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Default Investment Acceptance among Public Defined Contribution Plan Participants

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Acknowledgements

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Executive Summary

The increasing availability of and participation in defined contribution (DC) plans are fundamentally changing the way Americans save and invest for retirement. One important innovation in DC plans is default investments that are thoughtfully designed to make it easy for participants to invest in a professionally managed portfolio that is suitable for their situation, such as a target-date fund.

While target-date funds are increasingly used as the default investment in DC plans, the participant can still choose not to accept the default investment initially (i.e., self-direct the portfolio) as well as opt out at some point in time in the future (e.g., a year after accepting the target-date fund as the default investment).

While there is a growing body of research on the default investment decisions among participants in 401(k) plans, there is notably less research exploring the default investment decisions among participants in public sector DC plans. There are likely a variety of reasons, such as the fact that public DC plans have been relatively slower to introduce features such as automatic enrollment and automatic escalation. As public DC plans increasingly resemble their private DC counterparts, it is worth understanding both overall default investment acceptance rates among public DC participants and how acceptance differs among key demographic attributes, such as age, income, and gender.

This study seeks to address the following questions: How do demographic factors such as age, income, and gender influence the acceptance of default investments among participants in public defined contribution plans, and how do these patterns compare to those observed in private 401(k) plans? This paper explores this topic leveraging the initial investment decisions of approximately 340,000 newly enrolled participants in public DC plans. While the primary analysis focuses on plans that use target-date funds as the default investment, it also includes a limited number of plans using stable-value funds as default investments and provides context on the outcomes.

Some key findings include

Default investment acceptance declines with age and income levels and appears to be higher for female participants, holding other demographic factors constant.

There was notable variation in default acceptance in the year 2020 (i.e., a period of heightened market volatility) among older DC participants. This suggests that market conditions can affect the decision to select a default investment and that programs to revisit the default investment decision (i.e., among those who opt out) may be important in the case of a future bear market or a period of market volatility.

Default investment acceptance is higher for public DC participants than 401(k) participants when controlling for age and income.

- Controlling for factors such as income is important since wages were lower for public participants compared to 401(k) participants (and lower-income participants, on average, have a higher default investment acceptance rate.)

Participants who opt out of the default investment (i.e., decide to self-direct their portfolio) build portfolios with a wide range of equity allocations, but the median is generally reflective of a target-date glide path.

Opt-out rates among public DC plan participants who initially accept the default acceptance are about 1% per year but increase notably with age and income.

Introduction

When DC participants are defaulted into a retirement plan, they are automatically enrolled into a predesigned investment line-up provided by their employer (such as target-date fund, stable-value fund, etc.) While some participants choose to opt out of these default investment options and become investment DIYers, most participants choose to keep their default investment line-up for many years. Therefore, the default investment option design is vital for retirement plan sponsors and advisors to help participants plan a secure retirement future. Qualified Default Investment Alternatives (QDIAs) are used in both private and public sector retirement plans, but their application and regulatory framework differ slightly.[1]

It has become a trend to investigate the difference between workers in private and public sectors in terms of their QDIA adoption rate, opt-out rate, and the factors that impact their decisions. This study finds that the default investment acceptance rate in the public sector is very high, whether it is a target-date fund or a stable-value fund, generally exceeding 80% for all ages. Acceptance of the target-date fund declines roughly linearly by age, while acceptance of the stable-value fund is highest at the youngest and older ages (and is typically lower than the target-date fund.)

Dataset

This analysis leverages public sector participant-level administrative data from MissionSquare Retirement. There are four data files included in the analysis, with an identifier across each file linking the participants. The data is year-end for the years 2020, 2021, 2022, and 2023.

The number of participants varies by year. Here is some basic information about the dataset by year.

Exhibit 1 **Participant Counts by Year**

	2020	2021	2022	2023
New	64,195	81,891	94,054	98,611
All	687,057	723,072	774,993	865,173

There are a total of 969,794 unique participants across the four plan years. Various filters are applied to the participant totals, which may limit the total number of new participants (or total participants) included in a given analysis (e.g., if using income as a filter, this data point is missing for approximately 29% of participants).

This analysis focuses only on participants who are enrolled in the plan as of that year and how new participant allocations potentially change over future years. Newly enrolled participants are the primary focus of this study since these are participants who had to make recent decisions regarding how to invest their defined contribution savings.

