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The Facts on Retirement

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Thank you, Chris [Robling], and thank you to the Union League Club of Chicago for providing this opportunity to appear this morning. It's a great honor to be here.

As Chris noted, the Investment Company Institute has a deep and long-standing interest in America's retirement system. Mutual funds manage $5.7 trillion for participants in 401(k)-style plans and holders of individual retirement accounts, or IRAs—more than one-quarter of the assets Americans have earmarked for retirement.

But we have some guests with us today who share our deep interest in the issues we'll discuss today, and I'd like to mention some of them.

First, let me recognize Bob Benish, executive director of the Plan Sponsor Council of America, a national organization, based here in Chicago, that helps its member employers better manage their company's retirement plans.

We also are pleased to welcome Don Phillips, global head of research for Morningstar, and a number of his colleagues. Don has been educating and informing investors for 27 years, and retirement savers and other investors depend upon Morningstar's expert analysis of funds and investment every day.

I'd also like to recognize Richard Friedman, president and chair of the National Strategy Forum and a good friend for many, many years. NSF is a leading research organization on issues affecting U.S. national strategy and security.

A number of ICI member firms are represented here today—Ariel Capital, Aston Asset Management, Harbor Funds, Northern Trust, and Nuveen. Thank you for your support and for the good work you do for investors.

I'd also like to note the groups representing a number of area colleges and universities: Beloit College, Loyola University Chicago, DePaul University, and John Marshall Law School.

We made a special effort to include these young people in the audience because I believe that they, too, have a deep interest in my topic today—the strengths and challenges of the American retirement system.

When I prepare to talk about retirement, I'm sometimes urged to go to Sun City or some other haven where senior citizens are clustered. And it's true—retirement policy is important to retirees and older workers.

But I believe it is these young people, completing their education or starting their careers, who have the most at stake in ensuring the continuation and growth of a robust system that allows workers to plan for a secure retirement. So I am pleased that you are here today.

I'm going to single out Beloit for some special attention, because of an annual publication that I'm sure most of you have heard of—the Beloit College Mindset List. This is a compendium of what Beloit calls "the cultural touchstones that shape the lives of students entering college" in a given year—dozens of events, trends, and realities of everyday life that form the worldview of each new college class.

For example, for members of the Class of 2017—this fall's first-years—"having a chat" has seldom involved talking, and they have never needed to be in the same room to study with friends.

They grew up with Megan's Law and Amber Alerts, and communities anxiously on watch for their safety.

They never ask for directions—because their phones are equipped with GPS.

And they've never been in a tour bus driving down Pennsylvania Avenue in front of the White House, because the street was closed to traffic after the Oklahoma City bombings in 1995. As a longtime Washingtonian, that one makes me nostalgic.

Let me add one more item that the authors of the Mindset List could add.

Today's 18-year-olds have always lived in an America where the fastest-growing mechanism for achieving retirement security has been the 401(k) system.

When today's freshmen and women—and their older siblings—start their careers, odds are that they will work for employers offering defined contribution plans, such as 401(k) plans.

A few decades ago, having a pension almost certainly meant participating in a "defined benefit" plan. That meant the employer and the plan bore the risk of investing funds to deliver on the promise of a monthly pension check for life.

Defined benefit plans are still common. They are the dominant plans for state and local government employees, and are 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 away from "traditional pensions." In their place, emerging companies and other employers 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 that worker's career.

Now, 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.

I'm here to tell you today that this conventional wisdom is wrong.

Based on research by ICI and others—based on the deep involvement of ICI's member mutual funds with the 401(k) system—and based on the input we've received from workers who are actually participating in plans, we believe 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.

As evidence for those statements, I'm going to share several new findings from ICI's extensive research program on retirement.

That includes recent data on how the assets Americans have earmarked for retirement have grown, and new figures showing that more older Americans are collecting private-sector retirement income today than in the days when the traditional pension was considered the standard.

It also includes our latest research on how retirement savers came through the bear market of 2008. These data show how account balances for 401(k) participants and savers owning traditional IRAs have bounced back from the worst financial crisis since the Great Depression.

I'm going to discuss how events in Washington could threaten the tax incentives for saving that underpin the success of today's retirement system. We at ICI believe that preserving those tax incentives is vital to providing a secure retirement for today's and

tomorrow's workers.

And, because our 401(k) system is flexible and rapidly evolving, I'd like to discuss changes we support that could make it even stronger and more accessible for more workers.

Let's start with the big picture—and a new way to think about America's retirement system.

