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February 23, 2016

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

Dear Mr. Chiang:

I am writing in reference to the decision facing the Secure Choice Board on the investment plan to recommend to the legislature. I would argue strongly in favor of the pooled funding option. I make this judgement based on my research and participation in policy debates on retirement security over the last quarter century.

There are two reasons for preferring the pooled funding option. First and most important, the alternative, individual target date funds, does not protect workers from timing risk. While target date funds reduce a worker's exposure to the stock market as they approach their expected date of retirement, they are still likely to have 50 percent or more of their portfolio in the stock market in the last years before they retire.[1] This leaves them vulnerable to the sort of market downturn that we saw in both 2000–2002 and 2008–2009, both instances in which the main market indices lost more than half of their value.

Such downturns are presumably rare, but obviously not impossible. One of the biggest benefits that the State of California can provide to its workers through the Secure Choice program is protection against this risk. For most workers, losing 25 percent of their retirement savings as a result of a market downturn will mean a much less comfortable retirement. Since the pooled funding option provides a mechanism that will remove this risk at no cost to the taxpayers, it seems foolish not to take advantage of this possibility.

The other factor is simply that the pooled funding option will in the long-term allow workers to receive a substantially higher rate of return on their savings. I recognize that the study shows that these higher rates of return only accrue to later cohorts, with the first group of participants roughly breaking even with investments in target date funds, but if a long-term gain can be had at essentially

1 This risk is made greater by the fact that nearly 40 percent of workers retire earlier than planned, which means they may find themselves more exposed to the market than would be desirable at the point of their retirement (See Munnell, A, G Sanzenbacher, and M Rutledge, 2015. "What Causes Workers to Retire Before They Plan." Boston, MA: Center for Retirement Research at Boston College, http://crr.bc.edu/working-papers/what-causes-workers-to-retire-before-they-plan/).

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no short-term cost, it seems wasteful to forego the opportunity.[2] The study concluded that the pooled investment option would increase workers' retirement income by 10–20 percent compared with the target date fund option. This means that a worker who puts $2,000 a year into the pooled investment fund would get the same retirement income as a worker who put $2,200 to $2,400 annually into target date funds.

While I recognize the concern that the pooled investment option has some additional complications in management, the issues that arise should pose little difficult for competent actuaries.[3] There is also an issue that the pooled investment option may seem more complex to many participants. This is a risk, but surveys have consistently shown that workers are already quite confused about the nature of the investment options facing them. For this reason, it is likely that many will not understand the notion of a "target date fund" either. The issue is not comparing a fully transparent system with one that may seem somewhat opaque; it is comparing two systems, one of which may be marginally more complex than the other.

Even though I view it as important that workers be as well-informed as possible about their retirement system and what is being done with their money, whatever marginal confusion results from the pooled investment option seems a small price to pay for the elimination of timing risk and the increase in returns available to later cohorts of participants. For these reasons, I hope that the Board will recommend the pooled investment option to the legislature.

Sincerely,

Dean Baker
Co-Director

cc: Board members

2 In principle, it would be possible for the State of California to lend money to build up initial reserves in the system, although this may not be feasible for political reasons.

3 I have done analyses that project future stock returns based on the current ratio of prices to trend earnings. These suggest that a properly managed fund should face little risk meetings it return target (Rosnick, D and D Baker, 2012, "Pension Liabilities: Fear Tactics and Serious Policy," Washington, DC: Center for Economic and Policy Research, available at http://cepr.net/publications/reports/pension-liabilities-fear-tactics-and-serious-policy).

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