Default Investment Acceptance

Two potential default investments are considered for the analysis: target-date fund or stable-value fund (which is coded for the respective plan). Between the two, the target date is significantly more popular; approximately 99% of the new participants were in a plan that offered a target-date fund as the default investment. The lack of participants in plans that offer stable value as the default investment limits a more robust analysis of the demographic factors related to default investment acceptance, but Exhibit 2 includes the public sector DC participants' default acceptance rates by age and both default investment types.

Acceptance rates for either type of default investment were relatively high, regardless of type, generally exceeding 80% for all ages. There do appear to be important differences in default investment acceptance depending on whether it is a stable-value or a target-date fund. Overall, acceptance of the target-date fund is generally higher than stable value, except for the older ages. While default acceptance for the target-date fund declines roughly linearly by age, acceptance for stable value is highest at the youngest and oldest ages.

Exploring how target-date default investment acceptance has varied by calendar year is important, given the notable market volatility in 2020. The acceptance rates by age are included in Exhibit 3. Note that the annual acceptance levels for stable value are not included, nor are they further explored at any greater depth, given the lack of data across time and among the participants where it is the default.

Exhibit 2 **Initial Default Investment Acceptance by Age and Default Investment Types**

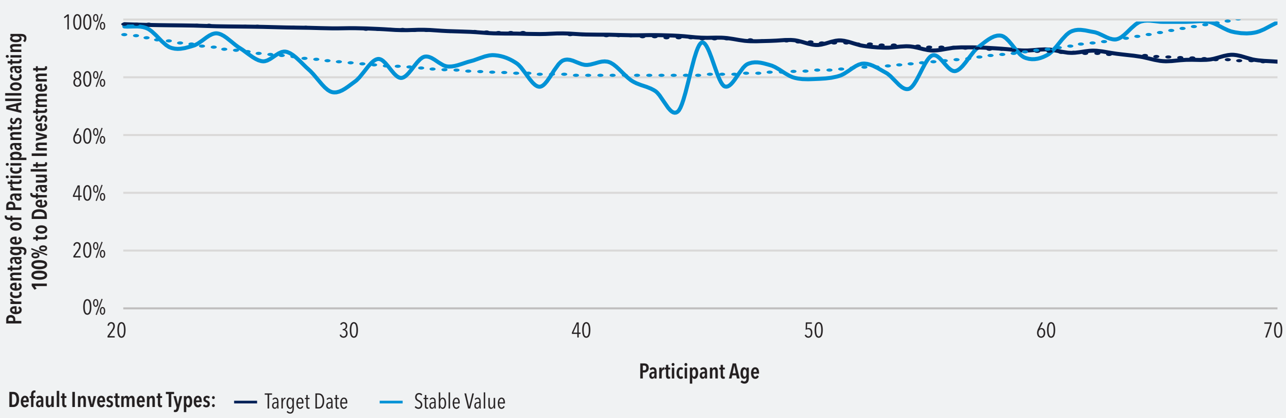


Exhibit 3 **Initial Target-Date Default Investment Acceptance by Calendar Year**

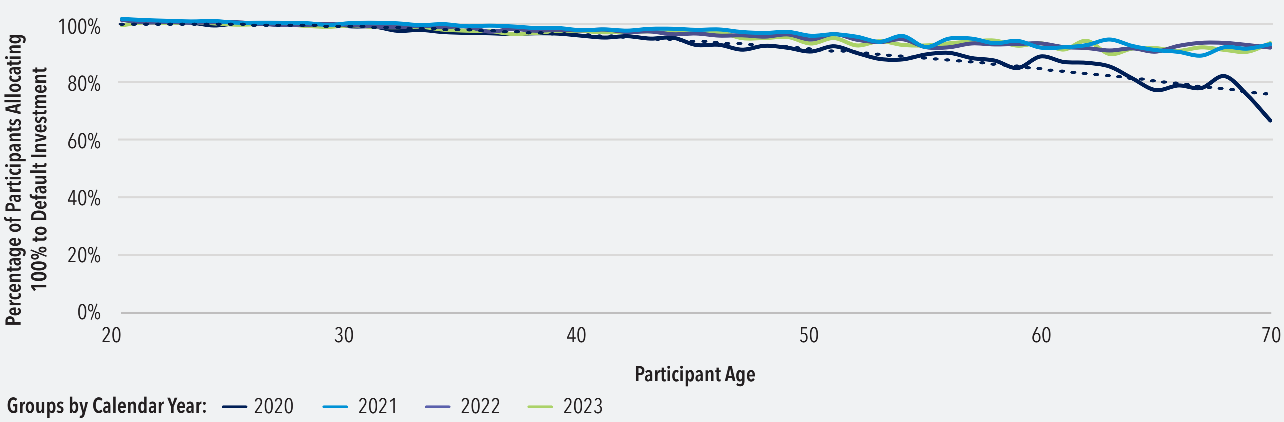


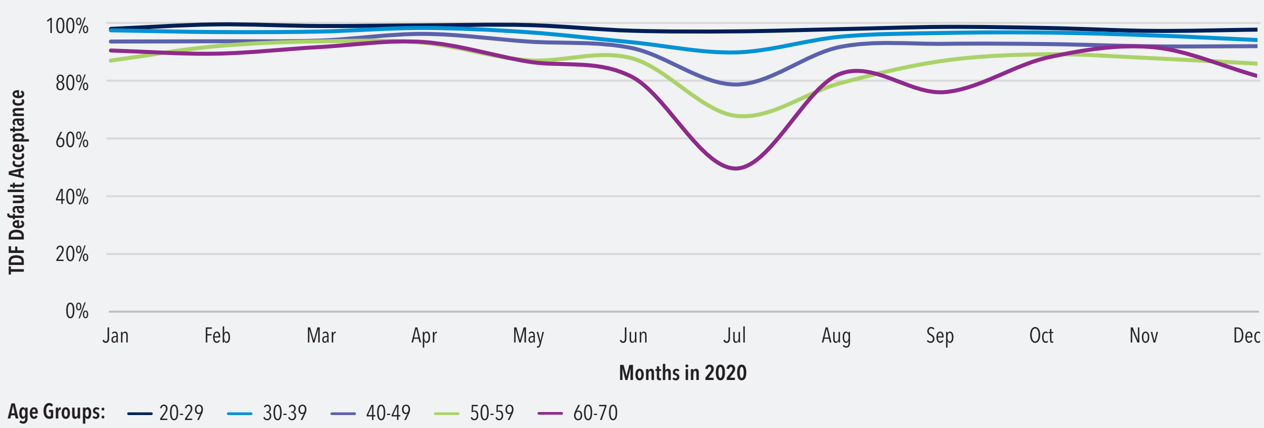
Exhibit 3 shows that default investment acceptance of a target-date fund was relatively similar in the years 2021, 2022, and 2023 but notably lower in 2020 when controlling for age. This may be related to the notable levels of market volatility experienced during the year. To better explore this, participants who enrolled in the year 2020 each month were grouped by age: 20 – 29, 30 – 39, 40 – 49, 50 – 59, and 60 – 70. Exhibit 4 includes the respective default investment rates.

