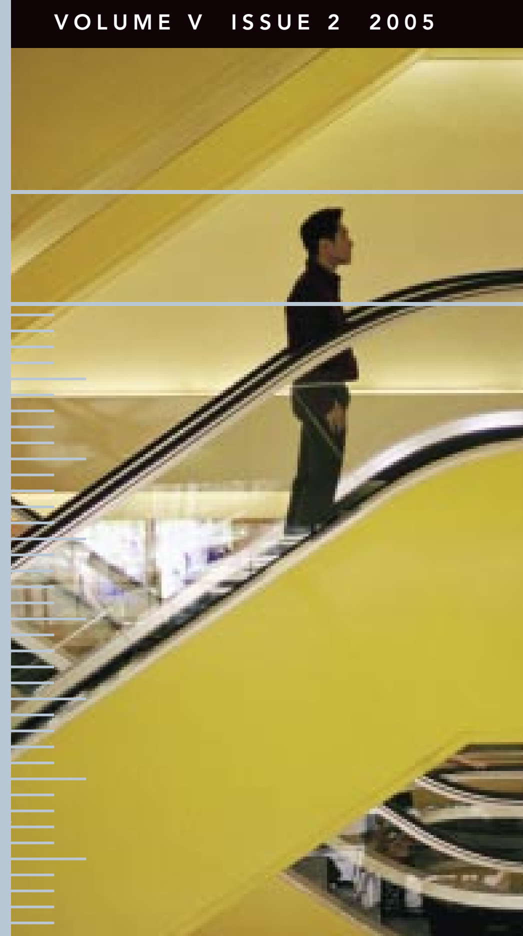
VOLUME V ISSUE 2 2005

The **Fidelity Investments** magazine for employers

Connections®



The big 401(k) fix—tomorrow's retirement plans to run on autopilot

By Alan Kunigis

The fix is in for defined contribution (DC) plans and it's a no-brainer. There is strong consensus among leading retirement plan authorities and researchers that 401(k) plans may be more effective if they are simpler for plan sponsors to run and for participants to use. Recently introduced changes in plan design options and pending regulations all point to simpler, more automatic workplace retirement savings plans becoming the norm in years to come. Observers see simplification as an essential step in aiding millions of American workers who, generally, are ill prepared for their approaching retirement.

DC plans are at a crossroads.

There is growing recognition that attempts to educate participants can go only so far. When faced with a wealth of choices, many people simply don't act. Starved for guidance, they remain inert. Is the answer, then, to use inertia to benefit employees?

Many haven't saved a dollar for their future. There are millions of other workers who are saving woefully inadequate amounts. Other retirement plan participants are taking on far too much risk by either having a dangerously high concentration in too few investments or by investing much too conservatively—for example, in a money market fund—for a goal two decades away.

Strategies intended to address these issues include automated plan features that relieve participants of decisions ranging from whether or not to enroll in the plan to choosing the investments into which their salary deferrals are to be directed. These and other plan design elements recall the simplicity of the defined benefit (DB) plan. DB plans typically pay retirees a benefit with little or no involvement from participants during their working years.

Creating positive inertia

Should employees be automatically enrolled as they would be in a DB plan, provided they could override this default if they are willing and able to overcome their inertia?

"Evidence suggests very strongly that people don't tend to override the default," says William Gale, an economist and senior fellow at The Brookings Institution and a principal of the Retirement Security Project. "We can use that inertia to encourage saving rather than discourage it."

Gale and others advocate a series of defaults—"intelligent defaults," he calls them—that would usher employees toward a more secure retirement. "We envision a 401(k) in which you are in the plan automatically unless you opt out," he says.

Contributions would start low and then rise over time unless participants chose to override this. Contributions could be invested in a professionally managed life cycle fund, for example. Plan assets could default into a rollover IRA, a new employer's DC plan should workers leave their firm before retiring, or remain with the original plan until withdrawn by the participant.

Dallas Salisbury, president of the Employee Benefit Research Institute (EBRI), and Olivia S. Mitchell, executive director of the Pension Research Council, both support automated DC plans with default enrollment and contribution rates that rise automatically with pay raises. "A number of people are too

continued on page 2

Table of contents

Redefining guidance, dispelling false confidence in 401(k) plans . . 4

Acceptance of stock option, ESPP rules, helps preserve viability 6

Lessons from the bond market in 2004 may guide investors in 2005 8

Lessons learned from early adopters of Health Savings Accounts 10

Case study: Creatively addressing differing needs among participants 12

401(k) fix/continued from page 1

overwhelmed or insecure to make an investment decision, so the default approaches are very important," Mitchell comments.

Keeping it simple

In addition to automating a DC plan with defaults that can help employees toward retirement security without having to think about it—a "no-brainer" in the best sense of the word—there is consensus on the need to keep information simple and, above all, to the point.

"The reason we don't see the balances in 401(k) plans that you'd expect to see is that all the responsibility has shifted from the employer to the employee, and individuals make mistakes every step along the way," observes Alicia Munnell, director of the Center for Retirement Research at Boston College. "The whole idea of opening a 401(k), and figuring out how to make those investments, and how to change them over time—these are all complicated decisions when you're living a busy, stressful life. That is why people tend not to do it."

Brian Graff, executive director and chief executive officer of the American Society of Pension Professionals and Actuaries (ASPPA), concurs. "It's hard enough for experts to read prospectuses, but to expect the average working American to understand them isn't realistic," he says. "We need supplemental information condensed in a form that is much more understandable and readable."

