The Retirement Security Project

# Automatic Investment:

## Improving 401(k) Portfolio Investment Choices

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## Improving 401(k) Portfolio Investment Choices

*By William G. Gale and J. Mark Iwry*

Introduction

Self-direction of investments is a common feature of 401(k) plans, but it is not working as well as it could. Employees frequently fail to diversify their investments or rebalance their portfolios over time. One concern is that workers often invest too large a share of their 401(k) savings in their employer's stock, which can prove especially costly: if the employer falls on hard times, workers stand to lose not only their jobs but also their retirement savings. But even when the plan sponsor does not collapse, poor investment choices impose unnecessary risk on workers, threaten the level and security of retirement income, and reduce the public policy benefits from 401(k) tax preferences.

Given the prevalence of 401(k) plans, the demonstrated inability or unwillingness of many workers to make sound investment choices is a significant concern: better investment performance could increase plan account balances and reduce the riskiness of participant investments. This policy brief discusses the nature and sources of the problem and outlines a potential solution: "automatic investment." Emerging evidence shows that the structuring of default choices in 401(k) plans can strongly influence participation and contribution behavior while preserving employees' option to tailor these choices to their individual preferences if they so desire.[1] We suggest a similar default approach for asset allocation and investment options. Under this approach, plan sponsors that offer qualifying automatic investment arrangements would receive a measure of safe harbor fiduciary protection. The proposal addresses both the general problem of poor investment choices made in 401(k)s and the specific issue of overconcentration in employer stock. The Retirement Security Project is undertaking further research and analysis of this and other ways to improve the design and performance of our nation's retirement savings system.

## Problems with the Current 401(k) System

Disciplined, sophisticated savers can benefit enormously from participating in 401(k) plans. Alicia Munnell and Annika Sundén point out, however, that for most workers the 401(k) revolution has not lived up to this promise.[2] Most workers are not covered by a 401(k) at all. Among those covered, many do not participate. Among those who participate, many contribute little to their accounts, and others take the money out before reaching retirement age. As a result, most households have few 401(k) assets. In 2001, 36 percent of households aged 55 to 59 had neither an Individual Retirement Account (IRA) nor a 401(k) or other defined contribution plan, and, among those who did, the median balance in such plans was only about $50,000.

Even those workers who successfully navigate the problems of coverage, participation, level of contribution, and retention of the funds are not in safe waters yet: many end up crashing on the reef of investment allocation. It appears that millions of 401(k) participants do not follow the most basic norms of prudent asset allocation. Rather than maintain a balanced portfolio, many hold either no equities or almost nothing but equities. Many also apparently fail to systematically rebalance their portfolio or adjust its asset allocation over time, and some underperform because of unsuccessful attempts at market timing. Much of the asset misallocation problem is attributable to overinvestment in company stock. Jack VanDerhei has found that, in plans that allow employer stock as an investment option, 46 percent of participants (some 11 million employees) hold more than 20 percent of their account balance in employer stock, and one-sixth hold more than 80 percent.[3]

The risks of inadequate diversification are widely recognized. In fact, pension law generally *requires* plan trustees, who make investment choices in plans without employee self-direction, to diversify plan portfolios to reduce the risk of large losses. Virtually all investment professionals scrupulously avoid investing more than a minuscule fraction of assets under their management in any single company. Economic theory suggests, and Lisa Meulbroek, James Poterba, and others have shown, that undiversified portfolios create significant risk without providing additional expected returns.[4] Moreover, when the undiversified stock is that of the investor's employer, the risk is compounded, because the worker's job and retirement savings could both be threatened at the same time if the firm runs into trouble.

Richard Thaler and his coauthors explore the causes of overconcentration in employer stock.[5] They find that most 401(k) participants are unaware that investing in a single stock is riskier than holding a diversified portfolio. For various reasons (several possibilities are suggested on the next page), workers do not appear to make the connection between what happened at Enron (or at other failed or distressed companies) and the risks of investing in their own company's stock.

## Sources of the Problem

The current situation reflects two underlying trends. First, the structure of the 401(k) plan has changed little since the early 1980s, yet 401(k)s have come to play a far more central and critical role in the pension system than was envisioned then. Second, Congress has meanwhile enacted rules that actually encourage both self-directed investment and overinvestment in company stock while doing little to help workers manage the responsibilities arising from the dramatic shift toward 401(k)s.

Twenty-five years ago, defined benefit plans (together with certain types of traditional defined contribution pension plans, such as employer-funded profit-sharing plans and money purchase plans) were workers' primary source of private pension coverage. These plans require workers to make almost no important financial choices before retirement. The firm enrolls all eligible workers, makes contributions on their behalf, and makes all the investment decisions (or retains professional investment managers to do so). The worker's only real choices are when and in what form to collect benefits.

