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Mutual Funds and the U.S. Retirement Market in 2004

Americans' tax-advantaged retirement savings have grown substantially in the past two decades, reaching a record \$12.9 trillion at year-end 2004, and retirement savers often turn to mutual funds to manage their assets. By year-end 2004, mutual funds managed \$3.1 trillion through individual retirement accounts (IRAs) and

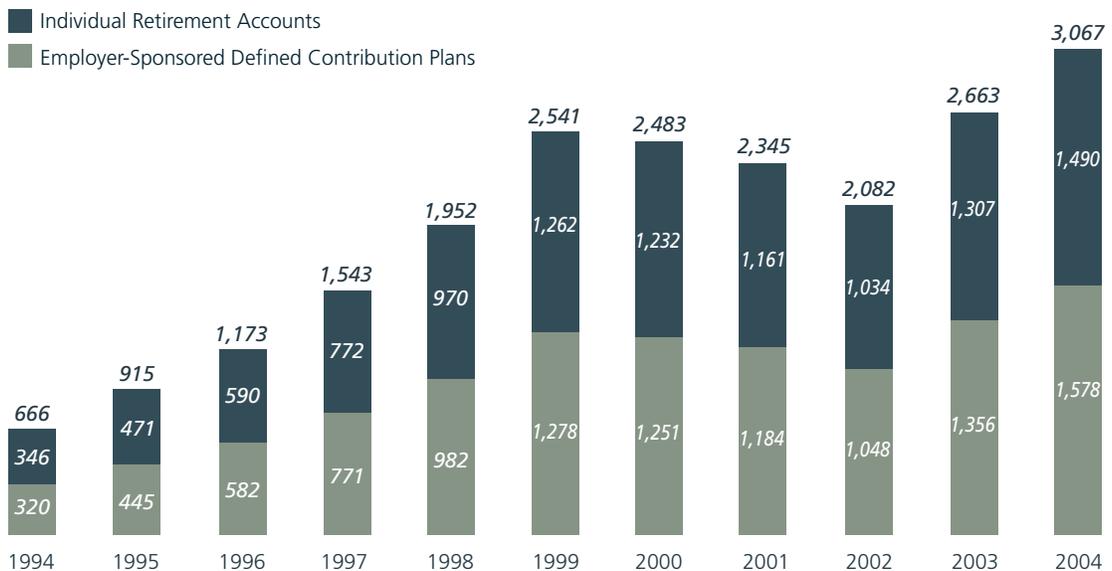
employer-sponsored defined contribution plans (Figure 1),^{1,2} and about 60 percent of the \$210 billion in net new cash flow to stock, hybrid, and bond mutual funds last year was invested through retirement accounts.

Given the importance of retirement savings to mutual funds and their investors,³ the Investment

figure 1

Retirement Assets Invested in Mutual Funds, 1994–2004

(billions of dollars)



note: Components may not add to total because of rounding.

source: Investment Company Institute

¹ Based on data from ICI's Annual Questionnaire for Retirement Statistics. The 2004 survey gathered data from 14,992 mutual fund share classes representing approximately 84 percent of mutual fund industry assets. Assets were estimated for all nonreporting funds. Data before 2004 reflect revisions to previously reported data.

Estimates of retirement assets in broker street name and omnibus accounts were derived from data reported on the Annual Questionnaire for Retirement Statistics and the Annual Institutional Survey.

² In this report, estimates of mutual fund assets in defined benefit plans have been excluded because of incomplete reporting. Federal Reserve Board, *Flow of Funds Accounts of the United States, Z.1 Release* (June 9, 2005) data indicate that mutual fund assets held in defined benefit plans accounted for about 1½ percent of the U.S. retirement market at year-end 2004.

³ Ninety-two percent of mutual fund shareholders indicate that saving for retirement is one of their financial goals and 72 percent indicate that it is their primary financial goal (see Investment Company Institute, "Profile of Mutual Fund Shareholders," *ICI Research Series*, Fall 2004 (http://www.ici.org/pdf/rpt_profile04.pdf)).

Company Institute (ICI) annually publishes statistics on the U.S. retirement market as an information resource for mutual fund companies, the media, policymakers, and researchers. ICI combines data from the U.S. Department of Labor, Federal Reserve Board, and other trade associations with ICI's own mutual fund survey information to estimate the employer-sponsored retirement plan arena and annuities not held in retirement plans. In addition, detailed total IRA asset information from the Internal Revenue Service (IRS) Statistics of Income Division helps complete the picture of the total U.S. retirement market.

