AARP Public Policy Institute

Retirement Saving Policy

Investment Platform: The Advantages of Placing Retirement Savings Assets in Pooled Accounts

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A state-sponsored retirement savings plan could help millions of private-sector workers who are not covered by an employer plan build financial security. Several features will help a plan become more effective and produce more secure retirements. This report discusses how placing retirement savings assets in pooled accounts can reduce both costs and risk.

A state-sponsored retirement system for private-sector workers has two basic choices with respect to its investment platform: (a) it may offer a menu of investment choices from which each participant creates his or her own investment portfolio, which is the approach that most 401(k)-type plans incorporate, or (b) it may pool assets in a single fund managed by professional asset managers. Under the second approach, all of a participant's contributions are invested in one diversified fund.

Whether managed by the public sector or a public private partnership, the pooled-investment approach has significant advantages to workers and retirees, including lower fees and costs, economies of scale, higher returns, and greater flexibility. This report describes five relative advantages of the pooled-investment approach over the investment-menu approach.

Advantages of Pooled Investments

1. **Pooled funds have lower costs and produce higher returns.** Ultimately, a plan's effective investment return depends, in part, on the investment and other fees that the plan pays. Pooled investment funds have significantly lower costs than most individual mutual funds. Indeed, researchers have estimated that pooled defined-benefit investment funds return approximately 1 percent more than participant-directed 401(k) plans, in part because of lower fees.[1] Fees are lower for several reasons:

   - Pooled funds can achieve economies of scale not possible with numerous individual investment options, reducing various administrative expenses.
   - The managers of pooled funds have a stronger bargaining position and bargaining incentives when dealing with service providers than does a plan administrator who puts together a menu of individual mutual funds that will be offered as investment options to each investor in the plan.

- The managers of pooled investment funds are sophisticated professionals who are able to identify direct and indirect fees and the effect of fees on overall plan investment returns. In contrast, individual investors in 401(k) plans often lack the experience and skill needed to determine the fee being charged for a particular investment or to understand the negative effect of seemingly small differences in fees on net return over a long-term investment horizon.

2. **Professional managers of pooled funds carefully design overall investment portfolios.** Considerable evidence indicates that many individual employees lack the experience, time, and discipline to make good investment allocations and to monitor and rebalance their portfolio on a regular basis. Some employees will invest too conservatively while they are young and will get low returns; other employees will invest too aggressively when they are old and will put their retirement security at risk.[2] Still other employees will try to time the market or will move to less risky investments after the market has fallen and will come back into the market after the market has already risen. Many employees do not diversify their investments rationally.[3] Others allocate assets pro rata among a plan's menu choices.[4] Although investment education can help, no research to date has shown that investment education appreciably improves a participant's allocation choices.

   Professionally managed funds, by definition, do not typically result in the kinds of errors that we associate with nonexpert individual investors. The managers (a) will make allocations that are appropriate for the participant population, (b) will be patient and less likely to chase short-term returns, and (c) will periodically rebalance funds to reflect relative performance of asset classes held in the plan's portfolio.

   Of course, plans that offer individual investment choice can respond to the problem of poor allocation decisions by offering investment default options in life-cycle or target-date funds, but fees for those options are sometimes high, particularly when the target-date fund is a fund of funds, creating two levels of fees.[5] In addition, some commentary on target-date funds notes that such funds have no rigorous definitional standards and vary considerably on what they consider appropriate allocations for different age groups. Moreover, some participants opt out of the default allocation, and some of those participants would continue to commit the types of errors made by inexperienced investors.

   Although providing plan participants with a choice of investment options allows them to tailor their portfolios to their risk and reward preferences, no compelling research indicates that the gains from such design flexibility outweigh the collective costs of individuals' poor investment allocation. Pooled investment funds can also be structured to reduce risk exposure as individuals move closer to retirement.

