

Americans and Retirement: Finding Strength in the 401(k) System

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Good afternoon. Thank you, Jon [Goodman, president of Town Hall Los Angeles], for that generous introduction and for welcoming me to Los Angeles. It is a great honor indeed to appear before this group, which has long served to advance new ideas and discussion of issues that are critical to our nation. Please allow me to recognize and thank my long-time friend and colleague, Paul Haaga, chairman of Capital Research and Management, for his role in inviting me here today.

As Jon noted, the Investment Company Institute and the funds it represents have a deep, long-standing interest in Americans' retirement security and the plans that promote it. Our funds are designed and managed to help American families meet their financial goals—and for many Americans, their number one financial goal is a secure retirement.

Mutual funds are vital in helping workers reach that goal. Indeed, Americans have entrusted some \$4.7 trillion—more than one-quarter of the nation’s retirement assets—to mutual funds. As a result, we take an active interest in research and policy developments affecting retirement generally and the two self-directed portions of our national retirement saving system—individual retirement accounts and 401(k) plans—particularly.

My topic today is the future of retirement—and the substantial, even crucial, role that 401(k) plans will play in building that future. But I have always found that public policy challenges are best understood with a bit of historical context. And so let me share with you some of the history of pensions and pension plans.

Both IRAs and 401(k)s are relative youngsters—IRAs date back to 1975, and the 401(k) era began officially in 1981. But “retirement” itself is, in many ways, also a relatively recent concept.

In societies built around agriculture and hand crafts—that is to say, for virtually all of the 50 centuries of recorded human history—people didn’t anticipate an extended period of leisure after their working years. Life expectancies weren’t that long, and the elderly tended to live in extended households where they could contribute even as their strength and acuity declined. Your “retirement plan” consisted of your land, your tools, your skills, your relationship with your family and community, and whatever you could put by to save for later.

There is one sector, however, where the concept of retirement benefits as we know them has a long history—and that’s the military.

It’s not hard to see why a society would want to make sure to provide for its soldiers and sailors. First, the hazards of war include a grave risk of disabling injuries or disease—risks that few would want to face without knowing that their king or country would offer some means of support. Second, the creation of a standing army brings with it a strong incentive to pay off older soldiers rather than leaving them destitute, angry—and armed.

Scholars cite the armies of ancient Rome as the first to offer pensions. In the days of the Republic, these arrangements were ad hoc—and were often used by political leaders to persuade troops to serve as their personal armies. After all, Marcus Licinius Crassus, one of Julius Caesar’s partners in the First Triumvirate, is said to have observed that no man is truly wealthy unless he can afford his own army.

When Augustus established the Empire, he turned these ad hoc arrangements into the first formal pension plan. Its outlines would look familiar even today: service of 20 to 25 years qualified a legionnaire for a lump sum that could produce an income in excess of two-thirds of a laborer’s earnings.

Here are two lessons we can draw from the history of pensions. The first: retirement benefits are seldom offered for purely altruistic reasons—a pension almost always comes with economic or political

motivations in tow. Second: from Ancient Rome to today, pension policy can be a powerful tool in the hands of politicians.

The fall of Rome put a 1,000-year halt to the development of pension policy, but the advent of professional armies in Europe in the 16th Century brought them back, from England to Prussia to Spain.

In America, every war from the Revolution through World War I was followed in turn by a new pension plan for veterans, their survivors, and their dependents.

The Continental Congress created the first national pension plan in 1775, for the Navy. Although this plan lasted almost 150 years, its history was checkered. The Navy's pension plan was supported by the government's share of "prizes"—the captured ships and goods of enemies or smugglers. Not surprisingly, during peacetime this turned out to be an unreliable source of revenues: the Navy pension fund went bankrupt and had to be bailed out by Congress three times between 1775 and 1842.

The Civil War and the blockade of Confederate ports revived its fortunes, but created the opposite problem—the fund grew so large that it became a tempting target for Congress, which eventually seized the money and turned it over to the Treasury. So we see another lesson—it's incredibly difficult to strike the proper balance when funding fixed, long-term promises with uncertain and variable resources.

The army's various pension plans tended to fare better, because their funding was always drawn from general revenues. Another strength was that retiring soldiers frequently were paid off, not with cash, but with grants of land—an inexpensive currency for a young and growing continental nation. This "lump sum" payoff had three potential benefits. It relieved the Treasury of a long-running liability. It put productive assets in the hands of citizens. And that, in turn, reduced the chances that those men would become dependent upon government for their support.

