

Retirement Success: A Surprising Look into the Factors that Drive Positive Outcomes

by David M. Blanchett, QPA, QKA, and Jason E. Grantz, QPA

Saving for retirement has changed considerably since Congress amended the Internal Revenue Code by adding section 401(k) in 1978. While only 17,303 companies offered 401(k) plans in 1984, today more than 400,000 companies are offering 401(k) plans to their employees. The 401(k) introduced a fundamental shift in the way many Americans prepare for retirement.

Before the 401(k), preparing for retirement was a relatively passive activity for most workers, with the majority of retirement income coming from a defined benefit (DB) plan and from Social Security. However, as the 401(k) became more popular, the burden (risk) of adequately preparing for retirement was increasingly placed on the shoulders of working Americans, the majority of whom were ill equipped to deal with the change.

401(k) plans shift the risk of accumulating an adequate retirement benefit from the employer (with a DB plan and required minimum funding standards) to the employee, without necessarily verifying or ensuring that the employee has the tools necessary to accumulate enough funds for retirement. While many plan sponsors are committed to providing quality 401(k) plans for their employees, the authors have observed that participants spend a disproportionate amount of time focusing on those success drivers that, while important, have a relatively minor impact on improving the likelihood of “retirement success,” *i.e.*, the ability for workers to retire with enough savings to maintain their standard of living and not outlive their wealth.

This article will explore and quantify the relative importance of the four primary “drivers” of retirement success: (1) Savings Rate, (2) Asset Allocation, (3) Asset Quality and (4) Actuarial Assessment & Intervention. In order for participants and the retirement plan professionals who work with participants to better understand and plan for retirement success, the disparity between those factors that



are most important at delivering a successful outcome and those that are overemphasized and less impactful must be illuminated.

The Drivers of Retirement Success

While originally intended for executives, 401(k) plans have become the most widely used retirement vehicle in America. 401(k) plans are attractive to employers for a variety of reasons: They are less expensive than defined benefit (DB) plans, because some or all of the administration costs can be passed onto participants and the primary funding comes from the participant rather than the employer; they create a more consistent funding cost for employers (sometimes no funding cost); and they allow the employer to shift the “investment risk” and the “market risk” of underfunding to participants.

Intuitively, one might think giving employees more control over their retirement success would be a good thing—it is certainly the American thing to do. However, the results thus far tell a different story. This “risk shifting” has had a dramatically negative impact on the preparedness of most

investors for retirement. Many behavioral finance studies show that emotional bias plays a significant role in how average investors make decisions with their money. DALBAR's "Quantitative Analysis of Investor Behavior" cites from the period of 1988–2007, the S&P 500 had annualized returns of 11.81%, investment grade bonds returned 7.56% while the average mutual fund investor (primary investment vehicle type along with unitized sub-accounts) returned 4.48% during the same time period.

Sponsors of DB plans typically engage a variety of professionals, such as actuaries, financial advisors and investment managers in order to help them determine funding requirements vs. affordability, how much to reasonably expect in earnings from investments and how to invest the assets. Plan sponsors of DB plans are mandated by the IRS to make minimum contributions and the Pension Benefit Guaranty Corporation stands ready to be the "guarantor of last resort" should the plan sponsor fail. In a 401(k), the participants bear the burden (or risk) for each of these decisions, and they may or may not have good (or any) resources available to guide them in the right direction. [Refer to Table 1, which compares the responsible party for various activities in 401(k) vs. DB plans.]

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Table 1: Responsible Party Comparison: 401(k) vs. Defined Benefit Plans

| Activity | Typical 401(k) Plan | Defined Benefit Plan |
|---|--|---|
| Determining How Much to Save | Participant | Actuary |
| Selecting and Monitoring Plan Investments | Plan Sponsor and Investment Consultant | Investment Consultant and Investment Manager |
| Asset Allocation | Participant | Investment Consultant and Investment Manager |
| Making Strategic Changes to the Allocations as Situations Warrant | Participant | Actuary, Investment Consultant and Investment Manager |

The activities in Table 1 are those that drive income replacement rates and retirement success: savings rate (determining how much to save), asset quality (selecting and monitoring plan investments), asset allocation, and actuarial assessment and intervention (making strategic changes to the allocation as situations warrant).

While each of these drivers is important, they are not *equally* important. The amount of time spent on each by plan fiduciaries, including advisors, versus the relative importance of each is considerably different. This concept is depicted visually in Table 2, which includes a comparison of the time spent on each driver by plan fiduciaries (in our experience) versus the relative importance of each to retirement success. These results will be demonstrated and discussed later in this article.

