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"Strengthening Worker Retirement Security"

February 24, 2009

Our nation's system of retirement security is imperiled, headed for a serious train wreck. That wreck is not merely waiting to happen; we are running on a dangerous track that is leading directly to a serious crash that will disable major parts of our retirement system. Federal support—which, in today's world, is already being tapped at unprecedented levels—seems to be the only short-term remedy. But long-term reforms in our retirement funding system, if only we have the wisdom and courage to implement them, can move us to a better path toward retirement security for the nation's workers.

One of the causes of the coming crisis—but hardly the only cause—is the collapse of our stock market, erasing some $8 trillion in market value from its $17 trillion capitalization at the market's high in October 2007, less than 18 months ago. However, this stunning loss of wealth reflects, in important part, a growing and substantial overvaluation of stocks during the late 1990s and early 2000s, "phantom wealth" which proved unjustified by corporate intrinsic value. (I'll discuss this subject in greater depth later in my statement.)

But four other causes must not be ignored. One is the inadequacy of national savings being directed into retirement plans. "Thrift" has been *out* in America; "instant gratification" in our consumer-driven economy has been *in*. As a nation, we are not saving nearly enough to meet our future retirement needs. Too few citizens have chosen to establish personal retirement accounts, and even those who have established them are funding them inadequately and only sporadically. Further, our corporations have been funding their pension plans on the mistaken assumption that stocks would produce future returns at the generous levels of the past, raising their prospective return assumptions even as the market reached valuations that were far above

[1] The opinions expressed in this speech do not necessarily represent the views of Vanguard's present management.

historical norms.[2] And the pension plans of our state and local governments seem to be in the worst financial condition of all. (Because of poor transparency, inadequate disclosure, and non-standardized financial reporting, we really don't know the dimension of the shortfall.)

Second is the plethora of unsound, unwise, and often speculative investment choices made not only by individuals responsible for managing their own tax-sheltered retirement investment programs (such as individual retirement accounts and defined-contribution pension plans such as 401(k) thrift plans provided by corporations and 403(b) savings plans provided by non-profit institutions), but also professionally managed defined benefit plans, largely created in earlier days by our nation's larger corporations and by our state and local governments.

Third, conflicts of interest are rife throughout our financial system. Both the managers of mutual funds held in corporate 401(k) plans and the money managers of corporate pension plans face a potential conflict when they hold the shares of the corporations that are their clients. It is not beyond imagination that when a manager votes proxy shares against a company management's recommendation, it might not sit well with company executives who select the plan's provider of investment advice. (There is a debate about the extent to which those conflicts have actually materialized.) In trade union plans, actual conflicts of interest among union leaders, union workers, investment advisers, and money managers have been documented in the press and in court. In defined benefit plans, corporate senior officers face an obvious short-term conflict between minimizing pension costs in order to maximize the earnings growth that market participants demand, and incurring larger pension costs by making timely and adequate contributions to their companies' pension plans in order to assure long-term security for the pension benefits they have promised to their workers.

Fourth, our financial system is a greedy system, consuming far too large a share of the returns created by our business and economic system. Corporations generate earnings for the owners of their stocks, pay dividends, and reinvest what's left in the business. In the aggregate, over the past century, the returns generated by our businesses have grown at an annual rate of about 9 ½ percent per year, including about 4 ½ percent from dividend yields and 5 percent from

[2] For example, in 1981, when the yield on long-term U.S. Treasury bonds was 13 ½ percent, corporations assumed that future returns on their pension plans would average 6 percent. At the end of 2007, despite the sharp decline in the Treasury bond yield to 4.8 percent, the assumed future return soared to 8 ½ percent. Even without the large losses incurred in the 2008 bear market, it seems highly unlikely that such a return will be realized.

earnings growth. Similarly, corporate and government bonds pay interest, and the aggregate return on bonds averaged about 5 percent during the same period.

But these are the *gross* returns generated by the corporations that dominate our system of competitive capitalism (and by government borrowings). Investors who hold these financial instruments, either directly or through the collective investment programs provided by mutual funds and defined benefit pension plans, receive their returns only *after* the cost of acquiring them and then trading them back and forth among one another. While some of this activity is necessary to provide the liquidity that has been the hallmark of U.S. financial markets, it has grown into an orgy of speculation that pits one manager against another, and one investor (or speculator) against another—a "paper economy" that has, predictably, come to threaten the real economy where our citizens save and invest. It must be obvious that our present economic crisis was, by and large, foisted on Main Street by Wall Street—the mostly innocent public taken to the cleaners, as it were, by the mostly greedy financiers.