I'm sure most of you have heard of the "three-legged stool"—a model that said retirement security should depend upon Social Security, employer retirement benefits, and individual savings. And if you've heard of the "stool," you've probably heard that one leg or another is broken.

At ICI, we think of U.S. retirement resources not as a stool, but as a pyramid.

A pyramid has a wide and sturdy base—and in our system, that is Social Security, an almost-universal system for workers that provides substantial benefits, especially for those in the lower income brackets.

The second layer of the pyramid is homeownership. That doesn't mean retirees need to sell their homes to live off their equity. Instead, owning a home is like having an annuity, because a homeowner lives without paying rent.

The next two layers are the resources that we tend to count as retirement assets—employer-sponsored retirement plans, whether defined benefit or defined contribution, and IRAs. These are closely linked, because about half of the assets in IRAs originated as savings in employer plans.

Finally, atop the pyramid are the other savings and assets that some households have amassed.

Now, one insight that the pyramid brings is that each household's pyramid can be different. Some rely more on Social Security; others have more assets in employer plans. While each family's pyramid may be different, each pyramid can be equally sturdy.

Let's focus for a minute on the third and fourth layers—employer-provided retirement plans and IRAs. One surprising finding of our research is that the vast majority of near-retiree households have these employment-based resources in their pyramids. In 2010, according to data from the Federal Reserve's Survey of Consumer Finance, about 80 percent of households approaching retirement had accrued benefits or assets from employer plans or IRAs.

Another remarkable fact is the growth of Americans' resources for retirement. As of June 30, ICI data show that Americans had a record $20.9 trillion in total retirement assets. That figure includes IRAs, annuities, and employer plans, both defined benefit and defined contribution, in both the private and public sectors. It doesn't count the value of Social Security benefits or homeownership.

Huge numbers—in the trillions—demand context, so let me offer two facts:

- First, these retirement assets make up about one-third of American households' financial assets.
- Second, retirement assets per household today are more than six times greater than in 1975, even after adjusting for inflation. Today's households enjoy significantly greater assets earmarked for retirement than their counterparts did when defined benefit plans were more prevalent.

Despite these statistics, many critics of today's retirement plans cling to the notion that America once enjoyed a "golden age of the golden watch"—a time when most workers were covered by defined benefit pension plans.

Let's take a look at the historical data.

New figures that ICI is releasing today show that 32 percent of retirees in 2012 received income from private-sector retirement plans. That share of retirees is up by almost half from 1975, when 21 percent of retirees had income from such plans. And the median income received by those retirees, in constant dollars, has risen by nearly one-third.

More retirees receiving more income—these data belie what you've read about the "decline" of private-sector retirement benefits. In fact, such benefits are more prevalent and greater.

We don't attribute this trend wholly to the growth of 401(k) plans.

It also reflects changes in defined benefit plans—such as standard and shorter vesting periods—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 workers in their forties are the first cohort 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 achieve substantial replacement rates 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 the lifetime earnings spectrum.” [1]

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.

Defined benefit plans generally have been designed for workers who retire from the workplace where they’ve spent most of their careers. Workers often need 25 or 30 years at one job to qualify for full benefits. Even if a worker can earn a partial benefit with a shorter tenure, the formula is heavily back loaded. This is no accident: these plans are designed to retain skilled workers through their most productive years, and then encourage them to retire and make way for younger talent.

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.

Eliminating formula-driven benefits also gives workers remarkable flexibility to define their own work schedules and retirement timetables.

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 in five years or less. 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 in the crisis markets of 2008.

In 2008, the value of large-cap stocks fell by 37 percent. If you go back to 1825—almost two centuries—you will find only one year with larger annual losses, and that was 1931. 2008 was a terrible year for investors.

Let’s look at how two groups of retirement savers were affected.

In one study that we are releasing today, ICI observes the activity of 5.8 million consistent holders of traditional IRAs—those who had accounts in every year from 2007 through 2011. In the bear market of 2008, their average account balances fell by one-quarter or more.

Yet by 2011, the average balances for traditional IRA investors younger than age 70 had fully recovered.

For investors aged 70 or older, the average balance rebounded from 2008, but did not rise above the average at year-end 2007. In part, this reflects the fact that these IRA owners are required by the tax code to take annual withdrawals.

The story is similar for 401(k) investors. In a separate study, also being released today, ICI and the Employee Benefit Research Institute, or EBRI, look at 8.6 million participants who had 401(k) accounts at the same employer every year from 2007 to 2011.

These “consistent participants” were also hit hard in 2008. Their average account balances fell by 34.8 percent—more than one-third—that year.

