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TOPIC #17: **Shift to Defined Contribution Plans**

PROMPT: **Discuss the shift towards defined contribution plans for both the public and private sectors and how benefits like portability & flexibility come at the expense of increased responsibility.**

Benartzi & Thaler (2007) recognize the shift towards defined contribution plans for both the public and private sectors (away from defined benefit plans), particular benefits include portability and flexibility, but all comes at the expense of "increased responsibility to choose wisely" (p. 81). The researchers view the domain organized for behavioral study, looking for both the simple "rules of thumbs" adopted by people in lieu of calculating personal optimal savings rates (ie., that account for future rates of returns, income flows, retirement plans, health, etc.) and the biases that emerge from said rules of thumbs (ie., heuristics) in the area of retirement savings.

As a result, the authors propose that employees with little training or with little financial literacy are relatively passive investors—slow to join advantageous plans, slow to make plan changes/adjustments, and typically adopt naïve diversification strategies. On employer matching, "taking advantage of [employer] match should be a no-brainer for all but the most impatient and/or liquidity-constrained household" (p. 82).

Data on 25 company plans displayed only 50% of eligible employees taking action to receive employer funded defined benefits when no auto-enrollment process was available (p. 82), which is further motivation to design plans where the default is being inside the plan unless you take action to opt-out (other studies show an extremely low o article also reviews research on "contributing the max allowable limit to the plan", the "pt-out rate"); the multiple-of-five heuristic (which explains the popularity of 5%, 10% and 15% contributions), as well as the "contribute the minimum necessary to get the full employer match" heuristic (p. 85).

Regarding naïve asset allocation, the authors quote a great confession from Nobel Laureate Harry Markowitz, a founder of modern portfolio theory, "I should have computed the historic covariances of the asset classes and drawn an efficient frontier. Instead, I split my contributions fifty-fifty between bonds and equities" (p. 86), and the authors go on to equate this behavior with modern Halloween trick-or-treat candy bar theory (p. 87). Also analyzed were small details like the "number of lines on the sign-up form" did in fact influence the number of funds selected within the portfolio (p. 88).

Also addressed are findings that typical naïve investors buy high and sell low when trying to time the market (p. 92), and address alleged benefits of company stock issuance, matching, etc (p. 91 & 94). And finally of notable interest was the "Save More Tomorrow Program" (p. 101) where researchers studied those who increased their current rate by 5% versus those would increase their savings rate by 3 percentage points every time they got a pay raise—results were dramatic, with control group at average 8.8% versus an almost 13.6% savings rate in the variable group of pay-raisers.

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The article offers numerous inroads to research topics, all while unassumingly stipulating, “the main alternative to education as a method of influencing decisions about retirement savings plans is to choose the features of the retirement savings plan in a way that promote the desired objectives” (p. 100).

Among many other topics, the authors discover specific plan features that may promote more retirement preparedness, positively identifying variables which could be further studied such as sensible default options, opportunities to increase savings rate with matching, and portfolios that automatically rebalance (p. 102).

The authors framed an interesting argument for embedded rationality assumptions required to successfully utilize a defined contribution plan: “the first implicit assumption is that households have the cognitive ability to solve the necessary optimization problem. The second implicit assumption is that the households also have sufficient willpower to execute this optimal plan” (p. 81).

The study went onto examine cross-sectional data on 170 retirement saving plans, looking at relative number of equity funds used in the portfolio versus the number available. Looking at the data, another diversification heuristic measure they studied between US plans (where people construct their own portfolios) versus the Chilean social security system, where individuals pick from one of many lifestyle funds (p. 90). The authors also share that a companion paper is available by Jonathan Skinner (2007), written to further discuss whether people are saving enough for retirement.

Reference:

- **Benartzi, S., & Thaler, R. H. (2007). Heuristics and biases in retirement savings behavior. *The Journal of Economic Perspectives, 21*(3), 3-104.**

- **Skinner, J. 2007. "Are You Sure You’re Saving Enough for Retirement?," Journal of Economic Perspectives, American Economic Association, vol. 21(3), pages 59-80, Summer.**

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