HOW PASSIVE WORKS

How US Retirement Savings Defaulted to Passive Investing

Defaults may be the most powerful force in product design.

Google paid Apple an estimated $12 billion to remain the iPhone's default search engine. **Making organ donor status the default option** could effectively solve the transplant shortage with the stroke of a pen. Consumer subscriptions from local gyms to HBO depend on you paying, and sometimes forgetting about, default monthly fees. A similar dynamic has taken hold in the capital markets.

The United States is the largest retirement market in the world. It has undergone a titanic shift in the past decade as a result of a new default product.

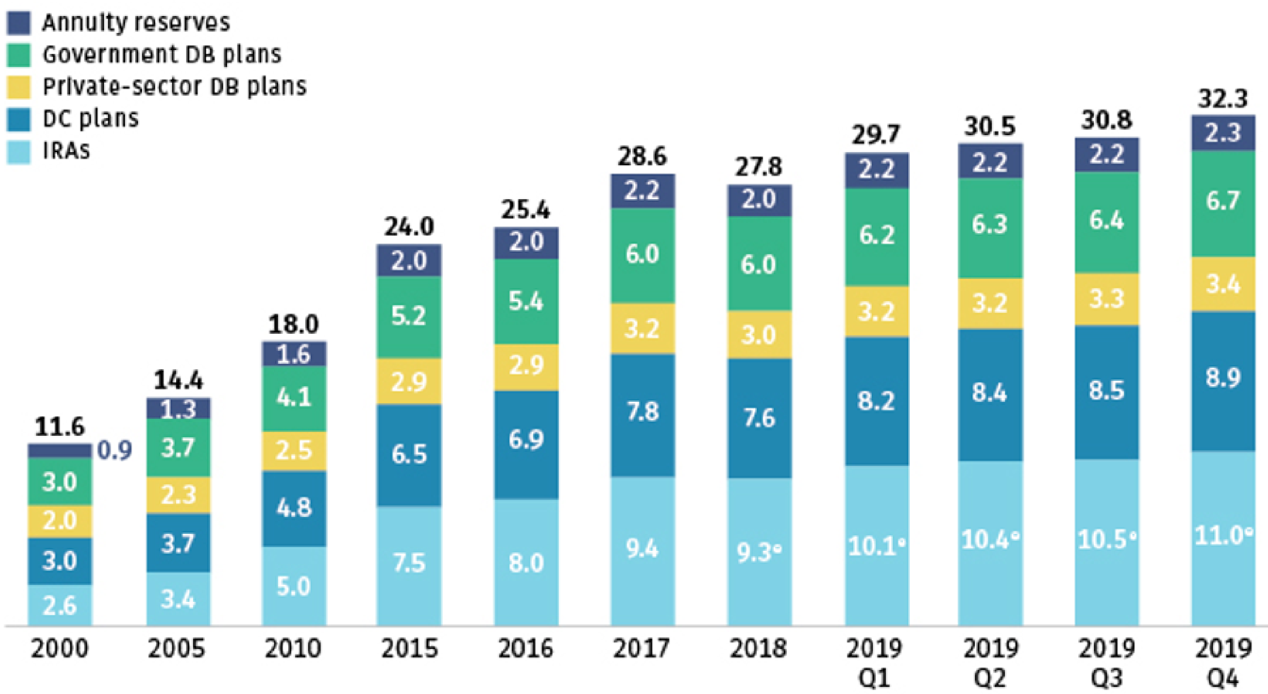
Let's set the scene.

From Defined Benefit to Defined Contribution

US households have approximately $32 trillion in retirement savings, comprising about 1/3 of all US household financial assets. The government offers tax advantages to encourage this saving behavior. Individuals can create their own retirement accounts, but employers direct the majority of retirement assets.

The leading retirement products are defined benefit (DB) plans, defined contribution (DC) plans, IRAs, and annuities. I'm going to focus on the first two. Defined benefit plans (aka pensions) feature guaranteed payouts from employers to retired employees. In DB plans, employers bear the risk that future investment returns won't cover the amount due to employees for retirement. Defined contribution plans, such as a 401(k) or a 403(b), place the burden of saving and investing onto employees. In DC plans, employers do not guarantee a set payout to employees.