Extracting Value From Society

I've written about our absurd and counterproductive financial sector at length. Writing in the *Journal of Portfolio Management* in its Winter 2008 issue, here are some of the things that I said about the costs of our financial system: " . . . mutual fund expenses, plus all those fees paid to hedge fund and pension fund managers, to trust companies and to insurance companies, plus their trading costs and investment banking fees . . . totaled about $528 billion in 2007. These enormous costs seriously undermine the odds in favor of success for citizens who are accumulating savings for retirement. Alas, *the investor feeds at the bottom of the costly food chain of investing*, paid only *after* all the agency costs of investing are deducted from the markets' returns . . . Once a profession in which business was subservient, the field of money management has largely become a business in which the profession is subservient. Harvard Business School Professor Rakesh Khurana is right when he defines the standard of conduct for a true professional with these words: '*I will create value for society, rather than extract it*.' And yet money management, by definition, extracts value from the returns earned by our business enterprises."

These views are not only mine, and they have applied for a long time. Hear Nobel laureate economist James Tobin, presciently writing in 1984: " . . . we are throwing more and

more of our resources into financial activities remote from the production of goods and services, into activities that generate high private rewards disproportionate to their social productivity, a 'paper economy' facilitating speculation which is short-sighted and inefficient."

In his remarks, Tobin cited the eminent British economist John Maynard Keynes. But he failed to cite Keynes's profound warning: "When enterprise becomes a mere bubble on a whirlpool of speculation, the consequences may be dire . . . when the capital development of a country becomes a by-product of the activities of a casino . . . the job (of capitalism) will be ill-done." That job is indeed being ill-done today. Business enterprise has taken a back seat to financial speculation. The multiple failings of our flawed financial sector are jeopardizing, not only the retirement security of our nation's savers but the economy in which our entire society participates.

Our Retirement System Today

The present crisis in worker retirement security is well within our capacity to measure. It is not a pretty picture:

Defined Benefit Plans. Until the early 1990s, investment risk and the longevity risk of pensioners (the risk of outliving one's resources) were borne by the defined benefit (DB) plans of our corporations and state and local governments, the pervasive approach to retirement savings outside of the huge DB plan we call Social Security. But in the face of a major shift away from DB plans in favor of defined contribution (DC) plans, DB growth has essentially halted. Assets of corporate pension plans have declined from $2.1 trillion as far back as 1999 to an estimated $1.9 trillion as 2009 began. These plans are now severely underfunded. For the companies in the Standard & Poor's 500 Index, pension plan assets to cover future payments to retirees has tumbled from a *surplus* of some $270 billion in 1999 to a *deficit* of $376 billion at the end of 2008. Largely because of the stock market's sharp decline, assets of state and local plans have also tumbled, from a high of $3.3 trillion early in 2007 to an estimated $2.5 trillion last year.

The Pension Benefit Guaranty Corporation. This federal agency, responsible for guaranteeing the pension benefits of failing corporate sponsors is itself faltering, with a $14 billion deficit in December 2007. Yet early in 2008—just before the worst of the stock market's collapse—the agency made the odd decision to raise its allocation to diversified equity

investments to 45 percent of its assets, and add another 10 percent to "alternative investments," including real estate and private equity, essentially doubling the PBGC's equity participation at what turned out to be the worst possible moment.

Defined Contribution Plans. DC plans are gradually replacing DB plans, a massive transfer from business enterprises to their employees of both investment risk (and return) and the longevity risk of retirement funding. While DC plans have been available to provide the benefits of tax-deferral for retirement savings for well over a half-century,[3] it has only been with the rise of employer thrift plans such as 401(k)s and 403(b)s, beginning in 1978, that they have been widely used to accumulate retirement savings. The growth in DC plans has been remarkable. Assets totaled $500 billion in 1985; $1 trillion in 1991; $4.5 trillion in 2007. With the market crash, assets are now estimated at $3.5 trillion. The 401(k) and 403(b) plans dominate this total, with respective shares of 67 percent and 16 percent or 83 percent of the DC total.

