Running head: The Potential Crisis of 401(k) Plans

The Potential Crisis of 401(k) Plans

Paul Elling

Amberton University, Garland, Texas

November 18, 2008

Background of 401(k) Plans

The idea of retirement is more of a modern concept than many people realize. Prior to the introduction of Social Security and company pension plans, retirement simply was not a reality for most workers. If someone decided to retire, then it was only feasible through personal savings or, if they were incapacitated, they were helped by family. Pension plans are also called defined benefit plans, and they are typically set up to provide a steady stream of income to retired workers until death. This arrangement allows people to work for a company or the government for decades with the peace of mind that they would not have to be worried about income after they were finished working. In the Employee Retirement Income Security Act of 1974 (ERISA), 401(k) plans were introduced as defined contribution plans, or an alternative to existing pension plans. (Wikipedia) In 401(k) plans, employers will contribute the same amount as employees up to a certain percentage of wages, usually 2% to 5%. These employer and employee contributions are accumulated tax-deferred until the employee retires and begins drawing money from the plan. Unlike, defined benefit plans, 401(k) plans are left to employees to manage throughout their careers. 401(k) providers will typically offer guidance to employees who seek it. The performance of a 401(k) plan, however, is determined by the funds an employee has selected. Initially, companies may deposit contributions to one of the standard funds in the 401(k) until an employee decides to alter fund designations. ERISA created a potential crisis when it implemented 401(k) plans in 1974. The problems that could lead to the crisis include plan fallacies, a general lack of financial education among employees, poor retirement planning, government interference, and upcoming massive distributions to retired baby boomers. The potential crisis could have grave implications for the economy as a whole. Fortunately, solutions to the problems exist but will take time to see results. These solutions include improving aspects of plans, improving financial education, and stopping government interference.

401(k) Plan Fallacies

Any employee who has examined his or her 401(k) plan knows that the available funds for contribution are limited to those offered by the provider and sometimes the stock of the company for which he or she is employed. 401(k) plan providers are companies, such as Fidelity or Vanguard, who also work in other capacities of personal finance. These companies have created various mutual funds, index funds, and exchanged-traded funds that are designed to make money for people regardless of whether the general market is up or down. The idea is that the diversification provided by mutual funds will act as a financial ark that will safeguard investors from financial peril. These funds are proprietary to the 401(k) provider. Employees are restricted to these options, and employees cannot go outside the fund options to select individual stocks or other investments of their choice. This fallacy imposes strict limitations on employees, which could be devastating. For instance, if Fidelity executives participate in fraudulent insider trading, the results of such activity could destroy many employees' retirement plans. It could lead to a major selloff of funds by market investors outside of 401(k) plans, which would drive down the prices and thereby significantly decrease the value of 401(k) portfolios. In addition, any bad news about Fidelity could have a similar calamitous effect on 401(k) plans. Earlier this decade, people witnessed the detrimental impact of the Enron scandal on employees' 401(k) plans. If providers increased investment options to the general stock market and acted as true brokers, then this limitation could be reduced.

An increasing limitation of 401(k) plans is that employers are deciding to stop matching employee contributions altogether. For example, in October 2008, General Motors announced that because of falling sales it would stop matching 401(k) contributions in addition to letting go of salaried workers and removing the benefits for remaining salaried workers. (Terlep) These decisions by employers have eliminated one of the major incentives for investing in 401(k) plans. Many employees base much of their reasoning for having a 401(k) plan on the fact that they get "free" money from their employers. If the elimination of matching 401(k) contributions becomes a trend, then many employees are likely to discontinue their 401(k) contributions as well. Furthermore, it might discourage some employees from considering their future retirements altogether. Some people may decide to withdraw their existing 401(k) balances and spend the money on non-essential items to allow them to deal with the frustrations.