This issue of *Fundamentals* provides an overview of the U.S. retirement market at year-end 2004 and the role that mutual funds play in managing these assets. Additional data on the retirement market are in an appendix available on ICI's website.⁴

An Overview of the U.S. Retirement Market

In addition to Social Security and private savings, Americans save for retirement in a variety of tax-deferred plans that held a combined \$12.9 trillion in assets at year-end 2004 (Figure 2).⁵ These plans include IRAs, employer-sponsored defined contribution and defined benefit plans, and annuities and

they are integral to households' overall retirement preparedness, accounting for more than one-third of household financial assets in 2004.⁶

The two largest components of the U.S. retirement market are assets in IRAs and defined contribution plans. Assets in these plans have grown more rapidly than in other types of retirement plans over the past two decades. By the end of 2004, IRAs and defined contribution plans made up more than half of all retirement assets, up from less than 40 percent in 1990. In 2004, IRA and defined contribution plan assets grew 13 percent, boosted by contributions and rollovers, as well as aggregate equity market returns of more than 10 percent over the year.⁷ Other retirement plan assets grew 7 percent over the year.

IRAs are the single largest component of the U.S. retirement market, holding \$3.5 trillion at year-end 2004 (Figure 3).⁸ Investors hold most (\$3.2 trillion) of their IRA assets in traditional IRAs,⁹ which they fund with rollovers from employer-sponsored retirement plans and/or contributions. Roth IRAs¹⁰ and employer-sponsored IRAs, such as SEP, SAR-SEP, and SIMPLE IRA accounts,¹¹ although a small portion of the IRA market (with combined assets of \$325 billion), have also experienced robust growth.¹²

⁴ The Appendix is available through ICI's public policy website at www.ici.org/pdf/fm-v14n4_appendix.pdf.

⁵ ICI adds non-annuity IRA, 457 plan, and 403(b) plan assets to total pension reserves reported in the Federal Reserve Board's *Flow of Funds Accounts*. To avoid double counting, annuities held in IRAs, 457 plans, and 403(b) plans are netted from life insurance pension reserves (annuities) reported in the *Flow of Funds Accounts*.

⁶ Federal Reserve Board, *Flow of Funds Accounts of the United States, Z.1 Release* (June 9, 2005) reports household financial assets of \$36.6 trillion at year-end 2004.

⁷ For example, the S&P 500 total return index increased 10.9 percent in 2004 and 28.7 percent in 2003 after falling 22.1 percent in 2002, 11.9 percent in 2001, and 9.1 percent in 2000 (see Ibbotson Associates, *SBB1 (Stocks, Bonds, Bills, and Inflation) 2005 Yearbook: Market Results for 1926–2004*, 2005).

⁸ Total IRA market assets are derived from tabulations of total IRA assets provided by the IRS Statistics of Income (SOI) Division for tax-years 1989, 1993, and 1996 through 2002. These tabulations are based on a sample of IRS returns. For a description of the SOI estimation techniques, see Peter J. Sailer, Michael E. Weber, and Kurt S. Gurka, "Are Taxpayers Increasing the Buildup of Retirement Assets? Preliminary Results from a Matched File of Tax Year 1999 Tax Returns and Information Returns," *National Tax Association, Proceedings, Ninety-Fifth Annual Conference on Taxation, 2002, Orlando, Florida*, Washington, DC: National Tax Association, 2003; pp. 364–369.

⁹ The Employee Retirement Income Security Act of 1974 (ERISA) created traditional IRAs. In 2004, approximately 36.7 million, or 32.8 percent of, U.S. households had traditional IRAs (see Sarah Holden, Kathy Ireland, Vicky Leonard-Chambers, and Michael Bogdan, "The Individual Retirement Account at Age 30: A Retrospective," *ICI Perspective*, Vol. 11, No. 1, February 2005 (<http://www.ici.org/pdf/per11-01.pdf>)).

¹⁰ Roth IRAs were created in the Taxpayer Relief Act of 1997 and were first available in 1998. In 2004, approximately 14.3 million, or 12.8 percent of, U.S. households had Roth IRAs (see Holden, Ireland, Leonard-Chambers, and Bogdan (February 2005)).