Individual Retirement Accounts. IRA assets presently total about $3.2 trillion, down from $4.7 trillion in 2007. Mutual funds (now some $1.5 trillion) continue to represent the largest single portion of these investments. Yet with some 47 million households participating in IRAs, the median balance is but $55,000, which at, say, a 4 percent average income yield, would provide but $2,200 per year in retirement income per household, a nice but far from adequate, increment.

Focusing on 401(k) Retirement Plans

Defined contribution pension plans, as noted above, have gradually come to dominate the private retirement savings market, and that domination seems certain to increase. Further, there is some evidence that DC plans are poised to become a growing factor in the public plan market. (The federal employees' Thrift Savings Plan, with assets of about $180 billion, has operated as a defined contribution plan since its inception in 1986.) Even as 401(k) plans have come to dominate the DC market, so mutual fund shares have come to dominate the 401(k) market. Assets

[3] I have been investing 15 percent of my annual compensation in the DC plan of the company (and its predecessor) that has employed me since July 1951, when I first entered the work force. I can therefore give my personal assurance that tax-deferred defined contribution pension plans, added to regularly, reasonably allocated among stocks and bonds, highly diversified, and managed at low cost, compounded over a long period, are capable of providing wealth accumulations that are little short of miraculous.

of mutual funds in DC plans have grown from a mere $35 billion in 1990 (9 percent of the total) to an estimated $1.8 trillion in 2008 (51 percent).

Given the plight in which our defined benefit plans find themselves, and the large (and, to some degree, unpredictable) bite that funding costs take out of corporate earnings, it is small wonder that what began as a gradual shift became a massive movement to defined contribution plans. (Think of General Motors, for example, as a huge pension plan now with perhaps $75 billion of assets—and likely even larger liabilities—surrounded by a far smaller automobile business, operated by a company with a current stock market capitalization of just $1.3 billion.)

I would argue the shift from DB plans to DC plans is not only an inevitable move, but a move in the right direction in providing worker retirement security. In this era of global competition, U.S. corporations must compete with non-U.S. corporations with far lower labor costs. So this massive transfer of the two great risks of retirement plan savings—investment risk and longevity risk—from corporate balance sheets to individual households will relieve pressure on corporate earnings, even as it will require our families to take responsibility for their own retirement savings. A further benefit is that investments in DC plans can be tailored to the specific *individual* requirements of each family—reflecting its prospective wealth, its risk tolerance, the age of its bread-winner(s), and its other assets (including Social Security). DB plans, on the other hand, are inevitably focused on the *average* demographics and salaries of the firm's work force in the aggregate.

The 401(k) plan, then, is an idea whose time has come. *That's the good news*. We're moving our retirement savings system to a new paradigm, one that will ultimately efficiently serve both our nation's employers—corporations and governments alike—and our nation's families. *Now for the bad news*: our existing DC system is failing investors. Despite its worthy objectives, the deeply flawed implementation of DC plans has subtracted—and subtracted substantially—from the inherent value of this new system. Given the responsibility to look after their own investments, participants have acted contrary to their own best interests. Let's think about what has gone wrong.[4]

A Deeply Flawed System

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[4] I recognize that the Pension Protection Act of 2006 provided important improvements to the original 401(k) paradigm, as described in Appendix A, attached.

I now present my analysis of the major flaws that continue to exist in our 401(k) system. We need radical reforms to mitigate these flaws, in order to give employees the fair shake that must be the goal if we are to serve the national public interest and the interest of investors.

* **Inadequate savings**—The modest median balances so far accumulated in 401(k) plans make their promise a mere shadow of reality. At the end of 2008, the median 401(k) balance is estimated at just $15,000 per participant. Indeed, even projecting this balance for a middle-aged employee with future growth engendered over the passage of time by assumed higher salaries and real investment returns, that figure might rise to some $300,000 at retirement age (if the assumptions are correct). While that hypothetical accumulation may look substantial, however, it would be adequate to replace less than 30 percent of pre-retirement income, a help but hardly a panacea. (The target suggested by most analysts is around 70 percent, including Social Security.)

Part of the reason for today's modest accumulations are the inadequate participant and corporate contributions made to the plans. Typically, the combined contribution comes to less than 10 percent of compensation, while most experts consider 15 percent of compensation as the appropriate target. Over a working lifetime of, say, 40 years, an average employee, contributing 15 percent of salary, receiving periodic raises, and earning a real market return of 5 percent per year, would accumulate $630,000. An employee contributing 10 percent would accumulate just $420,000. If those assumptions are realized, this would represent a handsome accumulation, but substantial obstacles—especially the flexibility given to participants to withdraw capital, as described below—are likely to preclude their achievement.

