



consider this your

WAKEUP CALL

One baby boomer is turning 50 years old every 8 seconds – more than 12,000 a day.

Many boomers are just waking up to the fact that they need to plan for a retirement that could last 30 years or longer.

– The Edmond Sun, July 15, 2005

be·hav·ior·al fi·nance \bi-hav-er-əl fi-nans\ *n* is the latest catch phrase in the retirement planning arena, and represents a growing convergence of academia and the investment industry in the study of Defined Contribution (DC) plan participant behavior.

Essentially, behavioral finance represents a body of research – both academic and industry-sponsored – that points to disturbing trends in the way employees view and use – and don't use – DC plans. The implications of these trends, especially over time, may have disturbing consequences for your plan and your employees.

Two over-arching themes, or potential problem areas, are consistently at the forefront of behavioral finance conclusions:

- **Plan participation** – too many employees simply decline to participate in Defined Contribution plans. Of those who do participate, very few maximize their contributions.
- **Investments** – employees fail to make appropriate investment decisions. They tend to allocate improperly, i.e., invest too conservatively, or invest heavily in company stock, have trouble “staying the course,” and/or try to chase market trends.

Too many “just say no”

The numbers vary with each study, but all point to the clear fact that not enough people are investing in DC plans.

Nearly 25 percent of employees who are eligible to participate in a Defined Contribution plan decline to do so at all. Of those who do participate, only 20 percent maximize their contributions.¹ Nearly half of Americans report no active investment for retirement (with nine percent not sure whether or not they are saving for retirement).²

On the other hand, Americans have unrealistically high expectations of their retirement readiness, and report a myriad of reasons for not investing in employer-sponsored DC plans, the most frequent being everyday expenses, child-rearing costs and medical expenses.³

A growing body of research also indicates that employees may not participate because they don't understand DC plans. They find it hard to determine the appropriate savings rate, they lack self-control, they may have good intentions about investing in general

but fail to act on those intentions.⁴ The sheer volume of information and required action attached to signing up and participation decision making can paralyze many individuals into *inaction*.

Finally, many are overwhelmed by too many investment choices. According to a Vanguard study reported in *USA Today*, there is a negative correlation between participation in 401(k) retirement savings accounts and the number of investment options available.⁵

Allocation conundrum

How do your employees make their asset allocation decisions? Conventional wisdom and DC communications protocol have assumed a measured, rational, risk-based approach to investment decisions.

Recent research suggests, however, that investors make decisions for reasons that may be anything but measured and appropriate:

- **Fear** – they are unable to stay the course when faced with market volatility. Behavioral Finance, as well as personal experience, has established that no other factor influences investor behavior more than aversion to loss (risk).⁶
- **The path of least resistance** – participants tend to make choices based on their plan's default options.⁷
- **The law of averages** – some participants apply a “1/n” logic to asset allocation by evenly allocating over their available choices.⁸
- **Familiarity bias** – participants over-allocate to what's familiar – company stock, for example.⁹
- **Conservatism** – they under-weight the long-term nature of retirement investing.¹⁰
- **Overconfidence** – some investors are overconfident in their abilities, which can lead to inappropriate diversification and overactive trading.¹¹

51% of Americans are confident that they have saved enough money to live on in retirement. **22%** is the average annual return rate Americans expect to receive from their personal investments once they retire.

\$51,000 is the median amount each household has in retirement savings, yet **21%** is the average amount of retirement savings expected to be withdrawn every year in retirement, and **73%** do not expect to face a financial crisis in retirement or in the future.

34% expect no change in lifestyle or income when they retire, yet most expect to need only **74%** of their pre-retirement income when they reach retirement.¹²

"What investors really do, what is in their best interest and what it costs them" – Dalbar, Inc.

THE AVERAGE EQUITY FUND INVESTOR – This represents the aggregate action of all investors. The return is calculated by treating aggregate industry flows as being representative of the average investor and applying these flows to an appropriate performance index.

Annualized Returns for 20-year period ending 12/31/04

Average Equity Fund Investor	3.7%
Average Fixed Income Investor	2.0%
S&P 500 Index	13.2%
Inflation	3.0%

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In today's world...

These are not new dynamics, but they are increasingly important, given the nature of today's workplace – with very, very few workers dedicating an entire career to a single employer – rising medical costs (and Medicare premiums), increased longevity and Social Security's reported instability.

Yet, conventional retirement planning wisdom and communication have pointed to retirement income as a three-legged stool consisting of personal investments, Social Security (for those eligible) and employer-provided pension benefits.

Brian Haendiges, ING's Head of Institutional Business Group, provides historical perspective. "Thirty or so years ago, when DC plans were first introduced, they were an add-on benefit," he says. "Investments in these plans weren't designed or intended to be a sole source of income. We weren't questioning whether Social Security would be around in the future. Many employers offered traditional Defined Benefit pension plans, and more workers were eligible for benefits under the DB plans because people didn't tend to job-shift the way they do now."

Today's workplace demographic represents a vastly changed picture. "Traditional Defined Benefit plans haven't disappeared entirely," says Jim Pedrick, ING's Head of Worksite Strategic Marketing, "but they have diminished significantly. The trend is

to convert these plans into something more affordable for the employer, and to limit eligibility to grandfathered employees. Plus, let's not forget that people change jobs far more frequently today. Even if DB plans were as robust as they were 30 years ago, fewer people would be eligible for them, and they'd likely receive lower benefits."

That's one leg of the stool that's potentially collapsing for many future retirees.

Social Security represents another. Already, the retirement age to receive full benefits has risen, and Haendiges points out that it's likely to rise further in the future. "As the Baby Boomers retire, the trust fund from which benefits will be paid will feel the strain; Social Security payments to those at the end of the Baby Boom, and younger, are by no means a sure thing," he says.

Down to one leg for many: Defined Contribution Plans.

Hence the disturbing implications of those Behavioral Finance trends. "That's a burden Defined Contribution plans were not intended to carry alone," comments Pedrick.

Other stories in this special edition of *Impact* shed additional light on the dynamics of Behavioral Finance research, data and solutions. Plan design, lifecycle funds, robust, multi-layered and intuitive plan communication all play a role.



1 "How Well Are Employees Saving and Investing in 401(k) Plans?" Hewitt and Associates, 2004 / 2 "Four in Ten Americans are Worried about Retirement. But Are They Saving for it?" Experian – Gallup Organization, July, 2005 / 3 "2005 Retirement Confidence Survey," EBRI and Matthew Greenwald Associates / 4 "Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving," Richard H. Thaler and Shlomo Benartzi, Journal of Political Economy, Vol. 112, 2004 / 5 "Some ask who belongs in 'ownership society,'" Jill Lawrence, USA Today, March 22, 2005 / 6 Dalbar, Inc. 2005 Quantitative Analysis of Investor Behavior: What investors really do, what is in their best interest and what it costs them / 7 "Asset Allocation and Information Overload: The Influence of Information Display, Asset Choice and Investor Experience," Julie Agnew and Lisa Szykman, Center for Retirement Research, 2004-15 / 8 "Behavioral Finance," Jay Ritter, Cordell Professor of Finance, University of Florida, August 31, 2002 / 9 "Familiarity Breeds Investment," Gur Huberman, The Review of Financial Studies, Vol. 13 (3), 2001 / 10 "Behavioral Finance," Jay Ritter, Cordell Professor of Finance, University of Florida, August 31, 2002 / 11 Ibid / 12 Merrill Lynch, 2004 Retirement Readiness Survey / 13 "How Well Are Employees Saving and Investing in 401(k) Plans?" Hewitt and Associates, 2004