

Susan S Bies: Retirement savings, equity ownership, and challenges to investors

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Good afternoon. I am delighted to be here to speak about some of the new challenges and opportunities that American families face from changes in retirement savings and equity ownership in the United States. I know that many of your members are economists who work in policy advisory roles in government. As an economist who enjoys getting back to her Ph.D. roots, I want to also address how traditional economic theory about consumer behavior and corporate governance are, at times, in apparent conflict with the practices that we observe. This in turn raises issues about the appropriate economic and policy frameworks for decisionmaking.

There has been a dramatic shift in employer-sponsored retirement plans over the past two decades - a shift from plans in which pension managers controlled most investments and retirees received preset benefits to plans in which workers directly control their investment portfolios and keep their investment returns. Many American families have responded by purchasing corporate equity - frequently through investments in mutual funds or other institutional accounts. With increasing control over their pensions, and broader participation in equity markets, Americans have far more options for financial planning than they did twenty years ago.

But with the new opportunities come risks and responsibilities. Households with more control of their resources for retirement have a greater need to employ sound financial planning. Moreover, though many might be unaware of it, stock-owning households share responsibility for oversight and governance of the corporations they own.

The headlines of the past couple of years have highlighted the importance of these risks and responsibilities. We have all witnessed a precipitous fall in stock prices and some spectacular corporate failures and have read accounts of retirement savings accrued over long careers only to be lost in a matter of weeks. Some of those corporate meltdowns were accompanied by the revelation of shoddy auditing practices and stock analyses tainted by conflicts of interest. And those who should have been ensuring sound corporate governance were often unwilling or unable to protect the interests of shareholders.

Recent developments suggest that households may, in coming years, take on even more responsibility for their retirement saving and assume additional responsibilities for corporate governance. The President's recently released budget for 2004 would considerably expand tax-preferred savings accounts for American families. And newly adopted Securities and Exchange Commission rules that give investors unprecedented access to proxy-voting records of mutual funds will enable and encourage investors to take more active roles in corporate governance.

With this backdrop, I would like to start by discussing some of the challenges confronting families, employers, and policymakers as workers assume greater control of their retirement planning. Later, I will turn to some issues related to individual investors' roles in corporate governance.

Retirement savings

The American pension landscape has changed dramatically in the past twenty years. Mostly gone are the days when companies addressed their workers' retirement needs solely by paying fixed pensions from retirement until death. Today's workers are much more likely to manage their own retirement resources by participating in employee-directed savings accounts. This trend has greatly expanded workers' responsibilities for their retirement planning. But it has also raised significant new questions about how effectively employees are handling their new freedoms and responsibilities, and what the appropriate role for employers should be in helping their workers plan for retirement.

What lies behind the two-decade trend toward worker-directed savings accounts? Companies like them because they relieve the firm of the burden of managing a pension fund to finance promised

benefits. One need only scan a few recent headlines to be reminded of the difficulties that underfunded pension plans can impose on corporate balance sheets. With a savings-account plan, in contrast, companies need only set up the accounts and let their employees manage the investments. And workers also like savings account plans, because they provide more choices and because they are portable - that is, they can travel with the employee from job to job. A particularly popular type of savings plan is the 401(k), which lets workers make pre-tax contributions to retirement accounts through payroll deduction. Twenty-five years ago 401(k) plans did not exist. Today they cover more than 40 million workers, take in \$150 billion in annual contributions, and hold assets worth more than \$2 trillion.

This is a significant development, because along with the greater flexibility of a 401(k) plan comes greater responsibility on the part of individuals to direct their own retirement saving. Workers must decide whether to participate in the plan, how much to contribute every pay period, where to invest contributions, when to rebalance their asset mix, and what to do with balances when changing jobs.

Economic theory provides the basis for making these types of choices, but the problems are complex and the average employee may not have developed the skills to formally evaluate the alternatives. And, in fact, recent research has found some troubling patterns: Many workers do not participate in their employers' retirement plans, contribute a small proportion of their wages, and make questionable investment and distribution choices.

