

Executive Summary

There is a worldwide trend, in both the public and private sectors, away from defined benefit (DB) retirement plans toward defined contribution (DC) plans. DC plans transfer much of the decision making authority about how much to save and how to invest from the employer or government to the employee. It is rare to find someone who has spent much time determining the optimal savings rate, given all the uncertainties about future rates of return, income flows, retirement plans, health, and so forth. Instead, most people attempt to cope with complexity by adopting simple heuristics, or rules of thumb, to aid decision-making. Simple heuristics often lead to counterproductive biases, however. In this paper, two noted behavioral economists examine some simple heuristics and biases in the realm of individual saving, such as whether to join savings plans, how much to contribute, and how to allocate their investments. What becomes apparent is the overwhelming power of inertia, and the utility of harnessing that power to move in a pro-saving instead of an anti-saving direction.

1. Enrollment. In voluntary 401(k) plans, enrollment rates are far from 100 percent, even though employee contributions are often matched by the employer. Studies have shown that making enrollment automatic—making participation rather than nonparticipation the default—can increase participation significantly. In one study, enrollment of new employees reached 90 percent immediately, whereas under the old opt-in approach it was only 20 percent after three months and only 65 percent after three years. Where new employees are required to make an active decision to enroll rather than being enrolled automatically, participation rates still increase substantially. And the evidence is that, once automatically enrolled, few employees drop out of the plans.

While automatic enrollment or “quick” enrollment makes the process of joining less daunting, adding funds to the plan can have the opposite effect. One study finds a negative correlation between the number of investment options offered in the plan and participation rates—the addition of 10 funds to the menu of investment options reduces the likelihood of employee participation by two percentage points.

2. Contribution Rates. One downside to automatic enrollment is that the initial contribution rate tends to be set at fairly low levels, too low to provide anything close to complete income replacement at retirement. Employees themselves indicate that they think they should be saving more. Employees often seem to use savings heuristics to decide on a contribution rate, such as using multiples of 5, or saving at the minimum rate needed to receive the full employer match.

3. Asset allocation. Simple heuristics adopted in the allocation of assets can often negatively influence an employee’s investments. Many employees appear to adopt naïve diversification strategies, using what the authors call a “1/n” decision rule by dividing their assets evenly across the array of “n” available options. This can have the effect of skewing investments more heavily toward more or less risky choices depending on the composition of the options.

Investment in company stock is another tendency that defies all the logic of diversification, and yet investors persist in the belief that investing in company stock is no more risky than investing in any other mutual fund. Investor behavior before and after the late 1990s equities boom provides strong evidence of inertia in investors' choices—as stock prices rose, 401(k) participants put more and more dollars into equities, and after the market fell they took their dollars out—timing the market exactly wrong by buying high and selling low. Loss aversion—a tendency to weigh losses more heavily than gains—and peer effects—overreliance on a perceived “expert”—are both shown to have undue influence on participants' choices about asset allocation.

4. Interventions by sponsors. The authors discuss education and plan design as two methods of improving saving rates among workers. They find little evidence that education is an effective tool to increase participation or saving rates, but that plan design may have more potential. Automatic enrollment has already been shown effective. They also have proposed a remedy for employees who maintain their contribution rate at levels that are too low to accumulate adequate retirement savings. They call their remedy Save More Tomorrow, which operates by automatically increasing workers' contribution rates when they receive wage increases. The worker agrees to have a portion of each wage increase allocated to additional contributions, up to some upper limit. Workers then still receive a wage increase as they contribute at higher rates, but experience no income loss as a result of the added contributions. Plan design could also be used to improve investment choices if the funds offered incorporate automatic rebalancing features.

Saving for retirement is a difficult and challenging task, and workers need all the help they can get. Fortunately, many effective ways to help participants are also the least costly interventions, namely, small changes in plan design, sensible default options and opportunities to automatically increase savings rates and rebalance portfolios. These design features help less sophisticated investors while maintaining flexibility for more sophisticated types.