Some of the major impediments to people realizing growth in their 401(k) plans are the fees imposed, some of which are hidden. According to an article in *Business Week*, the operating costs for providers to manage several 401(k) accounts prove to be expensive in comparison with other types of investment accounts. (Tergesen) In the same article, possible reasons for the higher costs are mentioned, including service providers sharing employee fees, providers not making enough effort to keep fees reasonable, and encouraging investors to select funds that are in the providers' best interests. For 401(k) portfolios that have years of poor performance, the fees could eat up any gains that employees might have made during the year.

Indeed, the 401(k) investment scheme is loaded with flaws. These flaws include a mandatory withdrawal mechanism, dependence on assumptions, a plethora of mutual funds, lack of insurance against a market crash, and an increasing cost of living after retirement. (Kiyosaki, 74) The requirement to withdraw funds limits freedom of choice as to when a retiree would prefer to sell. It prevents retirees from working with financial planners to devise an effective distribution strategy. Investment advice on the stock market is based on assumptions about past performance. Although past performance can be an indicator of future gains, assumptions are not guarantees and should not be perceived as such. Despite the fact that many financial experts recommend mutual funds, the trouble is sorting through all of them. In the market, many thousands more mutual funds exist than company stocks. The odds of picking winning mutual funds are greatly decreased by the volume. In defined benefit plans, employees were guaranteed a steady income after retirement. In 401(k) plans, however, no guarantee of income exists. If the market crashes, employees could lose much or all of their retirement savings. Nothing is built into 401(k) plans to insure retirees. A very possible future scenario could see inflation rise dramatically, especially with the government printing money at an ever increasing rate. 401(k) plans may not be designed to accommodate inflation.

Lack of Financial Education

When the United States government passed the Employee Retirement Income Security Act in 1974, a necessary component was missing--the requirement of public schools to educate students about financial matters. Over the course of the following years, many employers have traded in their defined benefit plans for 401(k) plans, which are defined contribution plans. The result is that employees became responsible for the management of their retirement plans, despite their lack of financial knowledge. Since schools have not educated students about money, most children learned about it from their parents. If someone's parents had poor money habits, then their children will very possibly inherit those same habits. Lack of financial knowledge can lead an employee to make poor decisions about his or her life and retirement. A large part of becoming financially educated is improving financial literacy in terms of reading financial statements, annual reports, or financial news articles. The public education system has not adapted to the phenomenon of employees taking responsibility for their own retirements. Thus, schools might teach about mathematics and science, but the critical subject of money and financial statements gets largely ignored. Upon graduation from high school, students might know how to balance a checkbook, but little else. Public school curriculum was designed in a time when most people in the world worked as farmers and had little need for extensive knowledge about financial matters. When the industrial age replaced the agricultural age, people still did not need to learn much about money. If they worked in a factory, then it was very possible that they received a pension, or defined benefit plan, upon retirement. The pension guaranteed that they would receive income. In this environment, it remained unnecessary to teach students about money. People knew that if they got a secure job and worked hard for a few decades, then they would be able to retire with peace of mind that their employer was managing their retirement funds. In the information age, employers switched sponsored retirement plans over to 401(k) plans. Unfortunately, public school curriculum reflects a time when people expected a safe and secure retirement without having to manage their own plans.

The problem persists even for highly educated people who have completed undergraduate degrees or higher. "Because students leave school without financial skills, millions of educated people pursue their profession successfully, but later find themselves struggling financially." (Kiyosaki, 65) Despite commanding a large income, many people find that they also spend the majority of that income, keeping very little for themselves. This behavior highlights that people lack an understanding of cash flow. Money comes in and it goes out. The money goes out to pay for a mortgage, cars, credit card balances, old college loans, and other forms of debt. Money also is a means for people to impress others by eating at expensive restaurants or enjoying expensive vacations. Yet, if people diverted some of the outward cash flow to investments, such as businesses, stock, or real estate, they might be able to keep their money. However, some people speculate in the stock market or real estate without a solid financial education, which makes them risky investors.