When 401(k) plans began their rapid spread in the early 1980s, they were viewed mainly as supplements to these traditional employer-funded plans. Since 401(k) participants were presumed to have their basic retirement income security needs covered by a traditional employer-funded plan and Social Security, they were given substantial discretion over their 401(k) choices, including whether to participate, how much to contribute, how to invest, and when and in what form to withdraw the funds.

Over the past 25 years, however, the pension landscape has changed dramatically. Many workers covered by an employer plan now have a 401(k) as their primary or only plan. Yet 401(k)s still operate in much the same way as in the early 1980s. Workers still must, for the most part, decide for themselves whether and how much to contribute, how to invest, and how and when to withdraw the funds. Imposing on workers the responsibility to make these choices may have been relatively harmless when 401(k)s were smaller, supplemental plans with limited coverage. The risk of workers making poor investment choices looms much larger as 401(k)s have become the primary pension vehicle.

Policy design is partly responsible for this situation. First, the Employee Retirement Income Security Act of 1974 (ERISA) relieved employers of most fiduciary responsibility for investment losses if they allowed employees to direct their own investments—which likely was one factor encouraging the shift to 401(k)s. Second, the main exception to the pervasive use of employee-directed investment in 401(k)s has been plan sponsors' frequent decision to make their contributions to these accounts in the form of employer stock. Although this tendency undermines diversification and might normally be considered a conflict of interest, Congress actually granted special exceptions from the normal fiduciary standards to allow employer (and employee) contributions to be heavily invested in employer stock.

With the expansion of 401(k)s, employer stock has moved from a supplemental to a far more central place in the pension landscape. Meanwhile, one of the main policy rationales originally articulated for providing special exceptions for employer stock—encouraging worker ownership of equities—has already been addressed by, among other things, the ready availability of diversified equity investments through 401(k)s. There are two other potential rationales for investing in employer stock: seeking to encourage higher productivity through increased worker ownership, and encouraging employers to contribute to retirement plans. But both these rationales fall short of justifying the extent to which employer stock has come to dominate so many workers' 401(k) portfolios.

## Current Policy Responses

The leading 401(k) legislative proposals under consideration, which were developed in the wake of recent corporate scandals, fail to respond adequately to either the specific problem of overinvestment in employer stock or the more general problem of less than optimal allocation of 401(k) assets. The proposals would limit plan sponsors' ability to explicitly require participating employees to invest in employer stock (with broad exceptions for the special plans known as employee stock ownership plans, or ESOPs). However, the proposals would allow employees—possibly with the effective encouragement of corporate management—to continue to overinvest their retirement funds in employer stock. As a result, such legislation would not prevent future 401(k) debacles because most 401(k) overinvestment in employer stock does not result from employers explicitly requiring such investment. It seems to result instead from a combination of factors: workers may view their own company as a more comfortable investment because it is familiar to them; they may also be influenced by management's strongly positive view of the company's prospects or by a concern about not appearing sufficiently loyal to the company. These factors may be buttressed by peer group reinforcement and by simple inertia.

One current legislative proposal would require 401(k) sponsors to give participants notice regarding the virtues of diversification. This, however, could prove ineffectual in many cases. For example, a company that still seeks to maximize plan investment in company stock may be able to make the notice inconspicuous or otherwise counteract its effects.

Another proposal would relax current fiduciary standards to allow 401(k) investment fund providers to advise workers on investing in the providers' own funds and those of their competitors. This raises concerns about new conflicts of interest arising on the part of the providers (concerns that are avoided when the adviser is independent and is not providing advice on its own funds). In addition, evidence suggests that only a small share of 401(k) participants respond to offers of investment advice. For example, at a June 2004 Brookings Institution conference on this topic, Michael Henkel, president of Ibbotson Associates, noted that, in his firm's experience, only about 5 percent of 401(k) participants follow investment advice provided on the Internet. Finally, despite assertions that the proposed investment advice legislation would prevent future 401(k) fiascos, the legislation as currently drafted actually stops short of requiring that investment advice extend to employer stock. It thus ignores precisely the area where employees have the most serious need for independent professional advice.

## A General Strategy

A better approach would offer employers relief from selected fiduciary liabilities if they offer participants alternatives to mandatory self-direction, through either standardized investments or professionally managed accounts; such alternatives could be the default investment option. This strategy would improve 401(k) asset allocation and investment choices while protecting employers and preserving employees' right to direct their accounts themselves if they so choose.

