Peer Review for Default Investment Safe Harbor Regulation
Department of Labor

Author of Peer Review:
Professor David Laibson, Harvard University, Department of Eocnomics

Date: June 5, 2006

My report mirrors the four questions in my "charge" for expert review.

1. PENSIM is extremely well-suited for the simulation tasks that have been used to write this report. I am highly impressed with the level of care that has been taken in generating the simulations. The analysis is first-rate. I have a few suggestions, and they have only minor consequences for the conclusions that are derived in the simulations.

At the moment, long-run inflation expectations are about 2.5%. The simulations use a 9.48% nominal average stock return. This implies a 6.5% real return for stocks. This is historically representative, but many (perhaps most?) economists do not expect this return to apply in the intermediate run. Current P/E ratios are high by historical standards, probably implying lower future returns. I would recommend a slightly more conservative estimate for stock returns during the next 20 years. However, the conclusions of the report would not be meaningfully changed if a more conservative stock return were adopted.

The simulations also assume that stock returns are serially uncorrelated. There is now a large body of evidence showing that stock return are slightly positively correlated at high frequencies (under one year) and slightly negatively correlated at low frequencies (greater than three years). However, the conclusions of the report would not be meaningfully changed if serially correlated stock returns were modeled.

It is not clear to me how fees were incorporated in the simulation analysis. Specifically, if the return on stocks is 9.48%, what is the net return after fees are deducted and how have these fees been incorporated in the analysis? Fees can range from 10 basis points to 200 basis points. Naturally, fees that exceed 100 basis points will have a significant deleterious impact on accumulation of retirement wealth.

2. I was a bit uncertain about what is implied by "eligible workers." Assuming that eligible workers include "all workers at firms that offer 401(k) plans or other defined contribution pension plans," than I believe that we could eventually converge to a situation in which 2/3 of those eligible workers are subject to automatic enrollment. That is my "high-impact" scenario and it is based on the ongoing very rapid adoption of automatic enrollment by HR decision-makers. (I agree with a low-impact scenario of 35%.) However, I may have the definition of "eligible workers" wrong. The authors should clarify the definition of eligible workers. Whatever the case, a higher impact would not change the conclusions of the report. Indeed, if automatic enrollment is a good

thing --- which the document assumes --- then more automatic enrollment is a better thing.

3. The assumptions about asset allocation are realistic. The assumptions about rates of return may be slightly too rosy, particularly once one takes account of mean reversion (from high P/E ratios) and management fees. Please see my comments above.

4. My suggestions do not change the broad conclusions that were reached through the simulation analysis. I have a very high degree of confidence in the PENSIM analysis that was undertaken for the DOL report.