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CONGRESSIONAL TESTIMONY

Appropriate Investments for Social Security Personal Retirement Accounts

**Testimony before
Subcommittee on Securities and Investments
Committee on Banking, Housing
and Urban Affairs
United States Senate**

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I appreciate the opportunity to appear before you today to discuss appropriate investments for Social Security Personal Retirement Accounts. This is an extremely important subject, and I would like to thank both Chairman Hagel and Senator Dodd for scheduling this hearing. Let me begin by noting that while I am a Research Fellow at the Heritage Foundation, the views that I express in this testimony are my own, and should not be construed as representing any official position of the Heritage Foundation. In addition, the Heritage Foundation does not endorse or oppose any legislation.

PRAs should be managed through a simple, low-cost administrative structure that uses the current payroll tax system and professional investment managers.

A simple and effective administrative structure is essential to the success of a PRA system. Probably the simplest and cheapest structure would be to use the existing payroll tax system. Under today's Social Security, the employer collects and sends to the Treasury Department both the payroll taxes that are withheld from an employee's check and those that are the responsibility of the employer. The payroll tax money from all of the firm's employees is combined with income taxes withheld from their paychecks and sent to the Treasury. The money collected is allocated annually to individual workers' earnings records after worker income tax records have been received.

Adapting this existing administrative structure to a PRA system would be easier to implement than other options. Under a PRA system, the employer would continue to forward to the Treasury Department one regular check containing payroll and income taxes for all of the firm's employees. The Treasury would continue to use its existing formula to estimate the amount of receipts that should be credited to Social Security and to reconcile this amount annually with actual tax receipts.

Once the Treasury determines the amount to be credited to Social Security, it would estimate the portion that would go to PRAs and forward that amount to a holding fund managed by professionals who would invest the amount in money market instruments until it is credited to individual taxpayers' accounts. The money would go to individual workers' accounts upon receipt of their tax information. It would then be invested in the default fund, except for workers who have selected (on their income tax forms) one of the other investment options, in which cases it would be invested accordingly.[13]

Using Professional Fund Managers. Rather that having the government trying to invest PRA money, the agency overseeing the accounts (which could be the Department of the Treasury, the Social Security Administration, or an independent board) should contract out fund management to professional fund managers. This investment management system is currently used by the Federal Employees Thrift Investment Board, which administers the Thrift Savings Plan, a part of the retirement system for federal employees.

Under this system, management of the specific investment pools would be contracted out to professional fund managers, who would bid for the right to manage an asset pool of a certain size for a specified period of time. The manager could invest the money only as directed by the agency. The agency would also contract out to investor services such tasks as issuing regular statements of individual accounts, answering account questions, and handling transfers from one investment option to another.

Advantages of this Administrative Structure. Building on existing structures and contracting out investment management and services should keep costs to the lowest level possible. In addition, employers would not have to change their current payroll practices. Using one central government entity to receive PRA funds also means that employers would not bear the cost of writing individual checks or arranging for individual fund transfers for each employee. In addition, this method allows the PRA contributions of workers who have multiple jobs to be based on their total income without placing any additional burden on either the worker or the employers.

From a worker's standpoint, this should be the lowest-cost structure available. In addition, because workers' PRA contributions would be distributed to their chosen investment plans only after their tax information has been received, workers with several jobs during a year should see contributions based on their total annual incomes.

Developing a simple personal retirement account system with very low administrative costs would be relatively simple.

State Street Trust, one of the largest managers of retirement savings, has estimated that administering a personal retirement account would cost from $3.55 to $6.91 per person annually, based on proprietary data that the bank accumulated from its experience in managing a host of pension plans.[8] In terms of the percentage of assets under management, the annual fee would be only 0.19 percent to 0.35 percent. This fee assumes an annual contribution per worker equal to 2 percent of his or her gross earnings. The cost would drop significantly if that contribution increased to an amount equal to 4 percent of earnings or higher. State Street Trust's findings were reviewed and accepted by the Government Accountability Office[9] as accurate.

This low level of administrative fees would certainly not reduce the benefits of a PRA. In addition, history shows that administrative costs are highest when a system is first implemented and start-up costs must be covered. As time passes, administrative costs decline significantly. This has been true for 401(k) accounts, the Thrift Savings Plan (TSP) for federal employees, and even Social Security. For example, the administrative costs of 401(k) plans have decreased over time, despite the plans offering an increasing number of investment options and a higher level of personal service. Although the costs of specific plans vary according to each plan's complexity, size, and the types of investments, many large companies have been able to keep their administrative costs as low as 0.3 percent by offering only a limited number of broad-based funds.

