REKENTHALER REPORT

401(k)s Have Reached Their Expiration Date

The plans are as good as they can be under the current framework--and that's not good enough.

John Rekenthaler
Jan 10, 2020

Revolutionary Thoughts
This article has been a long time coming. My views on 401(k)s have evolved over the years, but until now, always incrementally. My columns advocated this improvement, that change. Not this installment. It calls for an overhaul.

That statement is, to an extent, a confession. The 401(k) structure is deeply unpopular with most investment writers, who regard it as a patchwork scheme that permits companies to foist their retirement-income risks onto employees. Over the years, I have been among the handful of exceptions, defending 401(k)s while others denounced them. No longer.

As originally created, 401(k)s could never serve as the nation's mainstream retirement system. A scheme that is disseminated through self-education appeals most strongly to those who need the least assistance: the company's highest-paid workers. The masses, very often, are left behind.

This obstacle shouldn't have been a surprise, as 401(k) plans were *not*invented to serve the general public, being instead supplemental tax-avoidance schemes for the privileged. The issue wasn't immediately appreciated, though. Companies spent the 1980s and 1990s attempting to boost participation and contribution rates through ever-increasing educational efforts. Their successes were modest.

Automatic Advantages
Then came the logical enhancement: automation. Don't expect most people to become investment experts, any more than expecting them to become self-trained car mechanics. Do the investment tasks for them by diverting money from each paycheck into a pre-selected fund, then over time raising the contribution rate. Employees can exit the arrangement if they wish, but few will do so. That would involve effort.

That worked for me. There remained the considerable problem of serving those who lacked access to 401(k) plans, typically because their companies weren't big enough, but at least the automated approach solved half the country's problems. Employees who work in midsize to larger companies would be placed in well-diversified, low-cost funds that they would rarely trade. Their contribution rates would steadily increase, thanks to auto-escalation programs.

My confidence was misplaced. Four academics have recently compiled disconcerting news about the effectiveness of automated 401(k) services. Last week, one those researchers, David Laibson (the other three being John Beshears, James Choi, and Brigitte Madrian), argued that automated programs are not the panacea that I, and many others, had believed.

It's not that the claims for automated programs are false. When companies adopt auto-enrollment features, their plan-participation rates immediately skyrocket. Laibson provides the before-and-after results for four 401(k) plans that added automatic enrollments. Collectively, the participation rates for employees with 12 months of tenure averaged just over 50% before the firms enacted automatic enrollment and more than 80% afterward.

The contribution rates also rose. That improvement was less dramatic, because sometimes employees who voluntarily establish 401(k) accounts select contribution rates that are above the company's initial auto-enrollment rate, but the direction was nonetheless positive. Also, employees mostly accepted their auto-escalation contribution-rate increases. Inertia was indeed their investment friend.

The Catch
In summary, automation's early results--Laibson calls them "the proxy effects," thereby demonstrating that my knowledge of academic jargon is incomplete--are fine. The complications come later. One issue is that many employees who are not automatically enrolled in 401(k) plans, and who therefore fall behind their auto-enrolled peers, eventually catch up. When they do join their 401(k), they invest more heavily to compensate for lost time.

As concerns go, that is not a bad one, because it is relative rather than absolute. Research didn't find that automated programs failed their goals. Instead, it learned that the status quo was better than advertised. Education was a stronger path than I and other critics believed. It might not succeed initially, but over time, employees become more receptive as their retirement dates near.

The other finding, though, is a serious problem. Whether auto-enrolled or not, leakage from 401(k) accounts, caused by early withdrawals, is substantial. One paper shows for households under the age of 55, average 401(k) outflows equal 40% of the inflows. Another study, by Laibson's co-researcher Beshears, estimates that, within the first four years, 25% of the benefits of automated-enrollment programs are consumed by early withdrawals.

Tax penalties, it turns out, are insufficiently alarming. Most readers of this column, I suspect, have never paid the IRS a single penny as penalty for withdrawing tax-sheltered assets before the permissible date. You watch your investment assets carefully; that's why you are here. The general public, however, tends to treat its investments cavalierly. Each year, for example, 8% of adults under the age of 59 1/2 remove money from their IRA accounts.

What Should Be Coming

That's enough evidence for me. I was already troubled by the 401(k) system's failure with small companies. Thirty years after defined-contribution plans hit the large-company mainstream, they still are only sporadically available at smaller firms. Although I have suggested some cures for that disease, my prescriptions are not particularly strong, because they use the existing 401(k) framework. The additional problem of leakage closes the deal. Today's 401(k) structure must go.

Its replacement will in many ways be similar. America's New Retirement Plan will automatically enroll employees in a default investment and then escalate their contribution rates. It will be fully portable, so that it "rolls over" to the worker's next employer. Finally, it will remain fully voluntary, so that investors can opt out of the plan, change their investments, or alter their contribution rates.

However, unlike with today, there will be no exceptions. Every worker at every company, in every state, in every industry, will have access to a New Retirement Plan. In addition, the problem of leakage will be mostly fixed. How, you may ask, will these goals be achieved? That is for next Tuesday's column, but the short answers are: 1) by removing the employer from the system, and 2) by replacing early withdrawal tax penalties with a stronger deterrent.

John Rekenthaler has been researching the fund industry since 1988. He is now a columnist for Morningstar.com and a member of Morningstar's investment research department. John is quick to *point out that while Morningstar typically agrees with the views of the Rekenthaler Report, his views are his own.*