Let me just take a minute to cite some telling facts about 401(k) plans. Despite the tax advantages of 401(k) contributions, one-quarter of workers eligible for 401(k) plans do not participate at all, even when their employers would match a portion of their contributions.¹ These workers are effectively turning down a pay raise by leaving compensation on the table. And many who do participate save just a little. In a survey last year, one-quarter of firms reported that their rank-and-file 401(k) participants saved an average of less than 4 percent of pay.²

How will these plans affect retirement security in the long run? Several studies suggest that many workers are not saving adequately for retirement.³ In 2001, among households with retirement accounts who were approaching retirement age, one-half had balances of less than \$55,000, and one-quarter had balances of less than \$13,000.⁴ Clearly balances of this size will not be adequate to finance many economic emergencies and will barely supplement social security over the two or three decades that often follows retirement.

There are other concerns about the way in which employees manage their 401(k) plans. Some seem to give little attention to the way their contributions are invested. For example, some participants divide assets equally across all available investment options, or simply invest contributions according to plan defaults.⁵ And, as was made painfully clear last year, many 401(k) participants seem to invest heavily in employer stock.⁶ Overall, about one-quarter of aggregate 401(k) balances are in company stock, but for many employees the share is far higher.

Why do workers invest so much in company stock? The question is particularly pressing because workers' financial outcomes are already heavily dependent on the fortunes of their employer. Moreover, employers often require that the matching contributions they make on behalf of their employees be invested in company stock. Thus, when employees invest their own contributions in the company stock, they are ratcheting up an already-risky position. Elementary finance theory suggests they shouldn't do it.

¹ Deloitte and Touche, 2002 401(k) Annual Benchmarking Survey.

² Deloitte and Touche, 2002 401(k) Annual Benchmarking Survey.

³ For a review, see Olivia Mitchell, Brett Hammond, and Anna Rappaport, *Forecasting Retirement Needs and Retirement Wealth*, University of Pennsylvania Press, 2000.

⁴ Based on the Federal Reserve Board's 2001 Survey of Consumer Finances.

⁵ Nellie Liang and Scott Weisbenner, "Investor Behavior and Purchase of Company Stock in 401(k) Plans - The Importance of Plan Design," FEDS Working Paper 2002-36 and NBER Working Paper W9131, 2002. See also Shlomo Benartzi and Richard Thaler, "Naïve Diversification Strategies and Retirement Savings Plans," *American Economic Review*, vol. 91 (2001), pp. 79-98.

⁶ Nellie Liang and Scott Weisbenner, "Investor Behavior and Purchase of Company Stock in 401(k) Plans - The Importance of Plan Design." See also Shlomo Benartzi, "Excessive Extrapolation and the Allocation of 401(k) Accounts to Company Stock," *Journal of Finance*, vol. 56 (2001), pp. 1747-64.

Yet many workers believe that their employer's stock is less risky than broad market averages.⁷ What explains this apparent disconnect? As someone who held a large fraction of my own 401(k) plan in my company's stock for many years, perhaps I can help answer this question. There is a difference between risk and uncertainty. Employees may feel less uncertain about the prospects of the company for which they work relative to other companies about which they know little. This may make them more comfortable about holding their company's stock - even at the cost of a poorly diversified and highly volatile portfolio.

To summarize, experience has shown that while 401(k) plans offer workers unprecedented flexibility in managing their pensions, some workers do not seem to be using them effectively - they contribute too little, make questionable investment choices, or fail to participate at all. In response, some employers have expressed increased interest in employer-provided financial education.

But employers' attention to plan design turns out to be just as important. Contrary to predictions of traditional finance theory, the way retirement-plan options are framed to workers affects the choices they make. This is where the new discipline of behavioral finance has begun to offer significant contributions. Some of the most innovative and apparently effective ideas about retirement-plan design owe to the insights of behavioral finance.

As compelling evidence that framing matters, researchers have found that so-called "opt-out" plans, or plans that automatically enroll workers, have significantly higher participation rates than plans that require workers to sign up.⁸ Not surprisingly, employers have responded by making automatic enrollment more prevalent: A recent survey found that nearly a quarter of large plans either have adopted automatic enrollment or are considering adopting it.⁹

But automatic enrollment may not be enough, since automatically enrolled employees often give little attention to the default options of the plan. One study found that half of automatic enrollees had not moved from the defaults even three years after enrollment.¹⁰ This could be a problem because default contribution rates, which are typically 3 percent of pay, are often too low to allow workers to take full advantage of employer matches, let alone to build sufficient assets for retirement. In fact, there is some evidence that the low default rates reduce contributions among workers who would likely have saved more in the absence of the default. Finally, the default investment choice in automatic enrollment plans is typically the least risky, such as a money market or stable value fund. While these investments are especially safe, their expected returns may be too low to achieve long-term retirement security.

