THE LONG HIKE TO

Equipping DC Plan Participants for

by | **Richard J. Hudson**

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MAGAZINE

RETIREMENT:

Financial Success

Viewing retirement savings as a long and demanding hike may help defined contribution (DC) plan participants better comprehend key financial concepts and get started on the right path.

The journey to retirement savings often mirrors the experience of a long and challenging hike. Just as hikers prepare with the right equipment and knowledge to tackle the trail, defined contribution (DC) plan participants must be equipped with the necessary financial education to endure the trek to retirement security.

DC plans (including 401(k) and 403(b) plans) put the burden of managing financial risk on participants, many of whom lack financial training. Just as a hiker needs the right gear, conditioning, maps and trail guide, DC plan participants need the tools to navigate the complex terrain of retirement planning. Employers can play a role in educating these participants.

This article explores the various financial concepts that plan participants should understand to be better prepared for the long journey to retirement, including:

- Investment expenses
- Maximizing returns vs. derisking over time
- Managing your own portfolio vs. relying on target-date funds (TDFs) or investment managers
- Starting early and compound interest.

Following are messages using the hiking analogy that may resonate with plan participants.

Understanding Investment Expenses: Packing Light for the Financial Hike

When embarking on a long hike, every hiker knows that packing light is the key to an enjoyable journey. Similarly, it's important to understand the concept of investment expenses to navigate the financial terrain efficiently. Just as a hiker seeks to minimize the weight of their backpack, you should strive to streamline investment expenses to ensure a smoother financial hike.

The Burden of Fees: More Weight in Your Backpack

Imagine you're preparing for a long hike and every ounce counts. In the financial realm, the weight you carry comes in the form of fees. Just as an extra water bottle or an unnecessary gadget can weigh down your backpack on a hike, excessive fees can weigh down your realized returns and negatively impact your retirement savings.

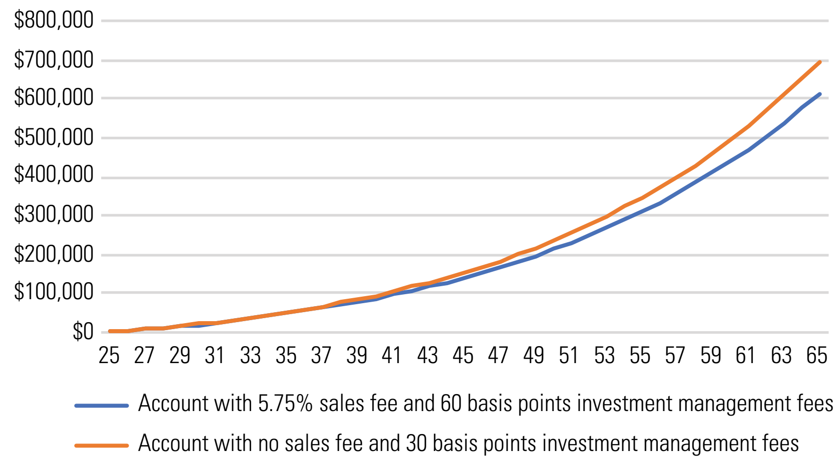
Here's an example: Many 403(b) plans, which are DC plans offered by public employers, offer their participants a choice of several financial providers to work with. A 25-year-old participant meets with an advisor from one of these providers who asks some basic questions and then sets up their 403(b) account for them. Since the individual is very young, the financial advisor decides to direct the participant's contributions to a large cap equity fund. The fund has a 5.75% sales fee and the annual investment management fees are 0.60%. When questioned, the advisor says that the participant is better off paying higher front-end sales fees to get lower investment management fees since they will be investing for more than 40 years.

Alternatively, the participant could have put all their money in an S&P 500 index fund, which has shown better historical performance. The fund has no sales fee and the investment management fees would have been only 0.30%.

Assume that the participant earns $60,000 per year, saves 6% of their salary and gets 2% pay raises every year. If both funds earn 6% per year before expenses, at age 65 the individual working with the investment advisor would have about $613,000 while the participant who chose to self-invest in the index fund would have about $700,000 (Figure 1).

