U.S. Department of Labor's Advisory Council on Employee Welfare and Pension Benefit Plans

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Written Statement On

Mandated Disclosure for Retirement Plans – Enhancing Effectiveness for Participants and Sponsors

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To inform the ERISA Advisory Council on their review of "Mandated Disclosure for Retirement Plans – Enhancing Effectiveness for Participants and Sponsors," I would like to meet a couple of different objectives today. First, I would like to present findings that address the level of financial literacy of plan participants. There are three sources for this research – work we did for The American College on financial literacy, findings of the TIAA Institute and the Global Financial Literacy Excellence Center on financial literacy, and my own observations having tested numerous materials in focus groups and in-depth interviews. Then I would like to comment on some of the documents under consideration. On behalf of Greenwald & Associates and myself, I would like to thank you for the opportunity to present my comments.

Retirement Literacy Studies

Greenwald conducts ongoing publicly-released research on the financial literacy of the American public for the American College of Financial Services. This research constructs an index based on 38 questions relating to retirement literacy on a variety of different issues such as investing, housing, Social Security, and retirement income. This study was done with 1,244 Americans between the ages of 60 and 75 and with at least $100,000 in investable assets. While not the target sample for materials tested here, the findings of this study are instructive in terms of what people know and don't know.

Overall this study shows that retirement literacy remains low overall, with three in four (74%) failing our 38-question retirement literacy quiz. The failure rate was significantly lower than in 2014 (81%), suggesting that retirement literacy has improved over this period. However, these low scores still show a worrying lack of knowledge that likely impedes effective retirement planning.

This study finds that older Americans continue to display a significant lack of knowledge when it comes to understanding investments**,** a knowledge that is becoming increasingly important as more need to manage the money they accumulate.

- Just one in three understand that the value of bonds and bond funds falls as interest rates rise.

- Only one in ten know that small company stock funds yield higher returns than large company stock funds, dividend paying stock funds, and high yield bond funds.
- Only one in four know that B-rated corporate bonds have higher yield than AAA corporate bonds or treasury bonds.
- Only 27% realize that their 401(k) is not at risk from corporate creditors if a large company sponsoring a plan goes bankrupt, an issue important in considering the rollover decision.
- Most importantly, for the purposes of this review, just three in ten know that actively managed mutual funds have higher fees than ETFs.

These findings suggest a lack of basic understanding about the value of various investments, the importance of diversification and of most significance, the reason why fees are sometimes higher. Fees aren't just a matter of knowing what a fund costs but also why they are being charged.

Greenwald also conducted research for the TIAA Institute and the Global Financial Literacy Excellence Center in September of 2016. In this online survey of 1,043 Americans, respondents were asked to choose between several responses on the impact of fees. Only 30% correctly chose that fees can reduce the amount accumulated over time. Fourteen percent chose that it will not matter if the money is held for a long time, 13% thought fees would be higher when returns are higher, and 41% were not sure of the answer. This study also found that half could not answer a basic compound interest question correctly.

Qualitative Insights of Researcher

Finally, I would like to comment on observations that I have seen in my research with plan sponsors and plan participants. I should also mention that I play a plan sponsor role for my company so I have had a chance to see principals in operation.

One thing I would like to point out is that we tend to think of plan sponsors as financial experts. I can tell you from experience that this is not always the case. I am sure that the plan sponsor from IBM or Merck are quite knowledgeable, but as companies get smaller, the level of knowledge often drops.

One issue we see with smaller companies is that there isn't always a manager that manages just the 401(k) plan. From my experience, companies need to have more than 50 to 100 or more employees before there is a plan sponsor who only has these responsibilities. A plan sponsor in a smaller company is often a benefits manager as well and can have more of a human resources background than a financial background. In fewer cases, the sponsor can be the treasurer or CFO and have a financial background.

The other factor that impacts the level of knowledge is industry. A construction company or restaurant may have less knowledgeable sponsors than a law firm. The point is that there can be thousands of companies with plan sponsors who are not highly educated on financial matters. While these sponsors are often advised, it is still something to keep in mind.

