PensionConsultantsInc.

For Immediate Release
Contact:
Amber Mueller, Marketing Manager
417-889-4918
amueller@pension-consultants.com

401(k) effective and achievable method to improve employees' financial security

Authors: Brian Allen, CFP® and Jay Pinkston

(Springfield, MO, April 25, 2023) – American workers struggle to get ahead financially. It's not new. In fact, it's been this way for a long time. So long that it is now simply accepted as the way things are.

Many workers, your coworkers perhaps, are unprepared for financial shocks. If everything goes right, nothing breaks, and the children's school doesn't make a financial request, they will be fine. But, when those untimely events do show up, it unleashes panic. Likewise, their financial future is ethereal. A cloud-like dream. A constant reminder of failure.

American workers are good people. They are responsible and hard-working. They teach their kids to tell the truth and honor their commitments. They are good community members. This is why the prospect of not being able to pay their bills or save for their future is so disturbing to them.

FINANCIAL INSECURITY

Financial insecurity is hard to quantify precisely. It is commonly defined as living paycheck to paycheck, or perhaps, more technically, the anxiety produced by the possible exposure to adverse economic events.

Most of us at one time or another have lived through periods of financial insecurity. For the lucky ones, it didn't last long. It was episodic. But, for others, it is ever-present.

The link between financial insecurity and mental health is well established. As recently as February 2022, the National Institute of Health (NIH) published a study, entitled, "The Relationship Between Financial Worries and Psychological Distress Among U.S. Adults."[1]

This study examined the association between financial worries and psychological distress among US adults. Data were derived from the cross-sectional 2018 National Health Interview Survey (NHIS) of the adult population. The hierarchical regression analysis revealed that higher financial worries were significantly associated with higher psychological distress.

The study concluded, "*Our hypothesis that financial worries are positively and significantly associated with psychological distress was supported across all models*."

We will attempt to document the link between financial insecurity and worker productivity. We will also argue that the 401(k) plan is an effective, and importantly, achievable method to improve financial security. As a result, we hope to link improved 401(k) terms and management with improved financial security, and therefore, improved worker productivity.

FINANCIAL INSECURITY AFFECTS WORKER PRODUCTIVITY

Research shows a certain amount of financial stress can be helpful. It can motivate us to make good decisions, such as preparing and following a budget, keeping debt to a minimum, and working hard to

[1] Ryu, S., & Fan, L. (2022), "The Relationship Between Financial Worries and Psychological Distress Among U.S. Adults." Journal of Family and Economic Issues, 44(1), 16–33. https://doi.org/10.1007/s10834-022-09820-9

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earn higher wages. That is not the kind of stress we are discussing here. We are talking about the corrosive, and common, form of stress that comes from financial insecurity causing ongoing and destructive psychological distress, like that found in the NHIS study above.

Everyone has financial struggles and worries that we fight hard to overcome. However, the impact of the never-ending financial stress that we're discussing here may seem far-fetched and uncommon to some. It is not. As we will uncover, financial security-related stress makes it difficult, if not impossible, to properly perform in many areas of our lives, much less enjoy them. If you look at any survey that focuses on stress or well-being, you will see how pervasive this issue is.

Salary Finance, a company that works with employers to offer financial services such as low-interest loans, savings accounts, and education to employees, releases an annual report called "Inside the Wallets of Working Americans." The report is based on surveys of employees from companies with at least 500 employees. Their 2022 survey of 3,001 American workers shows that money is the number one source of stress in America and that 45% of workers are experiencing financial stress.[2]

It is easy to assume that this issue could be solved by employers paying their workers more, but the 2020 survey from Salary Finance of 2,729 workers shows that financial insecurity is not only pervasive, but it also does not discriminate based on income. The 2020 report finds that while financial stress is most common among people with less than $25k in annual income, it is second most common in people with annual incomes between $130k-$160k. There weren't any outliers in the findings, as financial stress has a relatively even split among all income brackets.[3]

A 2021 report by Graystone Consulting from Morgan Stanley reviewing studies from the previous two years shows that 52% of people with incomes above $100k report feeling stressed by finances.[4] This makes sense, as nearly a third of people with income exceeding $100k regularly run out of money between paychecks.[3] The survey also asked about levels of stress in other areas. It was found that stress levels relating to career, relationships, and physical health are all substantially higher among workers with income greater than $100k.[3] While stress in other areas may vary based on income, money itself is still the greatest source of stress regardless of what is on your pay stub. More income doesn't solve the problem.

