

PENSION POLICY CENTER

Washington, DC

COMMENT SUBMITTED TO THE SECURITIES AND EXCHANGE COMMISSION

February 6, 2012

SECURITIES AND EXCHANGE COMMISSION

Release No. 34-66164; File No. 4-645

Comment Request for Study Regarding Financial Literacy Among Investors

ENHANCING FINANCIAL LITERACY CONCERNING RATES OF RETURN

Because of the widespread lack of financial literacy among 401(k) participants and other investors, it is important that the information provided to them be appropriate for their situations. One of the pitfalls that financially unsophisticated investors face is that they are unable to judge the quality or usefulness of the financial information they are provided. While attention has been given to financial education as a way to deal with financial illiteracy, a lot of financial information is provided to investors through other sources. These include financial advice, the content of disclosures, and the content of websites and financial planning software available over the internet.

Importance of Information on Assumptions for Future Rates of Return

Given a lack of interest in financial education by many people, financial literacy efforts should focus on key issues. With the growth of 401(k) plans, for many people one of the most important planning issues they face when considering retirement is whether their savings are adequate. A key issue is what rate of return they can expect on those assets. Providing investors with reasonable information that is relevant to their investment experience about likely future rates of return, taking into account fees, risk and other issues, is an important aspect of financial literacy.

The purpose of the comment is to draw attention to a problem that the Securities and Exchange Commission may want to address in the content of the financial information provided to unsophisticated investors. This comment focuses on rates of return used in hypothetical calculations in information provided to investors.

The issue addressed is the implicit or explicit advice that investors receive as to rates of return to use for projecting forward account balances. Part of the calculation to determine whether a

401(k) participant has saved adequately for retirement is the rate of return used to project forward future account balances. This issue is important for 401(k) participants planning for retirement, many of whom do not know what would be an appropriate rate of return to use for this purpose.

Information Currently Provided

Some retirement planning calculators available over the internet provide a default rate of return, with the worker having the option of choosing a different rate of return. Because of lack of knowledge, many users of these calculators may accept the defaults. These defaults provide information to unsophisticated users as to what rate of return to assume. Some companies use a default rate of return of 7 or 8 percent in financial planning software. When used this way, it is assumed that this rate of return will be received every year during the forecasting period, which could be thirty years or more. It is in effect a long-term risk-free rate of return.

Rates of return are also used on quarterly reports to some 401(k) plan participants for the purpose of projecting forward account balances. Again, some companies use 7 or 8 percent rates of return for that purpose. Rates of return are also used in examples companies provide as to the growth of IRA account balances when encouraging 401(k) participants to rollover to an IRA their account balances from former employers. Unsophisticated investors may be attracted to financial service companies providing unreasonably high rates of return in their sample calculations and in their financial calculators.

Reasons Why Expected Market Rates of Return Are Not Appropriate for Individual Investors

For a number of reasons, the rates of return used for these purposes are sometimes too high for individual investors. Expected market rates of return for individual investors would not be appropriate for several reasons. For example, some financial planning software programs that are available over the internet do not take into account fees. Fees for 401(k) participants average more than 1 percentage point, with some sources citing an average of 1.5 percentage points. Fees for mutual fund investors are lower, but still average about 85 basis points for investments in stock mutual funds. In addition, many programs do not take into account the evidence from behavioral economics that individual investors tend to do less well than financial markets due to errors they make in managing their investments. Programs often do not take into account financial market risk.

Because of biases demonstrated in behavioral economics of overconfidence in their ability as investors, and over optimism for the future, unsophisticated investors are particularly at risk of believing overly optimistic projections of future rates of return.

Comparison with Defined Benefit Plan Rate of Return Assumptions

The discussion in this comment can be contrasted with the rate of return assumptions appropriate for defined benefit pension plans. First, defined benefit plans have lower fees. Second, these plans presumably are not subject to the rate of return lowering errors made by unsophisticated investors. Third, these plans do not have the same target date (or retirement date) risk that individuals have. Individuals in 401(k) plans are generally advised to move toward more conservative investments as their retirement approach. That rate of return reducing strategy does not apply to defined benefit pension plans. Thus, for these three reasons, defined benefit pension plans can use higher rate of return assumptions than are appropriate for individual investors.

Conclusions

For individual investors, rates of return of 7 percent or higher for long term projections for balanced portfolios, including bonds, appear to be too high because they do not take into account fees, risk, and the evidence that individual investors underperform the market. By contrast, the U.S. Department of Labor, Employee Benefits Security Administration uses a rate of return of 5 percent for financial projections in the financial planning software it provides on its website. The SEC may wish to address this issue in its efforts to improve the financial literacy of investors.

John A. Turner, PhD