There are two relatively clear effects demonstrated in Exhibit 4. First, default investment persistently declines with age. This is consistent with both previous exhibits. Second, and perhaps more interesting, default investment acceptance declined significantly during the middle of 2020 by age group. This is likely due to the significant market volatility caused by the COVID-19 pandemic. Default investment did not change much at all for younger participants, but there was a notable drop among older participants (i.e., those aged 60 – 70), with the default investment for this group dropping to approximately 50% from an earlier steady state closer to 90%.

This clearly suggests that recent market performance is more likely to affect the default investment decisions among older participants than those who are younger. Longer term, if there is not any kind of re-enrollment or other action to force participants to revisit their initial default investment decision, it is more likely that those participants who are enrolled during periods of heightened market volatility will be less likely to be invested in the default investment.

Next, target-date default acceptance is considered with participants grouped by age and income. This analysis only includes participants whose incomes were available within the dataset and exceeded $25,000. This eliminates 34.8% of available participants, so it is a slightly different sample. In addition, there are not enough participants to

Exhibit 4 **Default Acceptance in the 2020 Calendar Year by Month and Age Group**



analyze stable value by age and income since those plans that offer stable value as the default do not tend to report their income. The resulting acceptance rates are included in Exhibit 5.

Default investment acceptance rates tend to decrease both by age and income. For example, younger, lower-income participants have the highest acceptance rate (97% of new participants), while older, higher-income participants have the lowest acceptance rate (69% of new participants). This indicates that when doing any kind of default investment benchmarking, it is important to consider more than just age, since income is clearly related to the default investment decisions.