* **Excess flexibility**. 401(k) plans, designed to fund retirement income, are too often used for purposes that subtract directly from that goal. One such subtraction arises from the ability of employees to borrow from their plans, and nearly 20 percent of participants do exactly that. Even when—and if—these loans are repaid, investment returns (assuming that they are positive over time) would be reduced during the time that the loans are outstanding, a dead-weight loss in the substantial savings that might otherwise have been accumulated at retirement.

Even worse is the dead-weight loss—in this case, largely permanent—engendered when participants "cash out" their 401(k) plans when they change jobs. The evidence suggests that 60 percent of all participants in DC plans who move from one job to another cash out at least a

portion of their plan assets, using that money for purposes other than retirement savings. To understand the baneful effect of borrowings and cash-outs, just imagine in what shape our beleaguered Social Security System would find itself if the contributions of workers and their companies were reduced by borrowings and cash outs, flowing into current consumption rather than into future retirement pay. It is not a pretty picture to contemplate.

* **Inappropriate Asset Allocation**. One reason that 401(k) investors have accumulated such disappointing balances is due to unfortunate decisions in the allocation of assets between stocks and bonds.[5] While virtually all investment experts recommend a large allocation to stocks for young investors and an increasing bond allocation as participants draw closer to retirement, a large segment of 401(k) participants fails to heed that advice.

Nearly 20 percent of 401(k) investors in their 20s own zero equities in their retirement plan, holding, instead, outsized allocations of money market and stable value funds, options which are unlikely to keep pace with inflation as the years go by. On the other end of the spectrum, more than 30 percent of 401(k) investors in their 60s have more than 80 percent of their assets in equity funds. Such an aggressive allocation likely resulted in a decline of 30 percent or more in their 401(k) balances during the present bear market, imperiling their retirement funds precisely when the members of this age group are preparing to draw upon it.

Company stock is another source of unwise asset allocation decisions, as many investors fail to observe the time-honored principle of diversification. In plans in which company stock is an investment option, the average participant invests more than 20 percent of his or her account balance in company stock, an unacceptable concentration of risk.

* **Excessive Costs**. As noted earlier, excessive investment costs are the principal cause of the inadequate long-term returns earned by both stock funds and bond funds. The average equity fund carries an annual expense ratio of about 1.3 percent per year, or about 0.80 percent when weighted by fund assets. But that is only part of the cost. Mutual funds also incur substantial transaction costs, reflecting the rapid turnover of their investment portfolios. Last year, the average actively managed fund had a turnover rate of an astonishing 96 percent. Even if weighted

[5] These data are derived from a Research Perspective dated December 2008, published by the Investment Company Institute, the association that represents mutual fund management companies, collecting data, providing research, and engaging in lobbying activities.

by asset size, the turnover rate is still a shocking—if slightly *less* shocking—65 percent. Admittedly, the costs of this portfolio turnover cannot be measured with precision. But it is reasonable to assume that trading activity by funds adds costs of 0.5 percent to 1.0 percent to the expense ratio. So the all-in-costs of fund investing (*excluding* sales loads, which are generally waived for large retirement accounts) can run from, say 1.5 percent to 2.3 percent per year. (By contrast, low-cost market index funds—which I'll discuss later—have expense ratios as low as 0.10 percent, with transaction costs that are close to zero.)

In investing, costs truly matter, and they matter even more when related to real (after inflation) returns. If the future real investment return on a balanced retirement account were, say, 4 percent per year (5 percent nominal return for bonds, 8 percent for stocks, less 2.5 percent inflation), an annual cost of 2.0 percent would consume fully 50 percent of that annual return. Even worse, over an investment lifetime of, say, 50 years, those same costs would consume nearly 75 percent of the potential wealth accumulation. It is an ugly picture.

Given the centrality of low costs to the accumulation of adequate retirement savings, then, costs must be disclosed to participants. But the disclosure must include the *all-in* costs of investing, not merely the expense ratios. (I confess to being skeptical about applying cost-accounting processes to the allocation of fund expenses among investment costs, administrative costs, marketing costs, and record-keeping costs. What's important to plan participants is the amount of *total* costs incurred, not the allocation of those costs among the various functions as determined by accountants and fund managers who have vested interests in the outcome.)