The level of plan participant knowledge also varies a lot based on occupation and level of education concomitant with that occupation. In general, however, there are a significant number of participants with very limited knowledge.

It isn't just about understanding what the fees are. Many simply do not understand what fees are for and why they can be different. There is a lot of contextual information that is missing:

- Most do not understand the difference between administrative and investment fees and what administrative fees are for. Administrative fees are simply a cost. Fund fees can pay for investment management services.

- Most participants do not understand that plan sponsors have some discretion about how much of the administrative burden to pass onto employees. These administrative fees can be buried in the share class that the employer chooses for the plan. An employer can choose a higher price share class and take on less of the administrative burden. Most employees see these costs as immutable.

- As discussed earlier, participants do not understand the drag that fees have over time, particularly in a strong return investment environment like we have been having. They think that if you make a high return in a given year that fees do not mean than much. The problem is that over many years, fees can reduce the nest egg substantially when collected year after year.

- In studies we have done for numerous clients, we also know that participants do not understand active versus passive investing. In the current environment, we know that many clients are unhappy with advisors who have employed an active strategy and not matched the market indices. However, advisors who employed this strategy in 2008 fared far better. Participants have forgotten that you pay extra for a manager that may prevent you from bearing the full brunt of a market correction – a fact that is especially important for older participant approaching retirement. I am not advocating active investing and in fact many employees have the time horizon to ride out market swings. I am just saying that some investment fees pay for something and it is important to not just provide fee information but to also understand what you get for them.

Another issue that we have found in research is that most participants do not take taxable withdrawals into account. Very few have thought about the impact of paying taxes some day on their retirement accounts or what will happen when RMD kicks in.

Finally, I also do quite a bit of research evaluating fund prospectuses and will use my background to comment on the large cap stock fund piece.

Comments on Reference Guide

In general, the guide is well written, in plain English, and easy to understand. My suggestions are as follows:

Section C – Our research suggests that participants tend to not understand the concept of "tax deductible" contributions. The concept of "pre" and "post" tax can be fuzzy to some and many mix them up. While not one of the more egregious problems, it is worth noting.

Suggest saying "you can save up to $18,000 <u>if you are under age 50</u>"

Section D – Again, it increases understanding if you say that pre-tax contributions mean that you get a tax deduction for contributing and after-tax contributions mean that you do not. The "After-tax contributions are deducted" sentence is confusing.

- It is not that easy to make the connection between contributions being deducted after paying taxes causing taxable income to not be reduced, resulting in a smaller net paycheck. It is easier to simply say "you don't get any tax deduction."

- What does it mean "but there are tax advantages on your investments while your contributions are in the plan?"

The Roth contribution sentence will be uninterpretable – too much info at once with no specificity. Can we discuss that the Roth allows you to get investment gains each year without having to pay taxes on them, and that you will not have to pay taxes when withdrawing the money later?

Section F – May want to mention that the target date fund is a diversified mix of investments suitable for your age

Section H – Instead of "get a distribution," can we say "take money out of the plan."

Comments on Fund Summary

I found the fund summary piece to be well written. There is some technical information in it but this is required to explain the fund.

My biggest concern with the prospectus is that there needs to be more in-class comparisons and not just apples and oranges comparisons to other types of investments.

Is the bolded 3.6 the risk of this fund? It never really says it. It seems like this is quite high for a large cap fund. Also, is the risk of this fund (3.6) a little higher than the average large cap (3.3)? Chart seems to suggest this and it would be good to note.

Also, I am not sure of the salience of the turnover rate as an indicator of cost. Can't we simply show the cost relative to others in the same class and to other funds in general. If we already know the cost, why show a one-off indicator of cost? I realize that the turnover rate is an indicator of the amount of active management done, but this is not explained nor should it be to a participant. Also, a turnover rate needs to be compared to other funds in the same class as well.

I did not comment on the sponsor-oriented material since I felt that it had to be technical by nature. However, I wonder if it may be useful to have a plain English document that explains what the broad goals of plan review and management are. It may be useful for those that will rely completely on an advisor to work with this information.

I am available to discuss this information and to assist you.

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