The federal Thrift Savings Plan, a privately managed retirement plan open only to federal employees, has experienced a dramatic 76 percent reduction in administrative costs since the system started in 1988. Today, participants pay annual administrative fees that are below 0.1 percent of assets under management. TSP's extremely low administrative costs are significant, given that many experts expect that a PRA system would closely resemble the structure and investment choices found under TSP.

The Social Security system experienced similar reductions in administrative costs during its formative years. In 1940, when the system first began to pay benefits, its administrative costs equaled 74 percent of all Old-Age and Survivors Insurance benefits paid. In 1945, this figure had declined to 9.8 percent. Today, administrative costs make up only 0.5 percent of payments from the OASI trust fund. Even though this is not a perfect comparison with the other two examples, given that Social Security's structure has changed over the years, it does suggest that fees could be very low.

PRAs should be invested in more than just stocks, but stocks are an essential part of the investment strategy.

Studies that purport to show that either PRAs or the Social Security trust fund would have lost money over the past few years if they had been invested in stock assume that 100 percent of the trust fund would have been invested in stocks, rather than a diversified portfolio that would have balanced stock losses with gains on bonds or other investments. They also focus on only the short-term market trends, ignoring the gains that would result from longer-term investments.

Morningstar, Inc., an independent market data and analysis firm, estimates that the value of mutual funds invested in diversified U.S. stocks declined 12.1 percent during the second quarter of 2002. However, not all types of investments went down. Mutual funds containing lower-risk instruments such as taxable bonds (which are routinely held by those nearing retirement) rose an average of 1.4 percent over that same period, while funds invested in tax-exempt bonds rose 3.2 percent. Thus, in one of the worst quarters for stock investment, PRAs invested in a diversified portfolio would remain strong.

Over the long run, all of these investments did even better. Over a five-year period including the second quarter of 2002, mutual funds invested in stocks earned an average of 3.9 percent per year, while mutual funds invested in taxable bonds and tax-exempt bonds earned an average of 5.0 percent a year.

PRAs should not be invested solely in stocks. They should instead be invested in a diversified portfolio of stock index funds and different types of bond index funds. The default investment for PRAs should be a lifestyle fund that automatically reduces the proportion of stocks as the worker gets older, thus locking in past gains and sharply reducing the chance of major losses in the years approaching retirement.

A carefully controlled set of investment options should be developed that includes an appropriate default option.

The investment options available to PRA owners should be simple and easily understood. While an increasing number of Americans are investing their money for a wide variety of purposes, a voluntary PRA system would bring in millions of new investors who may not have any previous investment experience. In addition, experience from both the 401(k) retirement plans and federal employees' Thrift Savings Plan shows that costs are far lower if the plan starts with only a few investment options and then adds more once the plan is fully established.

Carefully Controlled Investment Options. All investment options available under a PRA plan should be limited to a diversified portfolio composed of stock index funds, government bonds, and similar assets. Even if they so desire, workers would not be allowed to invest in speculative areas such as technology stocks or to choose specific stocks or bonds. Money in a PRA is intended to help to finance a worker's retirement security, not to be risked on speculative investments with the hope that taxpayers will support the worker if the investment fails.

Initially, workers would be allowed to put their PRA contributions into any one of three balanced and diversified mixes of stock index funds, government bonds, and similar pension-grade investments. Although the exact mix of assets would be determined by the central administrative agency, one fund might consist of 60 percent stock index funds and 40 percent government bonds, while another might be 60 percent government bonds and 40 percent stock index funds.

The third fund, which would also act as the default fund for workers who failed to make a choice, would be a lifestyle fund. These are funds in which the asset mix changes with the age of the worker. Younger workers would be invested fairly heavily in stock index funds, but as they age, their funds would automatically shift gradually toward a portfolio that includes a substantial proportion of bonds and other fixed-interest investments. This is designed to allow the portfolios of workers who are far from retirement to grow with the economy and to allow older workers to lock in that growth by making their portfolios predominantly lower-risk investments.

Workers would be allowed to change from one investment fund to another either annually (by indicating their choice on the income tax form) or at other specified times (by completing a form on the Internet). They would also receive quarterly statements showing the balance in their accounts. As with today's Social Security, PRA accounts are intended strictly for retirement purposes, and no early withdrawals would be allowed for any reason.

Structuring Accounts to Keep Fees Low. Under a successful PRA plan, all investments must be approved by the central administrative agency as being appropriate for this level of retirement investment. That agency would also ensure that administrative costs are kept as low as possible by awarding contracts to manage investment pools through competitive bidding and through direct negotiation with professional funds managers.