These findings are not isolated. Other studies and surveys find financial stress is even more common. A 2018 survey conducted by FINRA found that among working-age people, 60% say that thinking about their finances makes them anxious.[5] In PricewaterhouseCoopers 2022 annual employee wellness survey of more than 3,000 workers, 56% said they were stressed about finances.[6] These figures become easier to believe as a 2018 study by the U.S. Chamber of Commerce found that 1 in 4 workers have a combined household savings of less than $1,000.[7]

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[2] "Salary Finance's 4th Annual Report, Salary Finance Inc, 2022."

[3] "Salary Finance's 2nd Annual Report, Salary Finance Inc, 2020."

[4] Graystone Consulting from Morgan Stanley, "The Real Costs of Employee Financial Stress–and How Employers Can Help", Morgan Stanley. 2021, https://graystone.morganstanley.com/graystone-consulting-the-robertson-group/articles/graystone/thought-leadership/financially-stressed-employees. Accessed April 4 2023.

[5] Andrea Hasler, et al., "Financial Anxiety and Stress Among U.S. Households: New Evidence from the National Financial Capability Study and Focus Groups." FINRA. April 2021, https://gflec.org/wp-content/uploads/2021/04/Anxiety-and-Stress-Report-GFLEC-FINRA-FINAL.pdf?x85507. Accessed April 4 2023.

[6] PricewaterhouseCoopers, "2022 PwC Employee Financial Wellness Survey," https://www.pwc.com/us/en/services/consulting/business-transformation/library/employee-financial-wellness-survey.html. Accessed April 4 2023

[7] Sara Zellner, Ph.D., "Financial Wellness in the Workplace: The Business Imperative," U.S. Chamber of Commerce Foundation, December 2018, https://www.uschamberfoundation.org/reports/financial-wellness-workplace-business-imperative. Accessed April 4 2023

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FINANCIAL INSECURITY IMPACTS DAILY LIFE

Financial insecurity is stressful. Really stressful. Continuing the PwC survey, workers were asked how financial stress impacts them. 34% of respondents said their mental health was impacted, 33% struggled with sleeping, and another 23% said it has affected their physical health. When narrowed down to focus on respondents that said they are stressed about money, nearly half said it has had a "severe" impact on their mental health.[8]

Salary Finance backs up these findings in their report. They report that sleepless nights are eleven times more likely among those who feel financially insecure, and depression is seven times more likely.[9] Financial insecurity is so stressful that it makes those who experience it six times more likely to have panic attacks. Among those who feel financially insecure, 83% experience anxiety, and 56% experience depression.[10]

STRESS CREATED BY FINANCIAL INSECURITY IS INEVITABLY BROUGHT INTO THE WORKPLACE THROUGH ABSENTEEISM, PRESENTEEISM, AND TURNOVER

If financial insecurity is causing sleepless nights and depression, it is inescapable that it will be brought into the workplace. Simple logic allows us to conclude that financial stress cannot be checked at the door upon arriving at work. In their report, PricewaterhouseCoopers states that when financial stress is having a major impact on mental health, employees are seven times more likely to say attendance at work is impacted. [8]

Lost days are bad enough, but it will impact workers' productivity beyond missing days. 55% of employees struggling with financial stress admit to spending 3 or more working hours per week, or 156 hours per year, attending to financial issues according to PwC's survey.[8] When accounting for the national average hourly wage of $28.07 in December 2022[11], we see that employers are paying financially stressed employees $4,300 per year on average to attend to personal financial matters.

According to Salary Finance, the issue is even worse for employers. Their study finds that financially stressed employees spend closer to 5 hours per week dealing with financial matters. This comes to 30 lost workdays per year. Additionally, stressed employees are ten times more likely to not complete daily tasks at work. They are also nine times more likely to have troubled relationships with coworkers, which can of course lead to other issues at work. Ultimately, Salary Finance concludes that between dealing with finances or the inability to concentrate, ***financially insecure employees lose 29-39 productive days per year, and employers waste an estimated 13%-18% of salary costs due to this widespread issue.***[9]

In addition to absenteeism and lost productivity, another inescapable way financial insecurity impacts the workplace is through employee turnover. Only 53% of financially stressed workers say they are happy at work, compared to 77% who are not worried about money. Financially stressed workers are also three times as likely to be seeking alternative employment.[10]

It is not a stretch to say that financial insecurity is simply wreaking havoc on American workers. They are depressed, distracted, anxious, and feeling hopeless.

