

The Next Generation of Automatic 401(k) Plans

Automatic enrollment is the hottest trend in 401(k)s since the plans came into being. Passage of the Pension Protection Act of 2006 (PPA) and subsequent regulatory guidelines have spurred already climbing adoption rates. In 2006, 30.5% of companies with 200-999 participants used automatic enrollment, up from 19% the year before. For employers with 1,000 to 4,999 participants, those figures are 31.3% in 2006, up from 23.9% in 2005¹.

Adding automatic enrollment increases participation rates of new hires dramatically, particularly among women, minorities and low-income earners. This is an important first step, but more can be done to make automatic 401(k)s an even more powerful way to help employees save enough for retirement. The same automatic approach can be applied to enroll existing employees who are not in the plan, allow employees to increase contribution levels gradually over time, invest prudently and rebalance investment funds—all without putting the responsibility on the individual to initiate any of these steps.

Automatic Enrollment of Existing Employees

The majority of plan sponsors that implement automatic enrollment only focus on new hires. This is a good first step, but it leaves tens of thousands of non-participants out of the game. In fact, 22% of employees eligible to participate in a 401(k)-type plan do not.² We know that the powerful force of inertia that keeps employees from enrolling when they are first eligible can keep them from enrolling at all.

Some sponsors have taken the important step of sweeping non-participants into the plan, the same way they enroll new hires. Automatic enrollment can cut non-participation rates from roughly 25% to as little as 5 or 10% of eligible employees in an average plan. Non-contributing employees become contributors at the default deferral rate unless they choose to opt-out. But it appears that most of them stay in the plan, just as most new hires do. Automatic enrollment could be extended to non-participants once every two to three years, or even every year.

Automatic Escalation

According to an annual survey conducted by the Profit Sharing/401(k) Council of America (PSCA), the average deferral percentage in automatic enrollment plans is a mere 3%.³ Automatic escalation of contributions can gradually increase employees' overall contributions to 401(k)s. Only about a third of plans take the extra step of increasing that percentage over time. The rest of them don't. We know from experience that inertia will keep many participants from upping the amount on their own.

¹ Profit Sharing/401(k) Council of America. *50th Annual Survey. PSCA's Annual Survey of Profit Sharing and 401(k) Plans*. 2007.

² 401khelpcenter.com. *Benchmark Your 401(k) Plan – 2008; How Does Your 401(k) Compare with the "Typical" 401(k)?* <http://www.401khelpcenter.com/benchmarking.html>

³ Profit Sharing/401(k) Council of America. *50th Annual Survey. PSCA's Annual Survey of Profit Sharing and 401(k) Plans*. 2007.

Consider this:

A 35 year-old with no current retirement savings earns \$50,000. He saves 3% of salary each year, and his employer matches half of that. He will need a whopping \$1.3 million saved to support his retirement. At a static 3% a year, he'd fall short by more than \$800,000.⁴

Plan sponsors typically choose to raise the annual contribution rate by 1% a year, up to the maximum they set in the plan or up to the company match. A best practice is to escalate until an employee reaches 9% - 12% of pay, which goes a long way toward keeping retirement saving on track.⁵

Default Investments

In the early days of automatic enrollment, plan sponsors opted for conservative investment fund defaults. They reasoned that principal preservation funds were the 'safest' place to park employees' money, to avoid investment loss during market ups and downs (especially downs). Time and experience show that employees who are defaulted into an investment fund will stay in that fund. A principal preservation fund is typically not the place to be for the majority of retirement investors.

Plan sponsors have taken direction from the U.S. Department of Labor. The agency pointed out that historically, diversified portfolios that contain equities have generated higher returns over long time horizons than those composed only of fixed-income investments.⁶ This, plus new protections for fiduciaries under PPA and Labor Department regulations, have encouraged more sponsors to select equity-based default investments rather than principal preservation funds. According to the PSCA survey, the most common default selections are now target retirement date and lifecycle funds. (See [Don't Lose Sleep over Automatic Investments](#) for more about these types of funds). This trend has positive implications for tens of thousands of participants.

Automatic Rebalance

While not exclusive to Automatic 401(k) plans, automatic rebalancing of investment funds has been on the rise. The need for this feature is clear from a Hewitt study on employee investing behavior. It showed that only 17% of participants make fund transfers in a given year.⁷ Target retirement date and lifecycle funds typically rebalance as a function of their design. Automatic rebalancing where it doesn't otherwise occur helps ensure that a participant remains on track with her target allocation.

Are You a Next-Generation Automatic 401(k) Employer?

⁴ Based on a simple retirement calculator available at

<http://psca.org/RESOURCESTRAINING/RetirementCalculator/tabid/137/Default.aspx>

⁵ Kathryn Glass. *Auto Enrollment Makes 401(k)s Easy, but Experts Say it's Not Enough*. Foxbusiness.com.

<http://www.foxbusiness.com/story/markets/economy/auto-enrollment-makes-ks-easy-experts-say/>

⁶ U.S. Department of Labor. *Default Investment Alternatives under Participant-Directed Individual Account Plans; Final Rule*, 72 Federal Register Reg. 60452, 60470. Oct. 24, 2007.

⁷ Ibid.

Plan sponsors that automatically enroll new hires are to be applauded—but is it time to take further steps to help employees save? Here are some ways to do so:

- For plans with automatic enrollment, consider including existing employees to your automatic enrollment roster.
- Choose a meaningful default investment such as 6% or more.
- Help employees save more with automatic contribution increases.
- Consider default options with automatic rebalancing features to keep your employees' investment allocations on track as they age.

The majority of employees don't actively engage in managing their 401(k) savings. But with a well-designed automatic 401(k), one that uses the latest automatic features, this doesn't matter so much. Their retirement outlook dramatically improves without demanding their time and attention. With your help, it just happens.