These default acceptance rates among public sector employees are notably higher than those found in similar research on private sector workers. For example, Blanchett, Finke, and Liu (2022) explored the savings decisions among approximately 156,000 participants from 1,018 plans from a large U.S. DC plan recordkeeper. This study leveraged that same initial dataset but only included participants who were enrolled in a 401(k) plan, and only included those plans where at least 50% of new participants select the target-date fund. These actions resulted in an ultimate dataset of 116,528 participants. New participants were placed into the same age and income groups as the previous analysis. Default investment acceptance rates for these for-profit sector DC plans can be seen in Exhibit 6.

Exhibit 5 **Target-Date Initial Default Investment Acceptance by Age and Income**

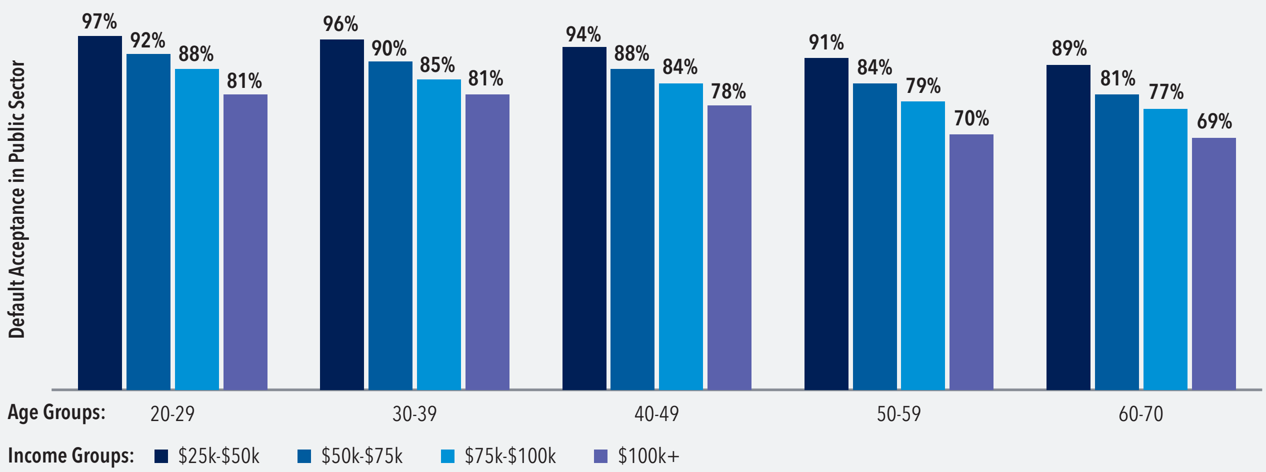
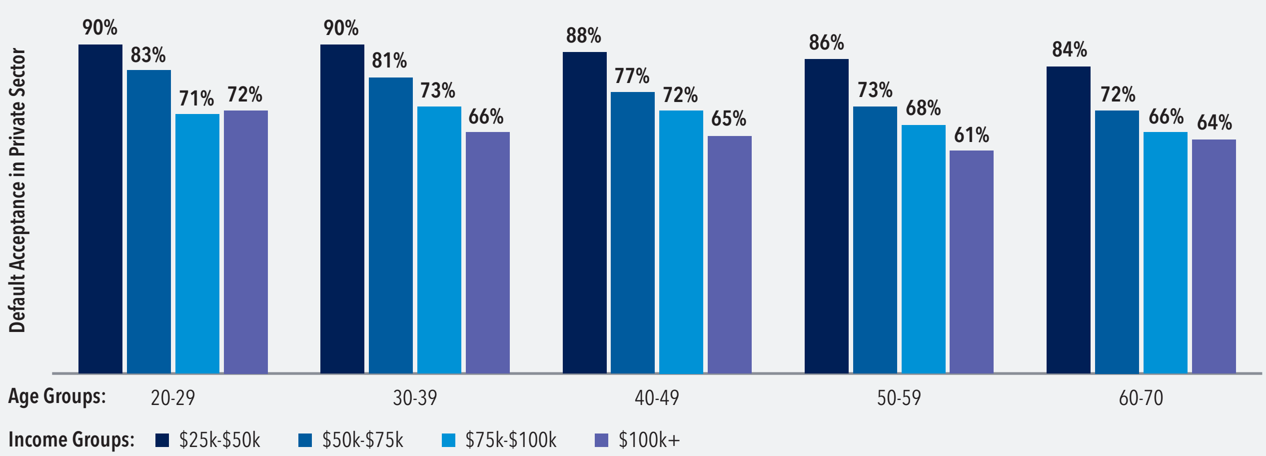


Exhibit 6 **Target-Date Initial Default Investment Acceptance by Age and Income in Private Sector Defined Contribution (i.e., 401(k)) Plans**



Source: "Save More with Less" dataset + 50% or more of participants in plan TDF plus NAICS code. A total of 116,528 participants.

