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Retirement Security
Reliable Research. Sensible Solutions.

March 4, 2016

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

Dear Treasurer Chiang:

Improving the retirement security of millions of Californians will depend on the recommendations of the California Secure Choice Investment Board to the state legislature. I thank the Board for its careful consideration of these matters. Also I would like to take this opportunity to share some of the research that the National Institute on Retirement Security (NIRS) has done comparing the returns from a pooled funding option with those from retirement accounts invested in target date funds—two options that you are considering.

NIRS is a non-partisan, non-profit research and education organization with a mission to conduct research designed to help ensure a U.S. retirement system that meets the needs of employers, employees, and the nation's economy. NIRS' national and state level research has documented the looming retirement savings crisis and the critical need to expand payroll-based retirement savings opportunities to all Americans through programs like the California Secure Choice plan.

In 2014, NIRS conducted an economic study of the cost efficiencies of providing retirement income through either a pooled fund in a defined benefit (DB) pension plan or target date funds (TDFs) in defined contribution (DC) retirement accounts. That report, *Still a Better Bang for the Buck: Update on the Economic Efficiencies of Pension Plans,* evaluates the economic efficiencies embedded in pooling DB plan assets. Specifically, we found that using a pooled fund that consistently invested assets using an optimal asset allocation delivers an 11 percent advantage over time when compared to individual participants investing their account in target date funds.

During the early years of the California Secure Choice Retirement plan, the most significant increase in the value of participant accounts will come from their ongoing contributions to the plan. The pooling of the California Secure Choice plan assets in a fund that will grow larger each year enables its managers to maintain an

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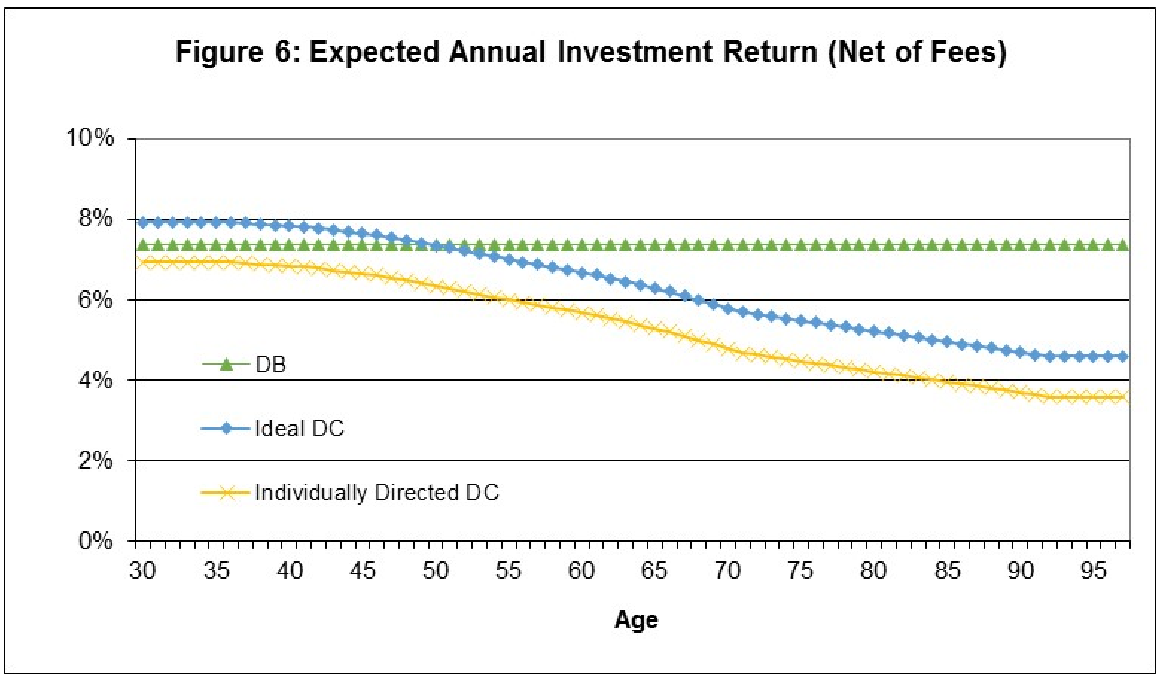
Tel: 202.457.8190 • Fax: 202.457.8191
www.nirsonline.org

