THE DOWNSIDE OF DEFAULTS

Comments from Joseph Piacentini
August 5, 2011
Lots of good findings
Helpful policy insights
But, how to translate into actual policy?
Example relating to investment choice in 401(k) plans
Directions for future research
KEY FINDINGS AND POLICY INSIGHTS

- “Information problems” increase probability:
  + Of choosing by default
  + Of regretting that choice
- “Quality, decision relevant information can reduce both default rates and regret”
- Policy should seek to improve communication and information
- But can policy really improve information, and will better information solve information problems?
EXAMPLE: DEFAULT INVESTMENT

- “Qualified Default Investment Alternative” (QDIA) – 2007 DOL rule confers fiduciary relief
  - Target date fund
  - Balanced fund
  - Managed account

- Generally expected (and intended) to increase equity exposure and promote auto-enrollment
  - Higher returns – usually
  - Higher participation, but some lower contributions
QDIA RULE: IMPACT ON 65+ POP IN 2034

**Income is**

- **Higher**
  - Millions of people: 2.5
  - Billions of 2006 $: 1.5

- **Lower**
  - Millions of people: 0.5
  - Billions of 2006 $: 0.5

**Aggregate amounts**

- **Increase**
  - Billions of 2006 $: 2.5

- **Decrease**
  - Billions of 2006 $: 0.5
Provided in advance, and then annually

Written to be understood by “average” participant

Must explain

- When contributions will be invested in the default
- Participants’ right to actively direct investment and available investment alternatives
- The QDIA’s investment objectives, risk/return characteristics, and fees
DISCLOSING INVESTMENT OPTIONS

- DOL rule (proposed 2008, finalized 2010) requires comparative chart showing returns, benchmarks, fees

<table>
<thead>
<tr>
<th>Options (examples)</th>
<th>Historical returns</th>
<th>Benchmark returns</th>
<th>Fees and expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>TDF</td>
<td>X.X%</td>
<td>Y.Y%</td>
<td>XX bps</td>
</tr>
<tr>
<td>Stock fund</td>
<td>X.X%</td>
<td>Y.Y%</td>
<td>XX bps</td>
</tr>
<tr>
<td>Company stock</td>
<td>X.X%</td>
<td>Y.Y%</td>
<td>XX bps</td>
</tr>
<tr>
<td>Bond fund</td>
<td>X.X%</td>
<td>Y.Y%</td>
<td>XX bps</td>
</tr>
</tbody>
</table>

(Stylized representation)
Early focus group testing showed chart is helpful, but:

- Confused by abbreviations and jargon (need glossary?)
- Can’t translate returns, fees to savings outcomes (need examples?)
- Too little information is already TMI
2008 PERFORMANCE OF “2010” TDFS

![Graph showing 1-Year Return vs. 1-Year Volatility for TSP and Lifecycle 2010]
Subsequent focus group and large survey testing explored adding simple, graphic risk/return indicator to chart:

- high
- low

Had no systematic effect on choices
Less financially literate found it unhelpful or even overwhelming
Not included in final rule
Choices are most affected by the order in which the alternatives appear!
**How Does it Really Look?**

**Appendix to $550,000.00 — Model Comparative Chart**

**ABC Corporation 401(k) Retirement Plan**

Investment Options — January 1, 20XX

This document includes important information to help you compare the investment options under your retirement plan. If you want additional information about your investment options, you can go to the specific Internet Web site address shown below or you can contact [insert name of plan administrator] or [insert telephone number and address]. A free paper copy of the information available at the Web site can be obtained by contacting [insert name of plan administrator] or [insert telephone number].

**Document Summary**

This document has 3 parts. Part I consists of information for plan participants showing how the investments have performed in the past. Part II expenses you will pay if you invest in an option. Part III contains information you will need under your retirement plan.

**Part I. Performance Information**

Table 1 discusses how the performance of the investment options that do not have a past history of performance. Table 2 shows how these options have performed over time and allows you to determine appropriate benchmark for the same time period. Performance does not mean that your investment option will perform in the future. Your investment in these options is subject to market risk and any information about an option’s principal risk is available on the Web site.

**Table 1 — Variable Return Investments**

<table>
<thead>
<tr>
<th>Name/Type of Option</th>
<th>Return</th>
<th>Term</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>A Index Fund S&amp;P 500</td>
<td>26.5%</td>
<td>2 Yr.</td>
<td>N/A</td>
</tr>
<tr>
<td>F Funds Large Cap</td>
<td>25.5%</td>
<td>3 Yr.</td>
<td>0.5%</td>
</tr>
<tr>
<td>B Index Funds</td>
<td>27.5%</td>
<td>5 Yr.</td>
<td>1.0%</td>
</tr>
<tr>
<td>C Index Funds</td>
<td>30.5%</td>
<td>10 Yr.</td>
<td>1.5%</td>
</tr>
<tr>
<td>D Index Funds</td>
<td>32.5%</td>
<td>15 Yr.</td>
<td>2.0%</td>
</tr>
</tbody>
</table>

**Part II. Fee and Expense Information**

Table 2 shows the performance of investment options that have a fixed or stated rate of return. Table 3 shows the annual rate of return for each such option, the term of length of time that you select, the date, and other information relevant to performance.

**Table 2 — Fixed Return Investments**

<table>
<thead>
<tr>
<th>Name/Type of Option</th>
<th>Return</th>
<th>Term</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Treasury Bonds</td>
<td>4.25%</td>
<td>1 Yr.</td>
<td>0.5%</td>
</tr>
</tbody>
</table>

**Part III. Annuity Information**

Table 4 focuses on the annuity options under the plan. Annuities are less complicated and receive a guaranteed rate of interest at regular intervals, usually on every year of your life. Annuities are not available to employees in this plan.

**Table 4 — Annuity Options**

<table>
<thead>
<tr>
<th>Name/Type of Option</th>
<th>Annuity</th>
<th>Objective/Goal</th>
<th>Pricing Factors</th>
</tr>
</thead>
</table>

Please visit www.ABCPlannings.com for a glossy of investment terms relevant to the investment options under this plan. This glossary is intended to help you better understand your options.
2010 PROPOSED CHANGE TO QDIA RULE

- Additional requirements to explain TDF QDIIAs:
  - Asset allocation, and how it will change (glide path)
  - When conservative endpoint will be reached
  - Table or graph illustrating glide path
  - If QDIA is dated (e.g., “2020 fund”), what the date means and what age group it is intended for
  - Statement that QDIA may lose money and is not guaranteed to provide adequate savings

- Also amends disclosure of investment options
DIRECTIONS FOR FUTURE RESEARCH

- Developing specific solutions for specific information problems
  - Can complex decisions be made simple to make?
  - How to best communicate information (including role of electronic communication)?

- Developing strategies to improve outcomes when information problems can’t be solved
  - Developing conditional defaults?
  - Identifying risk of regret and intervening?