¹¹ The SEP (Simplified Employee Pension) IRA was created under the Revenue Act of 1978. The salary reduction (SAR) SEP IRA was created under the Tax Reform Act of 1986. The Small Business Job Protection Act of 1996 prohibited the formation of new SAR-SEP IRAs after December 31, 1996, but introduced SIMPLE (Savings Incentive Match Plan for Employees) IRAs, which were first available in 1997. In 2004, approximately 9.6 million, or 8.6 percent of, U.S. households had employer-sponsored IRAs (see Holden, Ireland, Leonard-Chambers, and Bogdan (February 2005)).

¹² See Appendix Figures A6 to A12 for additional details on IRAs.

Defined contribution plan assets are the second largest component of the U.S. retirement market with \$3.2 trillion in assets in 2004 (Figure 4). The most common defined contribution plans, 401(k) plans, held \$2.1 trillion in plan assets at the end of 2004, up 13 percent over the year (Figure 5). Some employers offer other types of defined contribution plans to their employees. For example, many educational institutions and certain nonprofit organizations offer 403(b) plans,¹³ and state and local governments (and certain tax-exempt organizations) provide 457 plans to their employees. Some private employers offer defined

contribution plans, such as profit sharing plans, that may not have 401(k) features.¹⁴ Together, these non-401(k) defined contribution plans held \$1.1 trillion in assets at year-end 2004, having grown 12 percent over the year.

Private employer-sponsored defined benefit plans held \$1.8 trillion in assets at the end of 2004, while federal, state, and local government plans held a combined \$3.1 trillion (Figure 2). Assets in annuities not held in the other specified retirement accounts amounted to another \$1.2 trillion at year-end 2004.

figure 2

U.S. Total Retirement Market, 1990–2004

(billions of dollars)

	IRAs	Defined Contribution Plans ¹	State and Local Government Pension Plans	Private Defined Benefit Plans	Federal Pension Plans ²	Annuities ³	Total
1990	\$636	\$891	\$810	\$923	\$340	\$389	\$3,989
1991	776	1,060	894	1,074	382	420	4,606
1992	873	1,161	974	1,099	426	470	5,003
1993	993	1,320	1,067	1,213	468	519	5,580
1994	1,056	1,407	1,105	1,305	512	523	5,906
1995	1,288	1,713	1,325	1,492	541	570	6,929
1996	1,467	1,953	1,506	1,613	606	605	7,750
1997	1,728	2,335	1,774	1,783	659	628	8,907
1998	2,150	2,621	1,996	1,928	716	778	10,189
1999	2,651	2,978	2,282	2,117	774	878	11,681
2000	2,629	2,921	2,166	1,951	797	891	11,355
2001	2,619	2,655	2,012	1,723	860	977	10,845
2002	2,533 ^p	2,334	1,777	1,446	894	980	9,964
2003	3,080 ^e	2,865	2,017	1,717	959	1,109	11,746
2004	3,475 ^e	3,228	2,120	1,846	1,024	1,208	12,902

e=estimated

p=preliminary

¹ Defined contribution plans include private employer-sponsored defined contribution plans (including 401(k) plans), 403(b) plans, and 457 plans.

² Federal pension plans include U.S. Treasury security holdings of the civil service retirement and disability fund, the military retirement fund, the judicial retirement funds, the Railroad Retirement Board, and the foreign service retirement and disability fund. These plans also include securities held in the National Railroad Retirement Investment Trust and the Federal Employees Retirement System (FERS) Thrift Savings Plan (TSP).

³ Annuities include all fixed and variable annuity reserves at life insurance companies less annuities held by IRAs, 403(b) plans, 457 plans, and private pension funds.

note: Components may not add to total because of rounding.

sources: Investment Company Institute, Federal Reserve Board, National Association of Government Defined Contribution Administrators, American Council of Life Insurers, and Internal Revenue Service Statistics of Income Division

¹³ See Appendix Figure A17 for the asset composition of 403(b) plans.

¹⁴ See Appendix Figures A14 to A16, which contain information on total other defined contribution plan assets and their mutual fund assets.

