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AUTHOR: **Aaron M. Bell**, ChFC®, CLU®, CLTC®, MA

TOPIC #16: **Behavioral: 401k Education vs. Intimidation**

PROMPT: **How does the responsibility of investment selection intimidates participants from starting early & choosing wisely**

Clark, Morrill & Allen (2012) remind the individual worker that each person has a responsibility throughout a career to plan and save for retirement, and charges the baby boomers, XY, and millennials with a special challenge given increasing life expectancies to start early and choose wisely (ie., 15% of 401k accounts have no equities; p. 315). The article can help a practitioner learn methods from better help plan participants engage the HR objectives inherent in plan design—achieving the retention and motivation objectives of the employer, while strengthening the retirement preparedness for employees.

The role of financial literacy is highlighted to help investors understand the role of plan characteristics, and investment solutions. The authors also recognize that at the end of careers, workers are often faced with a series of important choices, they "must choose when to retire, when to claim benefits, and whether and how much of their wealth to annuitize" (p. 314).

The article emphasizes evidence that suggests the workplace is a conducive environment for financial literacy programs. It is the authors' hypothesis that workplace financial education will enhance understanding of financial mathematics, retirement plans, and behavior incentives. Plus preretirement planning seminars (ranging half day to two-and-half-day events) may help prevent older workers from making less than optimal decisions as they transition from work to retirement (p. 315), as they relate to qualified retirement plans, social security, Medicare, health insurance, annuities, housing wealth, life expectancy, and so on.

The SSA through the Financial Literacy Center examined five different employers providing different matching contributions and found "match terms and [plan] eligibility are important determinants of participation and contribution rate choices" (p. 315), as do automatic enrollment and automatic escalation (90% enrollment rate for auto's, compared to 60-80 percent for firms without automatic enrollment, p. 315). Personally, an unanswered concern is the double edge of a vesting schedule potentially promoting counteractive outcomes, deterring young people from starting while helping older people better reach retirement preparedness.

Glide path portfolios have permission to be a default investment solution in 401k plans (QDIA—qualified default investment alternative). Ellement, J. L., & Lucas, L. (2009) address the practical use of a target date fund, or glide path fund, asking specifically whether the goal of the plan should be to help a participate *reach* retirement or at the same time account for withdrawal tendencies *throughout* one's lifetime. This article helps clarify the competing definitions of a target-date fund objective, and sheds light on the justifications to warrant their QDIA status, plus the article emphasizes the need for transparent communication to the individual investor.

Aaron M. Bell | ChFC®, CLU®, CLTC®, MA | Financial Advisor

| **CANNATARO PARK AVENUE FINANCIAL**
| Nortwestern Mutual Wealth Management Co.
| 245 Park Avenue, Suite 1800
| New York, NY 10167
| cpaf.nm.com
| 646.366.6571
| Aaron.Bell@NM.com

Ellement, J. L., & Lucas, L. (2009) found target-date plans varied widely in allocation range and outcome, and looked closely at two glidepaths that assumed different income replacement ratios (Callan Associates' Callan Target-Date Glidepath Index, CTDI, and a modified conservative version, the Modified CTDI).

A good quote, "equity allocation differences in target-date fund glidepaths resulted in material variations in investment performance during 2008" (p. 11), was supported by three example 2010 target date funds that were down 10.8%, 22.4% and 32.7% respectively. Findings suggest the average target-date fund like the CTDI takes the "through" approach, acknowledging the participant will likely need some significant equity exposure at their retirement date to sustain future withdrawals. The article performed simulation analysis with these two indices and examined replacement ratios (ie., how much pre-retirement income is provided *during* retirement) ranging from 43.9% to 73.7% of final pay, concluding success was heighted by starting contributions at an ever earlier age and investing in glidepaths strategies that invest *through* one's retirement date. Note: target-date funds that have a *through* objective should be positioned as "lifetime funds" (p. 22).

Keep in mind, "differences in demographics, plan design and even the extent to which plan sponsors seek to keep terminated and retired participants in the plan" (p. 21) will have a large impact on what is the most appropriate glidepath for a given plan.

In my opinion, relying on any single solution fund can inherently struggle to be fully transparent in investment assumptions, and that challenge is exacerbated if we extend the target date behind one's retirement date and into their life expectancy. I think this article shows the challenge for plan sponsors to pick investment funds, let alone QDIA funds—and I believe there is an opportunity here to explore the added value of balanced funds or "managed accounts" as QDIA vehicles in terms of transparency of investment objectives.

Reference:

- **Clark, R. L., Morrill, M. S., & Allen, S. G. (2012). Effectiveness of employer-provided financial information: Hiring to retiring. *The American Economic Review, 102*(3), 314-318.**
- **Ellement, J. L., & Lucas, L. (2009). The Great Target-Date Fund Debate: Calculating the Impact of Managing Target-Date Funds "to" Versus "Through" Retirement. *Benefits Quarterly*, *25*(4), 10-22.**

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Aaron M. Bell | ChFC®, CLU®, CLTC®, MA | Financial Advisor

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