With the pending arrival of even more options—the Roth 401(k) due in January 2006, for example—keeping information simple will become more important than ever before. The Roth 401(k) option will give participants the choice of making after-tax contributions to their 401(k) that will allow qualified distributions to be made on a tax-free basis. Participants also will be faced with myriad decisions related to savings and tax strategies when considering whether to avail themselves of the Roth option if it is made available in their plan beginning in 2006.

Budgeting for the future

Salisbury says there will always be a need to educate employees on retirement. "We continue to face the reality of general financial illiteracy among Americans," he states. "Schools aren't teaching people how to balance a checkbook, let alone basic economics, budgeting, or how to manage credit card debt. Surveys have shown for years that many people who have their money in a 401(k) plan don't know the difference between a stock and a bond.

"If this basic education has not been done, individuals may move to 'total self-reliance' without understanding the concepts of longevity, average life expectancy, and probability in the context of general inflation and rising medical costs. This could increase the prospect of much higher rates of elderly poverty," he warns.

Mitchell also supports ongoing education. Education can help if an employer has selected a default investment that is too conservative, she points out, saying, "Employers are starting to look at alternative means of educating employees and getting them to understand the consequences of investing in U.S. Treasury bonds for 40 years, for example, versus something with a higher expected return."

> When faced with a wealth of choices, many people simply don't act. Starved for guidance, they remain inert.

The new generation of DC communications platforms that create hypothetical illustrations based on individual data captured from a plan's administrative recordkeeping system can contribute to the success of these educational programs. These communications can show how a change in deferral levels or asset allocation can impact a personal savings account over the course of several years.

Solving advice needs

Mitchell also points to the growing DC industry trend of third-party investment advice providers as another important development. With the help of tools such as online calculators, interactive portfolio analysis, third-party advice services, and discretionary management products, individuals are able to explore their risk preferences and time horizon as well as the various investment portfolios that match them. Some observers maintain that DB plans have accessed institutional money manager expertise for years and that, perhaps, the pendulum is now swinging toward DC plans' providing participants access to the same expertise.

David Wray, president of the Profit Sharing/401(k) Council of America (PSCA), says the trend to higher levels of support for participants is a result of relatively recent developments in the evolution of workplace retirement savings. One is the turnaround in what employees are seeking. In the 1990s, during the bull market, "they wanted to be more aggressively invested," he explains. "Employees pressed for more

Connections®
Volume V Issue 2 2005
The Fidelity Investments magazine for employers
Publisher: Meg Staknis
Editor: Jim Durning; Production Manager: Nancy Zuiewski; Design and Production: Fidelity Communications + Advertising
Connections® is a quarterly publication of Fidelity Institutional Retirement Services Company (FIRSCO), a division of Fidelity Investments Institutional Services Company, Inc., 82 Devonshire St., MM3E, Boston, MA 02109. Questions, comments, and suggestions, as well as changes of address (related to *Connections* only), are welcomed by Jim Durning at the above address or e-mail: James.Durning@fmr.com.
© 2005 FMR Corp. All rights reserved.
Before investing in any mutual fund, please carefully consider the investment objectives, risks, charges and expenses. For this and other information, call or write Fidelity for a free prospectus. Read it carefully before you invest.
Unless otherwise noted, the opinions provided by the authors and the experts answering questions are not necessarily those of Fidelity Investments.
For plan sponsor use only.

choice. People thought that the future of 401(k)s was that every employee would have a brokerage account."

However, after the market decline and related business and industry volatility, employees now are seeking help in addition to choice. Furthermore, employers are recognizing how important their fiduciary role is and how much attention it deserves. "We're seeing results-based employer solutions and decision making," Wray observes. "Companies are going from annual meetings of their retirement plan committees in which investment performance is reviewed to semiannual and even quarterly reviews. Ten years ago, most companies didn't have an investment policy statement; now the majority has one."

Wray also envisions greater reliance on electronic communications, which he says will facilitate customization and tailored communications. "The plan sponsor will have better, more easily obtained, and more timely information about how the plan is working and what individual participants are doing. I think that will lead to more individual attention. Employers will know who is in the plan and who's not, how much they're saving, and how they're investing. You'll be able to see who the person is and develop information for that person."

Plugging the leaks

Salisbury says job mobility patterns indicate that the typical individual will hold seven to 10 jobs during his or her entire working career. Even with automatic enrollment, other positive defaults, and better education, "this leaves the bulk of the workforce very vulnerable to bad decision making when considering what to do with account balances at the time of a job change," he comments.

Particularly important is education surrounding what to do with one's nest egg when leaving the workforce. "What do you do with the money?" asks Mitchell. "In the old days of the DB plan, it automatically became annuitized and you had a lifetime income stream. Because people tend to underestimate their longevity risk, we need to do much more in the way of educating and providing information for people on the verge of retirement regarding how to stretch their money until they die."

Delivering on promises

Wray sees a bright future for workplace retirement savings. "I think the DC system is on the threshold of really delivering on its promise," he says. "We are still learning, but the potential of the system is enormous. The total size of DC plans and individual retirement accounts has grown from under $1 trillion in assets in 1983 to more than $5.5 trillion in 2003, and I project that with reasonable returns, and if the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) contribution limits are retained, we could have $15 trillion in the plans in 2013." The EGTRRA limits and related provisions such as "catch-up" contributions for older workers and the Roth 401(k) are set to expire in 2010. Wray concludes, "Everyone wants to make this work. I'm very optimistic."+

The DC system is on the threshold of really delivering on its promise.... We are still learning, but the potential of the system is enormous.

An investment in a money market fund is not insured or guaranteed by the FDIC or any other government agency. Although money market funds seek to preserve the value of your investment at $1 per share, it is possible to lose money by investing in these funds

Alan Kunigis is a frequent contributor to Connections.