Rekenthaler Report
A Brief History of 401(k)s
By John Rekenthaler | 05-06-15 | 06:00 AM | Email Article

Unintended Consequences
I presented in late April at a "Global Retirement Savings Summit," held in Tokyo, on the characteristics of the default funds used by U.S. defined-contribution plans.

Now there's a sentence to chase away readers! However, my tale was much broader than the title suggests. To understand today's default funds requires understanding yesterday's 401(k) plans--and how the defined-contribution industry has evolved over the past 35 years.

The 401(k) was invented by accident. It was inserted into the IRS tax code in 1978 to address uncertainty about the tax status of profit-sharing plans. Such plans had existed for several decades, with earnings on their income deferred, but in the early 1970s Congress debated ending this favorable treatment. A discussion ensued, with the outcome being the 1978 401(k) tax provision. It was a minor item, intended to cover the relative handful of companies that used such plans. Those who supported the bill expected a negligible effect on tax revenue.

That negligible effect amounted to an estimated $57 billion in 2013--equal to the combined costs of running the Departments of the Treasury, the Interior, and Labor; the Army Corps of Engineers; the Social Security Administration, the National Science Foundation; and the Small Business Administration. Oops. As it turned out, the 401(k) provision could be extended to cover retirement-plans never envisioned by the law's authors--for example, a plan that deducted money from each paycheck, regardless of whether the firm turned a profit.

Moving the Volunteers
The 401(k) was created as a voluntary option. Profit-sharing plans typically offered employees the choice of taking their annual bonus in cash, taxable that year, or deferring taxes by rolling the assets into the plan. The newly designed 401(k) retained the notion of choice. The program wasn't solely for top executives; companies that used 401(k)s were expected to enroll a variety of employee types, with nondiscrimination testing used to ensure that they did. But the plan was distinctly optional. There was no sense of 401(k)s being a pillar of the American retirement system, with the desired outcome being widespread participation.

Logically, then, there was also no sense of automatic-enrollment programs or of default funds. Participation would come through education. Teach employees about investing, and they would become investors. Financial advisors, plan administrators, fund companies, and financial-education firms spent millions of collective hours on the task. The result? Perhaps 70% of employees would enroll (although most would not become true investors; rather, they would check the election box when the seminar ended and then forget about the subject). The other 30%, primarily lower-income and/or younger employees, could not be reached.

That was fine for meeting nondiscrimination tests, and for public policy, if the 401(k) had remained an obscure, little-used arrangement. But of course it did not. By the early 1990s, if not before, it was clear that corporate America was delighted to slough off its pension responsibilities and that the 401(k) provision gave it the opportunity to do so. With a tax-sheltered, employee-driven retirement system installed, companies believed that they could exit the pension business.

Which left 30% of employees outside of the plan. Apparently, they needed a nudge. The industry responded by inventing automatic-enrollment programs, which would drop new employees into a default fund. No more mandatory education sessions, no more attempts to turn workers into investors. The new notion was to have them own a fund without thinking about the matter. If they wanted, they could always opt out. But doing so took energy--so mostly they remained.

From the perspective of policymakers, automatic enrollment fixed the problem of participation. However, as academic papers pointed out--401(k)s had become a hot research topic, attracting several top professors who had not previously published on mutual fund issues--the new approach created its own problem, as most default funds consisted of cash. That approach had its virtues: An employer would never face a lawsuit by dropping somebody into cash, nor receive a call from a worker angry about market losses. But it was poor investment strategy. Also, the same inertia that kept defaulted investors in a fund prevented them from boosting their contribution rates. The default rate, generally a modest figure such as 3%, was only intended to get employees started. For success, they would need to contribute more.

Making it Automatic
The twin solutions were target-date funds and automatic-increase programs.

Target-date funds fixed the problem of low expected returns. As diversified pools that included stocks, bonds, and (increasingly) alternative investments, target-date funds increasingly resembled how institutional managers ran pension plans. In 2006, through that year's Pension Protection Act, target-date funds received official legal protection as Qualified Deferred Investment Options, meaning that plan sponsors following the appropriate procedures could safely put employees into target-date funds by default.

Target-date funds were neither uniquely protected nor uniquely qualified. Under the act, various flavors of allocation funds were permitted--traditional balanced funds, risk-based allocation funds (for example, a trio labeled as Aggressive, Moderate, and Conservative), or an individually managed account. All could do the job. However, target-date funds won the product battle. They were more customized than a single-size balanced fund; they were better suited for default programs than the risk-based funds (age being easier to determine than risk tolerance); and they were simpler to install and monitor than a customized managed-account program. Thus, target-date funds stormed the field.

In 2013, of Vanguard 401(k) plans that designated a default option, 91% used target-date funds. Currently, target-date funds command a healthy minority of overall 401(k) inflows rather than an outright majority, as most older workers hold traditional funds, but each year target-date funds gain more ground. Time is on their side. (As pointed out in Morningstar's 2015 Target-Date Fund Landscape Report, target-date funds have become a key part of the leading fund companies' businesses. In 2014, inflows into target-date funds accounted on average for more than 30% of those firms' overall net new assets.)

The mindset of the 1980s has been reversed. Today, to exaggerate the point only slightly, the goal is to *prevent* workers from becoming investors. Rather than have workers assemble their own portfolios, monitor performance, and trade as they see fit, plan sponsors and 401(k) providers are offering programs that steer employees away from decisions. This includes not only defaulted workers, but increasingly those who make their own selections. (One 401(k) provider at the Tokyo Conference stated that he deliberately gave the plan's non-target-date funds unattractive names, in the hopes that nobody would select them.) After all, they're unlikely to make better decisions than are professional investment managers.

Of course, the investment plan only works if the contribution rate is sufficient. Thus, following academic suggestions, auto-increase programs were invented. These programs invisibly push up contribution rates for defaulted (and other) employees, typically on an annual basis. As with automatic enrollment, participants may opt out of auto-increase programs. Also as with automatic enrollment, most do not. Currently, about half of 401(k) plans with automatic enrollment also have auto increase, and that percentage is growing.

Looking Ahead
In summary,

1. 401(k) plans were invented to fill a niche.
2. They rapidly became a mainstream pillar.
3. As a pillar, they needed to change their ways.
4. The marketplace, assisted by the academic community, found several solutions.
5. Lawmakers, via the Pension Protection Act of 2006, provided valuable assistance.

As I previously argued, the process is not yet complete. Large companies are well on their way, as their formula of low-cost funds, automatic enrollment, auto-increase programs, and (often) employer matches will put most of their workers in good stead, assuming that they do not opt out and that they roll over the assets into a new 401(k) if they leave the firm. Small companies remain a concern. Many either do not offer a plan at all or offer one that is outdated, with high-cost funds.

Thus, items 3 through 5 continue to apply to the small-company 401(k) market. The status quo is clearly inadequate; the pillar must change. The marketplace can and will bring solutions, one example being the much-discussed multiemployer 401(k) plan, which helps small companies achieve scale by purchasing a plan that stretches across several firms. Finally, legislation can (and should) clear the path, by eliminating wasteful "due diligence" searches and documentation. Those are vestiges of the original 1978 legislation--and it's not 1978 anymore.

In short, the 401(k) plan has radically changed along with the needs of its users. The creation and evolution of default funds is but one example. I believe this process to be mostly complete with large-company plans, but there is much room yet for improvement from smaller companies.

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