### Standard Investments

Congress could designate certain standardized, broadly described types of investments as qualifying for a measure of fiduciary safe harbor treatment. In other words, plan sponsors would enjoy a degree of protection from certain challenges for imprudence or lack of diversification under ERISA if they made such standard investments the plan's default investment and participants did not opt out of the default (or if participants affirmatively selected such investments from among an array of options). In addition to stable-value investments such as bond and money market funds, standard investments would include balanced, prudently diversified, low-cost funds (such as low-cost index funds) with a range of permissible allocations between equities and bonds. Plan sponsors would not be required to offer such investments but would be permitted to impose them on all participants, include them among participants' investment options, or make them the plan's default option. Standards could be drawn broadly enough so that market competition would continue on price, service, and, to some extent, product.

Plan sponsors would have an incentive to use standard investments to the extent that doing so would provide them safe harbor protection against charges of imprudent asset allocation or lack of diversification. Indeed, the market might come to view the types of investment that receive such favorable treatment as in effect enjoying a presumption of prudence. Use of "presumptively prudent" balanced or life-cycle funds as the default investment in lieu of stable-value funds or employer stock seems likely, in turn, to improve investment returns for participants.

The law could provide explicit approval for short-term default investment in stable-value funds, which then switch to balanced or life-cycle funds thereafter. This option could be especially useful for firms that include automatic enrollment as part of their 401(k) plan. The purpose would be to ensure that workers who quickly changed their minds and wanted to opt out of the 401(k), perhaps because they had not realized that they would be included as a result of automatic enrollment, would not experience capital losses. (A previous Retirement Security Project paper noted that policymakers could encourage automatic enrollment by providing a short "unwind" period during which workers who decided to opt out of the 401(k) could withdraw their contributions and could avoid early withdrawal penalties.[6] Accordingly, the default investment could be a stable-value fund for the duration of this unwind period.)

### Managed Accounts

Congress could also make it clear that plan sponsors seeking protection from fiduciary liability could designate an independent professional investment manager to invest participants' accounts.[7] This would free participants from having to manage their own accounts, although they could retain the option to do so. The plan sponsor and trustee would be protected from fiduciary responsibility for investments appropriately delegated to an independent investment manager (except for the continuing responsibility to prudently select and monitor the manager).

Like standard investments, managed accounts generally would ensure reasonable asset allocation and adequate diversification. (In practice, the two approaches would likely converge.) Accordingly, an important by-product would likely be the divestiture of excessive amounts of employer stock in the interest of diversification. And Congress could give managers a fiduciary safe harbor or exemption for investing some fraction (say, up to 5 or 10 percent) of each account balance in employer stock, if desired.


## Policy Strategies Targeted More Specifically to Employer Stock

Specific policy changes relating to company stock are also warranted. The goal is not to eliminate company stock investments, but rather to reduce the overconcentration that exposes so many participants to unnecessary risk. David Wray, president of the Profit-Sharing 401(k) Council of America, has noted that sometimes the choice is effectively between employer contribution of company stock and no contribution at all—especially during economically difficult times and for privately held companies.[8]

### "Crowdout" of Employer Stock

The minimalist strategy for diversifying away from employer stock would be simply to adopt the above proposals on the ground that exposing employees' 401(k) accounts to professional investment management (or standardized default investments) is itself likely to reduce the concentration in employer stock over time. The gospel of sound asset allocation and diversification will become more pervasive, and professional expertise will permeate the system far more readily, once employees are no longer the only or primary managers of their plan portfolios. Accordingly, as professional management and standard investments increasingly replace employee self-direction, the practice of overconcentration in employer stock and poorly balanced portfolios would eventually give way to diversification and sound asset allocation.

### Diversification Safe Harbor for Plan Sponsors

Congress could also give a fiduciary safe harbor to plan fiduciaries that follow a systematic employer stock divestiture program. This would facilitate divestiture by plan sponsors that recognize they might have gotten in too deep but are still hesitant to divest themselves of the company stock. Employers fear litigation for fiduciary breach if their plans sell company stock or sell it too quickly (in the event the stock value subsequently rises) or too slowly (in the event the stock value falls). A safe harbor "glide path" for systematic, gradual diversification would also help address employers' other legitimate concerns that large sales of company stock from the plan might depress the market for the stock or, more commonly, might be perceived by the market or by employees as a signal that management lacks confidence in the company's future.

### “Sell More Tomorrow”

Richard Thaler and Shlomo Benartzi suggest that plan sponsors offer employees the option of participating in a systematic program of gradual employer stock divestiture over a period of years.[9] Consistent with the employer-level safe harbor “glide path” approach suggested on the previous page, Thaler and Benartzi advocate this creative, employee-level approach (which they call “Sell More Tomorrow”) as a way to encourage employees to take a possibly difficult step by arranging to do most of it in the future. By spreading out the sale of the shares over time, this approach also avoids potentially depressing the market for the stock and mitigates any risk of remorse on the part of employees for having sold at the wrong time.