Little wonder that one of the quartermasters in George Washington's army, Brevet Major John Medearis of North Carolina, bestowed the name "Liberty" on the land that he was granted for his pension. You can see the historical marker to this day in Petersburg, Tennessee.

The Civil War, not surprisingly, led to the creation of the largest pension system offered in the United States prior to the creation of Social Security. At its peak in 1900, one out every five white males in America was on the rolls of the Civil War pension plan, which consumed nearly 30 percent of government spending. (By the way, if you visit Washington, DC, you can see the lasting legacy in the Pensions Building, a striking piece of architecture that now houses the National Building Museum.)

Yet despite the spread of these benefits following the Civil War, many Americans still didn't take what we would know as retirement.

As recently as 1900, almost two-thirds of American men aged 65 or older were in the work force. A major reason was that private employers were slow to offer retirement benefits, even as industrial-scale work for wages replaced craft shops. The American Express Company formed the first private-sector pension plan in the United States in 1875, followed in 1880 by the Baltimore and Ohio Railroad Company.

The concept caught on in a few industries—the railroads, banks, and public utilities—but didn't spread more widely, and the labor force participation rate of older American men didn't fall below 50 percent until the 1930s.

The Depression and World War II fundamentally changed the picture. In 1935, Congress created Social Security—a national program for retirees and survivors. And World War II's wage controls and tax incentives fueled the growth of private-sector pension plans. The vast majority of these plans offered "defined benefits," where the employer and plan bear the risk of investing funds to deliver on the promise of a monthly pension check for life—in other words, "traditional" pensions.

Defined benefit plans are still common—they are the dominant plans for state and local government employees. They're also offered by the federal government and by thousands of private employers. But as the economy has evolved over the past 30 years, we have seen a profound shift.

Emerging companies and employers that are launching or supplementing their retirement plans have tended to adopt a different model—the "defined contribution" approach of 401(k) plans. In this model, a retiree's ultimate benefits are not determined by a formula set by the employer, but by the savings and investment earnings accumulated during a worker's career.

Everyone involved in this shift—from workers on the factory floor to academics in the ivory tower—seems to recognize that it has had a powerful impact on America's retirement savings.

The conventional wisdom in some circles is that much of that effect has been negative.

To the contrary, we believe—based on research, on our members' deep involvement with the 401(k) system, and on the input we've received from workers who are actually participating in plans—that the trend toward 401(k) has strengthened Americans' prospects for secure retirement. The 401(k) fits the needs of American companies and workers, today and tomorrow. It's flexible and rapidly evolving to continue to meet those needs as our society and workforce change. And just as important, Americans have confidence in—and are committed to—the 401(k) system and the role it plays in securing their financial futures.

Strong statements—and I know that the discerning audience at Town Hall Los Angeles expects me to back them up. So let me start by dispelling some myths about the so-called "decline" of American retirement.

First—despite the financial crisis—Americans have set aside \$17.9 trillion in retirement assets at the end of 2011. That’s more than one-third of all household financial assets in the United States. That includes government employee plans, private-sector plans of all types, IRAs, and annuities—but it doesn’t include Social Security.

Second, our private-sector retirement system—both defined benefit and defined contribution— is providing more benefits to more people than ever before. Yes, you heard me right—more benefits to more people.

Conventional wisdom would have you believe that there was once a “golden age of the golden watch,” when most American workers were covered by defined benefit pension plans. Let’s take a look at the historical data. Despite everything you’ve read about the “decline” of private-sector retirement benefits, in fact the share of retirees who receive retirement income from private-sector plans rose by almost half from 1975 to 2010, from 21 percent to 31 percent. And the median benefit rose by almost one-third, after adjusting for inflation.

We don’t attribute this trend wholly to the growth of 401(k) plans. It also reflects changes in defined benefit plans that have improved the chances that workers actually collect meaningful benefits from the plans they’re offered.

But our further research shows that 401(k)s can provide substantial income replacement. Today’s 40-year-olds are the first cohort of workers who will spend their full career in a 401(k)-based system. Studies conducted by ICI and the Employee Benefit Research Institute show that these workers can replace a substantial portion of their working income in retirement from their accumulated 401(k) assets.

Many distinguished economists have reached similar conclusions. For example, James Poterba of MIT, Steven Venti of Dartmouth, and David Wise of Harvard conclude that “the advent of personal account saving will increase wealth at retirement for future retirees across [emphasis added] the lifetime earnings spectrum.”

I’d also note that even as defined contribution retirement plans are improving prospects for Americans’ retirement security, they are also working in other countries. Details vary widely, of course, but from Chile to Australia to Great Britain, the model of account-based individual savings is taking hold and helping address the severe fiscal problems of aging populations.

