



Investment Options for Public Sector Defined Contribution Plans

Governments face key choices when setting up plans to help workers boost retirement savings

Overview

Most state and local public workers are members of a traditional defined benefit (DB) plan, but many today also have access to what are known as defined contribution (DC) plans, similar to private sector 401(k)s.

Workers may participate in hybrid plans that provide them with both a DB and a DC plan, in supplemental DC options offered in addition to a pension, or as an alternate approach for university or other public employees. After they retire, most public workers depend at least in part on savings from these accounts rather than solely on guaranteed lifetime payments from employer-based pensions and Social Security.

Workers with DC accounts must decide how to invest their money, but many Americans have only limited knowledge about how to build retirement savings.¹ Government plan sponsors can help workers maximize these savings by providing well-designed investment options. For example, research shows that when DC or hybrid plan members are offered a limited number of low-fee investment options with appropriate asset allocations, they typically see the best outcomes.² Specifically, index and target date funds effectively limit fees, offer appropriate asset allocations, and help simplify investment decisions.

This brief examines the elements of a defined contribution plan that sponsors should consider, including the type of fund, corresponding fee levels, number of choices offered, and the default option. It also discusses the workings of retirement systems that manage DC assets internally alongside pension fund investments, effectively removing the need for workers to make investment decisions.

Investment options

Two types of funds—index and target date—typically have low fees and relatively straightforward designs, making them well-suited for DC plans. Index funds are passively managed, meaning they track the performance of a specific index, such as the Standard & Poor's 500 Index. In contrast, actively managed funds have a manager or team of managers that makes investment decisions on buying, holding, and selling.

Target date funds, also known as life-cycle funds, have diversified portfolios that adjust automatically as members near retirement, helping them invest easily with appropriate asset allocations. Target date portfolios are constructed with a mix of stocks and bonds, with the level of risk linked to an employee's age and assumed retirement date. Portfolios are then rebalanced over time, reducing the percentage of funds in stocks and increasing the percentage of bonds. That can limit risk exposure as members age. For example, the Rhode Island Employee Retirement System offers 12 target funds based on likely retirement year in five-year increments—from 2010-60.³ The fund for those expected to retire in 2060 is about 90 percent invested in stocks, compared with around 30 percent for those that had been expected to retire by 2010.⁴

Target date and index funds have become increasingly common in plans for both public and private sector workers.

Target date and index funds have become increasingly common⁵ in plans for both public and private sector workers. For example, in a 2014 analysis of Vanguard's private sector plans, the share offering target date funds grew from 28 percent in 2005 to 88 percent in 2014. About three-quarters (76 percent) of individuals who joined plans in 2014 invested in a target date fund.⁶ Separately, a 2013 survey of public DC plans found that over 80 percent reported offering target date funds.⁷ The use of index funds is similarly widespread; 84 percent of DC plans for public sector workers offer index funds.⁸

Fees

Fees can have a significant impact on members' total retirement savings.⁹ Because of the way index funds are structured, they typically offer lower fees than actively managed funds and often provide a better return after expenses.¹⁰

Target date funds also can be designed with low fees on par with those provided by DB plans. Public DB pension plans are estimated to have, on average, fee levels of about 0.43 percent, including administrative and investment fees.¹¹ Similarly low levels are found in public sector DC plans. A 2015 study found similar levels for DC plans, with fees ranging from 0.3 to 0.57 percent.¹² According to the Pew analysis, some report slightly lower fees.¹³ For example, the Massachusetts Deferred Compensation Save Money and Retire Tomorrow (SMART) Plan has investment management fee levels of 0.2 to 0.3 percent. Adding in administrative and other types of fees, the total cost is kept below 0.5 percent.¹⁴

Number of funds

Limiting the number of fund options may help members make better investment decisions. That's because offering too many choices can increase complexity and confusion for many participants.¹⁵

The Thrift Savings Plan (TSP) for federal civil service employees provides a good example of a DC plan with limited investment choices. Employees choose among 10 funds: five target date or life-cycle funds and five low-fee index funds.

Table 1

Thrift Savings Plan Investment Fund Options

Federal program provides a limited number of low-fee choices

Fund name	Description
Life-cycle funds	
L income	For members currently withdrawing from their account or expected to begin before 2017
L 2020	For members who will begin withdrawing their money between 2017 and 2024
L 2030	For members who will begin withdrawing their money between 2025 and 2034
L 2040	For members who will begin withdrawing their money between 2035 and 2044
L 2050	For members who will begin withdrawing their money after 2044
Other funds	
G Fund: Government Securities	Objective is to produce a rate of return higher than inflation while avoiding exposure to credit risk and market price fluctuations
F Fund: Fixed Income Index	Objective is to match the performance of the Barclays Capital U.S. Aggregate Bond Index
C Fund: Common Stock Index	Objective is to match the performance of the Standard & Poor's 500 Index
S Fund: Small Cap Stock Index	Objective is to match the performance of the Dow Jones U.S. Completion Total Stock Market Index
I Fund: International Stock Index	Objective is to match the performance of the MSCI EAFE (Europe, Australasia, Far East) Index