Poor Retirement Planning

Without a financial education, employees are throwing darts at the available funds in their 401(k) plans, and the result is often poor retirement planning. Employees may hear financial pundits on television or read statements in the newspaper that repeat a variety of oftheard statements, such as "diversify your portfolio" or "get a financial advisor" or "only invest in mutual funds". Some employees will then base their 401(k) retirement planning on these statements that seem like common sense, because so many people repeat them. Yet, these same employees neglect to investigate what these statements actually mean and how the underlying ideas can be most effectively applied to their retirement plans. For instance, diversification is a sound strategy when applied in a certain manner, but as Warren Buffett has said in the past, "Diversification is a protection against ignorance. It makes very little sense for those who know what they're doing." (Wikipedia) For an employee who has no interest in actively managing their retirement portfolio, trusting to a diversified set of mutual funds may work. However, this employee's lack of financial education can be equally damaging if those mutual funds perform poorly. Diversification is a sound strategy for owning different types of investments, such as stock, real estates, and businesses. While there certainly are gems of truth in these mantras of the financial planning industry, blindly following the advice of blanket statements can undermine the performance of an employee's 401(k) plan. Additionally, employees may feel a sense of loyalty to the company for which they work. Without any insight into financial matters, employees may choose their investments based on emotional sentiments rather than objective assessments of the available funds in their 401(k) plans. They may feel as though they are loyal employees by also being shareholders in their employers' stock available in their 401(k) plans. Then again, employees may believe they work for a great company and want to be part of the success. Enron employees certainly believed that they had made wise choices to invest in company stock via their 401(k) plans. Then, in early 2002, Enron declared bankruptcy and executives were accused of insider trading fraud in what became one of worst scandals in American corporate history. Many employees lost much or all of their retirement savings. Prior to the scandal, many Enron employees would have believed that they were financially smart for having invested their futures in Enron stock. After the scandal happened, many employees unfortunately did not share the same feelings as before. They worked hard all their lives and invested in their future retirements but likely had not invested much in their financial educations. In their cases, diversification into several funds in their 401(k) plans might have minimized the impact of Enron's stock decline. As mentioned, this strategy, however, cannot adequately replace the value and savvy of a high financial IQ. People can be naïve and believe that what happened to Enron employees will not happen to them. Rather than taking away the lesson of needing to improve their financial knowledge, they might blame corporations and greedy executives for ruining people's lives. Unfortunately, people have will possibly suffer the same fate that Enron employees experienced, thereby exacerbating the potential crisis of 401(k) plans.

Government Interference

One problem that has seen more prominence in recent times is that of government interference in 401(k) plans. Legislation has been created to limit the amount of loans that employees can take out, thereby limiting their freedom to decide what's best for their financial future. In recently proposed legislation, Congress has discussed removing the tax-deferred incentive for people contributing to 401(k) plans. In conjunction with this idea, Congress has had discourse about tying 401(k) contributions to Social Security to send retirees one disbursement check each month instead of two checks. Although government can offer meaningful assistance to financial markets, much of the interaction that government has had with markets in recent times involves handing out money to certain entities while trying to determine the parties that will pay for the handouts. With the new mountains of debt that the government is accumulating, 401(k) portfolios are being seen as sources of funding for this debt.

It's an abomination for the federal government to take money from employees' 401(k) plans and at the same time penalize those same employees for accessing their own money. When someone defaults on a typical bank loan or car loan, they must accept the consequences, because they are borrowing someone else's money. In the case of 401(k) plans, people are borrowing from themselves. In the opinions of plan providers and the federal government, 401(k) loan borrowers should be subject to the same consequences as other types of loan borrowers. According to the United States Department of Labor, providers are allowed to refuse a loan if they lack confidence in the borrower. (Compensation & Benefits for Law Offices, 6) In a truly free market, a person should be able to access all of their own money if they so choose. The idea that the government has jurisdiction over a citizen's money is similar to the idea of imminent domain, where the government can seize a person's property if that person doesn't accept a fair market offer for it.