What are the factors that make 401(k)s and similar defined contribution plans so well suited for today’s economy? I would single out three elements:

- Portability;
- Ownership; and
- Innovation.

America's earliest private-sector pension plans, in the railroads and utilities, were designed for near-lifetime employment. Like the Roman legionnaires, workers often needed 25 or 30 years at one job to qualify for full benefits. Even if a worker could earn a partial benefit with a shorter tenure, the formulas were heavily back loaded. This was no accident: these plans were designed to retain skilled workers through their most productive years, and then encourage them to retire and make way for younger talent as they aged.

Americans are a mobile workforce, and it's not unusual for them to move from job to job—even career to career. That puts a premium on retirement benefits that are portable—that can travel with a worker throughout his or her lifetime, and that treat the first five years on the job the same as years 16 to 20.

Eliminating formula-driven benefits also gives workers remarkable flexibility to define their own work schedules and retirement timetables. The notion that everyone has to retire around age 65 is no longer binding, thanks to the defined contribution structure.

Portability reflects the second key characteristic on my list—ownership.

The holder of a 401(k) account owns actual assets—not a promise of future benefits. 401(k) participants have full rights to their own contributions and the investment earnings on those, subject only to the tax rules that encourage workers to preserve their savings for retirement. If their employer makes contributions, workers acquire ownership of those on a schedule that can't exceed five years. Participants control their assets, and the investment manager who oversees them is subject to strict fiduciary and regulatory requirements to safeguard them.

Let's be frank—owning and investing one's own assets brings risks. No one needs reminding that 401(k) balances fell sharply—by about one-quarter—in the crisis markets of 2008.

But the design of 401(k) plans helps limit the impact of investment shocks and mitigate risks. 401(k)s tend to suppress the sort of bad investor behavior—such as trying to time the market—that can really damage long-term returns. Making contributions from every paycheck helps workers invest in a style known as “dollar-cost averaging”—buying funds or other assets on a regular schedule, rather than chasing prices as they rise and fall. And the long-term nature of retirement savings encourages workers to keep their investments in place during market turbulence.

Beginning in 2008, in the teeth of the financial crisis, ICI has surveyed the record keepers of 401(k) plans to document and understand how 401(k) participants have responded. We've found a remarkable commitment to stay the course: even in the depths of the bear market, fewer than 4 percent of savers quit contributing to their plans, and fewer than one in seven switched asset allocations.

As a result, these 401(k) savers were poised to catch the upswing when stock markets recovered. With market gains and new contributions, 401(k) assets have risen 39 percent since 2008.

What's often overlooked by critics of 401(k)s and self-directed investing are the risks of defined benefit pension plans. Workers move; companies fail; plans go bust—and in every case, “guaranteed” pension benefits suddenly are not as sound as promised.

For both private-sector and public plans, the dangers also include the risks of over-promising, underfunding, and investment returns that fall far short of the levels needed to bridge those gaps. Here in California, I don't need to tell you that many, many public-sector pension systems are far short of the funding levels needed to provide the benefits they've promised to police officers, firefighters, and other municipal workers. To meet their commitments to current and future retirees, cities and states are forced to curtail services sharply, raise taxes significantly—or hit citizens with both. Reforming these pension schemes brings political challenges that in many states have proven nearly insurmountable.

If I may point back to my history lessons earlier, the contrast I see here is between Brevet Major John Medearis, secure on his Tennessee farm, and his naval counterpart, whose pension fund depended on others to navigate the tides of war and financial management. Just as Medearis owned his land, today's 401(k) participants own their accounts and, within the rules of the plan, make their own decisions about savings and investments.

I think that this is the model that better suits most Americans—and retirement savers resoundingly agree. In our most recent survey on retirement policy issues, 97 percent of households that own defined contribution accounts agreed that it was important to have control of the investments in their defined contribution plans.

The third factor that makes 401(k) plans particularly well-suited to today's economy is innovation.

The rapid development of 401(k) plans reflects a unique partnership among employers, participants, service providers, and investment providers, working within a framework set by government. Each of these groups has played a critically important role in designing, bolstering, and promoting 401(k) plans—and creating innovative solutions to problems as they've arisen.

Are young workers missing out on opportunities to save because they aren't enrolling in their plans?

Relying on insights from behavioral economics, employers have devised auto-enrollment features that put new employees in the 401(k) unless they opt out—using workers' inertia to boost, rather than depress, saving.

Are workers failing to save a large enough share of their pay to meet retirement goals?