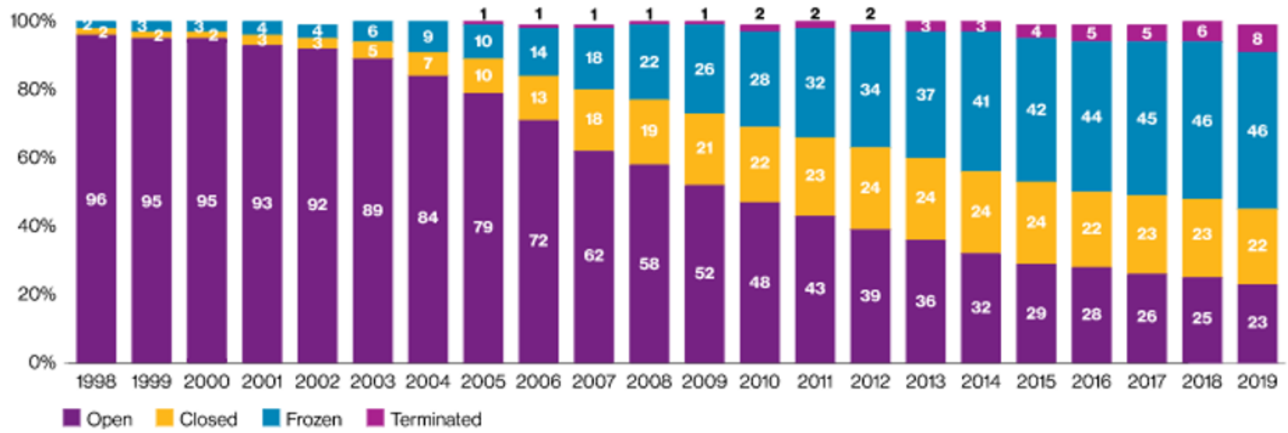
Fig 1. US total retirement market assets ($ trillions)



Source: **ICI**

Employers prefer defined contribution plans over defined benefit plans. They don't want to be forced to run a guaranteed-payout investment business in addition to their normal business. Since 2010, private employers have directed virtually all new retirement assets to DC plans (dark blue in Fig 1) and virtually none to DB plans (yellow in Fig 1). Over the past two decades, the majority of Fortune 500 companies have discontinued DB plans available to their employees.

Fig 2. Most Fortune 500 companies have stopped offering DB plans



Source: **Willis Towers Watson**

Here's the policy problem. If we shift the responsibility for saving and investing onto employees, what if they don't save enough for retirement?

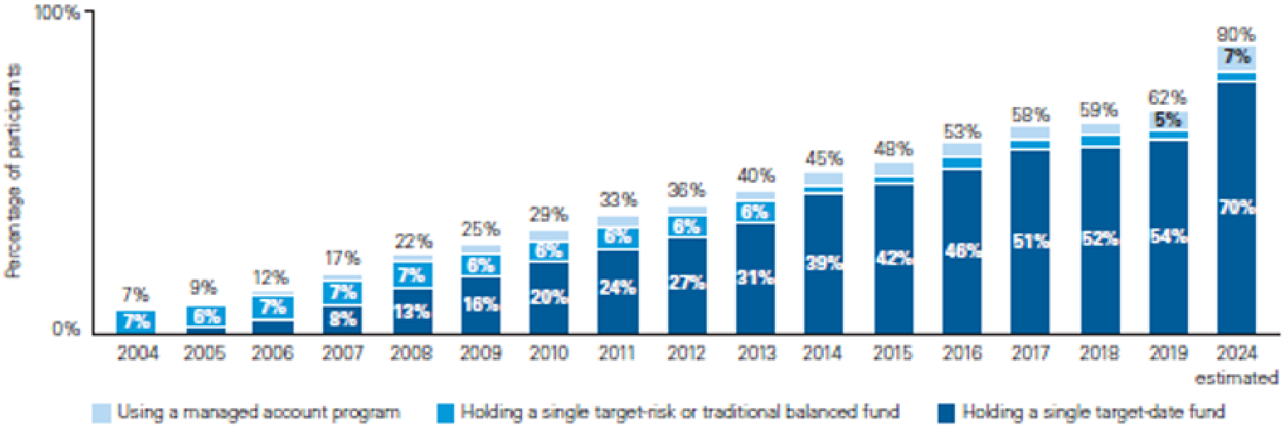
For years, large employers and the government fought back and forth. Employers kept finding loopholes to avoid guaranteeing retirement payouts decades into the future, and the government worked to close those loopholes.