In recent news, Congress has been debating whether to remove the benefit of saving money in tax-deferred 401(k) accounts and redirecting those savings to a new version of Social Security. In the plan being proposed, "…all workers would receive a $600 annual inflation-adjusted subsidy from the U.S. government but would be required to invest 5 percent of their pay into a guaranteed retirement account administered by the Social Security Administration. The money in turn would be invested in special government bonds that would pay 3 percent a year, adjusted for inflation." (Workforce) The reason for these discussions, according to legislators, is the recent drop in the stock market. Many people have lost a large portion on their savings due to the market downturn. In 2008, "…the average 401(k) account balance dropped roughly 19% to 25%..." and "…more than $500 billion has evaporated from 401(k) plans." (Laise) Though investors will be losing the benefit of high returns, they will be "saved" from disaster. This idea of saving investors goes back to the notion that the role of government is to rescue people from themselves. Although this role was not part of the original idea for the

United States government, it has found its way into the focus of the federal government over the past century. Astute investors might have recognized government's impetus to take over 401(k) portfolios by a related law that was passed in 2006, the Pension Protection Act. Through this law, which went into effect in 2008, employers are allowed to automatically enroll employees in their 401(k) plans. (Brandon) Employees are allotted the choice to opt out of their 401(k) plans, but this law and the aforementioned proposed legislation all have the feeling of government holding its citizens at gunpoint in order to pay for grandiose programs and government bailouts.

Baby Boomer Distributions

The potential crisis of 401(k) plans might be realized in the coming decades when millions of baby boomers begin retiring (with people born in 1946 turning 70 years old in 2016) and receiving distributions from their plans. Any retired employees who contributed to Social Security accounts or 401(k) plans are certainly entitled to their own money. The problem happens when millions of retired workers begin receiving those distributions. In order to send those distributions to people, shares of funds in their 401(k) plans must be sold. A dramatic increase in distributions could overburden the financial markets. This premise might encourage people to limit their distributions at certain times or even postpone distributions some months to let the money grow and thereby prevent a new type of run on the bank. Unfortunately, the ERISA law commands retirees to "…begin withdrawing from the market, by selling shares monthly, at age seventy and a half." (Kiyosaki, 54) At the other end of the spectrum, workers are purchasing shares of funds in their 401(k) plans. The worrisome aspect is that the future may see more baby boomer retirees selling their shares than the number of available workers with 401(k) plans to purchase those shares. With greater supply of shares, demand will fall along with prices of shares, rendering retirees' portfolios valuations increasingly lower.

Part of the problem with this troubling scenario is the past success of 401(k) plans in the 1990s. The stock market experienced strong growth in the 1990s, partially due to working baby boomers' demand for equities in their 401(k) portfolios. The success of seeing the stock market rise anywhere from 10% to 30% annually has caused many people to believe that those gains will continue indefinitely in the future. (Kiyosaki, 55) In addition, many "experts" argue that over the long-term the stock market always increases and outperforms money market funds, savings accounts, and other investment vehicles. This concept has helped convince current and future retirees that they have the winning retirement formula no matter what happens. However, past performance is no guarantee for future outcomes.

Solutions

Although the potential 401(k) plan crisis may seem massive, it can be overcome by providers improving different aspects of plans, improving financial education, and limiting government interference in 401(k) plans. 401(k) providers seek profit by selling their own mutual funds to investors. If this practice were changed to allow more freedom of choice, then employees would have more opportunities to improve their 401(k) performances by selecting the funds that contribute to their retirement goals.

