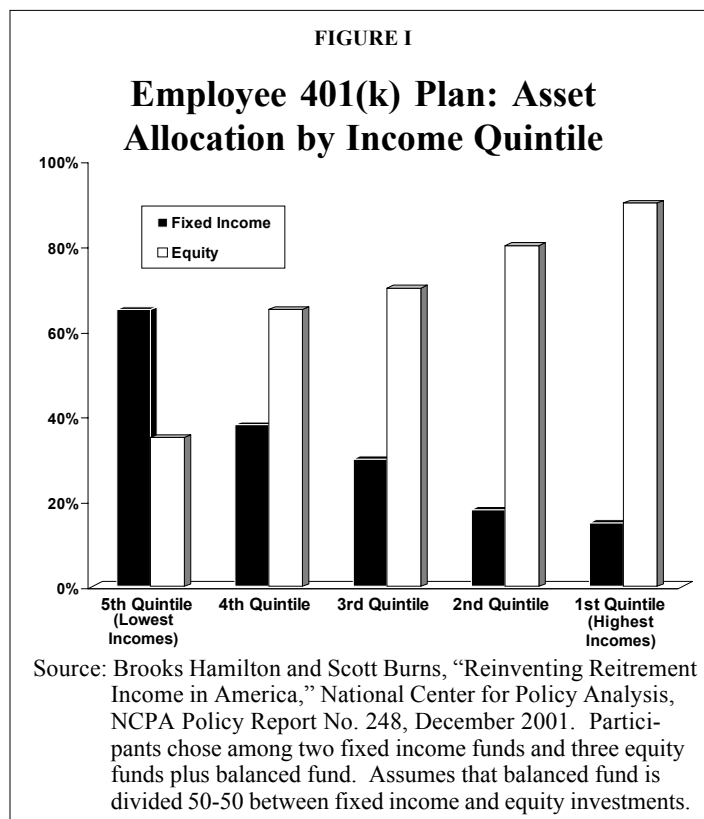
- What are the implications? Consider investing \$4,000 a year for 30 years: at 10 percent, the account will grow to about \$690,880, while at 8.1 percent the account will grow to \$480,224 — a difference of about 30 percent.

Why are 401(k) plans performing so poorly? The most important reason is that unsophisticated investors often make one or both of two poor investment decisions: 1) they invest in what they know and/or 2) they invest in what is safe.

Investing in What They Know: Last year, thousands of Enron employees lost most of their retirement savings when the company stock price fell dramatically. Enron's case is not unique. A

Hewitt Associates survey of 375 companies that offer 401(k) plans found that 55 percent of employers offer their own stock as an investment choice. Some 30 percent of plan assets were invested in employer stock. As the Enron example demonstrates, putting all of one's financial eggs in one basket is risky, even if the basket is the company one works for.

In fact, personal finance columnist Scott Burns suggests that company stock has little, if any, role in a 401(k)



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retirement saving plan. Company stock does have a role in company benefits, of course, but according to Burns, “day-to-day saving and investing for financial independence should be separate.”

Investing in What Is Safe: The other major mistake employees make is to be too conservative. They invest in securities that are safe but pay a low rate of return. Lower-income workers are particularly prone to opt for this alternative. Figure I shows the participants in a typical plan, categorized by income:

- Historically, almost two-thirds of the funds invested by employees in the lowest-income quintile have been in money market funds or bond funds.
- By contrast, about 85 percent of the funds invested by employees in the highest-income quintile have been in higher-earning, equity-type investments.

When employees do not choose an investment alternative, employers typically default them into a money market fund. From a tort liability perspective, employers view these funds as safe because the accounts cannot decrease in value. However, this option pays too low a rate of return for retirement investing. Much of the dichotomy between the investment choices of the highest-income and lowest-income quintiles is driven by the fact that up to a half of low-income employees end up in their employer’s “default option,” while higher-income workers make more sophisticated investments that yield higher returns over their working lives.

Employees do not need to be professional investors to make good investment choices for retirement savings. Consider what Scott Burns calls “Couch Potato Investing.” A would-be investor with no prior knowledge or

expertise can build a secure retirement portfolio by simply purchasing index funds that reflect the performance of the market as a whole. For example, the Couch Potato can invest in a 50/50 mixture of Vanguard 500 Index fund shares (which tracks the S&P 500) and Vanguard Total Bond Market Index fund shares (which reflects the bond market as a whole).

How does the Couch Potato portfolio compare with other investments? Last year, the Couch Potato portfolio lost only 1.8 percent, compared to the 11.32 percent loss

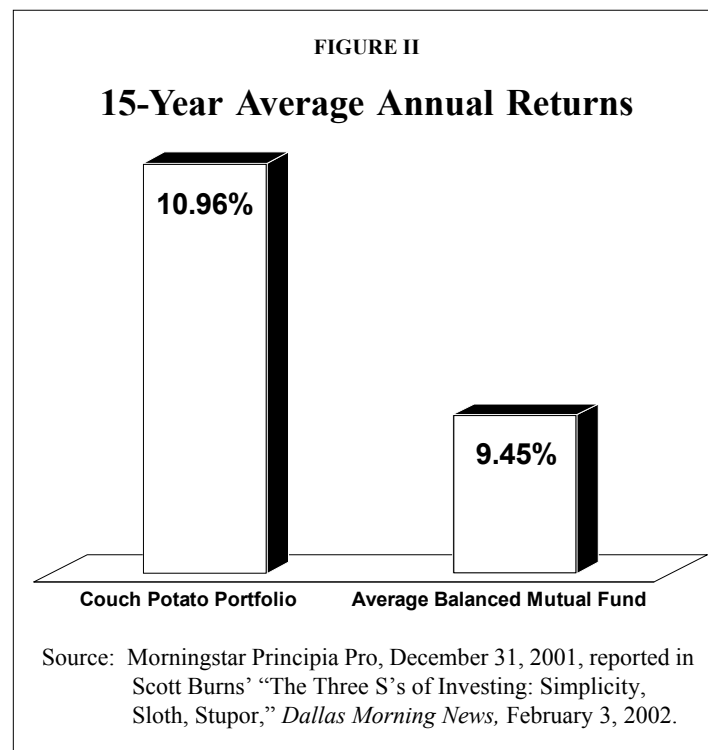
suffered by the average domestic equity fund. Over the past 3, 5, 10 and 15 years, the Couch Potato portfolio outperformed the average balanced fund and the average domestic equity fund. [See Figure II.]

401(k) Problems: Tort Law. The paltry returns currently earned in today’s 401(k) market could be increased if employers helped employees make the wise investment decision to invest in diversified portfolios. However, today most companies that offer 401(k) plans do not offer such guidance because they are afraid of opening themselves to lawsuits in case of investment losses. Most companies,

rather than take the risk, leave many employees to their own devices.

401(k) Reforms Needed. The danger in many reforms is that new regulations will make 401(k) plans too costly and burdensome for many companies to provide, especially small employers. A better approach would be to provide “safe harbor” protection from tort lawsuits for companies that encourage their employees to invest in diversified portfolios.

Matt Moore is a policy analyst with the National Center for Policy Analysis.



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