Role of Mutual Funds in the U.S. Retirement Market

In IRAs and defined contribution plans, mutual funds manage \$3.1 trillion, or about a quarter, of

total U.S. retirement market assets.¹⁵ In addition, there was about \$712 billion in variable annuity (VA) mutual fund assets outside IRA or defined contribution plan accounts at year-end 2004.¹⁶

figure 3

IRA Assets by Type of IRA, 1997–2004

(billions of dollars)

	Traditional ¹		SEP and SAR-SEP		Roth ²		SIMPLE		Total Assets (billions)
	Assets (billions)	Share ⁴ (percent)	Assets (billions)	Share ⁴ (percent)	Assets (billions)	Share ⁴ (percent)	Assets (billions)	Share ⁴ (percent)	
1997	\$1,642 ^e	95%	\$85	3%	-	-	\$1	(*)	\$1,728
1998	1,974	92	115	5	\$57	3%	4	(*)	2,150
1999	2,423	91	143	5	76	3	9	(*)	2,651
2000	2,407	92	134	5	78	3	10	(*)	2,629
2001	2,395	91	131	5	79	3	14	1%	2,619
2002 ^p	2,322	92	117	5	78	3	16	1	2,533
2003 ^e	2,799	91	151	5	104	3	26	1	3,080
2004 ^e	3,150	91	172	5	120	3	33	1	3,475

e=estimated

p=preliminary

¹ includes contributory and rollover IRAs

² includes contributory and conversion Roth IRAs

³ includes Education IRAs, which were renamed Coverdell Education Savings Accounts (ESAs) in July 2001

⁴ percent of total IRA assets

(*)=Less than ½ percent.

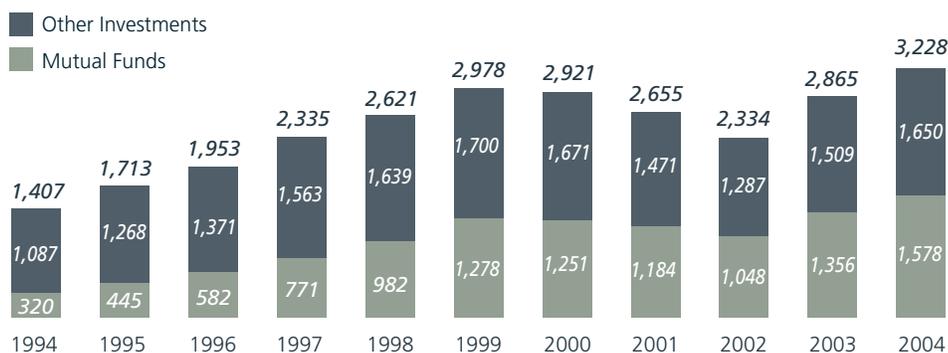
note: Components may not add to total because of rounding.

sources: Investment Company Institute and Internal Revenue Service Statistics of Income Division

figure 4

Defined Contribution Plan Assets and Amounts Held in Mutual Funds, 1994–2004

(billions of dollars)



note: Components may not add to total because of rounding.

sources: Investment Company Institute, Federal Reserve Board, National Association of Government Defined Contribution Administrators, and American Council of Life Insurers

¹⁵ At year-end 2004, IRA and defined contribution plan holdings of mutual funds were \$3.1 trillion, or 24 percent of the total \$12.9 trillion retirement market (see Appendix Figure A1).

¹⁶ At year-end 2004, variable annuity (VA) mutual fund assets totaled \$974 billion. About 27 percent of VA mutual fund assets were identified as being held in retirement plan accounts. The remaining \$712 billion was held outside retirement accounts through variable annuity contracts at insurance companies (which are counted in the annuity reserves in the U.S. retirement market totals) and variable life insurance contracts (which are not part of the U.S. retirement market annuities). See Appendix Figure A2 for VA mutual fund assets.