The issue of 401(k) fees must be addressed with relevancy. It is understandable that the providers must make a profit, but they should also improve the visibility of information. To their credit, 401(k) providers have willingly supplied valuable information on the historical performance of their funds. However, they must become more transparent about the fees that are charged as well. This issue is one area where it is appropriate for the government to become involved, especially with the growth in 401(k) participation over the past three decades. In recent times, the federal government is stepping up efforts to hold providers more accountable for disseminating information about fees. Among the initiatives that the government is taking, it is identifying the most important fee information and format for fee comparisons, improving the method of disclosing fees, and helping providers to determine how reasonable fees actually are. (Bovbjerg, 17) Such actions can go a long way to removing the frustrations that employees feel when they realize they are not getting all of the returns from their investments.

Initiatives to improve financial education can go a long way toward averting a crisis. The federal government could take steps to bolster financial education throughout the United States. For current workers, classes could be offered at universities, community colleges, and continuing education facilities. Many employers do provide sessions, often annually, to help employees gain insight into their 401(k) plans. Such offerings provide opportunities for employees to take initiative with their retirement plans. In addition to opportunities for current 401(k) contributors, the federal government should finally take steps to teach money and financial matters in public schools. Lesson plans could include learning about the stock market, real estate, banking, economics, and accounting. Future investors will need to understand concepts like cash flow, assets and liabilities, and return on investment. Furthermore, the government could encourage parents to become financially literate in the way they push health and fitness. Such messages might suggest that parents learn about money with their children.

If government is limited in how much it interferes in employees' 401(k) plans, then people will not have to worry about the negative influence. The role of government in 401(k) plans should be to punish fraud and enforce contracts in the general market. When an incident like Enron happens, it is the duty of the federal government to punish criminal activity. The government should definitely avoid creating a lot of new legislation. Instead, by focusing on the crimes and pursuing justice, the government would be most beneficial. Unfortunately, the solution to government interference is not easy, as it involves voting for political candidates who oppose such government expansion and holding those politicians accountable for any legislation that favors government involvement.

References

"Warren Buffett." Wikiquote. 1993. 2 Nov. 2008 <http://en.wikiquote.org/wiki/Warren_Buffett>.

"401(k)." Wikipedia. 2008. 2 Nov. 2008 <http://en.wikipedia.org/wiki/401k>

Terlep, Sharon. "GM Plans White-Collar Cuts." Wall Street Journal 23, Oct. 2008, final ed., sec. 1: 1+.

Bovbjerg, Barbara D. "Private Pensions: Increased Reliance on 401(k) Plans Calls for Better Information on Fees." United States Government Accountability Office (2007). Academic Search Premier. EBSCO. Amberton U, Remote Research Access, Toledo, OH. 3 Nov. 2008 <http://search.ebscohost.com>.

Turgesen, Anne. "Does Your 401(k) Cost Too Much?" Business Week 3886 (2004). Academic Search Premier. EBSCO. Amberton U, Remote Research Access, Toledo, OH. 4 Nov. 2008 <http://search.ebscohost.com>.

Kiyosaki, Robert T. Rich Dad's Prophecy. New York: Warner Books, 2002.

Kiyosaki, Robert T. Rich Dad Poor Dad. New York: Time Warner Book Group, 1997.

"Is It Time to Limit 401(k) Plan Loans?" Compensation & Benefits for Law Offices 5.4 (2005). Academic Search Premier. EBSCO. Amberton U, Remote Research Access, Toledo, OH. 3 Nov. 2008 <http://search.ebscohost.com>.

Hansard, Sara. "House Democrats Contemplate Abolishing 401(k) Tax Breaks." Workforce Management Oct. 2008. 5 Nov. 2008 < http://www.workforce.com/section/00/article/25/83/58.php>.

Laise, Eleanor. "Statement Shock Hits 401(k)s." Wall Street Journal 11, Oct. 2008, final ed., sec. 1: 1+.

Brandon, Emily. "New Rules Push Workers Into 401(k)s." U.S. News & World Report 1, Nov. 2007, final ed., sec. 1: 1+.