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[8] PricewaterhouseCoopers, "2022 PwC Employee Financial Wellness Survey"

[9] "Salary Finance's 2nd Annual Report, Salary Finance Inc, 2020."

[10] "Salary Finance's 4th Annual Report, Salary Finance Inc, 2022."

[11] Trading Economics, "United States Average Hourly Wages", https://tradingeconomics.com/united-states/wages. Accessed January 25 2023.

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401(K) PLANS ARE UNIQUELY POSITIONED TO IMPROVE FINANCIAL SECURITY

There are two underlying components of financial insecurity: an inability to withstand financial shocks, and hopelessness for the financial future. Both are rooted in a lack of savings.

Of course, saving is easier said than done, especially when living paycheck to paycheck. One powerful obstacle to saving, however, is behavioral. It is an inability to prioritize future needs and wants over today's needs and wants. In other words, inability to delay gratification. This is not a condemnation of people who struggle to plan for the future, but a recognition of a natural human condition.

This condition has been understood in the field of psychology for many years. In the famous "Marshmallow Experiment" from 1972, researchers from Stanford wanted to test the ability of children to delay gratification. They brought each child into a private room and offered them a marshmallow.[12] They told them they could have the marshmallow now, or if they could wait, they would be given two marshmallows. The researcher then left the room and observed the children. Some children ate the marshmallow immediately and others waited and received the extra marshmallow. The kids that were able to wait to eat the marshmallow distracted themselves to do so, some sang songs, bounced in their chairs, or took a nap. The successful children avoided eating the marshmallow by not thinking about it. It wasn't necessarily a stronger sense of discipline, but it was an ability to put it in the back of their mind and think about other things. The researchers conducted follow-up studies throughout the decades that followed and found a strong correlation between the ability to delay gratification and better life outcomes, including a 1990 follow-up study that found the children that waited for the second marshmallow ended up with higher average SAT scores.[13]

For many among us, instant gratification overwhelms future wants and needs. So, how can we help people overcome such a powerful natural behavior and save for the future?

By withholding savings before it is available to be spent. For workers, this describes payroll deduction, and the 401(k) is built on this concept. The 401(k), therefore, is uniquely suited to help many workers overcome their behavioral tendencies to spend instead of save.

In the Stanford study, those that waited for the second marshmallow were able to do so by keeping the treat out of their mind. The 401(k) paycheck deductions similarly allow saving to happen in the background, out of sight, and therefore, out of mind. The kid in us won't "eat the marshmallow" if we don't have to think about it every day.

401(K) PLANS NEED TO BE PROPERLY EQUIPPED TO OVERCOME FINANCIAL INSECURITY

To maximize the impact the 401(k) can have on the lives of its participants, it will need to be equipped to address both the short-term emergency savings needs and long-term retirement savings. We have stated that payroll deductions are a magic bullet to keep people saving, but before people can *keep* saving, they need to *start* saving. In this regard, the 401(k) has already made substantial progress.

The use of automatic enrollment has been steadily rising over the years. The Plan Sponsor Council of

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[12] Mischel W, Ebbesen EB, Zeiss AR. "Cognitive and Attentional Mechanisms in Delay of Gratification". J Pers Soc Psychol." 1972 Feb;21(2):204-18. doi: 10.1037/h0032198. PMID: 5010404. https://depts.washington.edu/shodalab/wordpress/wp-content/uploads/2015/05/1990.PredictingAdolescent_Shoda.pdf

[13] Shoda, Y., Mischel, W., & Peake, P. K. (1990). Predicting Adolescent Cognitive and Self-Regulatory Competencies from Preschool Delay of Gratification: Identifying Diagnostic Conditions." Developmental Psychology, 26(6), 978–986. http://home.cerge-ei.cz/lanchava/Literature_part1/5.%20Time%20Preferences/marshmallow.pdf