But 401(k) participants generally stayed the course. They kept contributing to their plans, and they didn’t radically change their investment mix. So when markets came back in 2009 and 2010, those participants were there to enjoy the gains.

By year-end 2011, their average account balances were up by 23.5 percent from 2007. That’s a compound annual growth rate of 5.4 percent over those four years—even including the steep drop of 2008.

We believe these results are no accident.

The design of 401(k) plans helps limit the impact of investment shocks. 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.

We've been discussing the risks of 401(k)s—but we should not overlook the fact that defined benefit pension plans bear risks, too. Workers move; companies fail; plans go bust—and in every case, "guaranteed" pension benefits suddenly are not as sound as promised.

For defined benefit plans in both the private and the public sectors, 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 Illinois, I don't need to tell you that many public-sector pension systems are failing to meet the funding levels needed to provide the benefits they've promised to police officers, firefighters, and other municipal workers.

To honor their commitments to current and future retirees, cities and states may be forced to curtail services sharply, raise taxes significantly—or hit citizens with both. Reforming these pension schemes brings political challenges that in many places have proven nearly insurmountable.

I'm not expert in public-sector retirement plans, so I won't offer advice on fixing these problems.

But I will say to any worker who is offered a defined contribution plan: 401(k) plans can—and do—work. The private sector's experience demonstrates that.

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 employers' retirement 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 adjust their contributions as they grow older?

Auto-escalation raises workers' contribution rates every year to increase their rate of savings for retirement over time.

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

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. We still face many challenges in building a more secure retirement system.

Unfortunately, the first challenge is to defend what we already have.

America's retirement system depends heavily on tax incentives for savings offered through employer-sponsored plans and IRAs. In both defined benefit and defined contribution plans, current compensation for workers is set aside, on a tax-deferred basis, to provide

future retirement benefits.

These tax incentives have been instrumental in helping Americans set aside $19.1 trillion in public and private retirement plans and IRAs.

Nonetheless, some in Washington would target these “tax expenditures” as potential sources of revenue—either to help close the yawning gap in our federal budgets, or to help pay for lower tax rates in fundamental tax reform.

Even before this month’s turmoil in Washington, ICI strongly supported action to corral the growth of federal debt. And we can support tax reform that would broaden the tax base and reduce rates on both the corporate and individual income taxes.

At the same time, we are strongly opposed to limits or reductions on tax incentives for retirement savings—and we have told Congress of our opposition in no uncertain terms.

How do we resolve this apparent contradiction?

We support fiscal policy that encourages and rewards savings and capital formation—not spending and consumption. A budget and a tax code that promote savings will increase investment, economic growth, employment, and prosperity for us all.

Keep in mind, too, that our employment-based retirement system takes an enormous potential burden off of government. Any budget strategy that seeks to restrain the growth of mandatory federal spending must recognize the crucial need to preserve the incentives for employer and individual retirement savings.

If we can preserve these tax incentives, we can build upon the success of the 401(k) system to make Americans’ retirement even more secure.

Start with Social Security.

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 all of 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.

We’d like to make sure that every American who wants to save for retirement has access to the tools to do so. There are gaps to be filled.

One particular area of concern is very small employers. While such companies have a number of options for savings plans today, none of those options work well for workplaces where the majority of workers are focused on saving for goals other than retirement—such as education, a home, or an emergency fund.

One approach to help these companies would be to create a new, simpler retirement plan—the Simpler K.

It would allow workers who are focused on retirement saving to put away between $5,000 and $10,000 a year, tax-deferred, without the rules and costs more applicable to large plans.

We can also take steps to promote savings through IRAs. For a brief period in the eighties, anyone with a job could make pretax contributions to an IRA.

Today, eligibility rules are so complex that anyone who wants to save through an IRA has to puzzle through a full-page chart published by the Internal Revenue Service. Regulators should simplify the rules and promote the availability of IRAs for millions of workers and their spouses.

Meanwhile, Congress should help older savers by increasing the “catch-up” contributions for inflation.

Next—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.

We have about a year of experience now with the uniform and enhanced information that savers are receiving from their plans. We’re confident that 401(k) participants will benefit from easier access to this information.

We need to continue to innovate to meet a wide array of needs among America's workers. To increase participation and savings, employers should be encouraged to use automatic enrollment, and to set their workers' default contribution levels at appropriate levels. We also encourage use of 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.

There's plenty of work to do.

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 nearly four out of five 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.

endnotes

[1] See "The Changing Landscape of Pensions in the United States," NBER Working Paper (September 2007), available at http://www.nber.org/papers/w13381.

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