FIGURE 1

Long-Term Impact of Investment Fees



Source: Author's calculations.

Whether you choose to self-invest or work with a financial advisor, being aware of fees is an important part of evaluating investments.

Maximized Returns vs. Steady Returns: Who Wins—the Tortoise or the Hare?

When considering which trail to take for this journey, you must make a choice—Are you looking for a challenging ascent with the potential for breathtaking views (maximizing returns and possibly retiring earlier), or do you prefer a more leisurely stroll with a steady, reliable path (stable returns and likely later retirement)? Here's a comparison.

Maximizing Returns: The Thrill of Climbing Peaks

Maximizing returns is like choosing the steepest and most challenging hiking trail. It's exhilarating, potentially offering breathtaking views, but it also comes with a significant level of risk and effort. However, the steeper trail will get you to the top of the mountain quicker, as long as you don't injure yourself during the journey. In the financial realm, if you opt for maximizing returns, you would likely allocate your investments more aggressively (i.e., investing in more equities) in the pursuit of higher yields.

Stable Returns: The Serenity of a Well-Trodden Path

A stable financial path is equivalent to a well-trodden hiking trail—It may not offer the same adrenaline rush, but it provides a reliable and more serene journey. If you choose stability over the thrill of wild returns, you will likely adopt a more conservative approach (i.e., more bonds), seeking to maintain a steady financial course while minimizing risk. This trail will take a little longer to reach the pinnacle, but hikers will get there safer.

Figure 2 shows the historical returns for the S&P 500 (orange bars) and Baa corporate bonds (blue bars) for the past 95 years. Keep in mind that using past results cannot predict future results. However, this is all we have, and this shows the basic concept that while equity investments carry more risk and volatility, the investor is typically compensated for that risk with higher returns.

Figure 3 analyzes the results for three sample portfolios: (1) 100% eq-

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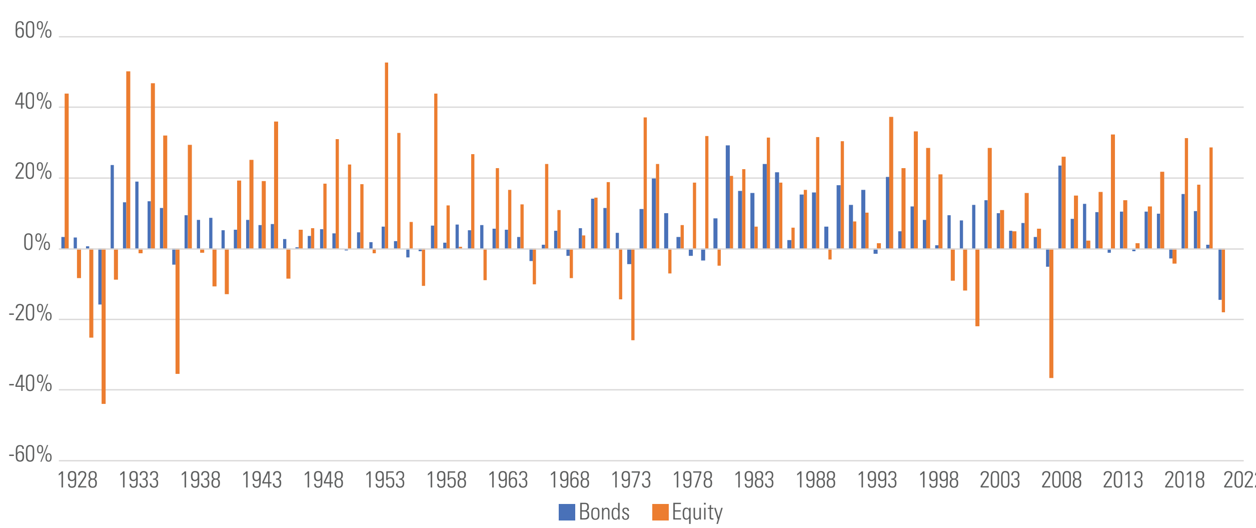
FIGURE 2

