

ICI VIEWPOINTS

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401(k) Plans Work in a Balanced Approach to Retirement Security

By Mike McNamee

Second in a [series of Viewpoints postings](#) on key facts about the 401(k) and the American retirement system

“Prediction is very difficult, especially about the future.”

— Said by either Nobel Prize-winning physicist Niels Bohr or New York Yankee Yogi Berra, depending on which source you consult.

What’s the outlook for American workers looking forward to retirement? Though the future is never entirely predictable, there’s ample data to show how our country’s retirement system is working today, and how it’s building resources for the decades ahead. In particular, researchers are studying how the increasing use of 401(k) and other defined contribution plans has affected Americans’ preparedness for retirement.

The answer, according to a growing body of research: taken as part of a broader retirement system, 401(k)s work for working Americans. Retirees do face legitimate risks—but the decline of private-sector defined benefit (DB) plans and the rise of defined contribution (DC) plans, such as 401(k) plans, isn’t one of them. This shift is unlikely to reduce retirement preparedness.

That may come as a surprise to many readers. In this series, *ICI Viewpoints* is addressing key features of 401(k) plans and the broader retirement system of which they’re a part. That requires puncturing myths that sometimes dominate discussions of retirement policy—and providing facts that often don’t show up.

Evidence of Success

In ICI’s 2012 paper, “[The Success of the U.S. Retirement System](#),” my Research colleagues Peter Brady, Kimberly Burham, and Sarah Holden lay out results of the latest research on Americans’ retirement prospects.

Among other things, they show that Americans rely on a “pyramid” of resources for their income in retirement. At the base is Social Security, which provides a strong foundation of inflation-protected retirement income for almost all workers. For the majority, Social Security may be the largest single source of income in retirement.

Atop that foundation, retirees can build their retirement by drawing upon the benefits of homeownership; upon employer-sponsored retirement plans, including both DB and DC plans; upon contributory and rollover individual retirement accounts (IRAs); and upon other savings. The composition of the retirement resource pyramid varies across households, and different households depend on each of these components to different degrees, depending on lifetime income, work history, and other factors.

Though Social Security and homeownership are primary sources of retirement resources, employer-sponsored retirement plans remain crucial for most households: data from the Survey of Consumer Finances (SCF), conducted by the Federal Reserve Board, show that about 80 percent of near-retiree households hold retirement resources in DB or DC plans or IRAs.

The retirement resource pyramid is working for most Americans. Research shows that workers are accumulating sufficient resources to maintain their standard of living in retirement, while analysis of the transition into retirement shows that most households maintain both consumption and after-tax income at the same level in the first years after retirement as when they were working. Moreover, studies that examine households later in retirement find that, on average, retirees maintain sufficient wealth to generate as much income as they could early in retirement.

The research also shows that retirement outcomes have been improving over time. For example, academic analysis (examples can be found [here](#) and [here](#)) has found that successive generations of Americans have reached retirement wealthier than the last. Assets specifically earmarked for retirement are now at record levels: adjusted for inflation and population growth, retirement assets have increased nearly sixfold since 1975, while the poverty rate among individuals aged 65 or older has declined from nearly 30 percent in 1966 to 9 percent in 2011.

And despite concerns about the DB-to-DC shift, the share of retirees receiving income from private-sector retirement plans and the amount of income that those retirees receive has gone up over time, not down.

That's the picture for current retirees. What's the outlook for today's workers?

Although few workers have had access to a 401(k) for a full working career, several studies show that the typical participant can accumulate enough in a 401(k) to provide adequate retirement resources, when combined with Social Security and other resources. In part, this reflects the balanced incentives of 401(k) plans, which encourage participation and savings across the income spectrum.

Research also shows that many workers, particularly workers who change jobs frequently, will be better off with a DC plan than a DB plan, even when taking into account the risks faced by participants in either type of plan (for example, the investment risk faced by workers in DC plans and the job-turnover risk faced by workers in DB plans).

In [testimony submitted in January 2013](#) to the U.S. Senate Committee on Health, Education, Labor and Pensions, ICI reviewed a Dartmouth College study that compared typical DB plans with typical 401(k) plans, using SCF data in a variety of possible labor market and investment return scenarios, concluded that "generally, 401(k) plans ... are as good or better than DB plans in providing for retirement." Furthermore, in an analysis of data from the University of Michigan's Health and Retirement Study (HRS) that looked at both detailed descriptions of retirement plans and the actual work histories of individuals, economists from MIT, University of Chicago, Dartmouth, and Harvard projected that retirement resources will be higher on average with private-sector DC plans than they would be with private-sector DB plans.

The 401(k) System Has Unique Benefits

Why has the 401(k) developed to be such a successful retirement tool? Three key elements make the 401(k) a success today.

Portability. Americans are a mobile workforce, and it's not unusual for them to move from job to job—even career to career. 401(k) benefits are portable and can travel with a worker and continue to grow throughout his or her lifetime.

Ownership. 401(k) owners own actual assets—not a promise of future benefits. Participants have full rights to their own contributions and their investment earnings, subject only to the tax rules that encourage workers to preserve their savings for retirement. The design of 401(k) plans also helps limit the impact of investment shocks and mitigate risks. For example, workers invest paycheck-by-paycheck (enabling them to take advantage of the benefits of dollar-cost averaging) in accounts that tend to be diversified.

Innovation. Innovation has created new, convenient services for participants, including daily balances, web-based retirement-planning tools, and call centers. Innovation has also helped boost participation—and retirement security. For example, employers can use automatic enrollment to get more workers into plans—a key social innovation that uses workers' inertia to boost, rather than depress, saving. Employers also can use auto-escalation of workers' contribution rates to increase savings rates.

In addition, more than 70 percent of 401(k) plans offer target date funds—innovative funds that allocate savings between stocks and bonds based on workers' retirement horizon, and rebalance those holdings as markets move and savers age. These funds provide diversification, keep 401(k) participants exposed to growth assets as part of a balanced portfolio, and help them rebalance in a timely and disciplined manner.

When talking about the adequacy of the 401(k) system to meet Americans' retirement needs, it's useful to remember that saving is really a lifecycle issue. People's focus on formal retirement savings typically occurs later in their working career—meaning households are more likely to focus on saving for retirement as they near retirement age and as their income increases. Consequently, distinct "snapshots" of coverage rates in any given year understate the share of the population who will retire with work-related retirement benefits.

Though it's hard to make predictions, [participants are committed](#) to the value and benefits provided by the 401(k) system. What is clear, as the research from ICI and others show, is that 401(k) and other DC plans are key parts of a balanced approach for achieving retirement security for working Americans.

For more key information on retirement, please visit our [Retirement Resource Center](#) or read the other entries in this Viewpoints series:

- [No Accident: The Strengths of the 401\(k\) System](#)
- [401\(k\) Plans Work in a Balanced Approach to Retirement Security](#)
- [The Facts on Limited Access to Retirement Funds Before Retirement](#)
- [The Facts on Fees and 401\(k\)s](#)
- [Americans Support Their 401\(k\)s](#)

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