

RESEARCH HIGHLIGHTS: How Well Are Employees Saving and Investing in 401(k) Plans 2006 Universe Benchmarks

The retirement landscape has been changing. Announcements of defined benefit plan reductions (e.g., freezing accruals, closing to new hires) by major employers are proliferating. Indeed, the number of U.S. employers providing defined benefit plans dropped by one-third between 1985 and 2005, from 91 percent to 61 percent.¹ Similarly, the share of large employers offering retiree health benefits halved between 1988 and 2005, from 66 percent to 33 percent.² Today a majority of plan sponsors view the 401(k) plan as the primary employer-sponsored retirement vehicle.

To help employees maximize the value of their 401(k) plan, many plan sponsors are enhancing program delivery through such features as automatic enrollment, contribution escalation, and premixed portfolios. At the same time, plan sponsors are enhancing program communication through personalization, targeting, and multichannel touch points.

The 2006 *How Well Are Employees Saving and Investing in 401(k) Plans* research report shows that the actions some plan sponsors are taking to facilitate better saving and investing appear to be paying off. However, the results also show that there is still work to be done to steer employees onto a path toward a more secure retirement.

The report examines the saving and investment behavior of more than 2.6 million eligible employees and more than 1.7 million active participants. It seeks to understand employee 401(k) saving and investment behavior by examining quality of participation, plan balances, account activity, investments, and demographics.

¹ Hewitt's 2005–2006 SpecSummary™ of Salaried Employee Benefits Provided by Major U.S. Employers.

² Kaiser/HRET 2005 Survey on Employee Health Benefits.

Key Findings

Plan Participation

In 2005, 67.2 percent of eligible employees participated in their defined contribution plan.

By demographic group, participation among low-tenure workers increased. The participation rate for those with less than one year of tenure increased approximately 6 percentage points.

Low-tenure employees traditionally have been a challenging demographic to influence in terms of plan participation. This increase may be attributable to the greater prevalence of automatic enrollment for new hires and to stepped-up targeted and personalized communication by plan sponsors.

Still, a large numbers of short-tenure eligible workers fail to participate in their defined contribution plan. Participation among those with one to two years of tenure also increased in 2005 but is still less than 50 percent. Likewise, participation among those with two to three years of tenure rose in 2005 but is less than 60 percent.

The majority of older workers participated in their defined contribution plan in 2005, but the majority of eligible workers in their 20s continued to avoid participation. Nearly three-quarters of workers in their 40s and 50s contributed to their defined contribution plan in 2005, versus just 47.5 percent of workers in their 20s.

Low-salary workers were among those with the poorest participation levels covered in the Hewitt Universe. Only 39.1 percent of eligible workers with salaries less than \$20,000 participated in their defined contribution plan. Just less than 61 percent of eligible workers earning \$20,000 to \$39,999 participated.

Contribution Levels

Contribution levels among those participating in the defined contribution plan were unchanged between 2004 and 2005, at 7.9 percent. Nearly 10 percent of participants reduced their contribution rate in 2005, while 16.6 percent increased their contribution rate. However, the rate of decrease exceeded the rate of increase—and 2.6 percent of workers went from contributing in 2004 to not contributing in 2005.

Year-Over-Year Changes in Contribution Rates

Percentage Decreasing	Average Decrease	Percentage Increasing	Average Increase
9.9%	6.1%	16.6%	4.1%

In 2005, 21.8 percent of participants did not contribute enough to their 401(k) plan to obtain the full company match. This is in line with 2004 experience. This means that altogether, nearly half of eligible employees are either failing to participate in their 401(k) plan or failing to contribute enough to obtain the maximum employer match.

Approximately 30 percent of participants contributed only enough to their plan to obtain the full employer match. Many plans in the Hewitt Universe match contributions of up to 6 percent of pay, and more than one in every four plans has a match threshold below 6 percent.

As such, even participants who are contributing enough to obtain the full employer match—but no more than that—may not be saving enough to fund an adequate retirement.

Indeed, more than one-quarter (26.7 percent) of those participating in their defined contribution plan contributed only between 1 and 4 percent of pay in 2005.

Not surprisingly, younger, lower tenure, and lower salary participants are most likely to contribute in a nominal way—but an even higher percentage of those participants did so in 2005 than in 2004. The increase may be attributable, in part, to the higher incidence last year of automatic enrollment—which, while highly effective at improving participation levels, cannot guarantee a high quality of participation when default contribution levels are set at nominal levels.