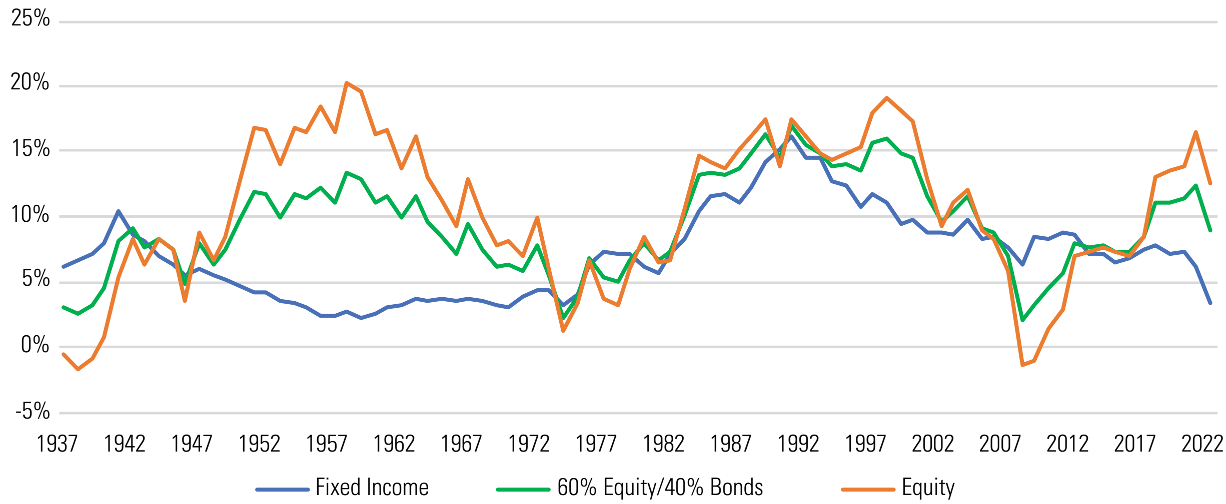
Historical Annual Returns—1928 through 2022



Source: Data compiled by the New York University Stern School of Business.

FIGURE 3

Ten-Year Compounded Return



Source: Data compiled by the New York University Stern School of Business.

uity, (2) 60% equity and 40% bonds, and (3) 100% bonds, compounded over ten-year periods.

The orange line (representing the 100% equity portfolio) outperforms the other portfolios in most years. The blue line (representing the portfolio of 100% bonds) did better during the Great Depression in the 1930s and the market collapse in 2008. The bond returns also matched the equity performance in the 1970s when interest rates were very high.

takeaways

- Defined contribution (DC) plans (including 401(k) and 403(b) plans) put the burden of managing financial risk on participants, many of whom lack financial training.
- Education on topics including investment expenses, the importance of starting early and maximized returns vs. stable returns may help plan participants achieve better results.
- Plan participants also should be aware of the pros and cons of investing in target-date funds (TDFs), which remove decision making from the plan participant but may have higher fees and may not consider their unique goals.
- Employers and plan sponsors may want to consider providing customized financial education that is independent of the DC plan's recordkeeper or administrator to avoid conflicts of interest and to help participants achieve better retirement outcomes.

Figure 4 shows what happens if the compounded return period is extended from ten to 20 years.

