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Importance of investor education in DC pension schemes

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A recent survey found that many corporate DC pension plan participants lack an adequate understanding of their DC scheme and that DC plan assets are still preponderantly invested in principal-guaranteed products. We see investor education as the key to rectifying such conditions.

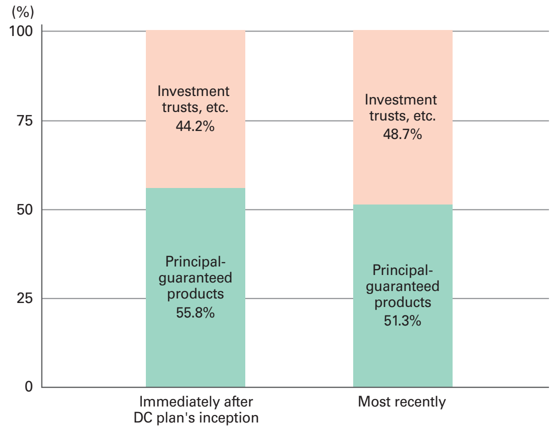
Defined-contribution (DC) pension plan participants are responsible for managing their own pension assets. They must decide for themselves whether to invest in principal-guaranteed products (e.g., term deposits) or risk-bearing products (e.g. investment trusts). To help them, companies with DC plans are endeavoring to provide investor education to increase participants' pension investment literacy. But how effective have such educational efforts been? Below we look at how companies are conducting investor education and how participants have actually invested their DC plan assets, based on the Pension Fund Association of Japan's FY07 (2nd) survey of DC plan sponsors and participants, the results of which were released in March 2008.

Participants' asset allocation

Exhibit 1 shows participants' asset allocation on a contribution basis. Investment trusts' share of total assets has risen 4.5 percentage points relative to immediately following the DC plans' inception, but principal-guaranteed products still account for over 50% of assets. Participants that invest in 5-year term deposits, a popular principal-guaranteed product, would earn an average return in the vicinity of 0.75% per annum (as of February 2008). Many corporate DC pension plans have an assumed rate of return[1)] of 1.5-2.5%[2)], a range that is virtually out of reach to participants who invest exclusively in principal-guaranteed products. If participants are rational investors, they should allocate a larger share of their aggregate assets to investment trusts, which have a high empirical probability of outperforming principal-guaranteed products over the medium to long term despite entailing a risk of negative returns over shorter horizons.

It is important for DC plan participants to think in terms of investing their pension assets in accord with their personal life or career plan. In reality, however, few participants give much thought to investing their own pension assets.

Exhibit 1. DC plan participants' asset allocation (contribution basis)



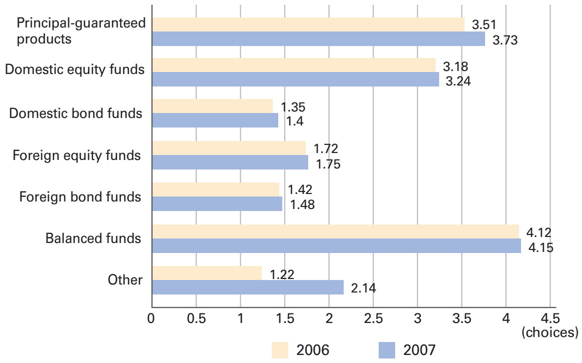
Source: PFA

Available investment products

DC plan participants' persistently large allocation of assets to principal-guaranteed products invites the question, What type of product lineup do DC plan administrators typically offer?

Exhibit 2 shows corporate DC plans' average number of product choices per product category. The average lineup comprises a total of 17-18 products, of which only 3-4 are principal-guaranteed products. In other words, despite having a wider selection of investment trusts than principal-guaranteed products, participants have a strong propensity to choose the latter.

Exhibit 2. Investment product lineup



Source: NRI, based on PFA data

Ongoing investor education is needed to foster understanding of DC plans

As noted above, it is important for DC plan participants to personally deepen their understanding of DC plans. Toward that end, employers and/or plan administrators conduct investor education for plan participants when the employer initially adopts a DC plan. Even afterwards, quite a few companies conduct ongoing investor education. However, when asked whether they understand how DC plans work, 53.2% of the Pension Fund Association survey respondents responded in the negative (Exhibit 3). The survey results indicate that participants' understanding of DC plans leaves much to be desired.

This lack of understanding is apparently largely attributable to employers' neglect to adequately ascertain participants' understanding of DC plans, investment knowledge, need or desire for ongoing education, and existing asset allocation before providing investor education. This conclusion is corroborated by the fact that 80% of employers that responded to the survey reported having never directly surveyed plan participants regarding their asset allocation or understanding of the plan.

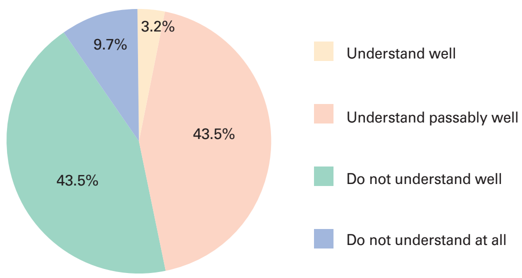
Behavioral finance research conducted in the US, where DC plans have long existed, suggests that investor education has inherent limitations and not all participants will become rational investors regardless of how much investor education is offered to them. This finding was incorporated into the US Pension Protection Act of 2006, which revised previous rules to make it easier for DC plan sponsors to offer a risk-bearing product as their plan's default option[3].

Even in Japan, some companies have recently followed the US's lead by switching their DC plans' default option to a non-principal-guaranteed product[4]. Additionally, the Ministry of Health, Welfare and Labor has issued rules that promote revision of DC plans' default option[5].

Such discussion of DC plans' default option may lead some to conclude that investor education is unnecessary. However, merely enabling DC plan sponsors to make an investment trust the default option does not obviate the need for investor education. In Japan, only 41% of corporate DC plan sponsors offer ongoing investor education. With investor education not yet sufficiently available, it is premature to speak of investor education's limitations.

There is still much that DC plan sponsors can try to do vis-à-vis investor education, such as adapting education programs to reflect the findings of periodic surveys aimed at identifying issues of concern to participants and monitoring the status of their investments.

Exhibit. 3. Participants' understanding of DC plans



Source: PFA

Note

1) When a company switches to a DC plan from another retirement benefits plan, the new plan's assumed rate of return is the rate of return required to provide the same level of benefits as the old plan.

2) FY07 (2nd) DC Pension Plan Survey Report

3) Default option: an investment product in which pension contributions are automatically invested when the DC plan participant has not explicitly selected an investment product

4) Newsletter on Pensions & Investment, 3 March 2008

5) Nikkei Shimbun, 3 April 2008

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