Subsequent research has highlighted how employers might improve their automatic enrollment plans. For example, they might set higher default contribution rates and greater default exposure to a diversified set of higher-yielding assets. Another possibility is to bring new employees on board with low contribution rates - just as is often done currently - but then to nudge contribution rates up as the workers receive pay raises. Some studies have shown that workers are willing to pre-commit to such a plan, which eventually results in significantly higher rates of savings.¹¹

But along with these new opportunities for employers come difficult new questions. How high should their employees' savings rates go? In an ideal world, all employees would be making well-informed savings decisions and wouldn't need any encouragement from their employers. But, in reality, a plan's design affects the financial well-being of its participants. And though a default savings rate of 3 percent of pay might seem too low, an employer is not necessarily in a good position to know what the appropriate saving rate should be. A high default rate may be inappropriate, particularly if employees respond by dissaving outside their retirement plan.

⁷ Vanguard Center for Retirement Research. *Vanguard Participant Monitor: Expecting Lower Market Returns in the Near Term*, December 2001.

⁸ Brigitte Madrian and Dennis Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," NBER Working Paper No. W7682, 2000.

⁹ Deloitte and Touche, *2002 401(k) Annual Benchmarking Survey*.

¹⁰ James Choi, David Laibson, Brigitte Madrian, and Andrew Metrick, "For Better or for Worse: Default Effects and 401(k) Savings Behavior," NBER Working Paper No. W8651, 2001.

¹¹ Richard Thaler and Shlomo Benartzi, "Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving," unpublished Manuscript, 2001.

Many employers will recoil from making these choices, because they do not want to become too paternalistic. But a significant and inescapable implication of this line of recent research is that employers cannot avoid responsibility in this area, because there is no "neutral" plan design - whatever design they choose will affect the retirement security of their employees.

To summarize, the past two decades have brought remarkable expansion of the financial options available to ordinary workers, including significant new tools for retirement planning. But this experience has also revealed some important lessons for workers, companies, and policymakers. While many - perhaps most - workers effectively use the new tools to prepare for retirement, some do not. Moreover, participants' choices are often affected by the presentation of the options. Thus, companies offering retirement savings accounts such as 401(k) plans face a delicate balancing act. While they desire to shift the maximum degree of decisionmaking to workers, they must acknowledge that basic plan-design choices will affect the long-term retirement security of their employees. Companies that find the right combination of financial education and plan design will be in the best position to help their employees prepare adequately for retirement.

Equity ownership

As Americans have stepped up their use of employee-directed savings accounts in the past couple of decades, many have also purchased their first shares of corporate equity - often within their 401(k) plans. More than half of U.S. households now own either stock or stock mutual funds.¹² Moreover, equity ownership reaches further into younger generations and the middle class now than it did in the 1980s. From 1989 to 2001, the fraction of Americans younger than 35 who owned stock more than doubled, as did stock ownership among families with below-median income.¹³

This striking increase in equity ownership is, in part, an outgrowth of the move toward worker-directed savings plans, as I've already discussed. More than two-thirds of U.S. stockholders now hold some stock in an employer-sponsored retirement plan.¹⁴ In addition, the heightened popularity of owning stocks probably reflects a broadened understanding of the potential benefits of equity investments and perhaps an increased tolerance for financial risk. Also important, especially for investors of relatively modest means, is that mutual funds in particular have substantially reduced the cost of purchasing a diversified portfolio. Despite the ease with which corporate equities can be traded directly nowadays - through on-line brokerage accounts, for example - a recent survey found that two-thirds of stockholders first bought their equity shares through mutual funds.¹⁵

Besides its financial risks and potential rewards, stock ownership imparts important corporate governance responsibilities. In fact, economic theories of firm behavior often stress the competing interests of management and ownership. With an ownership share in a business, every stock investor has a role in providing oversight on how that company is run. The egregious corporate scandals in the headlines last year have highlighted the need for responsible oversight by corporate boards and shareholders alike to check the behavior of management. So, as we look for solutions to corporate governance problems, we should not forget that every individual who owns stock has a role - perhaps a small one, but an important one.

