Hewitt

Survey Highlights

Trends and Experience in 401(k) Plans 2007

The 2007 *Trends and Experience in 401(k) Plans* survey results reveal emerging trends in 401(k) plan design and administration.

These findings and other insights are presented in the following report. Hewitt Associates conducted the biennial survey in the spring of 2007. Information on key aspects of 401(k) design, investments, education, communication, plan expenses, and plan success was collected from a cross-section of plan sponsors. Twenty-nine percent of *Fortune* 500® companies participated in the survey.

The following topics are measured and analyzed in this year's report:

- Basic design and participation;
- Automatic features;
- Employee and employer contributions;
- Investment options;
- Investment education;
- Transfers and restrictions;
- Plan expenses;
- Loans, withdrawals, and final distributions;
- ADP/ACP tests;
- Appendix—Historical investment details; and
- Participating employer information.

Three hundred and two employers participated in the survey, sharing information on the plan that covers the largest number of their salaried employees. The surveyed plans have a combined total of approximately 2.7 million participants and $270 billion in assets. The Trends and Experience in 401(k) Plans survey has been conducted every other year since 1991. While the focus of the survey and survey samples has changed over the years, there are still a number of areas where useful comparisons and trends across time can be examined. This report shows such comparisons and trends throughout the past several years. These results do not represent a constant sample of employers.

Please note that percentages in this report are rounded to the nearest whole number. Therefore, some totals will not equal 100% due to this rounding.

Overview

The pace of change in the 401(k) environment is not slowing. Trends that began over the past few years continue, some at an accelerated pace, while new trends begin to emerge as well.

Employer contributions into 401(k) plans are increasing, although this is generally indicative of a reallocation of dollars from pension plans and postretirement medical subsidies, rather than an overall increase in total employer-provided benefits. Along with this shift, there is an increasing focus among employers on improving employee behavior to better meet their increasing retirement income needs. In response, employers have increased efforts to automate their 401(k) plans in a variety of ways and default employees in a way that leads to better potential long-term outcomes. This change is evident by the significant increases in automatic enrollment, automatic contribution escalation, and more diversified default investment options.

In spite of increases in automation and employer efforts, overall participation rates in 401(k) plans have not yet significantly improved. Given most plan sponsors implement automatic enrollment only for new hires, participation increases will occur gradually. However, participation is no longer the dominant metric used by employers to measure 401(k) plan success. The percentage of plan sponsors using income adequacy as the primary metric has increased dramatically.

Another continuing trend is the focus away from investing the company match in employer stock. In addition to responding to new requirements of the Pension Protection Act of 2006, employers are focusing more energy on plan governance and improved fiduciary oversight, as demonstrated by survey results.

Investment fund design is moving towards a simplified, streamlined structure. Premixed portfolios (target-risk and/or target-maturity funds) are now offered in more than three-quarters of plans. Further, while the number of funds has risen, the bulk of this movement has been from the adoption of these premixed portfolios. Nonmutual fund alternatives, including collective trusts and separate accounts, are also gaining attention as employers seek alternatives to mutual funds.

Finally, plan expenses are top of mind with employers, with nearly two-thirds noting they are concerned about the topic. This topic has gained significant attention among the media, regulators, and litigators. Many plan sponsors have analyzed their current fee structure as well as the appropriate way(s) to communicate these messages to employees.

Results highlighting these and other trends are summarized below.

Basic Design and Participation

401(k) plans will clearly be the predominant source of retirement wealth for many Americans. Almost two-thirds of employers (65%) report that the 401(k) plan is the primary retirement savings vehicle for the employees they cover. This has leveled off after rising for over a decade. Notably, only 35% of employers surveyed ten years ago reported that the 401(k) plan was the primary program for retirement. Employers are providing earlier access to 401(k) savings, with nearly half of plans (49%) offering immediate eligibility to participate in the 401(k) plan. This is up from 43% in 2005.

Participation has not increased significantly since the last survey. On average, 78% of eligible employees participate in their companies' 401(k) plans. This is up marginally from 2005, although it is within the narrow range of rates reported since 1991 (between 72% and 79%).

While one-quarter of plan sponsors consider participation rate as the most important measure in evaluating plan effectiveness, this is down significantly from 43% two years ago. Retirement income adequacy experienced the biggest increase, and was cited as the most important measure by nearly one-quarter of plans (24%). This change reflects a shift in focus to the outcomes delivered by the retirement program.

Automatic Features

Automation is quickly becoming a standard part of 401(k) plans. The percentage of employers that automatically enroll participants has increased from 19% in 2005 to 34%, almost doubling in just two years. Similarly, automatic contribution escalation, where employees can elect to have their contribution rates automatically increased over time without any additional action, increased from 9% of employers in 2005 to 35% in 2007, an almost four-fold increase. Forty-two percent of respondents now offer automatic rebalancing, compared to only 26% in 2005.

