



## MEMORANDUM

To: PCA Clients

Date: August 10, 2010

From: Neil Rue, CFA, Managing Director

**RE: 401(k)s Are Not “The Answer”**

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Since the equity bear market of 2001-2002 and further magnified after the 2007/2008 economic crisis, the defined benefit (DB) retirement funding model has come under severe attack. One outcome is that many opponents of the DB model have promoted the 401(k) defined contribution (DC) model as the better, more cost-effective solution. However, the 401(k) model has yet to be truly tested, as society *en masse* is only now beginning to turn to their 401(k) accounts to finance their retirement needs. In contrast, DB plans have a several decades' track record of meeting retirees' needs.


In light of the ongoing DB vs. DC debate, it should come as no surprise that in recent weeks the *Wall Street Journal* and *BusinessWeek/Bloomberg* have reported that corporate sponsorship of employee-managed 401(k) plans has deteriorated.<sup>1</sup> As the *WSJ* pointed out, “Roughly a year into the current economic expansion, U.S. corporations and their shareholders are enjoying surging profits and rising dividends—yet many employees are still waiting for the restoration of one of their most important benefits, the 401(k) match.”

The articles go on to highlight that one-in-five large employers (>1,000 employees) have not restored, or only partially restored, their pre-crisis employer 401(k) matching contributions. Many companies have stated that restorations are coming soon. However, the articles also state that other companies will begin to review/reduce their matching programs. Such tactics are reasonable, given corporations' mandates to produce profits. What is highly likely from a retirement planning perspective, however, is that the resulting aggregate total contribution level into 401(k) plans will fall significantly short of pre-crisis levels. This result means that the 401(k) “solution” to America's pension problem is becoming an increasingly unreliable proposition, to say the least. More specifically, if the above trend is real, over time the 401(k) is very likely to produce the same dire funding results as many DB plans face today. Worse still, there won't be any recourse available from a risk-pooling employer/plan sponsor to make up the gap. The employee/retiree will just be standing there, pretty much empty-handed.

Not only is corporate sponsorship of the 401(k) plan likely to deteriorate in the form of reduced levels of aggregate corporate employer matching dollars, but the evidence continues to build that average DC plan/account investment performance continues to materially lag that of the average DB plan. In the late 1990s, Watson Wyatt reported that the investment performance of DC plans lagged their DB peers by (2%) per year. In 2004, Watson Wyatt updated this report and found that the average DC plan lagged its DB peer by nearly (4%) per year during the

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<sup>1</sup> See, for example, “Employers Slow to Resume 401(k) Matches,” *The Wall Street Journal*, August 3, 2010, [http://online.wsj.com/article/SB10001424052748704905004575405501459486806.html?mod=ITP\\_moneyandinvesting\\_0](http://online.wsj.com/article/SB10001424052748704905004575405501459486806.html?mod=ITP_moneyandinvesting_0)



2000-2002 bear market.<sup>2</sup> Recently, Callan Associates, reporting on its Callan DC Index™, highlighted that the average DC plan underperformed the average corporate DB plan by over (1%) per year since 2006 through 3/31/2010.<sup>3</sup>

Given these trends, it is surprising how anyone could promote the 401(k) as a *substitute* for the traditional DB plan, particularly when the current 401(k) funding standard of 6% of employee pay + up to 6%-of-pay employer match is likely inadequate anyway.<sup>4</sup> Many proponents of 401(k)-oriented solutions argue that, with several key refinements, a 401(k)-like model can achieve DB-like results. Forced contributions, automatic allocation adjustments, increased focus on annuitized products, on-and-on. The DC purveyors continue to seek DB-like model solutions. There are two big catches, of course: (i) in the refinement process, more and more employers are taking themselves out of the picture in terms of committing to the retirement security of their employees as part of an overall compensation structure and (ii) new DC solutions have been typically more vendor-driven – meaning that they are significantly more expensive to the end consumer than the DB model to implement.

In summary, it is highly likely that the 401(k) model will not provide the average individual (or society, in general) with sufficient retirement assets. We believe that promoting the 401(k) as a substitute solution for the DB plan is inappropriate. There are strengths and weaknesses to both funding/investment models. The marketplace of ideas should begin to recognize this fact as it searches for a solution model that can best meet society's long-term needs.

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<sup>2</sup> "Wake Up And Smell The Coffee!," Investment Insights, Barclays Global Investors, June 2006.

<sup>3</sup> <http://www.callan.com/research/dcindex/>.

<sup>4</sup> Given the 2007-2008 crisis, many of PCA's DB clients are now estimating that future contribution rates into their plans will be close to, if not exceed, 25% of pay on a combined employee contribution + employer contribution basis. While these levels are currently being reviewed, debated, and negotiated, such figures represent, on average, a required level of funding to meet retirement benefit levels that many would argue are not as glamorous as the press would have us believe. If this is indeed the case, where do we think a 6% of pay (employee) + up-to-6% of pay (employer) 401(k) model would leave the retiree? And, what happens if that employer match then disappears!?