Yet the growth in households' equity ownership has come with an ironic twist: While more households own shares of corporations, many of the new stockholders are unable to play a role in corporate governance. Why? Because Americans have largely purchased their shares through pension funds, mutual funds, insurance companies, and other financial institutions. These financial intermediaries, which act as the agents for household investors, have generally not made much, if any, effort to make their governance policies transparent and responsive to the preferences of their investors.

¹² Aizcorbe, Ana, Arthur Kennickell, and Kevin Moore, "Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances," *Federal Reserve Bulletin*, vol. 89 (January 2003), pp. 1-32, and Federal Reserve Board staff calculations from the Survey of Consumer Finances. See also Investment Company Institute and Securities Industry Association (ICI and SIA), *Equity Ownership in America*, 2002.

¹³ Aizcorbe, Kennickell, and Moore, "Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances."

¹⁴ ICI and SIA, *Equity Ownership in America*.

¹⁵ ICI and SIA, *Equity Ownership in America*.

So, as Americans have been purchasing most of their stock indirectly through institutional investors, the responsibilities for active monitoring of corporate management and governance mechanisms have been shifting to institutions. There's good news, bad news, and some promising news to report about this trend.

The good news is that we may have reason to expect that institutional shareholders would be especially active in working for good corporate governance. An institutional investor holding a large block of stock naturally reaps more of the rewards of good corporate governance than an individual holding a small number of shares, and the big institutional investor undoubtedly has more leverage with management. In addition, as individuals buy their stock through institutions, the task of forming shareholder coalitions to effect good governance ought to become that much easier.

The bad news is that, with some notable exceptions, institutional investors historically appear to have been fairly passive shareholders and have tended to shy away from challenging management directly and from initiating reform-oriented proxy proposals. Also some institutional investors may face conflicts of interest in providing active governance if they also compete to sell financial services - like pension-plan administration - to the firms whose shares they hold.

To be sure, the evidence on institutional shareholder activism and conflicts of interest is limited, because few institutional investors provide any information about how they vote the shares in their portfolios. So, individual investors interested in corporate governance are unlikely to be able to ascertain anything about how an institutional investor has voted shares on their behalf. Although some institutional investors may have been active in behind-the-scenes attempts to promote good management decisions, few details about these efforts are made available to the public, which ultimately bears the risk of stock ownership.

And the promising news? Just last month, the SEC approved new rules that will require investment advisers and mutual funds to disclose their proxy voting policies and specific proxy votes. For most investors in mutual funds, the new rule will provide unprecedented information about how votes are being cast on their behalf.

In fact, some have criticized the new disclosure rules for imposing too great a burden on mutual funds and for providing too much information to be useful to most investors. But that criticism misses the point. Disclosure of proxy voting records will likely initiate new efforts to educate individual investors on corporate governance issues.

Disclosures about proxy voting are especially important for index funds. Actively managed funds can signal dissatisfaction with corporate officers by selling shares, but index funds, which passively hold a basket of representative companies, cannot. Soon, by monitoring the proxy-votes of index-fund managers, investors will be able to gauge their fund managers' satisfaction with corporate officers.

By the time the first proxy-voting reports are required to become public in 2004, I expect that the initial steps toward corporate governance education will already have been taken. Individual investors looking for guidance on the way mutual funds vote their proxies will be able to turn to a slate of organizations that monitor and analyze mutual funds' voting records. I look forward to learning how my mutual funds have voted their proxies and to comparing their voting records with those of other funds. As other investors do the same, the new disclosures will likely have the additional side benefit of directing new attention to corporate governance.

Conclusion

Some of last year's most striking developments - tumbling stock prices, evaporating retirement accounts, and improper corporate oversight - highlighted the importance of longer-term trends in pension plans and equity ownership. As more workers have managed their own retirement accounts and more become stockholders through pension plans and mutual funds, more have learned about both the rewards and the risks of investing in capital markets. With individuals' increasing exposure to market fluctuations and greater participation in equity markets come both new opportunities and new responsibilities, for both workers and employers. Today I've discussed some of the issues that have come to light as a result of long-term trends in pension plans and equity ownership. And I'd like to leave you on an optimistic note with this observation: The issues I discussed today are only possible because of the remarkable breadth and depth of capital markets in the United States. I am confident that over the long haul, the concerns I noted will simply represent the ordinary climb along the

investment-learning curve as a broader segment of American households work to achieve their financial goals.