Research by State Street Global Investors[14] shows that administrative costs are lower if workers put all their money in one diversified pool of assets rather than attempting to diversify their portfolio by dividing it among several types of assets. For example, a worker who puts all of his or her money in one fund consisting of 50 percent stock index funds and 50 percent government bonds would earn the same as a worker who places half of his or her money in a government bond fund and half in a separate stock index fund. However, the first worker would incur significantly lower administrative costs.

Additional Choices for Larger Accounts. Once a worker’s PRA account reaches a certain size threshold (determined by the central administrative agency), he or she would have the option to move its management to another investment manager if that manager offered better service or potentially higher returns. However, only investment managers who had meet strict asset and management quality tests would be allowed to receive these accounts, and the managers would be sharply limited in the types of investments they could offer. In the event that the worker is dissatisfied with either the fees or the returns from these individually managed accounts, he or she could switch back to the centrally managed funds at any time.

PRAs should be invested in lifespan accounts unless the account owner chooses another investment.

A key feature of President George Bush’s recently announced Social Security plan is that workers’ personal retirement accounts (PRAs) would be invested automatically in a lifespan fund unless a worker expressly asked for another arrangement. Lifespan funds adjust (or "rebalance") a worker’s investments as he or she ages. For younger workers who are far from retirement, a lifespan fund would invest most of their money in stock index funds—safe funds reflecting the broad stock market. As these workers grow older, their lifespan funds would gradually and automatically shift more money into even safer bonds and other less volatile investments. In short, lifespan funds allow younger workers to take advantage of the higher returns that stock investments offer while making sure that the portfolio gets safer and safer as the worker gets closer to retirement.

Lifespan funds are designed to allow the portfolios of workers who are far from retirement to grow with the economy and to allow older workers to lock in that growth by moving their portfolios into predominantly lower-volatility investments. This means that if the stock market suddenly declined, workers who invested in a lifespan fund and were near retirement would have only a tiny part of their PRAs invested in stocks and thus would not see a significant last-minute change in the value of their PRAs.

As an example of how these funds would protect workers who are close to retirement, Morningstar, Inc., an independent market data and analysis firm, estimated that the value of mutual funds invested in diversified U.S. stocks declined 12.1 percent during the second quarter of 2002—one of the worst quarters in recent history. However, not all types of investments went down. Indeed, mutual funds containing lower-risk instruments such as taxable bonds (a common investment for those nearing retirement) actually rose an average of 1.4 percent over that same period, and funds invested in tax-exempt bonds rose an average of 3.2 percent.

Because a lifespan account would have automatically moved a worker's PRA almost entirely into bonds when that worker reached retirement age, a worker with a PRA who retired in the first quarter of 2002 thus would have seen his PRA grow during that last quarter before retirement. He or she would not have faced losses, even though the stock market as a whole experienced major declines during that period.

Lifespan funds have been gaining popularity in employer-sponsored retirement plans, such as 401(k)s, because they automatically make the kind of portfolio adjustments that investment professionals recommend for all workers nearing retirement. At the end of 2004, about 55 companies offered lifespan accounts as part of their 401k plans. Currently, the biggest players in the field are Fidelity Investments, with a 33 percent market share, and The Vanguard Group, with about 17 percent. Administrative fees depend in a large part on whether the funds are actively or passively managed. Fidelity, which consists totally of actively managed funds has an administrative fee of 0.81 percent of assets under management, while Vanguard, which consists totally of index funds has fees of 0.23 percent of assets under management. Passively managed index funds are much more suitable for Social Security accounts than are funds that pick and choose individual stocks.

For many years, investment advisers have advised workers to structure their retirement accounts so that more funds are shifted into fixed-income investments as they age. Advisors recognize that decreasing the proportion of investment in stocks reduces the potential for short-term loss. Although younger investors are better off investing most of their assets in stocks to get higher returns, those who are closer to retirement need to reduce the likelihood that a sudden market shift will affect them. Lifespan funds make this rebalancing process continuous and automatic and would let workers with PRAs approach retirement with confidence.

Conclusion.

Again, thank you for the opportunity to testify before you today. The success of Social Security personal retirement accounts as a way for individuals to build sufficient savings to fund a portion of their retirement benefits will in large part depend on the investment choices that are available. A simple, low-cost administrative platform would improve the ability of these accounts to assist individuals in meeting their retirement goals. Such a system is both feasible and realistic.

Thank you.

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