### Threshold Approach

Another possible approach to reducing overconcentration in employer stock would be to permit employees to invest employee contributions in employer stock only to the extent that the contributions in a given year exceed some threshold. Such a threshold could be set, for example, at 7 percent of pay—a level slightly above the actual average 401(k) contribution rate.

## Conclusion

As the private pension system continues to shift from traditional, employer-funded pensions to 401(k)s, a guiding principle for policy design should be to make the new system as easy for workers as the old one, and as safe as possible. Under traditional pensions, as explained earlier, workers can avoid making most financial choices relating to their pension until retirement. In current 401(k) plans, however, workers face many financial choices (as well as the risk associated with those choices), but most lack the expertise to choose soundly. The system could be reformed to save employees from having to be financial experts while continuing to allow self-direction for those employees who want it.

The underlying policy goal should be to automate the 401(k) plan. At each stage of the plan cycle—contribution, accumulation, and distribution—these plans would build pro-saving behavior and prudent management into the plan as the default or automatic mode. The automatic investment approaches described here—particularly the use of managed accounts or standard investments not only as an investment option but also as the default investment mode—would improve 401(k) investment performance generally while working in concert with other methods described here to reduce overconcentration in company stock.

The integrated strategy of using default or automatic arrangements to promote saving without sacrificing individual choice was originally formulated by the U.S. Department of the Treasury.[10] Automatic enrollment of workers in 401(k) plans has already been shown to raise participation rates. Automatic rollovers of pension distributions when workers change jobs would reduce leakage from the pension system. Both innovations laid the groundwork for automatic investment by requiring plans to prescribe default investments that apply unless employees choose differently. Automatic investment would represent another key step in the development of a better 401(k) design.

Now that automatic enrollment and automatic rollover have been authorized by law, the next logical step is 401(k) automatic investment. These measures would promote the unifying objective of these policies, namely, to enhance retirement security, particularly for the middle- and lower-income households who make up the majority of the nation’s working families.

## Footnotes

[1] William G. Gale, J. Mark Iwry, and Peter R. Orszag, "The Automatic 401(k): A Simple Way to Strengthen Retirement Savings," Retirement Security Project *Policy Brief* No. 2005-1. These and related publications are available on The Retirement Security Project website (www.retirementsecurityproject.org).

[2] Alicia H. Munnell and Annika Sundén, *Coming Up Short: The Challenge of 401(k) Plans* (Brookings, 2004).

[3] Jack VanDerhei, "Retirement Security and Defined Contribution Pension Plans: The Role of Company Stock in 401(k) Plans," Testimony before the Senate Committee on Finance, February 27, 2002.

[4] Lisa K. Meulbroek, "Company Stock in Pension Plans: How Costly Is It?" Working Paper 02-058 (Boston: Harvard Business School, 2002); James M. Poterba, "Employer Stock and 401(k) Plans," *American Economic Review* 93, no. 2 (May 2003): 398–404.

[5] Shlomo Benartzi, Richard H. Thaler, Stephen P. Utkus, and Cass R. Sunstein, "Company Stock, Market Rationality, and Legal Reform," Olin Working Paper 218 (University of Chicago Law and Economics program, 2004).

[6] William G. Gale, J. Mark Iwry, and Peter R. Orszag, "The Automatic 401(k): A Simple Way to Strengthen Retirement Savings," Retirement Security Project *Policy Brief* No. 2005-1.

[7] At the June 2004 Brookings Institution conference on this topic, John Kimpel, senior vice president and deputy general counsel at Fidelity Investments, described professional investment management as one of three emergent market practices, the other two being the use of interactive Internet websites to provide investment information, and the offering of diversified, balanced life-cycle fund options.

[8] David Wray's comments were also made at the June 2004 Brookings Institution conference.

[9] Shlomo Benartzi and Richard H. Thaler, "Sell More Tomorrow: Using Behavioral Economics to Improve Diversification in 401(k) Plans: Solving the Company Stock Problem," University of California, Los Angeles, 2002.

[10] Automatic enrollment was approved for 401(k) plans in IRS Revenue Rulings 98-30 and 2000-8 and for 403(b) plans and 457 state and local government plans in Revenue Rulings 2000-35 and 2000-33, respectively. Most recently, the IRS has affirmed that plans are permitted to increase the automatic contribution rate over time in accordance with a specified schedule or in connection with salary increases or bonuses. See letter dated March 17, 2004, from the Internal Revenue Service to J. Mark Ivry.

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## Mission Statement

The Retirement Security Project is dedicated to promoting common sense solutions to improve the retirement income prospects of millions of American workers.

The goal of The Retirement Security Project is to work on a nonpartisan basis to make it easier and increase incentives for middle- and lower-income Americans to save for a financially secure retirement.

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