* **Failure to deal with longevity risk**. Even as most 401(k) plan participants have failed to deal adequately with investment risk, so they (and their employers and the fund sponsors) have also failed to deal adequately with longevity risk. It must be obvious that at some point in an investment lifetime, most plan participants would be well-served by having at least some portion of their retirement savings provide income that they cannot outlive. But despite the fact that the 401(k) plan has now been around for three full decades, systematic approaches to annuitizing payments are rare and often too complex to implement. Further, nearly all annuities carry grossly excessive expenses, often because of high selling and marketing costs. Truly low-cost annuities remain conspicuous by their absence from DC retirement plan choices. (TIAA-CREF, operating at rock-bottom cost and providing ease and flexibility for clients using its annuity program, has done a good job in resolving both the complexity issue and the cost issue.)

The New Defined Contribution Plans

Given the widespread failures in the existing DC plan structure, and in 401(k) plans in particular, it is time for reform, reform that serves, not fund managers and our greedy financial system, but plan participants and their beneficiaries. We ought to carefully consider changes that move us to a retirement plan system that is simpler, more rational and less expensive, one that will be increasingly and inevitably focused on DC plans. Our Social Security System and, at least for a while, our state and local government systems would continue to provide the DB backup as a "safety net" for all participating U.S. citizens:

1. Simplify the DC system. Offer a single DC plan for tax-deferred retirement savings available to all of our citizens (with a maximum annual contribution limit), consolidating today's complex amalgam of traditional DC plans, IRAs, Roth IRAs, 401(k) plans, 403(b) plans, the federal Thrift Savings Plan. I envision the creation of an independent Federal Retirement Board to oversee both the employer-sponsors and the plan providers, assuring that the interests of plan participants are the first priority. This new system would remain in the private sector (as today), with asset managers and recordkeepers competing in costs and in services. (But such a board might also create a public sector DC plan for wage-earners who were unable to enter the private system or whose initial assets were too modest to be acceptable in that system.)

2. Get Real About Stock Market Return and Risk. Financial markets, it hardly need be said today, can be volatile and unpredictable. But common stocks remain a perfectly viable—and necessary—investment option for long-term retirement savings. Yet stock returns have been oversold by Wall Street's salesmen and by the mutual fund industry's giant marketing apparatus. In their own financial interests, they ignored the fact that the great bull market we enjoyed during the final 25 years of the 20th century was in large part an illusion, creating what I call "phantom returns" that would not recur. Think about it: From 1926 to 1974, the average annual real (inflation-adjusted) return on stocks was 6.1 percent. But during the following quarter-century, stock returns soared, an explosion borne, not of the return provided by corporations in the form of dividend yields and earnings growth, but of soaring price-to-earnings ratios, what I define as *speculative* return.

This higher market valuation reflected investor enthusiasm (and greed), and produced an extra speculative return of 5.7 percent annually, spread over 20 full years, an event without precedent. This speculative return almost doubled the market's *investment* return (created by dividend yields and earnings growth), bringing the market's total real return to nearly 12 percent per year. From these speculative heights, the market had little recourse but to return to normalcy, by providing far lower returns in subsequent years. And in fact, the real return on stocks since the turn of the century in 1999 has been minus 7 percent per year, composed of a negative *investment* return of -1 percent and a negative *speculative* return of another -6 percent, as price-earnings multiples retreated to (or below) historical norms.

The message here is that investors in their ignorance, and financial sector marketers with their heavy incentives to sell, well, "products," failed to make the necessary distinction between the returns earned by business (earnings and dividends) and the returns earned by, well, irrational exuberance and greed. Today, we realize that much of the value and wealth we saw reflected on our quarterly 401(k) statements was indeed *phantom wealth*. But as yesteryear's stewards of our investment management firms became modern-day salesmen of investment products, they had every incentive to disregard the fact that this wealth could not be sustained. Our marketers (and our investors) failed to recognize that only the fundamental (investment) returns apply as time goes by. As a result, we misled ourselves about the realities that lay ahead, to say nothing of the risks associated with equity investing.

3. Owning the Stock Market—and the Bond Market. Investors seem to largely ignore the close link between lower costs and higher returns—what I call (after Justice Brandeis) "The Relentless Rules of Humble Arithmetic." Plan participants and employers also ignore this essential truism: *As a group, we investors are all "indexers."* That is, all of the equity owners of U.S. stocks together own the entire U.S. stock market. So our collective gross return inevitably equals the return of the stock market itself.