Investment defaults under automatic enrollment have migrated toward diversified investment options. Currently, 50% of plans default into target-maturity funds, while only 17% default to money market or stable value funds. Further, 83% of employers set their default contribution rates at 3% or higher, compared to just 66% two years ago. In addition, almost three out of ten employers (28%) use contribution escalation in conjunction with automatic enrollment, with more than 40% of employers escalating employees to target rates between 8% and 15%.

Employee and Employer Contributions

Almost all responding employers (98%) contribute employer money to their plans, and two-thirds provide a fixed employer matching contribution. The most common type of match is $0.50 per $1.00 up to a specified percentage of pay (most commonly 6% of pay), reported by 26% of all plans. These numbers are consistent with the 2005 survey.

Continuing a downward trend, among plans that offer employer stock as an investment option, nearly one-quarter (23%) invest the employer matching contribution exclusively in company stock. This is down from 36% in 2005 and 45% in 2001. Further, of those that do default the match to employer stock, there are fewer restrictions associated. Currently, 67% of these plans allow employees to diversify or transfer employer matching contributions at any time. This is up from 46% in 2005. A primary driver of this change is the Pension Protection Act's diversification requirements as well as plan sponsor concerns about fiduciary risk and exposure.

Investment Options

The process of selecting and monitoring investment options continues to be top of mind with employers. Eight out of ten plans (83%) have a written investment policy statement, up from 78% in 2005. Another 10% expect to write one in the next 12 months. An investment policy statement provides a framework for decision making.

Over three-quarters of employers (77%) offer a premixed portfolio (target-risk and/or target-maturity funds). This is up from 63% in 2005. Of the employers offering premixed funds, 58% offer target-maturity funds, 31% offer target-risk, and 10% offer both. The average number of target-date funds offered is 7.5, while the average number of target-risk funds is 3.3.

The average number of investment options increased from 14 to 17 in the past two years. However, much of this increase is attributable to the utilization of premixed portfolios—excluding premixed portfolios, the average is 12 funds, up from 10 (note, the median is 11).

The most popular asset classes offered remain stable value (84%), bond (88%), large-cap U.S. equity (98%), and international equity (97%). Employer stock is an investment option within 46% of plans. In terms of asset allocation, the bulk of 401(k) assets remain invested in stable value (18%), large-cap U.S. equity (26%), and employer stock (16%). In terms of the types of vehicles offered in 401(k) plans, nonmutual fund alternatives including collective trusts and separate accounts are utilized by nearly six out of ten employers (59%).

Continuing an upward trend, the percentage of plans offering a self-directed brokerage account increased from 16% to 18% of plans. Access to a brokerage window can be an effective way for plans to consolidate fund options and still allow greater choice for the small subset of employees that desire this type of access. Hewitt's research finds that where a brokerage window is available, on average 2% of employees access the feature.

Investment Education

Consistent with the previous surveys, the vast majority of employers provide investment education to employees. Nearly all respondents use written materials for communicating investment concepts, and 70% report that they are somewhat effective. Eighty-nine percent of plan sponsors use on-site seminars/workshops in their education efforts, and 45% report that they are very effective.

Four out of ten employers (40%) offer outside investment advisory services to employees (including advice, guidance, and managed accounts). This is a slight increase from 2005, when 37% offered such services. An additional 16% of employers plan to add this service in the next 12 months. Of those employers not offering the feature(s), the most prevalent barrier cited was cost (23%).

Transfers and Restrictions

Nearly three-quarters of plan sponsors (73%) have some type of transfer restrictions in place. Eleven percent of plans restrict transfers on all funds and 62% restrict only on certain funds. Over half of employers (55%) acknowledge they added the restriction at the request of the fund manager. Across available asset classes, international funds were most likely to have trading restrictions (73% of plans).

Plan Expenses

An increasing number of employers are taking a closer look at 401(k) plan fees. Sixty-one percent of employers noted they are very or somewhat concerned about expenses amid the recent scrutiny of the government and media, as well as concerns of potential litigation. Six out of ten plans have attempted to calculate the total cost of maintaining the 401(k) plan—an increase from 34% in 2003. More than half of employers (57%) have made efforts to reduce expenses, while 40% noted they were planning to evaluate the cost of their funds.

Loans, Withdrawals, and Final Distributions

Nearly all of the surveyed plans (98%) have a loan provision, with 99% offering general purpose loans and 77% offering home loans. It is most common for plans to offer one or two loans.

Most plans (94%) have a hardship withdrawal provision, and this is consistent with the previous surveys. Further, 90% of plans allow in-service withdrawals for participants who have attained age 59½.

All plans surveyed offer lump-sum payments, over half offer installment payments, and 15% offer annuities as forms of payment for final distributions. Additionally, 66% of plans have force-out provisions in their defined contribution plans.

ADP/ACP Tests

Twenty-nine percent of employers report using a safe harbor design in lieu of ADP/ACP testing. Among employers using ADP/ACP testing, more than half (53%) expected to pass the 2006 401(k) ADP test without adjustment to highly compensated employees' (HCEs) contributions. At the same time, nearly one-quarter (24%) anticipated limiting the percentage of contributions that HCEs may contribute in order to pass the nondiscrimination test.

A copy of the complete report can be obtained for $2,500 from:

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