Source: Thrift Savings Plan, "Investment Funds," <https://www.tsp.gov/InvestmentFunds/index.html>

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In contrast, many state DC plans offer many more investment options. A review of optional DC plans and hybrid plans shows that most have about 20 choices, double the number in the Thrift Savings Plan approach. Target date funds by definition offer multiple options based on retirement date, resulting in at least half of the fund choices offered through state retirement DC plans being target date options.

Table 2

Number of Investment Options Varies Widely

State plans offer public sector workers range of choices

Plan	Type	Number of investment options
Florida Retirement System Investment Plan	Optional plan for state employees	11 traditional, 10 target date
Maryland Optional Retirement Program*	Optional plan for university employees	34 traditional, 23 target date
Massachusetts Deferred Compensation SMART Plan	Supplemental plan	21 traditional, 13 target date
Washington State Hybrid Plan (Plan 3) Defined Contribution Component	DC component of a hybrid plan	8 traditional, 13 target date

* The Maryland Optional Retirement Program has two fund providers, one providing 28 options, including 12 target date funds, and the other providing 29 options, including 11 target date funds.

Sources: Maryland State Retirement and Pension System Optional Retirement Program, <http://www.sra.state.md.us/Agency/Investment/OptionalRetirementProgram.aspx>; Massachusetts Deferred Compensation SMART Plan Fund Overview, <https://mass-smart.gwrs.com/wrFundOverview.do?accu=MassachusettsWR&groupID=98966-01&db=pnp>; Washington State Department of Retirement Systems Plan 3 Fund Descriptions, <https://savewithwa.empower-retirement.com/preLoginContentLink.do?accu=DRSWR&contentUrl=preLogin.Tab5.E&specificBundle=preLogin>; Florida Retirement System Investment Funds You Can Choose, <https://www.myfrs.com/InvestmentFundTabs.htm>

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Default option

Plan managers may want to provide well-designed default fund options for members who do not make active investment choices. Because members often follow default options, plans can help workers choose options that should boost their retirement security. Individuals with lower than average financial literacy are especially likely to opt for and stay with the default option.¹⁶ The evidence also indicates that DC plan members who default into well-designed funds fare better than those who are encouraged to actively select their own investments.¹⁷

In the public sector, target date funds are commonly the default, as is the case in the Tennessee and Washington hybrid plans and the Colorado, Florida, and Indiana optional DC plans.¹⁸ This is also true in the private sector, where most companies that automatically enroll members in a DC plan adopt target date funds as the default. The analysis of Vanguard private DC plans, for example, shows that more than 80 percent had a target date or balance fund plan as the default option.¹⁹

In other instances, plan sponsors might default members into an investment option with low risk and a “safe” or guaranteed return instead of a target fund. For example, the federal Thrift Savings Plan initially set a default for new members into the Government Securities Investment Fund (G Fund). That was the most stable investment

option offered under the plan but also unlikely to provide returns as high as other funds. The Federal Retirement Thrift Investment Board, which administers the TSP, found that new government hires younger than 29 had too much money invested in the G Fund, probably because the fund was the default option.²⁰ In response, the board asked Congress to change the default for new employees into the appropriate target date fund. In 2014, Congress approved legislation to do so.²¹

State managed funds

Although most state investment options for DC accounts are managed externally, members can in some instances invest DC accounts in state-managed funds. For example, the Indiana Public Retirement System allows employees to invest with a fund managed by the Board of Trustees that provides a guaranteed annual return rate.²² The Washington hybrid plan offers a range of externally managed funds as well as a state-managed investment option. Under Oregon's hybrid plan, all DC funds are invested with the state's Public Employees Retirement System and managed by the state Treasury.²³

State-managed funds can take advantage of economies of scale that often lead to fees lower than available to those in the private market. They also can provide members with expert management of assets, which is especially beneficial to those without solid financial literacy. At the same time, the asset allocation of a state-managed trust fund is typically designed for a long time horizon that may not be the appropriate risk level for members at some points in their careers. Externally managed options that focus on appropriate allocations also can reduce costs by placing members in low-fee target date funds.

Conclusion

When designing or reforming defined contribution plans, policymakers should carefully consider the types of funds to offer, the corresponding fee levels, the number of choices, the default, and whether to offer a state-managed option. There is no one-size-fits-all approach to best meet the needs of employers and workers. Still, the research indicates that offering a limited number of low-fee investment options with asset allocations that suit a range of retirement dates and risk preferences leads to the best outcomes.

Endnotes

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