How Your Default Investment Decision Can Impact Savings

Defined-contribution plan sponsors often focus on investment performance when evaluating managed accounts and target-date funds, or TDFs. But for many participants, improving returns may not be nearly as meaningful as boosting savings rates to help bolster retirement readiness.

We looked at the differences in savings rates for plan participants who were defaulted into either managed accounts or TDFs. Here's a look at some of our key findings:

Participants defaulted into managed accounts tend to save more than those defaulted into TDFs.[3]

- At the participant level, the median plan participant defaulted into a managed account saves 2% of salary more, on average, than the median participant defaulted into a TDF—at 6% and 4%, respectively.[3, 4]
- At the median plan level, participants defaulted into managed accounts saved 1% of salary more than those defaulted into TDFs.[3]
- Plans with managed accounts as the default tend to have older participants with more tenure in the plan and higher salaries.[3]
- But after controlling for these variables and others, individuals defaulted into managed accounts still tend to save about 0.5% more for retirement.[3]

Participant deferral rates are generally lower for plans with automatic enrollment.[1]

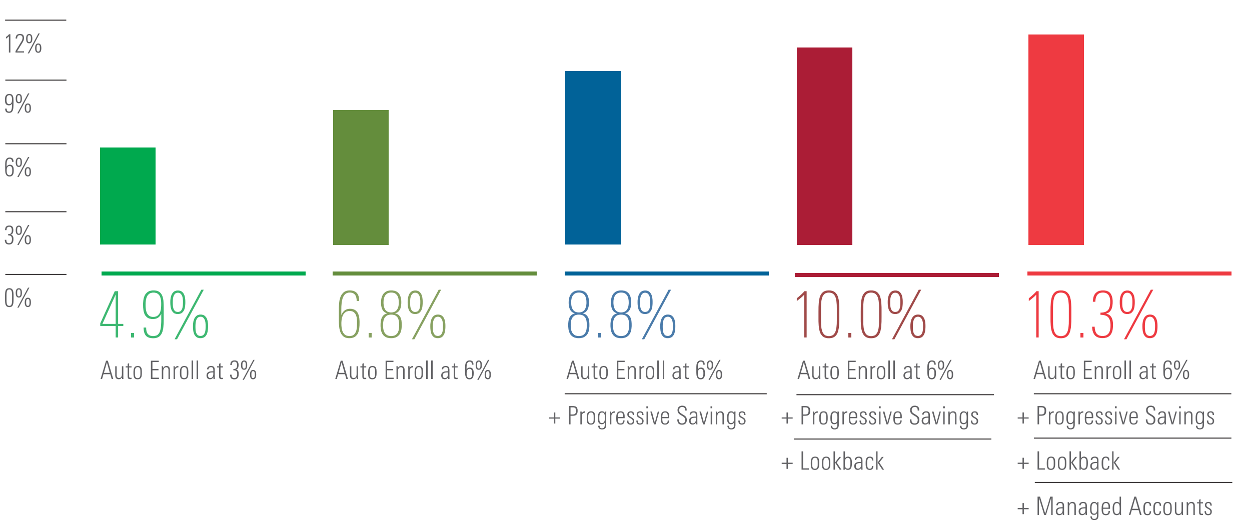
- Automatic enrollment will likely result in lower savings rates among plan participants unless the default deferral rate is 6% or above.[1]
- A plan with a 3% default automatic enrollment rate will have deferral rates that are about 1.6 percentage points lower than if the plan offered voluntary enrollment.[1, 2]
- Many managed accounts participants exhibit a much wider dispersion of equity allocations, especially near retirement, showing the greater customization capability of managed accounts.[1]

The increased savings benefits could likely outweigh the costs of managed accounts for many participants.[3]

- The "average" participant could benefit from using a managed account as long as the fee were 2.4% of total assets or lower.[3]
- That fee-hurdle level is significantly higher than the fees charged by most managed accounts providers, which tend to be less than 0.5%.[3]

Deferral Rate

For illustrative purposes only.



Source: Blanchett, David. Dan Bruns, and Nathan Voris. 2016. "The Impact of the Default Investment Decision on Participant Deferral Rates: Managed Accounts vs. Target-Date Funds." Morningstar White Paper.

Important Disclosures

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1 Starting with an initial universe of data from Charles Schwab that included 195 retirement plans covering 66,297 participants, Morningstar Investment Management LLC conducted an analysis to determine how average deferral rates may change with respect to various enrollment options for a defined contribution plan.

2 This analysis was completed using KJE Computer Solutions, LLC's Retirement Contribution Effects on Your Paycheck calculator. For the base case, it assumes a hypothetical 41-year-old retirement plan participant with an annual income of $55,853 is saving 3% per year in his or her retirement plan account with a 50% employer match up to 5%, and the account has an annual nominal rate of return of 6.5%. The calculator uses 2016 IRS withholding schedules and rates. The analysis is repeated to determine the effect on the participant's retirement plan account balance at age 65 when the participant's savings rate is increased from the base case assumption of 3%.

3 For purposes of this analysis, Morningstar Investment Management LLC assumed the participant was 45 years old, did not rollover a previous retirement plan account balance into his or her current defined contribution account, and stays in the defined contribution plan for 5 years. The participant had an average salary over the test period of approximately $54,000, an average total savings rate of approximately 8%. The analysis assumes monthly contributions and a portfolio real return of 4%. It was determined that a managed account annual fee of 2.4% would equalize the account balance of the average participant in a managed account option to one in a target date fund option after five years.

Participants with smaller account balances would likely see the most benefit from a program to improve participant savings rates in defined contribution plans, while participants with higher account balances would need to increase their savings rates by a larger percentage in order to offset the cost of a managed account solution. For example, the same 45-year-old participant described above but that had added a rollover balance equal to their current salary to their current retirement account would likely need to increase their savings rate between 0.5% to 1.0% in order to offset the cost of a typical managed account solution. The same participant that had added a rollover balance of five times their current salary would likely need to increase their savings rate by over 2.0% to offset the cost of a managed accounts solution.

4 Morningstar Investment Management LLC used data from Charles Schwab for 195 retirement plans covering 66,297 participants and analyzed those participants thatwere defaulted into either a managed account (65 plans covering 17,950 participants) or target date fund option (130 plans covering 48,347 participants) that had specific plan and participant level data available