Discussion of Session: Rethinking the Resilience of Defined Contribution Plans

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Reshaping Retirement Security:
Lessons from the Global Financial Crisis

* Views presented do not necessarily represent the views of the Investment Company Institute or its members.

Non-Scientific Summary of Views of 401(k) Plan Investor Behavior

- Are too conservatively invested (circa late 1990s)
- Are too aggressively invested (circa late 2000s)
- Do not trade enough (inertia)
- Don’t know how to trade (chase returns)

How Should a 401(k) Participant Behave?

- Let me see your utility function and I'll tell you

<u>Generally</u>

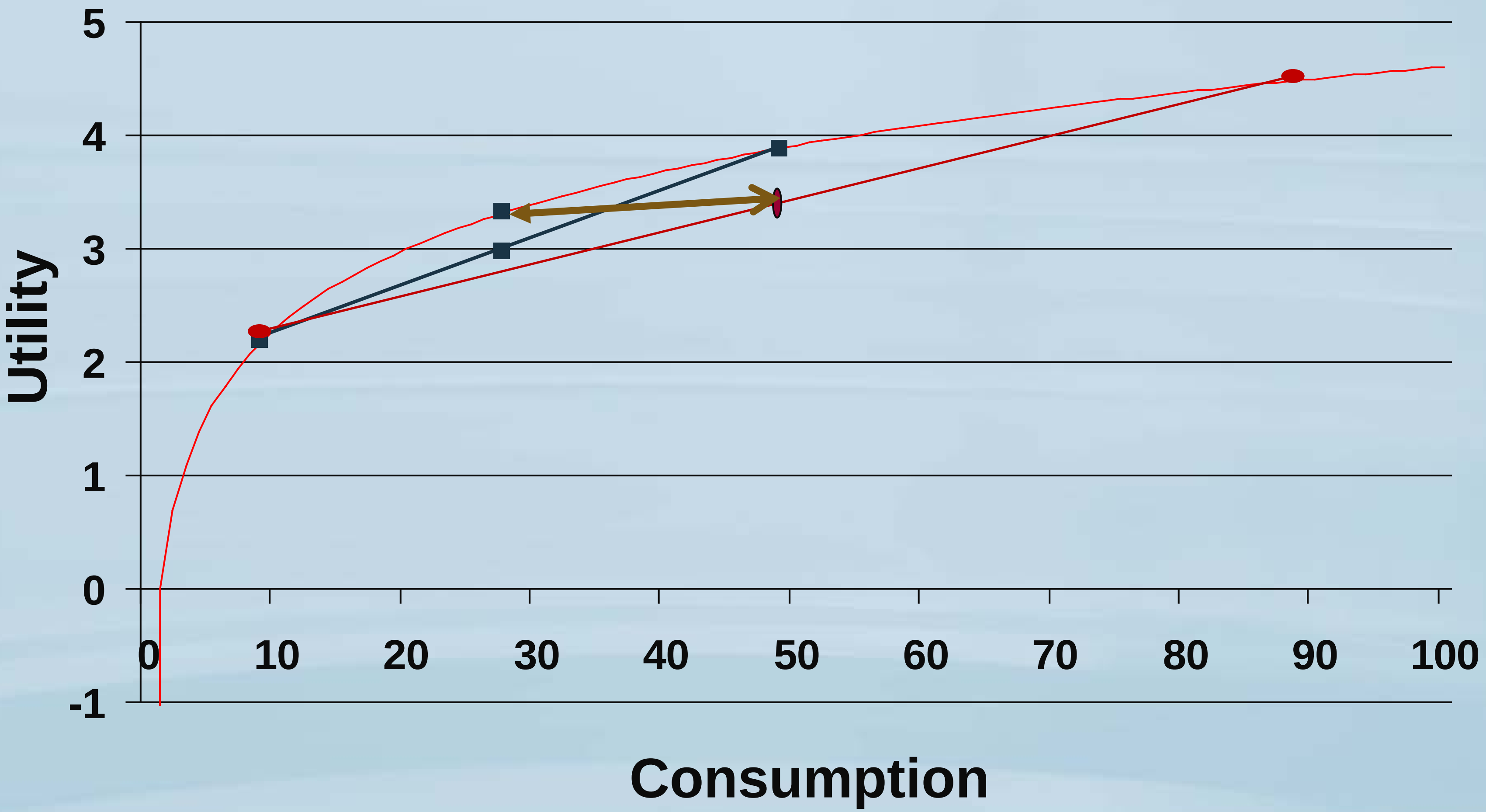
- Fixed asset allocation?
- 100 minus your age?
- Inflation-indexed securities?
- Compare inverse-price-earnings ratio to Treasury yield?

<u>In Response to a Shock</u>

- Stay the course?
- Rebalance?
- Reassess?