The default investment acceptance rates in Exhibit 6, focused on private sector 401(k) participants, are notably lower than the default investment rates among the public DC participants, noted in Exhibit 5. Exhibit 7 includes the differences in the default investment acceptance rates for the various demographics.

While there are differences by age and income groups, the default investment acceptance was about 10% higher for public DC participants compared to 401(k) participants. Since there could be other factors driving these differences beyond age and income (e.g., the recordkeepers are different), this difference is something that is worth additional exploration (e.g., from a recordkeeper that serves both 401(k) and public DC plans).

One more demographic variable considered with respect to default investment acceptance is gender. Overall, 88.7% of men accepted a target-date fund as the default investment versus 90.9% of women. This high-level statistic could mask some important demographic differences. For example, the women in the dataset were slightly older (median age of 36 versus 35) and had slightly higher incomes (median of $38,850 versus $38,773). Therefore, when considering gender, along with default investment acceptance more generally, it's important to control for demographics like age and income. Exhibit 8 includes the difference in target-date default acceptance by gender, where it is the rate of female default acceptance minus male default acceptance.

Exhibit 7 **Difference in Target-Date Initial Default Investment Acceptance by Age and Income: Public Plan Participants vs. (minus) Private Sector 401(k) Participants**

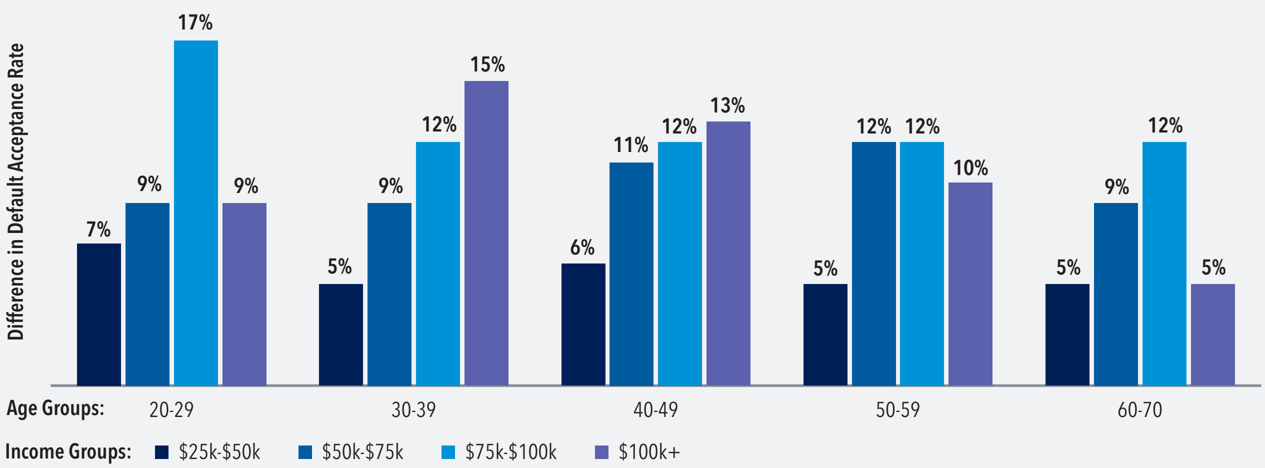


Exhibit 8 **Difference in Target Date Default Acceptance by Gender (Female Minus Male)**