And because providers of financial services are largely smart, ambitious, aggressive, innovative, entrepreneurial, and, at least to some extent, greedy, it is in their own financial interest to have plan sponsors and participants ignore that reality. Our financial system pits one investor against another, buyer vs. seller. Each time a share of stock changes hands (and today's daily volume totals some 10 billion shares), one investor is (relatively) enriched; the investor on the other side of the trade is (relatively) impoverished.

But, as noted earlier, this is no *zero-sum game*. The financial system—the traders, the brokers, the investment bankers, the money managers, the middlemen, "Wall Street," as it were—takes a cut of all this frenzied activity, leaving investors as a group inevitably playing a *loser's game*. As bets are exchanged back and forth, our attempts to beat the market, and the attempts of our institutional money managers to do so, then, enrich only the croupiers, a clear analogy to our racetracks, our gambling casinos, and our state lotteries.

So, if we want to encourage and maximize the retirement savings of our citizens, we must drive the money changers—or at least most of them—out of the temples of finance. *If we investors collectively own the markets, but individually compete to beat our fellow market participants, we lose. But if we abandon our inevitably futile attempts to obtain an edge over other market participants and all simply hold our share of the market portfolio, we win.* (Please re-read those two sentences!) Truth told, it *is* as simple as that. So our Federal Retirement Board should not only foster the use of broad-market index funds in the new DC system (and offer them in its own "fall back" system described earlier) but approve only private providers who offer their index funds at minimum costs.

4. Asset Allocation—Balancing Risk and Return. The balancing of returns and risk is the quintessential task of intelligent investing, and that task too would be the province of the Federal Retirement Board. If the wisest, most experienced minds in our investment community and our academic community believe—as they do—that the need for risk aversion increases with age; that market timing is a fool's game (and is obviously not possible for investors as a group); and that predicting stock market returns has a very high margin for error, then something akin to roughly matching the bond index fund percentage with each participant's age with the remainder committed to the stock index fund, is the strategy that most likely to serve most plan participants with the most effectiveness. Under extenuating—and very limited—circumstances participants could have the ability to opt-out of that allocation.

This allocation pattern is clearly accepted by most fund industry marketers, in the choice of the bond/stock allocations of their increasingly popular "target retirement funds." However, too many of these fund sponsors apparently have found it a competitive necessity to hold stock positions that are significantly higher than the pure age-based equivalents described earlier. I don't believe

competitive pressure should be allowed to establish the allocation standard, and would leave those decisions to the new Federal Retirement Board.

I also don't believe that past returns on stocks that include, from time to time, substantial phantom returns—borne of swings from fear to greed to hope, back and forth—are a sound basis for establishing appropriate asset allocations for plan participants. Our market strategists, in my view, too often deceive themselves by their slavish reliance on past returns, rather than focusing on what returns may lie ahead, based on the projected discounted future cash flows that, however far from certainty, represent the intrinsic values of U.S. business in the aggregate.

Once we spread the risk of investing—and eliminate the risk of picking individual stocks, of picking market sectors, of picking money managers, leaving only market risk, which cannot be avoided—to investors as a group, we've accomplished the inevitably worthwhile goal: a financial system that is based on the wisdom of long-term investing, eschewing the fallacy of the short-term speculation that is so deeply entrenched in our markets today. Such a strategy effectively *guarantees* that all DC plan participants will garner their fair share of whatever returns our stock and bond markets are generous enough to bestow on us (or, for that matter, mean-spirited enough to inflict on us). Compared to today's loser's game, that would be a signal accomplishment.

Under the present system, some of us will outlive our retirement savings and depend on our families. Others will go to their rewards with large savings barely yet tapped, benefiting their heirs. But like investment risk, longevity risk can be pooled. So as the years left to accumulate assets dwindle down, and as the years of living on the returns from those assets begin, we need to institutionalize, as it were, a planned program of conversion of our retirement plan assets into annuities. This could be a gradual process; it could be applied only to plan participants with assets above a certain level; and it could be accomplished by the availability of annuities created by private enterprise and offered at minimum cost, again with providers overseen by the proposed Federal Retirement Board (just as the federal Thrift Savings Plan has its own board and management, and operates as a private enterprise).

