INITIATIVE ON FINANCIAL SECURITY

THE ASPEN INSTITUTE

Department of Labor: Proposed Rule on Investment Advisors

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The Initiative on Financial Security at the Aspen Institute (Aspen IFS) appreciates this opportunity to comment on the proposed rules for providing investment advice to plan participants and beneficiaries under ERISA Section 402(g). Aspen IFS agrees with the Department of Labor's conclusion that "DC plan participants and IRA beneficiaries often make costly investment errors." It does not, however, agree that "quality investment advice" is the preferred – or only - solution to this problem. What savers need is not more advice but auto-pilot investment options that don't need advice.

The mission of Aspen IFS is to promote sound public policy that enables all Americans, especially low- and moderate-income Americans, to build financial security that lasts a lifetime. Aspen IFS believes that one of the significant policy failures in 401(k) plans over the last twenty years has been the transfer of investment risk to plan participants who are unprepared and often uninterested in assuming this responsibility. The result has been a 401(k) plan system that is not yet delivering adequate financial assets for a secure retirement.

Many believe that the best way to improve 401(k) performance is to "fix the people," that is, to educate participants to make better investment decisions or, failing that, to offer them, at their own, substantial expense, personal advisors to assist them in making better decisions. Aspen IFS recognizes that there are behavioral challenges to turning people into savers and savers into investors. It believes, however, that the better, and cheaper, alternative to "fixing the people" is "fixing the product", that is, offering plan participants an investment option that mitigates the need for complex decision-making and professional advice yet is capable of delivering superior returns at a low cost.

Aspen IFS has developed just such an investment option that is a much less expensive but equally effective alternative to the use of investment advisors to enable unsophisticated investors to achieve better investment returns without a professional advisor. Our proposal, called "Real Savings Plus" (RS+), is a computer-driven model, based upon generally-accepted principles of modern finance theory which automatically allocates individual account assets to:

- Fully guarantee all contributions and matches (if any) against loss due to default risk, basis risk or market risk as well as erosion of purchasing power due to inflation.
- Provide upside potential through automatic investment of those contributions not needed for the guarantee in an index of common stocks.
- Minimize the expense ratio of managing the underlying assets to 5 basis points or less through the use of just two passively-managed but widely-traded assets, TIPS and a low-cost S&P500 index or exchange-traded fund.

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Aspen IFS recognizes that some plan participants with complex incomes, assets and tax situations could benefit from the services of a sophisticated investment advisor and/or a sophisticated computer model. It believes, however, that the majority of 401(k) plan participants, particularly those with low- and moderate-incomes, would prefer to avoid the front-end and continuing expenses of such advice. RS+ provides them instead with an "auto-pilot" investment option – one that is inexpensive, simple, safe and fully-transparent and yet provides the upside potential needed to provide a comfortable retirement. Such a well-designed, automatic investment plan will continue to meet the basic objectives of most workers, without modification, over most or all of their working lives. RS+ savers can set their investment contribution and retirement targets just once and never have to change them again.

RS+ guarantees the return of real contributions at retirement, while providing the upside of common equities by investing a sufficient proportion of each retirement contribution in Treasury Inflation Protected Securities (TIPS) to guarantee each worker the return of his or her contributions, fully adjusted for inflation, when that worker retires. For example, the cost of guaranteeing the real return of a $1,000 contribution at retirement in 30 years is the present value of $1,000 for 30 years at the real interest rate on 30 years TIPS, recently about 2.2%, which would result in a cost of $520.56. The difference between the entire retirement contribution ($1,000) and the amount invested in TIPS ($520.56) would be $479.44 which would be invested in a low-cost stock index, such as the S&P 500, to give savers some of the upside potential available through equity investing.

In design, RS+ resembles a target-date fund but it is important to differentiate RS+ from the target-date funds which disappointed many workers in the past two years. First, RS+ produces an automatic, individualized target-date fund for each saver based on a selected retirement date. Second, RS+ contains a guarantee that contributions will be returned, adjusted for inflation, at the selected retirement date. Aside from the lack of asset-allocation transparency of many target-date funds, a flaw which can easily be remedied, target-date funds suffered from levels of market risk that proved to be unacceptable to many workers, particularly those approaching retirement age. For workers who are highly risk-averse, either in general or specifically with respect to their pool of retirement assets, a principle-guarantee may well be desirable, particularly if it is not expensive.

RS+ gives savers the benefits of a principle-guarantee for their contributions without default or inflation-risk but it also provides them with some potential upside from equity investing. This is particularly important for low- and moderate-income savers who need the most help in growing small nest eggs into adequate assets for retirement. These are also the savers who are least likely to seek out a professional advisor or to be able to bear the expense of such a service. The following table gives returns expected from investing $1,000 annually in RS+ in comparison to a totally secure investment in "R-bonds" which is the Department of the Treasury's proposed label for an all-TIPS investment option. Using Monte Carlo simulations and the parameters given below, the table also gives the probability that RS+ will outperform R-bonds.

- The S&P 500 has a historical (nominal) mean return of 9.65 per cent and a standard deviation of 20.52 per cent.
- TIPS have a historical (real) mean return of 2.207 per cent and a standard deviation of .25 per cent.
- Inflation (increases in the US Consumer Price Index) has a historical mean of 3.02 per cent and a standard deviation of 3.11 per cent.

The results tell us that, as the result of the upside potential of common stocks, RS+ is likely to result in higher retirement accumulations than the R-Bond in all four time periods, offering workers sizeable upside potential in comparison to a totally safe instrument while continuing to guarantee invested principal fully. However, it is very clear that the longer the accumulation period, the greater the expected difference in accumulation and the greater the probability that RS+ will outperform the R-Bond. For example, in 40 years, savers using RS+ will expect to accumulate a nominal value of $523,405, which is more than 4 times as much as they would accumulate using R-Bonds. In addition, there is a 98.8 percent probability that they would do better using RS+ than R-Bonds, or just a 1.2 percent chance that they would do better using R-Bonds.

Table 1. Expected Value of Retirement Savings for RS+ and Real R-Bonds and Probability that RS+ Savings Will Exceed R-Bond Savings for Various Savings Periods

	10 Years	20 Years	30 Years	40 Years
RS+ Retirement Accumulation	$14,212	$49,458	$158,905	$523,405
R-Bond Retirement Accumulation	$12,915	$33,431	$65,140	$111,708
Probability that RS+ will Exceed R-Bond	90.1%	94.1%	97.5%	98.8%

Because of the simplicity of its design, RS+ is low cost. RS+ is composed of two products, TIPS and S&P500 index funds, which are already available, highly liquid and nearly costless. For example, the expense ratio for S&P500 exchange traded funds offered by i-Shares (symbol IVV) is just 9 basis points and their TIPS ETF (symbol TIP) costs 20 basis points, for an average of about 14.5 basis points. It should be noted that TIPS can be bought at Treasury auction without a brokerage fee, potentially reducing the total expense ratio of investment management to as little as 4 or 5 basis points, depending largely on number of years worked.

In conclusion, Aspen IFS believes that, while some workers with complex financial situations can benefit from the expertise of investment advisors, this is an expensive solution to the wrong problem for most savers and especially for low- and moderate-income savers. A better alternative to "fixing the people" is "fixing the product" by offering savers instead a well-designed, auto-pilot, automated investment system such as Real Savings Plus that will guarantee the safety of contributions while providing upside potential, all at a minimal cost. More information about Real Savings Plus can be obtained at http://www.aspeninstitute.org/policy-work/financial-security.

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