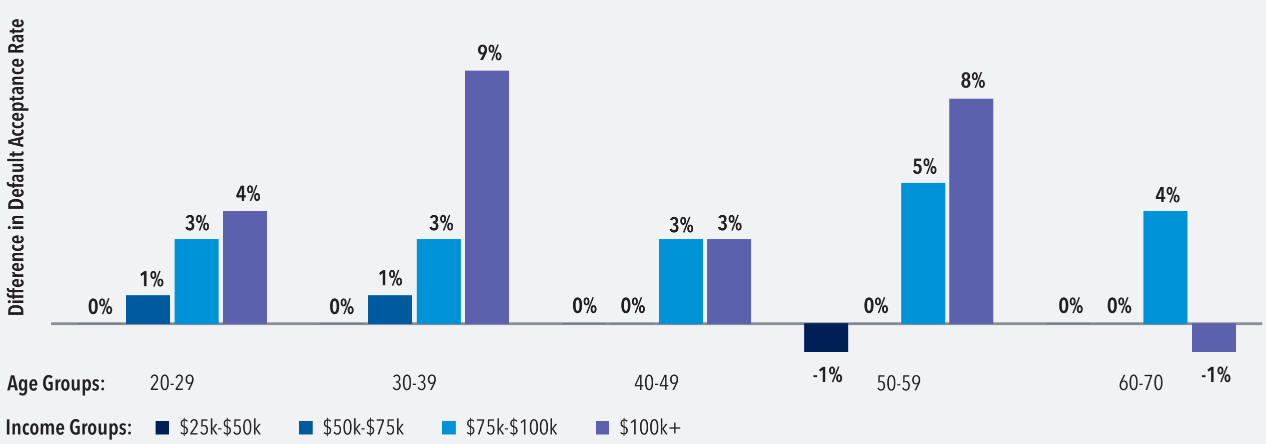


Exhibit 8 clearly demonstrates that females are more likely to accept a target-date fund as the default investment, with the greatest differences occurring at higher income levels. The differences in default investment acceptance by gender were greater among public sector DC participants than among private sector 401(k) participants.

Next, for information purposes, information was provided about the equity allocations of participants who decided not to use the targe-date fund. For this analysis, the equity allocations were estimated for all available funds, which are assumed to be static over the entire period. The resulting equity allocations are included in Exhibit 9.

While there is a significant variation in the equity allocation among DIY investors, the median equity allocation generally takes the shape of a target-date fund glide path, where allocations become more conservative for older investors.

Opt-Out Rates over Time

Finally, the study analyzed how the decision to stay in default investment changed in the future years after enrollment. As a reminder, the primary analysis focuses on participants who enrolled in the plan during the respective calendar year. While acceptance of target date funds was relatively high initially, it is worth exploring how the allocations changed over time (i.e., the percentage of participants who opted out). Exhibit 10 includes the opt-out rate among participants in the future years based on age.

Exhibit 9 **Equity Allocations of Participants Not Allocating 100% Initially to the Target-Date Fund (i.e., DIY Investors) by Age and Percentiles**