3. **Pooled investment funds are flexible and can be designed to share risks among participants, to provide some guarantees to participants, and to smooth interest rates and investment returns over time.** Pooled investment funds permit structures that can be used to create unallocated plan reserves and thus give the plan

the ability to (a) provide certain guarantees (such as guarantee of principal or a minimum annual rate of return), (b) permit benefit increases if investment performance is strong, and (c) distribute risk and reward among participants according to age.[6] Individual mutual funds are not structured to provide such choices, although some life insurance products can provide guaranteed levels of returns backed by their reserves and can provide protection against participants' outliving their life expectancy.

4. **Pooled funds permit easier and more effective evaluation of performance.** The managers of a retirement plan should regularly monitor a plan's performance and make adjustments as needed. The task of monitoring is complicated if the managers must evaluate the effectiveness of the entire menu of choices for individual employee investment rather than merely the investment performance of a pooled fund.
5. **Pooled funds reduce workers' and retirees' burdens and anxiety**. Pooled funds do not require participants to commit time and resources to learn how to invest for retirement, to determine appropriate asset allocations, to change those allocations over time, to identify investment options with reasonable fee levels, to monitor and rebalance portfolios, or to worry about whether they have made the correct choices.

Investment-menu plans with default investments in a target-date fund can, to some extent, replicate the auto-set features of a plan using pooled investments. However, as this report has already noted, target-date funds can have higher-than-average fees and other issues. In addition, some participants in investment-menu plans will mistakenly believe that they should invest in both a target-date fund and in other investments from the plan's menu, thus re-creating the problems that target-date funds were developed to address.

Conclusion

Although many private-sector retirement savings plans offer participants a menu of individual investment choices, another design choice for a state-sponsored retirement system is a single professionally managed investment pool. Single professionally managed funds offer some important advantages over an investment-menu approach, including professional management, economies of scale, lower fees, and reduced burdens on individual participants. In addition, single pooled funds give retirement systems design flexibility, for example, to offer some benefit guarantees to participants and to provide intergenerational risk sharing.

It is also possible to structure a plan with more than one professionally managed investment pool. Under that approach, the participant would have a choice of several pools, all of which could have similar characteristics, with all of the participant's funds going into one of the choices. In a plan with automatic enrollment, participants who do not select an investment pool would be assigned to a pool either by design or at random. Such an approach is used in New Zealand's KiwiSaver plan and provides a level of competition among fund managers. All funds are periodically reviewed, and those with poor returns are replaced with new pools.

Pooled investments are superior to offering participants individual investment choices. That approach is likely to result in varying outcomes for different participants, depending on their knowledge of asset allocation and their ability to assess their own investment-risk tolerance, their available capacity to monitor their investments and rebalance their portfolio as necessary, their ability to identify and understand the effect of fees on their overall return, and their diligence, discipline, and attention. In addition, plans that offer investment options will generally result in higher investment and administrative fees for their participants and thus lower net returns.

Endnotes

1 Alicia Munnell, Mauricio Soto, Jerilyn Libby, and John Prinzivalli, "Investment Returns: Defined Benefit vs. 401(k) Plans," Issue in Brief 52, Center for Retirement Research at Boston College, September 2006, http://crr.bc.edu/wp-content/uploads/2006/09/ib_52.pdf.

2 Susan J. Stabile, "The Behavior of Defined Contribution Plan Participants," *NYU Law Review* 77, no. 1 (2002): 71–105.

3 See, for example, Dana Muir, "Choice Architecture and the Locus of Fiduciary Obligation in Defined Contribution Plans," *Iowa Law Review* 99, no. 1 (2013): 1–56.

4 See, for example, Shlomo Benartzi and Richard H. Thaler, "Naive Diversification Strategies in Defined Contribution Saving Plans," *American Economic Review* 91, no. 1 (2001): 79–98.

5 See, for example, William Baldwin, "The Trouble with Target Funds," *Forbes*, June 24, 2013, http://www.forbes.com/sites/baldwin/2013/06/05/the-trouble-with-target-funds; Randy Schaller, "The Good, the Bad, and the Very Ugly Aspects of Target Date Funds," *Smart 401K Blog*, November 22, 2013, http://site.smart401k.com/blog/bid/326242/The-Good-the-Bad-and-the-Very-Ugly-Aspects-of-Target-Date-Funds.

6 A single pooled investment fund can establish the equivalent of target-date funds for different age groups.

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