Risk Aversion & The Assumption of Risk

Example with Logarithmic Utility



Three Approaches to the Question

- Wray: Examine behavior of plans and participants in the wake of the crisis

- Tang, Mitchell, & Utkus: Examine trading behavior of 401(k) participants before and during a crisis

- Chai, Maurer, Rogalla, & Mitchell: Model how rational individuals should behave in response to a crisis

The DC System Passes the Stress Test

- Defense of the system
  - Plan sponsors
  - Plan participant behavior

- Suggestions

Trading in 401(k) Plans

- Findings
  - React more negatively to market volatility
  - Switch from momentum to contrarian
  - Important effect of report month
- Comments/Suggestions
  - Decision to trade
  - Decision to increase equity exposure or decrease equity exposure
  - More descriptive analysis
  - Sensitivity tests; alternative measures; additional questions

Lifecycle Impacts of the Financial Crisis

Summary

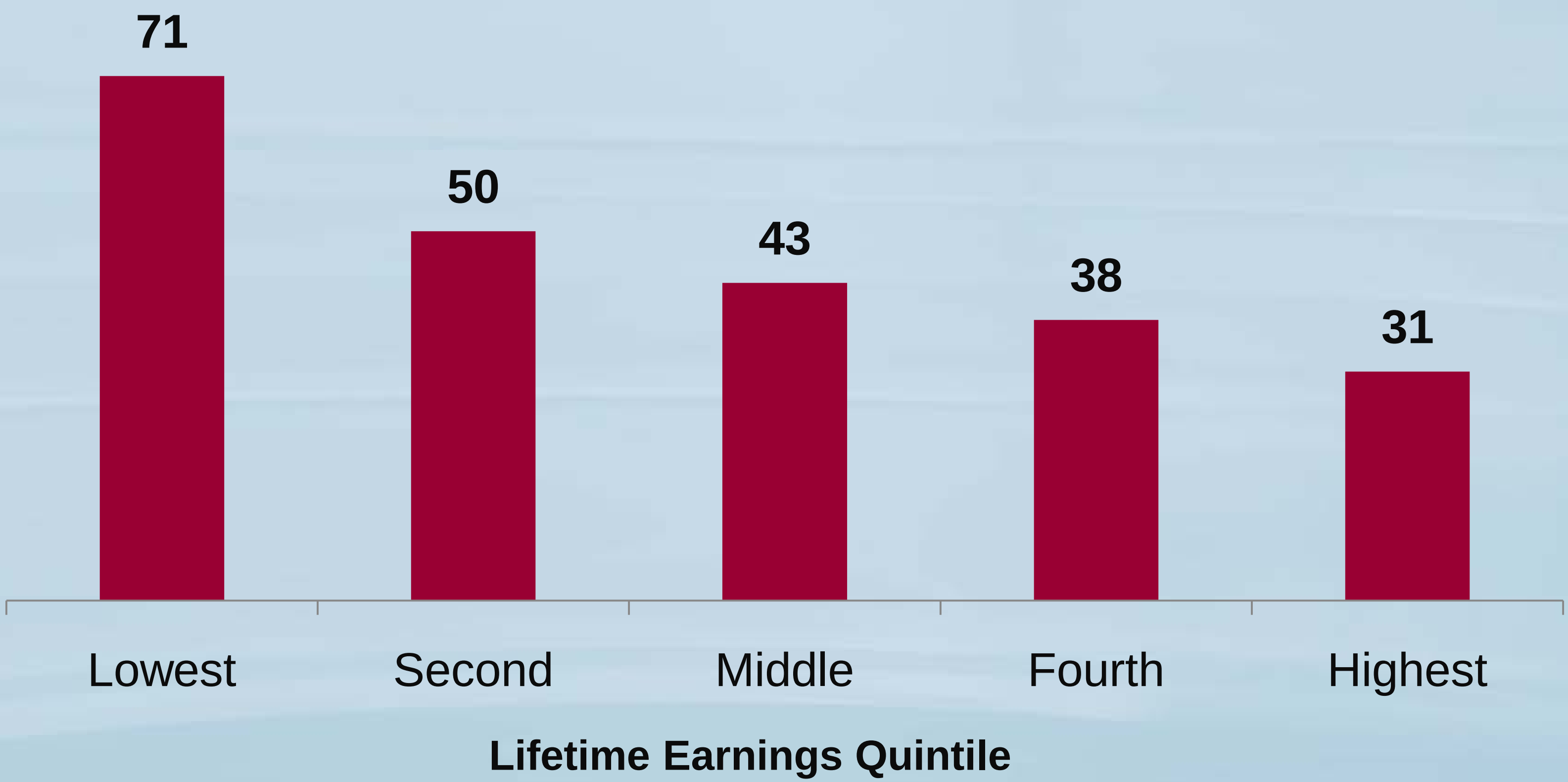
- Solves lifecycle model with stochastic stock market and labor market shocks
- Illustrates optimal behavior for base case, crisis, "triple whammy" & "double fortune"
- Predictions premised on optimal behavior by rational individuals
- Some short term predictions consistent with observed behavior

Question/Comments

- Hump-shaped wages
- Social Security specification

Social Security Benefits are Primary Resource for a Large Portion of Retirees

CBO estimates of first year benefits relative to average indexed earnings by household lifetime earnings, 1940s birth cohort, percent



Source: Congressional Budget Office (*CBO's 2010 Long-Term Projections for Social Security: Additional Information,* available at http://www.cbo.gov/doc.cfm?index=11943)

Summary

- "What Does the Market Crash Mean for the Ability of 401(k) Plans to Provide Retirement Income?" (NTJ September 2009)
  - Risk in 401(k) plans needs to be put into context of other household resources
  - All else equal, lower earners are less exposed to 401(k) risks because Social Security is bulk of retirement income
  - For moderate income worker (earning $35K & $55K at age 40), one more year of work more than offsets most simulated shocks to retirement income
- Portfolio allocation is not the biggest risk for most individuals
- How to structure retirement & who to bear the risk?