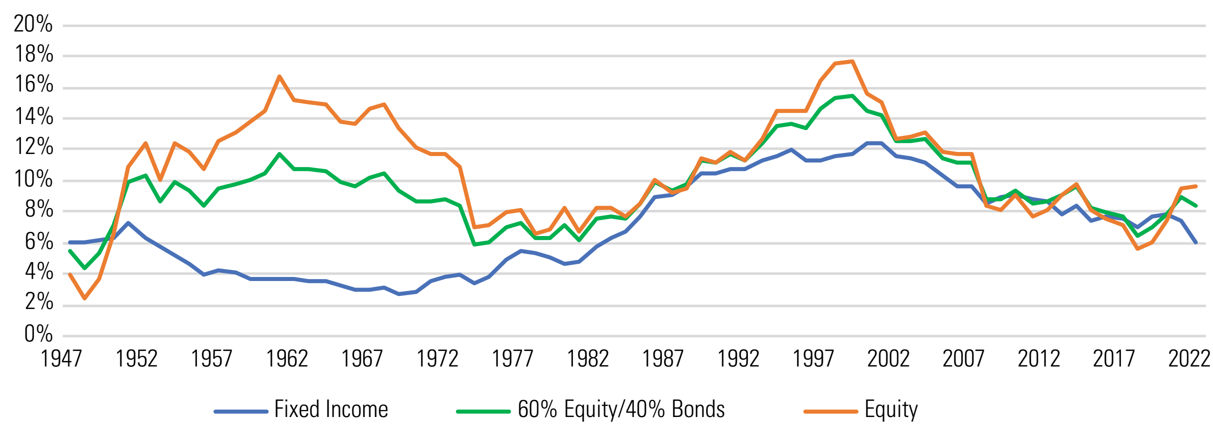
Extending the period makes it more difficult for the bond investments to keep pace with the equity investments. The longer the period, the bigger the difference becomes.

So, should everyone take the steeper trail and try to win the race to retirement? Probably not. Like everything else, details matter and not everyone will be in a situation where it makes sense to take on a lot of risk. Key considerations when setting up your investment portfolio and determining how much risk to take are:

- **Job risk:** If you are working in a physically demanding or even dangerous job, you may become disabled or forced into early retirement. If this happens suddenly, you may have to rely on your retirement savings and be forced to sell equity investments during a down market which may lock in significant losses.
- **Health:** If your health is declining, you may have to access your retirement savings earlier than expected
- **Time to retirement:** If you can plan on working more than ten to 15 years with a very low likelihood of needing any money from your retirement savings, you can certainly consider taking on more risk. If the risk pays off, you may be able to retire a couple of years early. If the risk does not pay off, you may find the worst-case

FIGURE 4

20-Year Compounded Return



Source: Data compiled by the New York University Stern School of Business.

scenario is having to work another couple of years while you wait for the markets to recover.

- **Ability to work later than you originally planned:** Are there mandatory retirement ages to consider that may prevent you from continuing your employment? The main idea here is if you have good job security and flexibility around when you retire, the added risk may be a consideration, and it is typically easier to remain employed rather than retiring too early and having to reenter the workforce after five or ten years of retirement.

Managing Your Own Portfolio or Relying on Target-Date Funds: DIY vs. Guided Tours

In the world of hiking, one can either plan a solo expedition or join a guided tour. Similarly, you face the decision of managing your own portfolio—akin to a solo trek—or entrusting your financial journey to target-date funds (TDFs) or a financial advisor, equivalent to a guided tour.

Managing Your Own Portfolio: The Trailblazers

Think of managing your own portfolio as setting out on a solo hiking expedition. It's an adventure that offers complete control, customization and the potential for unique discoveries. If you choose this path, you take on the responsibility of selecting and managing your investments, much like a hiker who charts their course, packs their gear and navigates the trail with self-reliance.

You determine how to invest your assets, select the riskiness of your portfolio and balance the various risks that can come into play. However, you may need some assistance to get started. You could inquire about current weather conditions, have a local trail guide provide some basic information and maybe purchase a trail map. Similarly, if you

TABLE

The Impact of Starting Early*

Age participant begins saving for retirement	Expected account balance at age 65
25	$700,000
35	$425,000
45	$230,000
55	$ 95,000

*Assumes the participant earns $60,000 annually, receives 2% pay raises each year, saves 6% of their salary and the net return after investment expenses is 5.70%

choose to invest on your own, you may still need some guidance to be better prepared for the challenges that lie ahead. Resources may include investment education provided by your plan or discussing your goals with a financial planner to get started.

