EBRI
Employee Benefit Research Institute

Statement Before

The Senate Special Committee on Aging

Hearing on

The Future of the Social Security Program

by

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STATEMENT OF PAUL J. YAKOBOSKI
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SUMMARY

A clear understanding of the investment decisions that workers are currently making in their 401(k) plans and how these decisions vary with worker demographics is important for policy purposes, in particular, for evaluating the implications of proposals that would to some degree privatize the Social Security System with individually directed accounts.

Many analysts have focused on average allocations in past studies of worker investment decisions in 401(k) plans. While informative, data on average allocations mask much of the detail regarding the variation in investment preferences among workers with differing demographic characteristics. Our research indicates that a significant fraction of plan participants, particularly younger ones, are heavily diversified into equities, while at the same time a large percentage of their peers hold zero equities in their accounts. The data indicate that the low earning, younger participants may not appreciate the advantages of diversifying their 401(k) portfolio to include equities when investing for a retirement that is decades in the future.

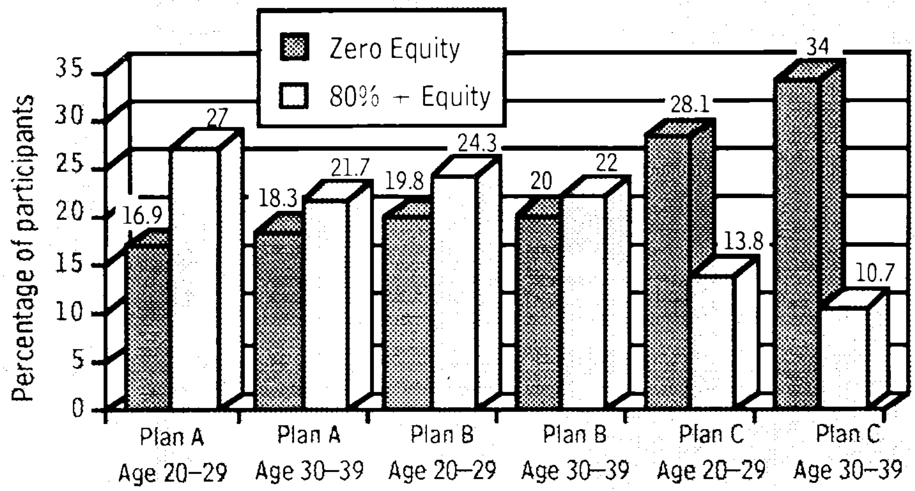
For example, in one large plan 21 percent of participants had none of their account balances invested in any equity-based funds (not including company stock). It is particularly noteworthy that 17 percent of participants in their 20s and 18 percent of those in their 30s had <u>none</u> of their account balances invested in the equity options. On the other hand, 21 percent of all participants had over 80 percent of their account balances invested in equity-based funds. Twenty-seven percent of participants in their 20s and 22 percent of participants in their 30s had heavy equity investments (greater than 80 percent of account balances). Relatively few low earning participants were invested heavily in equities with their 401(k) account balances. At higher income levels, about one-quarter of plan participants had over 80 percent of their assets invested in equities. Higher income participants were also much less likely to have zero equity investments. This was a plan that had an extensive participant education program.

According to the 1995 EBRI/Greenwald Retirement Confidence Survey, 95 percent of plan participants utilizing educational material provided to them reported that the material included a description of the investment options available in the plan, and 69 percent reported that the material covered the principles of asset allocation and diversification. Almost one-half (46 percent) of these workers reported that the material led them to reallocate their money among the options available in the plan. This effect was slightly more likely among those with a high school degree or less (50 percent) than among those with more education (45 percent).

Our research indicates that education can have an impact in terms of leading workers to reallocate their 401(k) savings investments. At the same time we see that, even in plans with relatively sophisticated education and communication programs, there exists a real dichotomy in the allocation behavior of workers within similar demographic groups. Variations in decisions will naturally lead to variations in retirement income results.