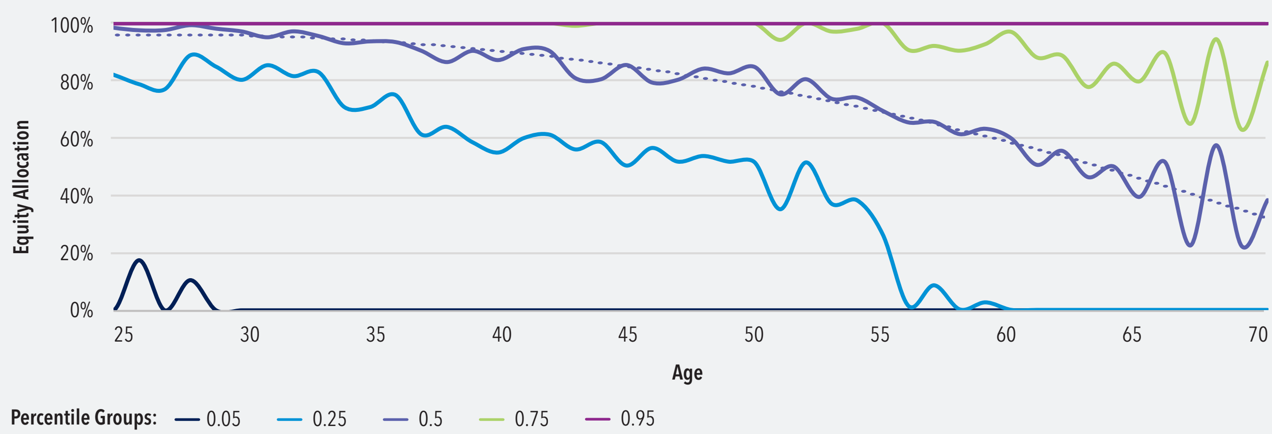
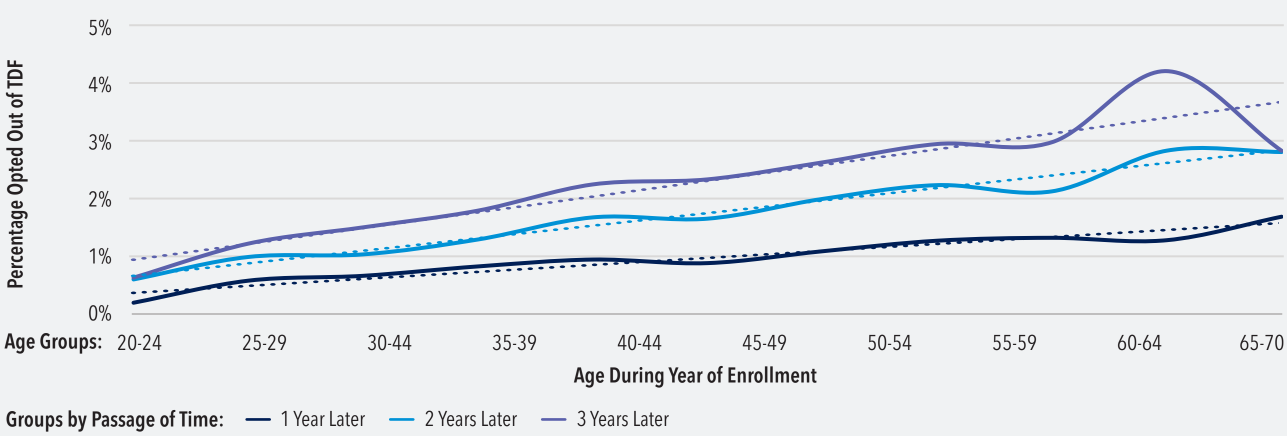


Exhibit 10 **Opt-Out Rate of Participants over Time, among Those Initially Allocating Entire Balance to Target-Date Default Investment (by Age)**

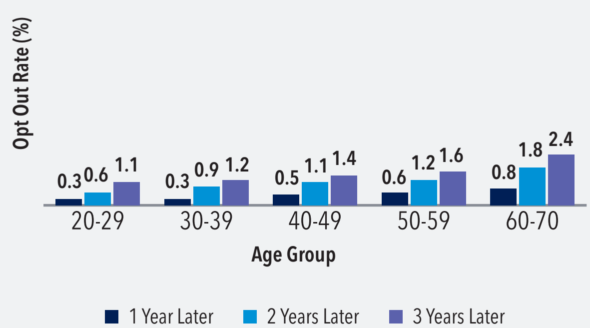


Opt-out rates were highest among older participants, who also tended to have the lowest initial default acceptance rates. Differences in opt-out rates by income can be seen in Exhibit 11.

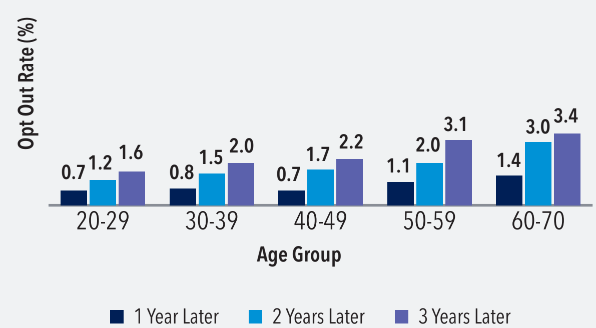
These opt-out rates are notably higher among higher-income participants, as well as those who are older. In other words, not only are older participants less likely to accept the default investment, but they are also more likely to opt out even if they are enrolled initially.