Total Plan Balance

There has been a significant increase in average total balance since 2002—partly due to the market recovery and partly due to new contributions made by participants. In 2005, the average 401(k) participant's total plan balance increased to nearly \$76,000 from \$68,600 in 2004. Across comparable participants, the average total balance increased 17 percent in 2005. This represents a smaller increase than in 2004 and 2003. This is largely due to differences in participants' rates of return. The personal rate of return in 2005 for the median participant was 5.4 percent, versus 10.1 percent in 2004 and 22 percent in 2003.¹

Increase in Average Total Plan Balance—Across Comparable Participants		
2005	2004	2003
17%	21%	35%

With about 20 years to age-65 retirement, the typical 401(k) participant with 11 years of tenure has accumulated just over one times his or her average salary of \$60,630.

The median total plan balance is paltry compared to the average total plan balance at \$27,100. The median participant has saved only 50 percent of annual pay within the 401(k) plan.

¹ The median personal rate of return for 401(k) participants is based on a subset of the entire Hewitt Universe.

Almost one-quarter of participants had only a nominal total plan balance (defined here as a total plan balance under \$5,000) at the end of 2005. In addition, more than half (57 percent) of participants ages 20–29 had nominal total plan balances in 2005.

Investments

Overall Asset Allocation

As in prior years, the average participant's largest holdings in 2005 were in company stock (21.9 percent), GIC/stable value (18.2 percent), and large U.S. equities (18.2 percent).

The average participant spread his or her 401(k) investments across only four asset classes, while the average plan provides eight asset classes. Company stock and GIC/stable value commonly comprise two of the asset classes held.

At the same time, participants' allocation to non-U.S. equities increased in 2005. The average participant had 6.1 percent of balances in international and emerging market equity funds, up from 4.4 percent in 2004. Participants with less than one year of tenure invested 8.5 percent of their balances in non-U.S. equity funds, or 13.1 percent of equity balances.

Further, the proportion of participants holding only one or two of the asset classes available to them in the investment fund lineup has been declining: In 2005, approximately 30 percent of participants held only one or two asset classes, down from 34 percent in 2003. And, the number of participants holding more than four asset classes (with premixed portfolios in this category) has been increasing—from 40 percent in 2004 to nearly 44 percent in 2005.

Equity Allocation

Across all plans, the average participant's overall allocation to equities was 67.7 percent at the end of 2005. Comparing the allocations of participants with 401(k) balances at both the end of 2004 and the end of 2005 finds that the percentage allocated to equities was unchanged year-over-year. This is not surprising given the lackluster stock market of 2005.

Short-tenure, low-balance, and low-salary participants are most likely to have no equity exposure in their 401(k) portfolio. Nearly 10 percent of participants ages 20–29 had no equity exposure in their 401(k) plan at the end of 2005. This can be attributed to “default” investor behavior (failure to allocate monies away from default investment funds such as stable value investments) and lack of investment experience and confidence.

The average participant in a plan that offers company stock had a higher allocation to equities than the average participant in a plan that does not. The average participant allocated 69.5 percent of his or her balances to equities in plans with company stock at the end of 2005. However, when company stock was not present as an investment option, the average participant invested only 58 percent of his or her balances in equity investments.

Older participants are more likely to have heavier overall equity allocations when company stock is present than are younger participants. Participants ages 50–59 in plans without company stock averaged 51 percent in equities. In contrast, those ages 50–59 in plans with company stock averaged 67 percent in equities—with nearly 40 percent of that equity allocation in the form of company stock.

In plans with company stock, participants age 60 and older are also the most likely out of any age group to have all of their 401(k) balances in equities. These observations could be evidence that participants do not understand security-specific risk—even (or especially) when that security is their employer’s stock. This lack of knowledge may also be accompanied by inertia and loyalty to the employer, creating a scenario in which participants may be assuming greater investment risk than they would otherwise be willing to assume.

Company Stock

The average participant’s company stock allocation declined from 26.5 percent in 2004 to 21.9 percent in 2005. This was partly due to a change in composition of the Hewitt Universe. Still, in examining the asset allocation of participants who were in the Hewitt Universe in both 2004 and 2005, the allocation to company stock decreased by 1.6 percent year-over-year. This can be attributed to a decrease in prevalence of plan sponsors who offer company stock as an investment option in the 401(k) plan, invest the match in company stock, **and** restrict diversification out of the match in company stock.