Table 2: Time Spent on the Drivers of Retirement Success by Plan Fiduciaries vs. Actual Relative Importance to Retirement Success

| Activity | Time Spent by Plan Fiduciaries | Importance for Retirement Success |
|----------------------|--------------------------------|-----------------------------------|
| Asset Quality | Most | Least |
| Asset Allocation | More | More |
| Adequate Savings | Less | Most |
| Actuarial Assessment | Least | Less |

Interestingly, the authors found that while the quality of plan investments (generally mutual funds, unitized insurance sub-accounts or bank collective trusts) is typically the single largest consideration for most plan fiduciaries, it has the least impact, in the aggregate, on generating a successful retirement. Often, plan sponsors or their advisors view the 401(k) plan as an investment vehicle (versus a savings vehicle or benefit program). Under this circumstance, the majority of a plan fiduciary's time will be spent selecting and monitoring plan investments in addition to their formal role as the ERISA plan administrator. In fact, many 401(k) oversight committees are referred to as "plan investment committees," where the primary focus is on ensuring high investment quality, rather than ensuring benefit adequacy or measuring participant retirement success.

There are likely a number of reasons for this “investment first” focus in 401(k) plans. First, the relative performance of plan investments is fairly easy to objectively quantify, benchmark and communicate. Second, many plan advisors are current or former investment advisors or registered reps—trained and often experienced in evaluating investments. Many of them are also effective sales professionals and relationship managers. These investment professionals spend their energy focusing in the area in which they have the most expertise and where they have the greatest array of tools at their disposal to provide metrics and measurements. Third, plan investments (asset quality) have been a common area for litigation in the past. Few participants are likely to sue because they didn’t save enough money, especially since saving is an employee decision. Finally, let’s not forget that the plan trustees have a fiduciary duty to act in the best interest of the participants and that ERISA itself deals with investments as a primary area of responsibility. In general, plan fiduciaries are required to ensure that quality investments are offered to plan participants.

Asset Quality and Asset Allocation

As mentioned, asset quality tends to get the most attention from plan fiduciaries for a variety of reasons. Many investors and financial planners (and plan oversight committees) spend considerable energy searching for funds that are going to outperform an appropriately selected benchmark on a risk-adjusted basis, even though the majority of the return experienced by a plan is going to be based on market exposure. Research by Sharpe [1992], for example, demonstrates that style and size explain 80%-90% of mutual fund returns, while stock selection explains only 10%-20%. More simply, most of the return comes from the market beta exposure (*i.e.*, the asset allocation) and not from the portfolio manager exposure.

The importance of the strategic asset allocation decision is well known and generally accepted among financial planning professionals. Brinson, Hood and Beebower [1986] provided the most well-known (and often misquoted) statistic that asset allocation explained 93.6% of the variation in the 91 large U.S. pension plans tested. Research has consistently shown, though, that the average 401(k) participant makes poor asset allocation decisions. For example, Mottola and Utkus [2007] reviewed the allocations of approximately 2.9 million participants at Vanguard and found that only 43% of participants had “green” portfolios with balanced exposure to diversified equities,

while 26% of participants had “yellow” portfolios that were either too aggressive or too conservative and 31% of participants had “red” portfolios with either no equities or a high concentration of employer stock.

Recent legislation such as the Pension Protection Act of 2006 should improve participant asset allocation decisions with the introduction of Qualified Default Investment Alternatives (QDIAs). QDIAs can be used as the default investment for participants who are automatically enrolled in a plan but who did not affirmatively elect a particular investment. Target date mutual funds have overwhelmingly become the most commonly used QDIA investment for plans. In fact, 96% of plans that offer the automatic enrollment feature are using target date funds according to a summary of committee research report prepared by the majority staff of the Special Committee on Aging in October 2009.

While target date funds represent an improvement over “do-it-yourself” investing, drawbacks remain. Participant misuse is common among plans where target date funds are offered, including combining target date funds with other plan investment options, thus destroying their fundamental purpose. A second drawback is the average costs associated with these types of funds. A study by BrightScope, Inc. found that target date funds have internal fees that are between 10% to 25% more expensive than other funds offered on the core menu. Finally, this “one size fits all approach” to lifetime risk, where there is no such thing as a conservative 30-year-old or an aggressive 60-year-old, simply assumes too much uniformity among participants.

