Report Highlights Savings Gaps, Ways To Close Them

A new report finds that while many participants aren't yet on track to meet their retirement savings goals, a combination of plan design changes and participant commitment can close the gap.

Based on Financial Engines' inflation-adjusted projections, three out of four workers are going to be unable to replace 70% of their pre-retirement income with the combination of their 401(k) plan and Social Security if the markets perform typically—and if they perform poorly, those same participants could be unable to replace even half (50%) of their pre-retirement income. Only 12% of participants overall are expected to have a median outcome above their ideal goal (70% of pre-retirement income) and at least 50% of their pre-retirement income if market performance is poor.

Contributing to the shortfall, a third of participants in the sampling (34%) have what Financial Engines deemed "inefficient" portfolios and/or portfolios with inappropriate risk levels; 23% of participants with company stock as a plan option hold too much of it; and 39% of participants are not contributing enough to their 401(k)s to receive the full employer match, according to the report.

That said, the Financial Engines National 401(k) Evaluation, which considered some 2.8 million participant accounts at 272 large-plan sponsors, did find some room for optimism as well.

Goal Posts

While the gaps cited above seem large, the report notes that some groups of participants are not as far from reaching their goals. Participants with lower salaries in their 40s and 50s, and younger participants with higher salaries, are a median of only 10% away from closing in on their retirement income goals—and the report notes that saving more and making better investment decisions could help close this gap. Of course, for participants with lower incomes, Social Security accounts for a larger proportion of their retirement income needs than for higher-salary participants.

As for how that gap could be closed, the report notes that, depending on how far participants are from meeting their retirement-income goals and how far they are from retirement, there are generally a limited number of options: to save more, to improve the risk level and diversification of their portfolios, to delay retirement and work longer, and, of course, to reduce their standard of living in retirement.

The report cites as an example a 45-year-old participant earning $50,000 per year, who has a $50,000 401(k) account balance, is deferring 4%, and who is 27% below his ideal goal. However, by reallocating his portfolio, deferring 2% more, and deferring his planned retirement date for two years, he could close that gap (or he could just save 8% more every year, according to the report).

Higher-income workers will, of course, have a larger challenge. The report considers the situation of a similarly situated worker who has a $100,000 balance and makes $100,000 a year—and that leaves him 41% below his goal. If this participant takes to heart the three strategies outlined above, he would still be 15% short of his retirement goal. For him to close that gap, he would need to reallocate, save 8% more per year, and push back retirement for three years.

On the other hand, younger workers—who have more time to save and a longer period over which those portfolio reallocations can work—have time on their side, according to the report.

While the 2008 National 401(k) Evaluation found that participants with the lowest salaries made the most investment mistakes, this year's report—a snapshot taken after the impact of qualified default investment alternatives (QDIAs) has taken a greater hold—found that, in general, participants under age 30 and over age 60 have a more diverse and what Financial Engines deemed a more "risk-appropriate" portfolio than they had two years ago. In fact, the report claims that 43% of participants under age 30—more than any other age group—have efficient and risk-appropriate portfolios (compared with 32% in 2008).

Those nearing retirement have improved slightly but are not doing as well as the youngest employees. One-third (33%) of participants in their 50s and another third (33%) of those over 60 are still invested inefficiently and/or inappropriately, down slightly from 2008.

Plan Design Impacts

To determine how those kinds of plan design changes are affecting participant portfolios, Financial Engines looked at plans in the sample that appeared in their 2008 report and for which they had plan design data. Of this subset of 70 plans, 63 currently invest new participants in a QDIA while seven do not. And, at least according to Financial Engines' evaluation, nearly two in five participants (39%) in plans with a QDIA have green Risk and Diversification portfolios, compared with only about one in four (28%) in plans without a QDIA.
The report notes that the impact of QDIAs on asset allocation is being felt most strongly by younger participants, who are more likely automatically enrolled into the plan with an age-appropriate QDIA. It noted similar trends with lower balance and lower compensation levels, all of which are the categories of participants who typically have the least access to affordable professional help.

Of the 272 plan sponsors in the 2010 report, 17 (representing more than 155,000 participants) currently passively enroll all participants into managed accounts (rather than just newly hired workers). The report notes that when the risk and diversification stoplights of plans that have automatically enrolled all participants into managed accounts are compared with those that have not, the passive plans have nearly twice as many participants with green Risk and Diversification stoplights (57% vs. 31%), and those plans also have "notably fewer red and yellow Risk and Diversification stoplights."

Downturn Dip

The economic downturn has lowered participant savings rates relative to those in the 2008 report (which was based on 2007 participant data). Of the 2 million contribution-eligible participant accounts evaluated in this report, 39% of participants are not saving enough to receive the full employer match (or at least 5% of salary in companies without a match), up from 33% in 2008. Only 6% are saving within $500 of their annual pre-tax IRS limits, down one percent from 2008. It also should be noted, however, that just 185 of the companies in the sample offered a 401(k) match.

The report noted that participants under 40 and those with mid-level incomes pulled back their savings the most in the last two years; more than half (53%) of participants under 30 and nearly half (44%) of those in their 30s failed to save enough to receive the full employer match, compared with 48% and 35% respectively, in 2008. In addition, participants earning between $25,000 and $75,000 per year were more likely to have lower contribution rates than they had two years ago, which the report's authors said reflected "the seriousness of the economic crisis and its impact on the middle class of working Americans." Half of those with yearly salaries between $25,000 and $50,000 and more than a third of those earning between $50,000 and $75,000 did not save enough in their 401(k)s to receive the full match in 2010, compared with 39% and 24%, respectively, in the prior report.

On the other hand, the report noted that a full two-thirds of participants in plans with automatic escalation do save enough to receive the full employer match, compared with just 52% of participants in plans without that feature. The Financial Engines National 401(k) Evaluation is available online at www.financialengines.com