optimally balanced investment portfolio from inception and maintain that allocation throughout the working careers and retirements of typical participants. In contrast, isolating each participant's contributions in an individual account using a target date fund (TDF) forces the participant to down shift from a portfolio with high equity allocations when young to a lower risk portfolio of cash and bonds as he or she approaches retirement. This automatic shift in asset allocations of target date funds will sacrifice higher potential investment returns generated from stocks. By design, TDFs deliver lower investment returns when the retirement assets in individual accounts have their greatest value.

The model in *Still a Better Bang for the Buck* estimated gross investment returns for pooled and TDF approaches starting with asset allocations for each and then applying a uniform set of assumptions about the long-term returns for each asset class. Our pooled fund was modeled on the asset allocation typical in a large public sector DB plan. In the TDF approach, we incorporated a gradual shift out of higher risk/higher return assets in favor of lower-risk/lower return assets. We adapted the model's TDF glide path from the asset allocation glide paths of the two largest investment managers offering TDFs: Vanguard and Fidelity.



In the NIRS model, the well-diversified pooled fund's expected investment returns was 7.36 percent per year, net of fees. This return is represented graphically by the

green line, marked "DB" in Figure 6. While the typical TDF asset allocation glide path in our study would earn higher returns than the pooled fund during the first half of a worker's career, those returns drop below a pooled fund's returns when a participant is in his or her late 40's. Figure 6 illustrates these TDF returns by the blue downward sloping line marked "Ideal DC." Once retired, individuals are assumed to reduce their exposure to equities even more. For detailed pooled and TDF asset allocations and projected returns, see Table A1 in the Technical Appendix of *Still a Better Bang for the Buck: Update on the Economic Efficiencies of Pension Plans* at:
http://www.nirsonline.org/storage/nirs/documents/Still%20a%20Better%20Bang/bangforbuck_2014.pdf.

Furthermore, another example of pooled fund option is the TIAA participating annuity, which features a pooled investment fund, establishes reserves for contingencies, and declares dividends annually. Although insurance regulations require TIAA's pooled investment fund to be less diverse than the proposed option, TIAA's dividend policy of distributing unneeded reserves to retirees may suggest an alternative way that early funds diverted from returns to create the desired reserve levels could flow back to those individuals.[1]

While it remains a somewhat complex task to explain the pooled funding approach to participants, TIAA has a nearly 100-year track record demonstrating the benefits of a pooled fund for individuals. While many feel that TDFs simplify the investment selection for individuals saving in retirement accounts, TDFs do not eliminate the risk of significant market drop generating a large drop in individual participants' accounts. Given the generally lower income levels of uncovered workers, data suggest that many may have lower tolerance for investment risk. These participants in the California Secure Choice plan may unknowingly be exposed to greater investment risk in the TDF option than they may realize. Should a major market downturn hit their TDF account, they may react negatively, lowering their future participation.

In any case, the pooled fund approach could serve as an evolutionary step as best practices in administering state-supported retirement savings plans unfold. The California Secure Choice plan could launch a plan with more secure savings and better returns in the long run, while remaining well positioned to implement the best models available for workers and employers.

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[1] B. Goodman and D. Richardson, 2014, "TIAA and CREF: Program Features and Recent Evidence on Performance and Utilization," TIAA Institute, New York, NY
https://www.tiaainstitute.org/public/pdf/rd114a_program_features_recent_evidence.pdf

Thank you for your work leading the California Secure Choice Investment Board.

Sincerely,

Diane Oakley

Diane Oakley, Executive Director

1612 K STREET, N.W. SUITE 500 • WASHINGTON, DC 20006
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www.nirsonline.org