Economic Policy Institute
1333 H Street NW Suite 300
Washington DC 20009

February 25, 20009

Treasurer John Chiang
Chair
California Secure Choice Retirement Savings Investment Board
915 Capitol Mall, Room 110
Sacramento, CA 95814

Dear Treasurer Chiang,

I commend the board and the authors for a thoughtful report on design options for the California Secure Choice plan.

I am writing in support of recommended investment option 2, the pooled IRA with reserve fund. In the long run, this option will provide greater retirement income to participants yet better protect them from damaging losses than recommended option 1 (target date funds).

The Economic Policy Institute's Guaranteed Retirement Account plan had an early model of a reserve fund used to smooth investment risk across retiree cohorts (Ghilarducci 2008) (http://www.epi.org/publication/bp204/). I also discussed the advantages of a reserve fund in my response to the California Secure Choice Retirement Savings Program RFI (http://www.treasurer.ca.gov/scib/rfi/epi.pdf).

Target date funds, though an established investment vehicle, are poorly understood by participants and even many financial advisors, who believe them to be less risky than they are. In the popular understanding, target date fund investors achieve high returns early in their careers by investing mostly in equities, then lock in these gains by increasing the fixed-income share of their portfolios as they approach retirement.

In fact, participants in target date funds are as likely to lock in low early returns as high ones. That is, a portfolio that gradually shifts from a 75/25 stock-bond allocation to a 35/65 allocation—similar to the "lower-risk" target date fund in the report—is no less risky than one with a fixed 55/45 allocation. And due to volatility drag, a target date fund will achieve a slightly lower return on average than a similarly risky portfolio with fixed asset class shares.

As I noted in my response to the RFI, the only real advantage to target date funds is that younger workers are better able to adjust their contributions or retirement expectations in response to investment returns. The advantage is not, as is commonly believed, that investing in stocks early in a career is less risky because cumulative returns average out over time (they do not).

This advantage of target date funds—that younger workers have more time to adjust their savings and retirement plans—must be weighed against the false sense of security these funds engender. Participants are likely to underestimate the risk of late-career losses even for the “lower-risk” target date fund presented in the report, let alone for the “typical” target date fund with a glidepath going from 90 percent stocks to 50 percent stocks. The problem of overconfidence in bull markets—and panic selling in bear markets—is not a hypothetical one, as the baby boomers learned to their dismay.

While the pooled IRA with reserve fund option would not eliminate investment risks (nor counterproductive responses to these risks), it would help smooth retirement outcomes while protecting workers against late-career losses. Thus, participants would be able to take advantage of higher expected returns on moderately risky portfolios while being shielded from the worst outcomes, such as those experienced by baby boomers approaching retirement during the recent financial crisis and ensuing Great Recession.

Importantly, the reserve fund would shield participants against losses at no cost to participants as a group, in contrast to strategies that rely on purchasing guarantees or investing very conservatively. The board may want to explore whether additional risk smoothing could be achieved by narrowing the collar or other changes, but regardless the reserve fund restores some of the risk pooling lost in the shift from a pension to an individual savings model of retirement.

Sincerely,

Monique Morrissey
Economist