Exhibit 11 **Opt-Out Rate of Participants over Time, among Those Initially Allocating Entire Balance to Target-Date Default Investment, by Age and Income**

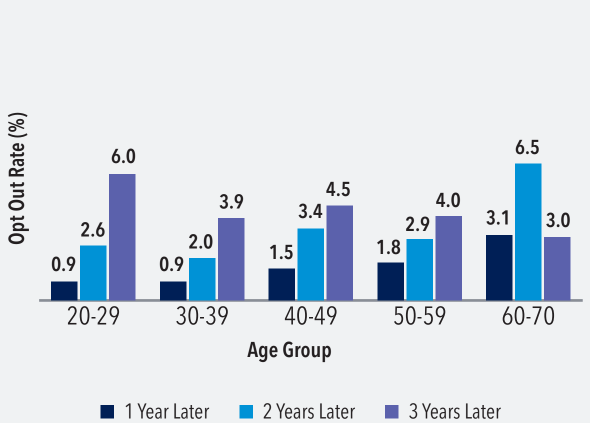
Panel A: Income $25,000 – $49,999



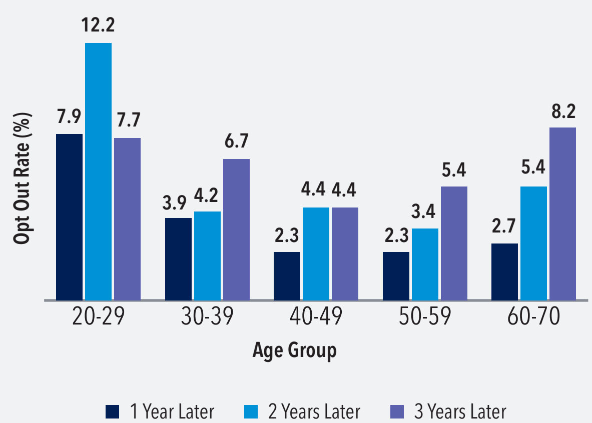
Panel B: Income $50,000 – $74,999



Panel C: Income $75,000 – $99,999



Panel D: Income $100,000+



Conclusions

As the importance of defined contribution (DC) plans with respect to saving for retirement continues to increase, it is crucial to understand the decisions participants tend to make with respect to saving and investing. This research explored default investment decisions among public DC plans and found some notable differences by age, income, and gender, as well as potential differences more generally from 401(k) plans.

- Public sector DC plan participants, compared to private sector 401(k) participants, are more likely to accept default investment options provided by their retirement plan sponsor.
- Extreme market volatility is likely to affect default investment decisions, especially among older participants.
- Default investment acceptance rates decline with age and income level and appear to be higher among female participants.
- Public sector DC plan participants have a high default acceptance rate and a low opt-out rate. Both TDF and stable value default acceptance rates are generally exceeding 80%, across all ages. The opt-out rate is approximately 1% per year but increases with age and income.

This information could be useful for employers, plan sponsors, and consultants who are interested in how well their plans are doing in terms of getting participants to leverage the default investments. Since public sector DC plan participants are more likely to accept and stay within default investments, plan administrators and advisors should take more responsibility/actions for designing default options that would better facilitate participants making appropriate saving and retirement planning decisions. More generally, the analysis suggests that implementing effective strategies to incentivize participants to periodically revisit their default investment decisions, especially among those who opt out, may be worth considering.

References

Blanchett, D., Finke, M., & Liu, Z. (2022). Save more with less: The impact of employer defaults and match rates on retirement saving. *Financial Planning Review*, 5(4), e1152. https://doi.org/10.1002/cfp2.1152.

Endnotes

1. In the private sector, QDIAs are explicitly defined and regulated under the Employee Retirement Income Security Act (ERISA), as amended by the Pension Protection Act of 2006 (PPA). QDIAs are default investment options for participants in defined contribution plans (e.g., 401(k) plans) who do not actively choose an investment option. The PPA provides fiduciary protection to plan sponsors if they use a QDIA, as long as the investment meets specific criteria, such as being a target-date fund, balanced fund, or managed account.

In the public sector, QDIAs are not governed by ERISA, as most public sector retirement plans are exempt from ERISA regulations. However, many public sector defined contribution plans (e.g., 457(b) or 401(a) plans) voluntarily adopt QDIA-like principles to align with best practices and encourage better retirement outcomes for participants. Public sector plans often use target-date funds or balanced funds as default investment options, similar to private sector QDIAs, but the specific rules and fiduciary protections may vary depending on state or local regulations.

Both sectors use QDIA-like investments to ensure participants who do not make active investment choices are placed in diversified, professionally managed options designed to grow over time. Private sector QDIAs are subject to ERISA and PPA regulations, while public sector plans are not. Public sector plans may adopt QDIA principles voluntarily or as part of state/local statutes or plan design.

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