Chart 1

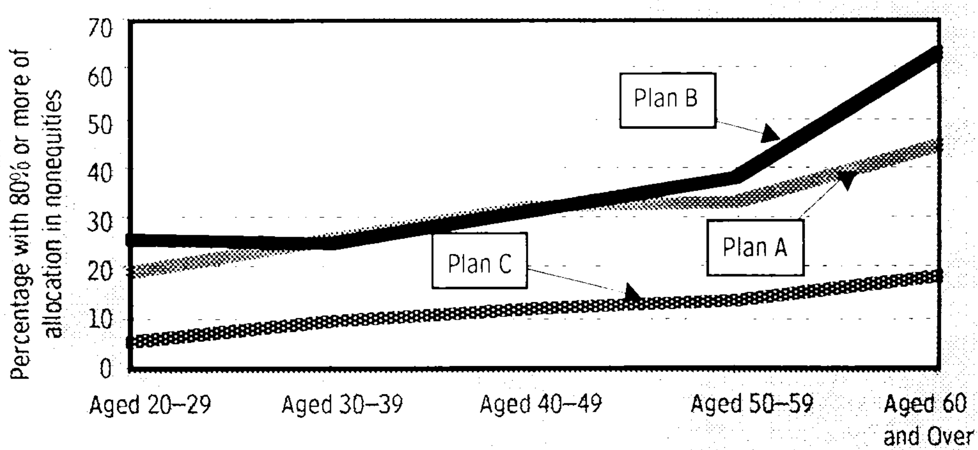
EQUITY INVESTMENT PATTERNS AMONG YOUNG PLAN PARTICIPANTS



Source: Employee Benefit Research Institute.

Chart 2

HEAVY[a] NONEQUITY INVESTMENTS BY PARTICIPANT AGE



Source: Employee Benefit Research Institute.

[a]Greater than 80 percent of account balances.

STATEMENT OF PAUL J. YAKOBOSKI

RESEARCH ASSOCIATE

EMPLOYEE BENEFIT RESEARCH INSTITUTE

BEFORE THE SENATE SPECIAL COMMITTEE ON AGING

SEPTEMBER 24, 1996

Mr. Chairman:

I am pleased to appear before you this morning to discuss issues regarding the future of the Social Security program and specifically the asset allocation decisions that workers make when they participate in 401(k) plans. My name is Paul Yakoboski. I am a Research Associate at the Employee Benefit Research Institute (EBRI), a nonprofit, nonpartisan, public policy research organization based in Washington, DC.

EBRI has been committed, since its founding in 1978, to the accurate statistical analysis of economic security issues. Through our research we strive to contribute to the formulation of effective and responsible health and retirement policies. Consistent with our mission, we do not lobby or advocate specific policy recommendations.

Worker Investment Decisions

A clear understanding of the investment decisions that workers are currently making in their 401(k) plans and how these decisions vary with worker demographics is important for policy purposes, in particular, for evaluating the implications of proposals that would to some degree privatize the Social Security system with individually directed accounts. Until recently, data rich enough to provide this type of information has been sorely lacking. As part of EBRI's ongoing Defined Contribution Project, we have collected plan-specific data that allow such analysis. We recently published an *EBRI Issue*

Brief (August 1996) based on an analysis of data provided by three large 401(k) plan sponsors with an average of 60,000 participants per plan. We looked at worker investment decisions and how these decisions varied with worker demographics such as age, salary, and tenure. The three plans used in this analysis have well developed educational programs designed to assist workers in making appropriate decisions regarding their participation in the plans. We are currently analyzing a database provided by a plan service provider that consists of over 1,000 plans with more that 100,000 participants. I will discuss the results based on these four data sources today.