5. Mutuality, Investment Risk, and Longevity Risk. The pooling of the savings of retirement plan investors in this new DC environment is the *only* way to maximize the returns of these investors as a group. A widely diversified, all-market strategy, a rational (if inevitably imperfect) asset allocation, and low costs, delivered by a private system in which investors automatically and

regularly save from their own incomes, aided where possible by matching contributions of their employers, and proving an annuity-like mechanism to minimize longevity risks is the optimal system to assure maximum retirement plan security for our nation's families.

There remains the task of bypassing Wall Street's croupiers, an essential part of the necessary reform. Surely our Federal Retirement Board would want to evaluate the possible need for the providers of DC retirement plan service to be *mutual* in structure; that is, management companies that are owned by their fund shareholders, and operated on an "at-cost" basis; and annuity providers that are similarly structured. The arithmetic is there, and the sole mutual fund firm that is organized under such a mutual structure has performed with remarkable effectiveness.[6]

Of course that's my view! But this critical analysis of the structure of the mutual fund industry is not mine alone. Listen to Warren Buffett. "[Mutual fund] independent directors . . . [have] been absolutely pathetic . . . [They follow] a zombie-like process that makes a mockery of stewardship . . . '[I]independent' directors, over more than six decades, have failed miserably." Then, hear this from another investor, one who has not only produced one of the most impressive investment records of the modern era but who has an impeccable reputation for character and intellectual integrity, David F. Swensen, Chief Investment Officer of Yale University: "The fundamental market failure in the mutual fund industry involves the interaction between sophisticated, profit-seeking providers of financial services and naïve, return-seeking consumers of investment products. The drive for profits by Wall Street and the mutual fund industry overwhelms the concept of fiduciary responsibility, leading to an all too predictable outcome: . . . the powerful financial services industry exploits vulnerable individual investors . . . The ownership structure of a fund management company plays a role in determining the likelihood of investor success. Mutual fund investors face the greatest challenge with investment management companies that provide returns to public shareholders or that funnel profits to a corporate parent—situations that place the conflict between profit generation and fiduciary responsibility in high relief. When a fund's management subsidiary reports to a multi-line financial services company, the scope for abuse of investor capital broadens dramatically . . . *Investors fare best with funds managed by not-for-profit organizations*, because the management firm focuses

[6] I'm only slightly embarrassed to be referring here to Vanguard, the firm I founded 35 years ago. (My modest annual retainer is unrelated to our asset size or growth.) Even a glance at Vanguard's leadership in providing superior investment returns, in operating by far at the lowest costs in the field, in earning shareholder confidence, and in developing returns and positive cash flows into our mutual funds (even in the face of huge *outflows* from our rivals during 2008) suggests that such a structure has well-served its shareholders.

exclusively on serving investor interests. No profit motive conflicts with the manager's fiduciary responsibility. No profit margin interferes with investor returns. No outside corporate interest clashes with portfolio management choices. Not-for-profit firms place investor interests front and center . . . ultimately, a passive index fund managed by a not-for-profit investment management organization represents the combination most likely to satisfy investor aspirations."

What Would An Ideal Retirement Plan System Look Like?

It is easy to summarize the ideal system for retirement savings that I've outlined in this Statement.

1. Social Security would remain in its present form, offering basic retirement security for our citizens at minimum investment risk. (However, policymakers must promptly deal with its longer-run deficits.)

2. For those who have the financial ability to save for retirement, there would be a single DC structure, dominated by low-cost—even mutual—providers, inevitably focused on all-market index funds investing for the long term, and overseen by a newly-created Federal Retirement Board that would establish sound principles of asset allocation and diversification in order to assure appropriate investment risk for each participant.

3. Longevity risk would be mitigated by creating simple low-cost annuities as a mandatory offering in these plans, with some portion of each participant's balance going into this option upon retirement. (Participants should have the ability to opt-out of this alternative.)

4. We should extend the existing ERISA requirement that plan *sponsors* meet a standard of fiduciary duty to encompass plan *providers* as well. (In fact, I believe that a federal standard of fiduciary duty for all money managers should also be enacted.)

It may not be—indeed, it is not—a system free of flaws. But it is a radical improvement, borne of common sense and elemental arithmetic, over the present system, which is driven by the interest of Wall Street rather than Main Street. And, with the independent Federal Retirement Board, we have the means to correct flaws that may develop over time, and assure that the interests of workers and their retirement security remain paramount.