Savings Rate

From a practical perspective, adequate savings is the most important driver of successful income replacement. Simply put, regardless of the rate of return you earn on your savings, if you save enough, you’ll be able to retire successfully (assuming you don’t invest it all with Bernie Madoff). Conversely, if you don’t save anything you won’t be able to retire successfully. America is a competitive consumption society, where happiness and wealth are often equated. In the aggregate, Americans are not good savers. They tend to have one of the lowest savings rates among other developed nations [Guidoli and La Jeunesse (2007)].

The act of saving is difficult, but determining how much to save in order to fund a successful retirement is even more difficult. Unlike DB plans,

where the annual contribution is defined by an actuary, 401(k) participants are often left to their own devices or may rely on service provider tools, which may be rudimentary or flawed, to determine the appropriate contribution rate. The authors' experiences suggest that most 401(k) participants are not familiar with time value of money calculations or more complex calculations that help determine actuarial equivalencies at different points in time. While there are a variety of free calculators available online, it requires proactive effort on the part of the participant, as well as the know-how that most would agree participants do not have.

Recent legislative changes in the Pension Protection Act of 2006 have made "forced" saving easier through features like automatic enrollment and automated progressive savings. A study by Vanguard (2007) noted that new employees hired under automatic enrollment designs have participation rates dramatically higher than new

employees hired under voluntary enrollment designs, 86% versus 45%. Despite the fact that participants can still opt out of automatic enrollment and automated progressive savings, many, if not most, 401(k) plan sponsors have still not adopted these plan features. According to PLANSPONSOR.com's "2009 Defined Contribution Survey," only 30.8% of 401(k) plans use automatic enrollment.

Actuarial Assessment & Intervention

Many 401(k) participants do not receive any regular guidance about how to allocate their portfolio. More likely, they receive irregular asset allocation guidance in the form of group employee meetings where they receive education rather than advice or they receive guidance once from an advisor in a one-on-one setting, but rarely, if ever, meet again with them to reassess. Many 401(k) plan statements do not address whether participants are on track to retire successfully, but

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Instead of focusing on selecting the best investments (asset quality), 401(k) advisors should spend their energies on those things that truly have an impact on retirement success, such as improving savings rates and improving asset allocation.

rather focus on investment performance. We've observed that most participant educators focus on helping participants determine the right mix of investments, but not necessarily on increasing the probability of achieving adequate income replacement. **IMPORTANT NOTE:** Maximizing the probability of achieving a successful retirement is not the same thing as maximizing the account value at retirement. To maximize the probability of achieving a successful retirement, once the lifetime income need has been determined one should take the least amount of risk necessary to achieve the goal (*i.e.*, dial back the risk whenever possible). Clearly, this approach is quite different from one where *maximizing* the account value at retirement is the goal.

Managed account platforms are one way to implement an actuarial assessment & intervention solution, as well as an improved solution for asset allocation. These platforms appear to be gaining acceptance in 401(k) plans. However, there are a number of barriers that will likely make widespread acceptance of managed account platforms difficult. First, managed accounts are not usually the default option for participants (*i.e.*, participants have to affirmatively select them). Second, there are typically additional costs for managed accounts, with fees ranging from 25 basis points (or .25%) to over 75 bps (or .75%). Finally, in many cases, managed accounts are presented as just an investment solution and not a total financial planning solution since they do not incorporate savings rates or seek to calculate the likelihood of retirement success. They tend to be un-targeted accumulation vehicles, rather than endpoint driven accumulation vehicles.

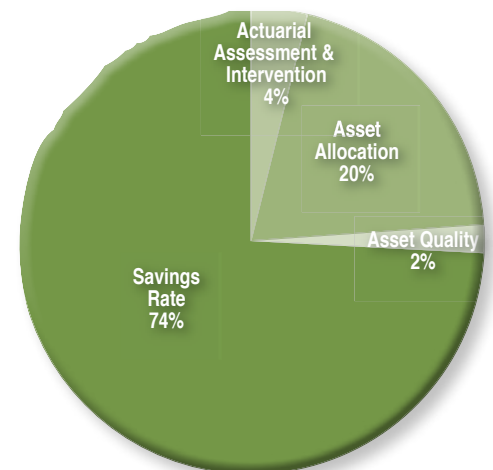
Quantifying the Relative Importance of Retirement Success Drivers

In order to determine the relative importance of each of the aforementioned drivers of retirement success, three different tests were conducted with varying levels of complexity. The goal of the analysis was to provide clear quantitative guidance as to the relative importance of those factors driving retirement success. For purposes of this article, we will focus our attention on the results, rather than on the underlying calculations of the tests.