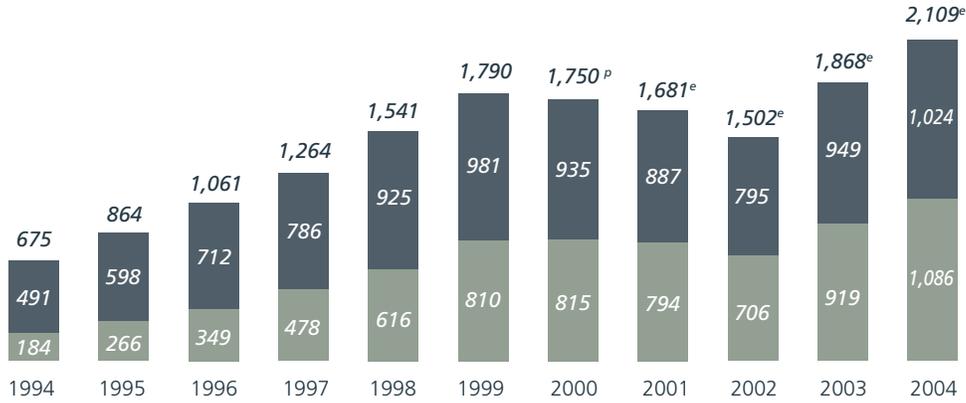
figure 5

Defined Contribution Plans by Type of Plan and Amounts Held in Mutual Funds, 1994–2004

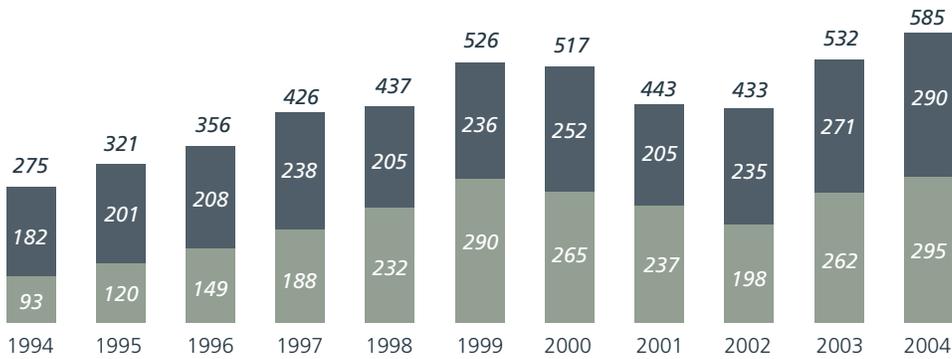
(billions of dollars)

■ Other Investments
■ Mutual Funds

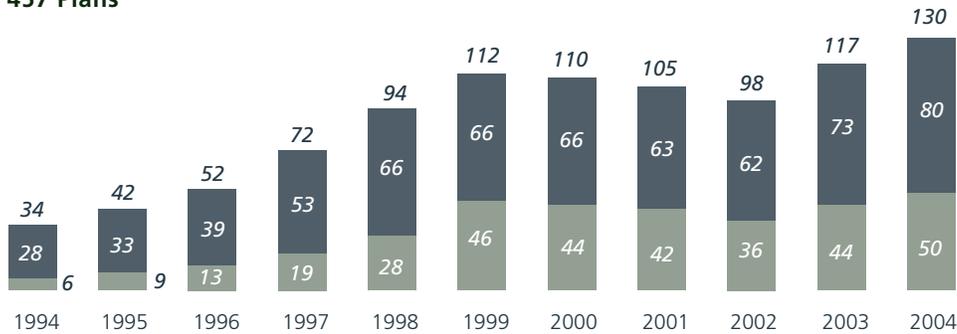
401(k) Plans



403(b) Plans



457 Plans



e=estimated

p=preliminary

note: Components may not add to total because of rounding.

sources: Investment Company Institute, Federal Reserve Board, National Association of Government Defined Contribution Administrators, and American Council of Life Insurers

Pension funds, banks, and insurance companies manage most of the remaining assets. Mutual funds represent significant shares of IRA and defined contribution plan assets, and as assets in these accounts have grown relative to other types of retirement assets, mutual funds' share of the retirement market has also increased. At year-end 2004, about half of the \$3.2 trillion in defined contribution plan assets was invested in mutual funds (Figure 4).

Mutual funds also managed a record \$1.5 trillion of the IRA assets in 2004 (Figure 6). Despite the record level of assets, mutual funds' share of the IRA market has declined slightly since the late 1990s (peaking with the bull market in equities in 1999) as the share of securities directly held

in brokerage and separately managed accounts increased.