A New Default

The solution was to create a default product. First, the **Pension Protection Act of 2006** created Qualified Default Investment Alternatives (QDIAs) for defined contribution plans. A QDIA is a safe harbor allowing employers to enroll employees in DC retirement plans without legal liability for the investment returns. In plain English, the employee can't sue the employer if the QDIA underperforms. QDIAs also auto-escalate – an employee's default contribution automatically increases every year.

The most popular QDIA, by far, is called a **Target-Date Fund (TDF)**. QDIAs are so closely tied to Target-Date Funds that many retirement researchers I spoke with use the terms interchangeably. Employer allocations to DC plans have gone hand in hand with allocations to TDFs. Because Vanguard is the biggest player in this space, let's use them as the canonical example.

Fig 3. Defined Contribution plans shifting into Target-Date Funds



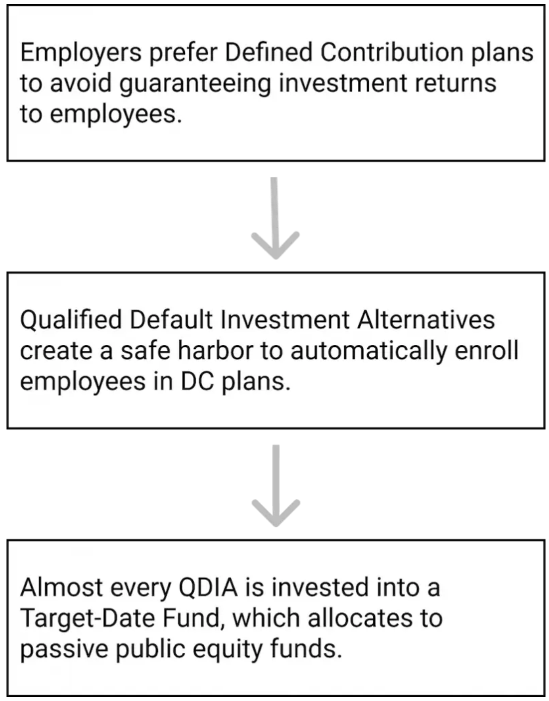
Source: **Vanguard, How America Saves (2020)**

Target-Date Funds are the unambiguous present and future of the US retirement system. Currently, TDFs comprise 37% of all Vanguard DC plan assets and receive 60% of new contributions. 54% of Vanguard's DC plan participants are only invested in a single TDF (dark blue in Fig 3). In five years, that number will be 70%. That's it. That single default Target-Date Fund will be that person's entire retirement plan.

The Pipeline to Passive

In sum, Vanguard gathers retirement assets from employees enrolled by default and then invests those assets into Vanguard's own passive investment funds. The end result: a monumental capital flow from US retirement schemes into passive investment vehicles.

Fig 4. The Default Path from US Retirement into Passive Funds



Source: Lembas Capital

Lawyers can rejoice at their newly guaranteed employment deciphering all of this.

If you're a US public equity investor, here's the upshot.

Major shifts in capital flows create major investment opportunities. Fundamental investors who study the mechanics of those capital flows can find repeatable buying windows and selling opportunities in today's markets. But first, we need to examine how these Target-Date Funds allocate to passive funds and how that dynamic is shifting too. That will be the topic for our next segment.

Special thanks to the research staff at the Investment Company Institute, the Federal Reserve, the Georgetown Center for Retirement Initiatives, and Vanguard for their help with this piece.

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Postscript — Here's a glossary for those of you who aren't yet swimming in the sea of finance terms and acronyms:

What is the difference between defined benefit vs defined contribution plans?

A defined benefit plan is an employer-sponsored retirement plan in which the employer guarantees retirement payouts to employees. DB plans are also known as pensions. A defined contribution plan is an employer-sponsored retirement plan in which the employee bears the investment risk for retirement and the employer may match employee contributions into the plan. The most popular DC plan is a 401(k).

What is a QDIA?

A QDIA (Qualified Default Investment Alternative) is a safe harbor created by the Pension Protection Act of 2006 to allow employers to enroll employees by default into defined contribution retirement plans without legal liability for the investment returns.

What is a TDF?

A TDF (Target-Date Fund) is a mutual fund targeted toward an estimated payout for an investor by some future date. Many TDFs target the year an employee is expected to retire. Vanguard is the largest TDF manager.

What is the difference between active vs passive investing?

Active investing is the idea that investors can actively decide what to invest in. Passive investing attempts to free ride on active investors by replicating the market or some portion of the market. Because passive funds and the indexes they replicate are themselves constructed by investment managers, active vs passive is best thought of as two ends of a spectrum (not as a clean split).