Our analysis suggests that savings rate is clearly the primary driver of retirement success. This result should make intuitive sense to readers without their even having to consider the underlying math. However, on a relative basis, we found the savings rate to be approximately five

times more important to achieving retirement success than asset allocation, approximately 30 times more important than actuarial assessment & intervention, and approximately **45 times** more important than asset quality. These results are shown visually in Figure 1. While changing some of the assumptions of the tests would affect the percentages in the results, it is unlikely that the order of importance would be materially affected (*i.e.*, savings rate will always be the most important and asset quality will always be the least important).

Figure 1: The Relative Importance of the Drivers of Retirement Success



Implementing These Results

What do the results of this analysis tell us about saving for retirement? First, focusing on picking the next great mutual fund is not the activity that's going to maximize the probability of retirement success for a retirement plan or its participants. We all know that savings is important, but historically it has been difficult to relay the relative importance of savings in quantitative terms, which we will now be able to do. The analysis conducted for this paper suggests that savings rate is clearly the primary driver of retirement success by a wide margin.


Although improving savings rates can be difficult, spending additional time having meetings with participants, sending targeted mailers or implementing "smart" plan defaults like automatic enrollment and automated progressive savings are some relatively easy things to implement in order to improve deferral rates in retirement plans. These are the types of activities for which financial planners are excellently suited, given

their direct contact with participants. While some plan sponsors may worry that higher deferral rates may lead to a higher employer cost due to the higher employer match, there are plan design techniques that can be used to mitigate this cost increase. If an employer is only willing to spend a certain amount in contributions for the 401(k) in a given year, they can work with their consultant or plan administrator to determine the smartest way to maximize total employee contributions while keeping the employer contribution amount static. Of course, this design has to be within any nondiscrimination boundaries required by ERISA.

An additional step that is important to implementing these practices is changing the participant's focus. Right now participant 401(k) quarterly statements are primarily focused on performance, not on retirement success. The first thing participants see when they look at their quarterly statements is some information as to how well their account has performed over the most recent period. While this information does have some value, it tells participants very little (or nothing) about whether they are on track to retire successfully. Shifting the focus of 401(k) statements to make them more "benefit" focused would not only provide participants with valuable information, but it would also change the focus from near-term performance (which can often lead to poor market-timing decisions) to long-term funding adequacy.

Conclusion

This research provides clear quantitative guidance as to the relative importance of each of the four key components to retirement success: savings rate, asset allocation, actuarial assessment & intervention and asset quality. It was determined that savings rate is clearly the primary driver of retirement success and is approximately five times more important than asset allocation, approximately 30 times more important than actuarial assessment & intervention, and approximately 45 times more important than asset quality.

While asset quality, which could be thought of as the time spent selecting and monitoring the plan investments, is the driver that typically receives the most attention, it is the driver that has the lowest impact on retirement success. Instead of focusing on selecting the best investments (asset quality), 401(k) advisors should spend their energies on those things that truly have an impact on retirement success, such as improving savings rates and improving asset allocation. Introducing plan features such as automatic enrollment and automated progressive savings are simple steps that can lead to a dramatic improvement in deferral rates and ultimately improve the statistic that really matters: the number of participants who are going to be able to retire successfully. 



David M. Blanchett, QPA, QKA, CFP®, CLU, AIFA®, CFA is the director of consulting and investment research for the Retirement Plan Consulting Group at Unified Trust Company in Lexington, KY. Unified Trust is a nationally chartered trust company that specializes in the fiduciary management of retirement plans. At Unified Trust, David is responsible for helping 401(k) advisors with fiduciary, compliance, operational and investment issues relating to Unified Trust's retirement plan services. He has published more than 35 papers in various industry journals. (david.blanchett@unifiedtrust.com)



Jason E. Grantz, QPA, AIF® is an institutional consultant in the Retirement Plan Consulting Group at Unified Trust Company in Lexington, KY serving and overseeing the Northeast. Unified Trust is a nationally chartered trust company that specializes in the fiduciary management of retirement plans. Jason's main focus is providing clarity on often misunderstood retirement plan topics such as: evaluating and analyzing stable value investments, ERISA fiduciary standards and advanced fiduciary topics. Jason has been published in various prestigious industry journals and is the creator and primary author of The 401(k) Plan Blog, <http://the401kplanblog.blogspot.com>, a centralized forum for the discussion of issues surrounding retirement plan governance, consulting and services. (jason.grantz@unifiedtrust.com)



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