Retirement accounts are an important component of the mutual fund business, holding nearly 40 percent of all mutual fund assets.¹⁷ Investors primarily hold long-term (stock, hybrid, and bond) mutual funds in these accounts. In 2004, \$2.1 trillion (or 70 percent) of retirement account mutual fund assets were invested in stock funds, \$361 billion in hybrid funds, \$315 billion in bond funds, and \$250 billion in money funds.¹⁸ Most of the retirement assets invested in mutual funds are held in actively managed funds, with investors holding about \$2.6 trillion in actively managed long-term mutual funds and \$249 billion in index funds at year-end 2004.¹⁹

figure 6

IRA Assets and Share of Total IRA Assets by Institution, 1990–2004

	Mutual Funds		Bank and Thrift Deposits ¹		Life Insurance Companies ²		Securities Held in Brokerage Accounts ³		Total Assets (billions)
	Assets (billions)	Share ⁴ (percent)	Assets (billions)	Share ⁴ (percent)	Assets (billions)	Share ⁴ (percent)	Assets (billions)	Share ⁴ (percent)	
1990	\$139	22%	\$266	42%	\$40	6%	\$191	30%	\$636
1991	187	24	282	36	45	6	262	34	776
1992	235	27	275	31	50	6	313	36	873
1993	319	32	263	26	61	6	349	35	993
1994	346	33	255	24	69	7	386	37	1,056
1995	471	37	261	20	81	6	476	37	1,288
1996	590	40	258	18	92	6	526	36	1,467
1997	772	45	254	15	135	8	567	33	1,728
1998	970	45	249	12	157	7	774	36	2,150
1999	1,262	48	244	9	202	8	943	36	2,651
2000	1,232	47	252	10	202	8	944	36	2,629
2001	1,161	44	255	10	211	8	993	38	2,619
2002	1,034	41	263	10	268	11	967 ^e	38	2,533 ^p
2003	1,307	42	268	9	285	9	1,221 ^e	40	3,080 ^e
2004	1,490	43	270	8	314 ^e	9	1,402 ^e	40	3,475 ^e

e=estimated

p=preliminary

¹ Bank and thrift deposits include Keogh deposits.

² annuities held by IRAs, excluding variable annuity mutual fund IRA assets

³ Securities held in brokerage accounts exclude mutual fund assets held through brokerage accounts, which are included in mutual funds.

⁴ percent of total IRA assets

note: Components may not add to total because of rounding.

sources: Investment Company Institute, Federal Reserve Board, American Council of Life Insurers, and Internal Revenue Service Statistics of Income Division

¹⁷ See Appendix Figure A3.

¹⁸ See Appendix Figures A6 and A13 for IRA and defined contribution plan holdings of mutual funds by type of fund.

¹⁹ See Appendix Figure A4 for index mutual fund assets.

Lifestyle and lifecycle funds have grown in popularity among investors and retirement plan sponsors in recent years. Lifestyle funds maintain a predetermined risk level and generally use words such as “conservative,” “moderate,” or “aggressive” in their names to indicate the fund’s risk level. Lifecycle funds follow a predetermined reallocation of risk over time to a specified target date, and typically rebalance their portfolios to become more conservative and income-producing by the target date.²⁰ About \$103 billion was invested in lifestyle and lifecycle funds at the end of 2004,²¹ and two-thirds of the assets were held in retirement accounts (Figure 7).

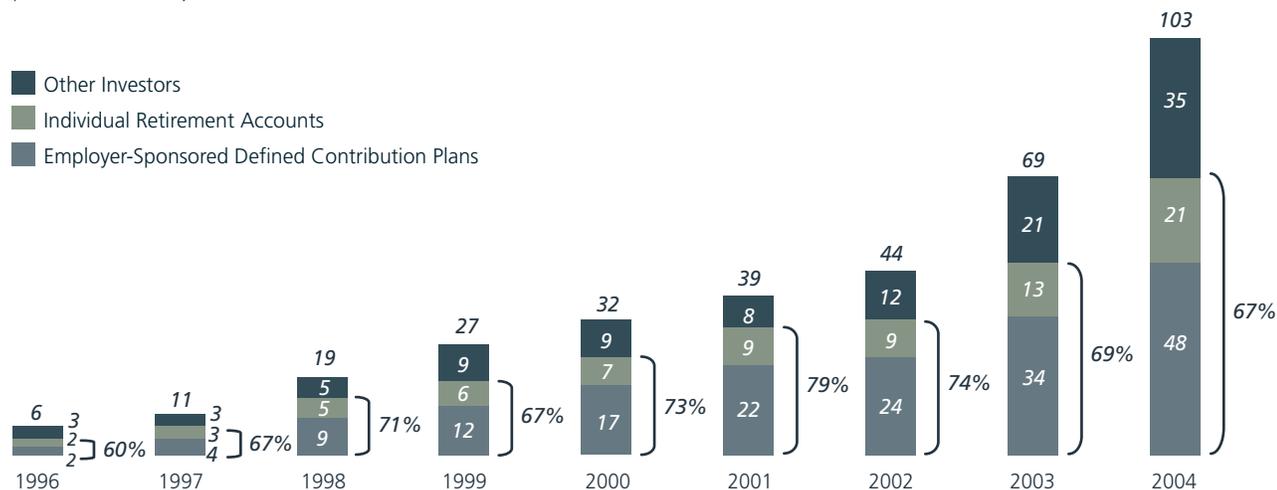
Estimated Net New Cash Flow from Retirement Accounts