TDFs or Financial Advisors: The Guided Tours

In contrast, investing in TDFs or using financial advisors to manage your account are akin to joining a guided tour, much like a hiker who embarks on a well-organized adventure led by experienced guides. These funds or advisors provide a diversified investment mix based on your target retirement date. Keep in mind that the investment mix in TDFs is very generic and may not be correct for your situation. For example, a 55-year-old's DC plan contributions would be directed to a TDF with a target retirement date of 2030. But that might not be the right choice if that participant plans to continue working after age 65. The 2030 fund is probably more heavily invested in conservative options, but a participant who plans to retire later could likely have a more aggressive portfolio.

Some DC plans also offer managed accounts, which offer more customization than a TDF because an investment manager sets the strategy based on the individual's circumstances.

Participants who opt for TDFs or financial advisors delegate the responsibility of asset allocation and rebalancing to professionals, allowing them to sit back and enjoy the ride. Obviously, hiring a trail guide for a day or a week will increase the cost of the trip. Similarly, this investment strategy will have higher associated fees and likely generate lower net returns since the fees are a drag on performance. It may take longer to get where you wanted to go because of the higher fees, but that path may be more stable.

For the Plan Sponsor: Offering Investment Education

Defined contribution (DC) plan participants must make extremely complex decisions when saving and planning for retirement. Plan sponsors can assist in this by providing seminars and other education for participants. These seminars can be run by financial professionals who are independent of the plan administrator, or the plan sponsor can request the current plan administrator or recordkeeper to provide this information. Advantages of using the recordkeeper or administrator may be familiarity with the plan and lower cost.

However, having the investment firm that administers the DC plan provide the education may create a perceived conflict of interest since the firm may benefit from the investment selections participants make.

Independent education can enable participants to evaluate investment options objectively, thereby reducing the risk of being swayed toward products that may not align with their best interests. Providers may include local financial planners or an employer's financial wellness program. Plan participants can make informed decisions about their investment choices and better understand whether they are getting value for the fees charged or if low-cost index funds or exchange-traded funds (ETFs) are a better option.

Independent financial education also can assist in customizing strategies to different participants, considering the industry they are in and what other benefits are being provided rather than following a one-size-fits-all approach. This flexibility can lead to better outcomes and a more tailored approach to retirement planning. For example, financial education programs that are not customized discuss the need to diversify without regard to considering the financial position of the participant (e.g., it may fail to recognize that a participant has a DB plan). Independent financial education may better assess how to discuss this topic with participants and ensure that they understand when the participant's financial position should be considered and when it may not be as significant an issue.

Regardless of whether it is independent, one potential drawback of providing financial education is the risk of overwhelming participants with information. Finance can be a complex and daunting subject, and some participants may feel inundated with details, leading to decision paralysis. To counter this, effective financial education programs should be structured to provide manageable, step-by-step guidance. Trustees and plan sponsors can work with educators to discuss any feedback they have received from generic education materials and what they think will better resonate with their members and employees.

The Advantage of an Early Start

The benefits of starting early on the retirement savings hike are akin to beginning the trailhead before the sun rises. If you commence your savings journey early, you can leverage the power of compound interest, maximize the potential for growth, and navigate the ups and downs of the financial terrain with more ease.

Compound Interest: The Magic of Financial Momentum

Just as an early start on the hiking trail allows hikers to cover more ground and see more sights, starting to save early in a DC plan offers the financial advantage of compound interest. The table on page 27 displays a few scenarios that show the difference in expected account balances based on different starting ages.

Conclusion

On this extended path through the world of DC retirement planning, participants must be equipped with the essential financial education to succeed in their journeys.

Plan sponsors and trustees should consider how they can help their participants succeed. Simply adding on more investment options or annuity options in the plan is of little value if the participants don't fully understand the options. Plan sponsors and trustees should consider surveying participants and asking them what their needs are and what type of education they would like to have. As many researchers and studies have shown, providing more education to participants will help improve retirement outcomes.[1]

bio

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Endnote

1. See for example, Global Financial Literacy Excellence Center, *Defined Contribution Plans and the Challenge of Financial Literacy*. Nicole Boyson, Northeastern University D'Amore-McKim School of Business, Best Practices for Defined Contribution Plans and Organisation for Economic Co-operation and Development (OECD), *Financial Education and Saving for Retirement*.