Many analysts have focused on average allocations in past studies, but while informative, data on average allocations mask much of the detail regarding the variation in investment preferences among workers with differing demographic characteristics. Our analysis indicated that a significant fraction of plan participants, particularly younger ones, are heavily diversified into equities, while at the same time a large percentage of their peers hold zero equities in their accounts. The data indicate that the low earning, younger participants may not appreciate the advantages of diversifying their 401(k) portfolio to include equities when investing for a retirement that is decades in the future. This puts them at risk of accumulating insufficient assets to fund a desired retirement lifestyle or being unable to retire when they desire.

For example, in one large plan 21 percent of participants had none of their account balances invested in any equity-based funds (not including company stock). It is particularly noteworthy that 17 percent of participants in their 20s and 18 percent of those in their 30s had none of their account balances invested in the equity options. On the other hand, 21 percent of all participants had over 80 percent of their account balances invested in equity-based funds. Twenty-seven percent of participants in their 20s and 22 percent of participants in their 30s had heavy equity investments (greater than 80 invested heavily in equities with their 401(k) account balances. At higher income levels, about one-quarter of plan participants had over 80 percent of their assets invested in equities. Higher income participants were also much less likely to have zero equity investments. Again, this is a plan that has an extensive participant education program.

Findings from the other two large plans were similar, especially with regards to younger workers; in all three plans there was a sizable fraction of younger participants with zero equity investments (ranging from 17 percent to 34 percent). At the same time, in two of the three plans there were even larger fractions of workers in the same age groups who invested heavily in equities (more than 80 percent) (see chart 1). These findings highlight real differences in allocation behavior among workers within similar demographic groups. Situations occur within a plan where a sizable fraction of participants has no equity allocations and simultaneously another fraction has very heavy equity allocations.

Our recent analysis of the database consisting of over 1,000 broad-based plans again provides similar findings. In this database, almost one-half (49 percent) of all plan participants had none of their account balances invested in equity-based funds (not counting employer stock). Among workers in their 20s, 41 percent had no equity investments. Among workers in their 30s, 45 percent had no equity investments.

At the same time, there is evidence within the three large plans of workers matching their investment patterns with their time horizons in a textbook manner, e.g., older workers having larger allocations devoted to nonequity investments than their younger colleagues. Chart 2 shows that in the three plans analyzed, the percentage of participants with more than 80 percent of their account balance invested in nonequity-based options increased for plan design and policymaking. For example, in this analysis examining averages would show greater nonequity investments among older participants, but it would mask the occurrence of both zero and heavy equity investments among young participants.

<u>Other Research</u>

According to the 1995 EBRI/Greenwald Retirement Confidence Survey, 95 percent of plan participants utilizing educational material provided to them reported that the material included a description of the investment options available in the plan, and 69 percent reported that the material covered the principles of asset allocation and diversification. Almost one-half (46 percent) of these workers reported that the material led them to reallocate their money among the options available in the plan. This effect was slightly more likely among those with a high school degree or less (50 percent) than among those with more education (45 percent).

According to the 1996 Retirement Confidence Survey, which will be publicly released next week, 24 percent of workers are very confident in their ability to invest wisely for retirement, 47 percent are somewhat confident, and 29 percent are not confident. Workers with college degrees and those earning over $50,000 are the most likely to be very confident.

Conclusion

Our research indicates that education can have an impact in terms of leading workers to reallocate their 401(k) savings investments. At the same time, we see that, even in plans with relatively sophisticated education and communication programs, there exists a real dichotomy in the allocation behavior of workers within similar demographic groups. Variations in decisions will naturally lead to variations in retirement income results. EBRI has undertaken a Social Security simulation modeling project designed to capture such variations. The EBRI project will provide a two-phase analysis of the present system and the consequences of alternative reforms. Our project is unique in that it will not only estimate the reforms' effects on the U.S. population, the U.S. economy, and the Social Security program but also explore the implications of reforms' effects for employment-based plans. As results become available in early December, we would be happy to share them with the members of this committee.

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