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America (PSCA) highlights this in their 64th annual survey of more than 500 plan sponsors.[14] According to the PSCA report, 62% of plans used automatic enrollment in 2020,[15] compared to 46% who used it in 2011.[16]

Automatic enrollment is proving quite effective at increasing participation. In the "How America Saves 2022" report from Vanguard, which draws from 1,700 plans and nearly 5 million participants, we find the impact of automatic enrollment is profound among workers earning under $30k. According to the report, only 37% of workers earning between $15k and $29.9k participate in retirement plans with voluntary enrollment. When the plan has automatic enrollment, that number jumps to 86%. Replacing the opt-in feature with an opt-out feature (i.e., automatic enrollment) doesn't just help low-wage workers either. While the impact may be smaller among higher earners, it still increases plan participation in every income bracket.[17]

While automatic enrollment features are getting workers to participate in their 401(k), improvements are still needed to reach our goal of dramatically reducing financial insecurity.

Too many plans that utilize auto-enrollment features use a low initial default deferral rate. Many at three percent or less. To adequately prepare for the future, plans should use a default deferral of at least five percent and auto-escalate annually by one percent until reaching a deferral rate of fifteen percent. If plans did this, by and large, we could begin to feel confident that most workers would be prepared for their future financial needs.

However, there is one more glaring weakness in the structure of 401(k) plans that must be addressed before the hopelessness of the future component of financial insecurity is adequately remedied. That is the cashing out of savings when changing jobs.

- **Reduce the rate at which workers cash out their retirement savings upon leaving employment.**
  Under the current 401(k) regime, every time someone changes employers, the money saved by payroll deductions, and therefore, built up out of sight, comes back in full view, tempting the worker. To reference the Stanford Marshmallow experiment once again, it's like reminding the child that a yummy marshmallow is on the table in case they'd like to eat it.

  According to the Bureau of Labor Statistics, the median job tenure for American workers in 2022 was 4.1 years.[18] That means that a typical worker is confronted with the choice to continue to save for the future or cash out and use the money for something they want or need now every four years.

  Upon termination from their old job, the current system asks the plan participant to sign a form indicating their choice.

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16 "PSCA's Annual Survey Shows Company Contributions are Bouncing Back", BusinessWire, March 7, 2023. https://www.businesswire.com/news/home/20121011005105/en/PSCA%E2%80%99s-Annual-Survey-Shows-Company-Contributions-are-Bouncing-Back".

17 "How America Saves 2022", Vanguard, June 2022. https://institutional.vanguard.com/content/dam/inst/vanguard-has/insights-pdfs/22_TL_HAS_FullReport_2022.pdf.

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417-889-4918
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For anyone who struggles with prioritizing future needs above current needs, asking them to decide each time they change jobs whether they want to rollover their savings or cash it out, is doomed for failure.

A recent Harvard Business Review study of over 162,000 exiting employees between 2014-2016 found that 41.4% of employees liquidated a portion of their retirement plan upon leaving. Equally unsettling was that 35.19% of employees cashed out their entire balance.[19]

These so-called, voluntary cash-outs must be dramatically reduced to get the typical American worker to have hope for their financial future. One way to do that would be to change the law requiring negative elections for cash-outs.

Negative elections are the same approach used in the automatic enrollment of plan participants. It simply means that a choice will be made unless a person proactively makes another choice. In the case of automatic enrollment, the participant is enrolled at a certain level unless they proactively make another choice.

In the case of changing jobs, the default choice, or negative election, would be to roll the 401(k) over. A cash-out is still available, but only if the employee proactively makes the choice.
The Portability Services Network (PSN) is one potential solution. In the fall of 2022, Retirement Clearinghouse announced the creation of the PSN, a digital hub connecting record keepers and plan sponsors to reduce cash-outs by introducing auto portability for employees leaving with a balance under $5,000. PSN will act as a clearinghouse for automatically locating a participant's active workplace retirement account in their current employer's plan and transferring the same participant's account from their prior employer's plan into their active account.

Despite just becoming operational in Q1 2023, the PSN already covers 44 million workers as there is a consortium of record keepers involved, including Alight, Empower, Fidelity, and Vanguard. If a plan sponsor uses a record keeper in the PSN, they can adopt the auto portability provision. Just like automatic enrollment creates a new default and changes the way participants think about saving, PSN aims to create a new default to help participants keep the money they save.