Auto-escalation features raise workers' contribution rates every year to reach a more appropriate target level.

Is excessive risk aversion motivating employers or employees to direct contributions to low-yielding cash investments that don't offer significant growth potential over time? Are employees neglecting to

rebalance their 401(k) investments?

Target date funds now give participants a mix of stock and fixed-income investments that evolves over time, becoming less focused on growth and more focused on income as a participant ages. And under new regulations, employers have a safe harbor to use target date funds as default investments for their workers.

Each of these ideas gained momentum from the Pension Protection Act of 2006, legislation that sparked a burst of innovation that continues today. For just one example, data from the Vanguard Group show that the share of defined contribution plans offering auto-enrollment grew six-fold from 2005 to 2011.

And the timing could not have been more fortunate. It's not surprising that investors born in the 1970s, who have seen two severe bear markets bracketing the first decade of this century, are less willing to take investment risk and less inclined to invest in stocks. But in one area—balanced funds, including target date funds, in their retirement plans—they are increasing their exposure to stocks and the growth that those assets promise.

In short, the recent developments in 401(k) plans are helping these investors avoid over-reaction to the financial crisis—over-reaction that could hurt their retirement security decades from now.

To sum up: 401(k) plans are working to provide Americans with greater security in their retirement future. And thanks to their key features—portability, ownership, and innovation—401(k)s best meet the needs of today's rapidly changing economy.

Does that mean that our retirement system has achieved perfection?

Of course not.

Social Security provides the foundation of retirement security for almost all American workers—and for the majority of Americans, it may be the largest single income source in retirement. But on its current course, Social Security is not going to be able to meet its future obligations. I don't pretend to have the expertise to prescribe solutions. But let me say up front that I believe it is absolutely imperative to put Social Security on a sound financial footing. Social Security plays an indispensable role in our system as a universal, employment-based, progressive safety net for all Americans.

Workers need a deeper understanding of retirement savings. ICI worked hard for many years to help the Department of Labor craft comprehensive new disclosure standards for fees, risks, performance, and other vital information. The fruits of that labor are starting to appear this summer as savers receive uniform and enhanced information from their plans for all their 401(k) investment options.

We need to continue to innovate to meet a wide array of needs among America's workers. To increase participation and savings, ICI has called upon Congress to consider requiring all 401(k) plans to use

automatic enrollment and automatic savings escalation.

We must redouble our efforts to provide financial and investor education to all Americans at every age. This is a job for educators, for government at all levels, for financial institutions, and for all firms that serve the retirement market. And we must ensure that investors have access to the advice and support they need, whether saving through an employer plan or within an IRA.

We must meet the needs of 401(k) savers who are becoming 401(k) retirees by offering innovations to help them manage their assets to produce steady income streams in retirement. For example, mutual fund sponsors are working on pairing sophisticated investment models with systematic withdrawal programs to help retirees turn their 401(k) assets into consistent income streams throughout retirement. To meet the challenge of inflation, some providers are including Treasury Inflation Protected Securities, or “TIPS,” in their target date fund portfolios.

Finally, we must, as a nation, face up to our fiscal challenges without undermining the tax incentives and other features that successfully encourage millions of Americans to accumulate savings during their working lives and thus generate income in retirement. On this, Americans are solidly in agreement: in our 2011 survey, 85 percent of all U.S. households disagreed when asked whether the tax advantages of DC accounts should be eliminated, and 83 percent opposed any reduction in employee contribution limits.

Let me just leave you with one last thought: the next time you hear a commentator criticizing the impact of 401(k) plans on Americans’ retirement security, please keep in mind that the American people don’t share that view.

In our latest survey, almost two-thirds of all households—and more than three-quarters of those that own IRAs or DC accounts—said they have a “very favorable” or “somewhat favorable” view of 401(k) and similar defined contribution plans. And more than three-quarters of households with DC or IRA accounts said they were “very confident” or “somewhat confident” that these accounts can help individuals meet their retirement goals. That is a striking—and nowadays, unusual—degree of national consensus on a matter of such importance.

Americans face many economic challenges today, including the task of providing for a secure retirement. Meeting that goal requires thrift; it requires planning; it requires each of us to take responsibility for our future.

My message to you is that today’s Americans have the tools that they need to get that job done, building on the foundation of Social Security. In the 401(k) system, they have the means to save and invest—and to meet their goals. And working together, America’s employers, workers, plan providers, and government can continue to improve this flexible, innovative, and powerful system to the benefit of our nation.

Thank you, and I’ll be pleased to take your questions.

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