EVOLUTION OF EMPLOYER-SPONSORED RETIREMENT PLANS: NEW CHALLENGES FOR PARTICIPANTS

Taking matters into your own hands: Compared to past generations of Americans, fewer-and-fewer employees are able to rely on employer-sponsored pension plans to fund retirement

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Evolution of Company-Sponsored Retirement Plan

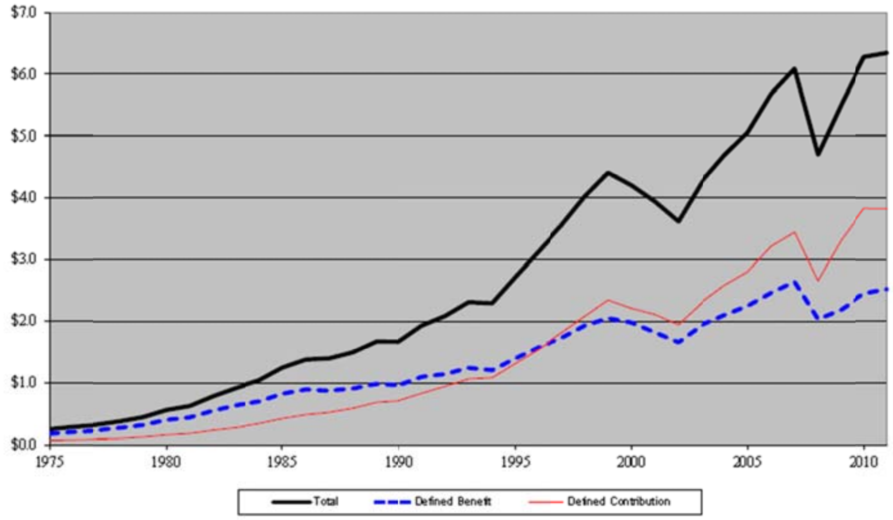
In prior generations, employees tended to stay at a single company for much of their working lifetimes. Upon retirement, employees would receive periodic payments from the company's pension plan, sometimes referred to as a *defined-benefit* plan. The amount of these payments would be determined by factors such as age, salary, life expectancy, and years of service (among other factors). The actual management of pension plan assets, including all trading research, projections and operational functions was left to investment professionals. Employees did not have to assume responsibility for making any investment decisions themselves. The responsibility of fulfilling the financial obligations to retirees fell upon the employer. Additionally, employers bore the liability of poor investment performance. From the employee's perspective, retirement planning was simple. The company would take care of everything.

The Rise of 401(k) and 403(b) Plans

In recent decades, many employers have made calculated decisions to shift away from pension plans to 401(k), 403(b) or 457(b) plans - sometimes referred to as defined contribution plans.

The following chart[1] depicts the growth of such plan assets over the last four decades. Total retirement assets in the United States are represented by the black line. Pension assets are shown in blue, while defined contribution assets are shown in red. Units are in $ trillions:

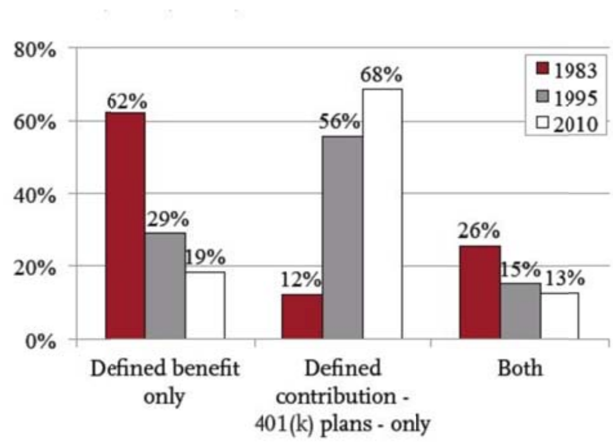
[1] US Department of Labor, Employee Benefits Security Administration. *Private Pension Plan Bulletin Historical Tables and Graphs.* Available at: http://www.dol.gov/ebsa/pdf/historicaltables.pdf. March 2012.



Today, total defined contribution assets exceed total pension asset by $1 Trillion. By transitioning from pension plans to defined contribution plans, benefits, investment risks and responsibilities shift from the company/organization to the participating employees.

This transition is especially apparent in the private sector. In 1995, total 401(k) plan assets approximately equaled those of private pension plans[2]. By 2010, total 401(k) assets ($4.5 trillion) *doubled* those of total pension assets ($2.2 trillion)[3].

In terms of employee coverage, growth was even more dramatic. From 1983 to 2010, the percentage of employees covered by only pension plans decreased from 62 percent to 12 percent, while the percentage of employees covered by only 401(k) plans increased from 19 percent to 68 percent.



[2] See previous footnote.

[3] Investment Company Institute. *Retirement Assets Total $17.5 Trillion in Fourth Quarter 2010.* Available at http://www.ici.org/pressroom/news/ret_10_q4. 13 April 2011.

Many defined-contribution plans include matching employer-contributions as a benefit. In most cases, taking advantage of this "free money" makes common financial sense.

Unfortunately, most defined-contribution plans come attached with drawbacks for participating employees. Although employees assume all investment risk in defined-contribution plans (unlike pension plans), plan sponsors (the employer) infrequently provide sufficient guidance. Many defined-contribution plans suffer from fundamental drawbacks, resulting in common mistakes:

- A lack of information that is useful in the decision-making process
- Generic, one-size-fits-all investment recommendations; no knowledge of outside employee-owned assets
- No understanding of the employee's attitudes towards and ability to accept investment risk
- A lack of specific investment options
- Investment options too similar in nature (making it more difficult to diversify away unsystematic risk)
- Insufficient ongoing due diligence
- No systematic rebalancing and/or reallocation options

These drawbacks often result in the following investing mistakes:

- Avoid investing altogether (holding all assets in a cash or money market account)
- Reactive investing (chasing winners)
- Failure to rebalance and reallocate
- A general lack of understanding risk and return tradeoffs
- Failure to consider other investments in asset allocation decisions
- No incorporation of new economic data or new investment options in asset allocation decisions

Comparing Performance of Pensions and Defined-Contribution Plans

In 2006, the Center for Retirement Research at Boston College published a report comparing the performance of pension plans to 401(k) plans. Over the time period measured (1988 to 2004), **pension plans outperformed 401(k) plans by approximately 79% on a cumulative basis** despite "the fact that 401(k) plans held a higher portion of their assets in equities during the bull market of the 1990s[4]."

[4] Munnell, Alicia; Soto, Libby and Prinzivalli. Center for Retirement Research at Boston College. *Investment Returns: Defined Benefit vs. 401(k) Plans.* Number 52. September 2006.

In short, trillions of dollars in retirement assets are mismanaged, simply because many employees do not have access to meaningful investment advice or tools.

Takeaway Points for Plan Participants

From a plan participant perspective, it is important to acknowledge the following:

- Defined contribution plans are most likely here to stay; therefore, it is important for employees to take responsibility of their financial future
- By default, defined contribution plans require the employee to make important financial decisions regarding their retirement money
- If they don't understand the decisions they face or don't have the proper time to dedicate then it is incumbent upon them to seek professional advice
- The price is too high just to ignore their retirement assets
- Employees should also take advantage of all employer sponsored education regarding their retirement plan