In addition, plan sponsors’ efforts to improve diversification through offering premixed portfolios, advice, guidance, and targeted and personalized communication appear to be paying off in terms of lower allocations to company stock by 401(k) participants.

In 2005, one in five participants (20.1 percent) held half or more of their total defined contribution plan balances in their employer’s stock, down from one in four (27.1 percent) in 2004.

Still, company stock remains the single largest holding for participants in plans with company stock. The average participant with an allocation to company stock dedicated 36.8 percent of balances to that investment.

Premixed Portfolios

When available, premixed portfolios are widely used by 401(k) participants. In 2005, 40.3 percent of participants who had premixed portfolios available in their plan elected to invest some or all of their balances in premixed portfolios in 2005.

However, a minority of participants use premixed portfolios as a turnkey investment solution. In 2005, 19.9 percent of participants who held premixed portfolios invested all of their diversified 401(k) balances in the premixed portfolio they selected. The typical participant with a premixed portfolio also held an additional four funds.

Still, the number of participants using premixed portfolios as a turnkey solution is increasing—up from 15 percent in 2004. Also:

- Premixed portfolios tend to be a significant allocation within the portfolio of those who invest in them. The average percentage of balances dedicated to premixed portfolios by those who invest in them was 40 percent in 2005.
- Participants with premixed portfolios have lower company stock allocations than average. Participants with premixed portfolios averaged 13.7 percent in company stock, compared to 21.9 percent of balances in company stock across the full Hewitt Universe.
- Low-tenure participants are the most likely to have balances in premixed portfolios; 57.5 percent of participants with less than one year of tenure invested in premixed portfolios in 2005. Of those low-tenure participants investing in premixed portfolios, nearly half invested all of their diversified 401(k) monies in a single premixed portfolio in 2005.

Account Activity

Transfer Activity

It is uncommon for defined contribution plan participants to engage in any form of transfer activity. In 2005, approximately one out of six participants (17.3 percent) made at least one trade in their defined contribution account. This proportion is virtually unchanged from 2004.

Participants with higher balances are more likely to trade. Approximately one-third (32.1 percent) of participants with \$100,000 or more in balances made a trade in 2005, and each of these participants averaged 3.6 trades.

There has been a decrease in the average number of trades made by participants over the past few years. Overall, a higher percentage of participants traded only once last year, and a lower percentage of them traded more than 10 times versus in 2004. This suggests that transfer restrictions put in place by plan sponsors have effectively lowered excessive trading activities.

There are many reasons why 401(k) participants do not rebalance or reallocate their portfolios on a periodic basis. Such activities are predicated on the fact that the participant's portfolio has been invested according to a strategic asset allocation. Often, this is not the case. Participants also may confuse rebalancing and reallocation with market timing—which they have been told to avoid. Rebalancing can also be a counterintuitive and even an emotional activity—participants may be loath to shift money from their best-performing investments into their worst-performing investments in order to rebalance.

Loans and Withdrawals

The proportion of participants with loans outstanding remains consistent year over year. In 2005, 22.4 percent of active participants had a loan outstanding, in line with 2004 levels.

Middle-age and middle-income participants most commonly have outstanding loans.

This “sandwich” generation may be using defined contribution plan loans to fund their children’s college education or to pay for elder care.

Participants with loans, on average, had lower contribution rates in 2005 than participants who did not have loans outstanding—6.7 percent versus 8.4 percent.

Only a very small number of participants take withdrawals in a given year. In 2005, 5.1 percent of participants took a withdrawal from their 401(k) plan. This is essentially unchanged from 2004 and 2003 levels. Plans that match after-tax contributions experience nearly three times as many withdrawals as plans that do not match after-tax contributions.

Inactive Participants

Inactive participants represent a significant portion of the typical 401(k) plan’s population. Nearly one-third (30 percent) of workers with defined contribution balances in the Hewitt Universe are inactive participants. Assets of inactive participants represent 31.4 percent of total 401(k) plan balances. These participants tend to have more conservative asset allocations, higher total plan balances, and less account activity than active participants.

A copy of the complete report can be obtained for \$350 from:

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