There is a lot of hope for the impact PSN may have, but it is still new and only covers employees with a balance of less than $5,000. It is not a cure-all. Employees in plans not covered by PSN, and employees with balances of $5,000 or greater will need attention.

The other major contributor to this issue is the mandatory distribution provision common in many employer-sponsored plans. Typically, when an employee with less than $5,000 in the retirement plan terminates employment, their balance is forced out of the plan.

The factors contributing to the high retirement leakage rate have solutions within reach. These items are largely evolutionary as elements of them are already being used in many plans.

- **Adopt the SECURE 2.0 Act provision allowing for the 401(k) to double as emergency savings.**
  The inability to withstand financial shocks comes from a lack of emergency savings which historically are accumulated in an account outside of work. This means they haven't been able to benefit from the 401(k)'s payroll deduction feature and are instead an individual responsibility of

[19] Lynch, John G., Yanween Wang, and Muxin Zhai, "Too Many Employees Cash Out Their 401(k)s When Leaving a Job", Harvard Business Review, March 7, 2023. https://hbr.org/2023/03/too-many-employees-cash-out-their-401ks-when-leaving-a-job?ab=hero-subleft-2.

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the worker. This can explain a 2021 survey result from Bankrate finding that more than 60% of Americans cannot cover an unexpected $1,000 expense.[20] Emergency savings is a vital component of reducing financial stress. When people have a funded emergency savings account, the thought of a financial shock, like a broken water heater, no longer creates the feeling of doom.

Thanks to recent legislation, the 401(k) can now address the inability to withstand financial shocks. Beginning in 2024, the *Setting Every Community Up for Retirement Enhancement Act (SECURE) 2.0 Act* allows the 401(k) plan to also act as an emergency savings vehicle for up to $2,500.[21] As it is written, retirement plan sponsors can create a "sidecar" account tied to a participant's retirement account. The magic bullet of payroll deductions can now be used for both major sources of financial insecurity. Having an emergency savings account funded by payroll deductions can go a long way in reducing this stress. Payroll deductions happening in the background will keep workers saving.

Importantly, the legislation allows employers to automatically enroll participants into the sidecar account at rates up to 3%. To make it easier for employees to get started, employers can consider reducing the traditional 401(k) automatic enrollment by 3% upon the introduction of the emergency savings feature. After the employee's principal balance in the sidecar emergency savings account reaches $2,500, the law allows the additional contributions to be directed to the retirement plan.

CONCLUSION

American workers are struggling. They are dealing with significant daily stress about their finances, and they're constantly worried a big expense will arise that they are not prepared for. They are feeling hopeless about their financial future. This stress is impacting their daily lives. They are distracted at work, lose sleep, and feel depressed.

This doesn't have to be the case. 401(k) plans are uniquely positioned to help workers improve their feeling of financial security.

Getting employees to save properly through automatic enrollment and escalation features will increase their confidence in the future. Helping them whenever they leave employment by reducing the amount of leakage from the plan through auto portability will help keep their savings intact. Finally, the emergency savings feature created in SECURE 2.0 will provide the financial liquidity to handle financial shocks, greatly reducing stress in the process.

While the 401(k), or similar workplace retirement plan, may not be able to solve every financial problem workers face, it is an extraordinarily powerful tool. And it is, without question, the <u>best</u> way for employers to help their workers reduce their financial stress and as a result, improve work productivity.

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[20] "Less than 4-in-10 Could Pay an Unexpected $1,000 Expense Out of Savings", Bankrate, January 11, 2021. https://www.bankrate.com/pdfs/pr/20210111-january-fsp.pdf.

[21] "SECURE 2.0 Act of 2022," U.S. Congress, December 29, 2022. https://www.finance.senate.gov/imo/media/doc/Secure%202.0_Section%20by%20Section%20Summary%2012-19-22%20FINAL.pdf

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Through our purpose to improve the financial security of American workers, PCI abides by our two core values to serve our clients. Doing it right means we have fanatical attention to detail, take responsibility, and get better in all we do. Doing the right thing means complete transparency and never holding money above integrity.

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