Net new cash flow to mutual funds from retirement accounts picked up in 2004, as inflows to bond and stock funds continued to recover from the economic slowdown. The popularity of lifestyle and lifecycle funds boosted hybrid fund inflows from retirement accounts. Inflows to stock, hybrid, and bond funds from retirement accounts reached \$129 billion in 2004 (Figure 8),²² about 60 percent of the \$210 billion in net new cash that investors added to long-term funds for the year.²³ Money market funds continued to have outflows from retirement accounts, mirroring a pattern seen in general for money funds.

figure 7

Lifestyle and Lifecycle Fund Assets* by Account Type, 1996–2004

(billions of dollars)



*A lifestyle mutual fund is a hybrid fund that maintains a predetermined risk level and generally contains “conservative,” “aggressive,” or “moderate” in the fund’s name. A lifecycle mutual fund is a hybrid fund that typically rebalances to an increasingly conservative portfolio as the target date of the fund (mentioned in its name) approaches.

note: Components may not add to total because of rounding.

source: Investment Company Institute

²⁰ The target date is usually indicated in the fund’s name.

²¹ Often, lifestyle and lifecycle funds are organized as funds of funds, with their underlying portfolios invested in other funds managed by the fund sponsor.

²² ICI does not collect sales or net new cash flow for retirement plans on its Annual Retirement Questionnaire. Net new cash flow is sales of shares (other than reinvested distributions) less redemptions plus net exchanges. Net new cash flow was estimated by assuming that retirement assets within an investment objective category had the same investment performance as all mutual fund assets in that category. Investment performance for each investment objective was calculated by taking the total change in assets and adjusting for total net new cash flow during the year. Retirement assets were adjusted by investment performance. The residual change in assets was attributable to net new cash flow. The formula for the flow calculation is:

$$RF_t = \frac{TF_t(RA_{t-1} + RA_t) + 2(RA_t)(TA_{t-1}) - 2(TA_t)(RA_{t-1})}{(TA_t + TA_{t-1})}$$

For a given investment objective, RF represents retirement net new cash flow, TA represents total assets, TF represents total net new cash flow, and RA represents retirement assets.

²³ See Appendix Figure A5 for net new cash flow to mutual funds from retirement accounts by investment objective and industry totals. In addition, Investment Company Institute, *2005 Investment Company Fact Book, 45th Edition*, May 2005 (<http://www.ici.org/factbook/index.html>) highlights recent developments in the mutual fund industry.

