

Retirement Security and 401(k) Plans

Closing the Gap between Expectations and Action

An overwhelming majority of Americans view retirement as their primary savings objective, yet many workers do not take full advantage of their single best investment opportunity – 401(k) and similar defined contribution plans. When originally conceived in the late 1970s and early '80s, policymakers believed that the combination of tax-deductible contributions, tax-deferred savings, and matching employer contributions would be so irresistible to workers that maximum contribution levels were established. Moreover, it was assumed that such consistent savings over a 30- or 40-year working life would provide a comfortable nest egg. Although the growth of 401(k) plans has been explosive over the past 25 years, only six out of ten eligible people participate in these plans, and only 14 percent contribute the maximum amount.

By Elizabeth Pasciucco

More than 40 percent of all workers in the private sector participate in defined contribution plans. According to the U.S. Department of Labor, current trends indicate that more than one-half of private-sector workers who will be 65 by the year 2025 will rely solely on defined contribution plans for private retirement benefits. Will workers accumulate sufficient assets for a secure retirement? Do they have a clear understanding of the chances of living to older ages and the likelihood of needing long-term care? Do they have realistic expectations for their retirement lifestyle? Do they understand the impact of not saving incrementally on their ultimate retirement goal?

According to the most recent Putnam Participant Poll, a national survey of active 401(k) participants conducted by Brightwork Partners, a slight majority of plan participants expect to live as well or better in retirement as they do today. The basis for this expectation, however, is unclear. Only 9 percent are very confident that they will be prepared financially to retire, and only 12 percent are very confident that they know how much money they will need in retirement.



These and other findings reveal a wide gap between workers' expectations of their future retirement and the reality of their current saving behavior. Younger workers, in particular, fail to take advantage of the long-term benefits of 401(k) plans by deferring their participation.

In fact, few participants have any idea of the actual dollar amount they can contribute to their 401(k)s. Only 8 percent under age 50 correctly identified their 2003 limit as \$12,000. For people age 50 or over, only 2 percent correctly identified their limit of \$14,000.

Of course, not everyone can afford to "max out" their 401(k) contributions, and recent market turbulence has contributed to the reticence of many participants. On the other hand, retirement is expensive, and more than half of the participants wished they had saved more in their 401(k) over the last year.

Actively Managing Retirement

There are steps employers and plan providers can take to help close the gap between the hopes of workers and the realities of retirement. With a simple investment lineup, a commitment to continuous education, and clear communication, workers can receive the help they need to take a more active role in managing their own retirement savings. At a minimum, this means contributing as much as possible to a 401(k) plan, taking advantage of the employer match, and assessing annually asset allocation and risk tolerance.

The process of managing retirement begins with setting a lifestyle goal – typically, a retirement income that is 70 to 80 percent of current income. Only one in two plan participants has established such a goal. Without one, it is, of course, impossible to measure your progress, or lack thereof, toward achieving retirement security.

Once a goal has been established, it is a fairly straightforward process to calculate the amount that should be saved – annually, monthly, and even weekly – for retirement. Retirement calculators are widely available from plan providers and on the Internet. The variables include current age and desired age of retirement, expected length of retirement, current income and assets, and expected rates of return.

One of the major barriers to saving for retirement is that workers are confused by 401(k) rules and regulations, plan designs, and investment options. There is a great deal of advice available, primarily online, for saving with 401(k) plans, but it's complicated and time-consuming. Only about 1 percent of 401(k) plan participants take advantage of such advice.

A better approach utilizes a spectrum of advisory services, which Putnam provides, that includes offering advice online, over the phone, and via a third-party network of advisors who provide free one-on-one consultation to plan participants. Such services help participants determine how much they need to save and develop a comprehensive asset allocation strategy in line with their risk tolerance and investment time horizon. These services can also illustrate possible future retirement income based on the current level of savings and hypothetical returns.

Diversification of assets is central to successful long-term investing. In fact, more than 90 percent of portfolio returns are the result of asset allocation. Yet many workers are overwhelmed by the many different investment options, which often creates investor confusion and paralysis.

Pre-diversified funds are the “one-stop shopping” alternative for people who do not want to choose and monitor their own investments. For example, Putnam’s RetirementReady™ portfolios, which are based on the year of expected retirement, are managed to reduce risk exposure as an investor nears retirement. RetirementManager™ portfolios provide a range of choices based on risk tolerance – conservative, balanced, or aggressive. Each of these portfolios is professionally diversified and automatically rebalanced every quarter.

There are also tools to help make 401(k) transactions easier. Plan participants find such transactions less difficult than applying for a mortgage or correcting an error on a credit card statement but more difficult than booking an airline flight. Among participants who have recently enrolled in plans, 44 percent said the process “should have been considerably easier.”

A majority of participants are interested in programs that automate the decision-making process to some extent. Putnam provides an online tool, called SmartGoal™, that “automatically” increases the amount participants contribute each year based on a pre-approved schedule. We also provide an online tool that automatically rebalances portfolios to an approved allocation.

Traditionally, and somewhat passively, plan providers have offered investment products and employers have provided benefits that employees either chose or did not. Providers and employers face an ongoing marketing and educational challenge. Given the disparity in age, risk tolerance, and investment sophistication, developing a simple investment lineup is not an easy task. In addition, people will change jobs – and 401(k) plans – seven or eight times in a career, on average. Plan providers need to work full-time to keep participants informed and motivated to save. The goal is getting people to do something periodically and continuously over a period of 40 years, a marketing challenge without rival.

Despite the volatility in the equity markets, investor uncertainty, and frequent job-changing, contributing regularly to a 401(k) plan is still the best investment anyone can make in his or her future. If a secure retirement for workers is to become a reality, not a fantasy, providers, employers, and employees – working together – must ensure that a 401(k) plan is the anchor of retirement savings.



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