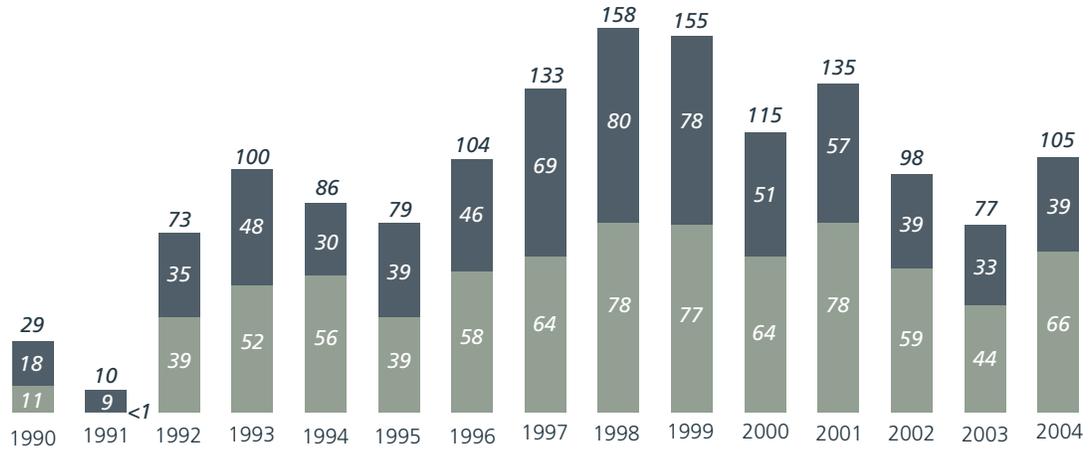
figure 8

Estimated Net New Cash Flow¹ to Mutual Funds from Retirement Accounts, 1990–2004

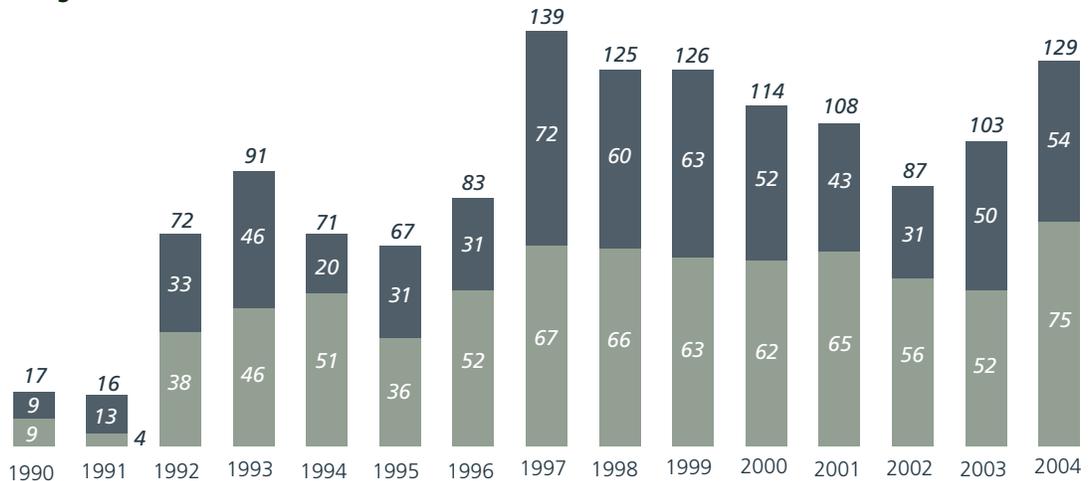
(billions of dollars)

■ Individual Retirement Accounts
 ■ Employer-Sponsored Defined Contribution Plans

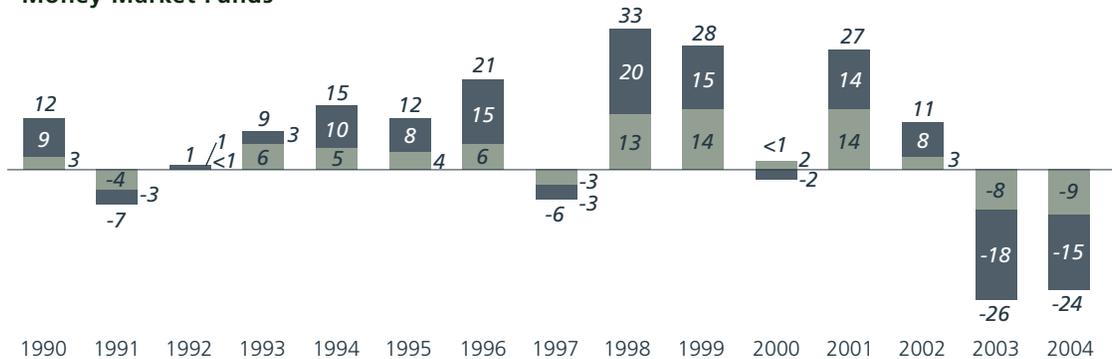
All Funds



Long-Term Funds²



Money Market Funds



¹ See text footnote 22 for an explanation of the procedure used to estimate net new cash flows.

² Long-term funds include equity, hybrid, and bond mutual funds.

note: Components may not add to total because of rounding.

source: Investment Company Institute