The impact of small amount cash-outs on retirement income

alight

The current state of small cash-outs

Many of you may be familiar with the butterfly effect — the notion that small initial changes, like a butterfly flapping its wings, can create results that may majorly impact a later state or time. The term has been traced back to a short story where the main character travels back in time and steps on a butterfly, which, in turn, has a major ripple effect on the events thereafter. As the main character realizes he cannot alter his course of action, the story conveys two valuable lessons: little things may have great consequences and mistakes often cannot be undone.

These principles can also apply to saving for retirement. Due to the power of compound interest, seemingly small amounts that leak from accounts when people change jobs can cause major erosion to retirement nest-eggs down the line. Fortunately, new andinnovative ideas, such as auto portability, can help curb this leakage and preserve retirement assets.

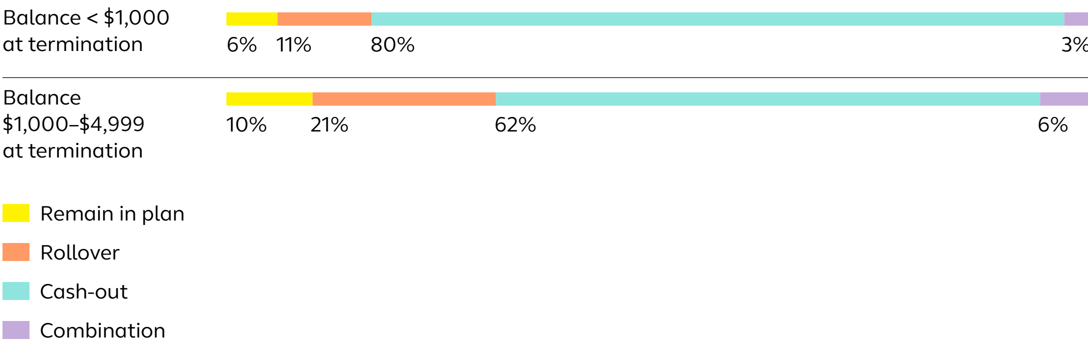
This paper seeks to examine what people do with their 401(k) balances when they leave an employer and looks at the demographics of people who roll in balances to their new employers. We specifically highlight the behavior of those with small balances as people are much more likely to change jobs when they are younger[1] and have little saved for retirement.

Most people with small retirement accounts cash out their balances when they change jobs

According to previous research at Alight, four out of every 10 people cashed out their balances after termination within a ten-year period.[2] Perhaps not surprisingly, the group most likely to cash out are those with the smallest balances — 80% of people who had an account of less than $1,000 cashed out. Among people with balances between $1,000 and $5,000, nearly two-thirds cashed out.

Post-termination behavior

by balance size among individuals who terminated between 2008-2017[3]



[1] See, for example, Bureau of Labor Statistics, Number of Jobs, Labor Market Experience, and Earnings Growth: Results from a National Longitudinal Survey, which shows that individuals held an average of 12.3 jobs with almost half of them coming before age 24.

[2] Alight Solutions, Distributions from Defined Contribution Plans

[3] Alight Solutions, Distributions from Defined Contribution Plans

Rollovers rarely go to employer plans

Although we included both plan-to-plan rollovers and IRA rollovers in the "rollover" category, the amounts are hardly equal. Overall, the dollars rolled into IRAs outnumber those going into new employer plans by a factor of roughly 10-to-1. Among people with balances less than $1,000 at termination, 1.7% rolled money into their new employer's plan, and among those with balances between $1,000 and $4,999, 3.9% had a plan-to-plan rollover.[4]

Examining 2.5 million actively employed participants on our recordkeeping platform, we find that 7% have money in their account that was rolled in from a prior employer's plan.[5] Most roll-in transactions take place among new hires. Of the participants hired in 2019, 3.6% rolled in money by year-end. In addition to tenure, age has an impact on roll-in behavior. Workers in their 20s are least likely to roll in money, followed closely by those who are in their 60s. Workers in their 30s were most likely to roll in balances.

Percentage of participants rolling in balances in 2019
by age and tenure

	Under 30	30-39	40-49	50-59	60+
2019	2.4%	4.7%	4.3%	4.0%	2.6%
2018	1.1%	2.5%	2.3%	2.1%	1.3%
2017 and prior	0.3%	0.5%	0.4%	0.4%	0.3%

Income is also correlated with roll-ins. People with higher compensation were much more likely to roll-in balances. New hires making at least $80,000 were more than 8 times more likely to roll-in balances than new hires making less than $40,000.

Percentage of participants rolling in balances in 2019
by pay and tenure

	< $40K	$40-59K	$60-79K	$80-99K	$100K
2019	1.0%	3.4%	5.8%	8.3%	8.3%
2018	0.7%	1.6%	2.9%	3.3%	4.0%
2017 and prior	0.2%	0.3%	0.5%	0.7%	0.7%

[4] Among those who terminated employment between 2008-2017. Source: Alight record keeping data.
[5] As of January 1, 2020.

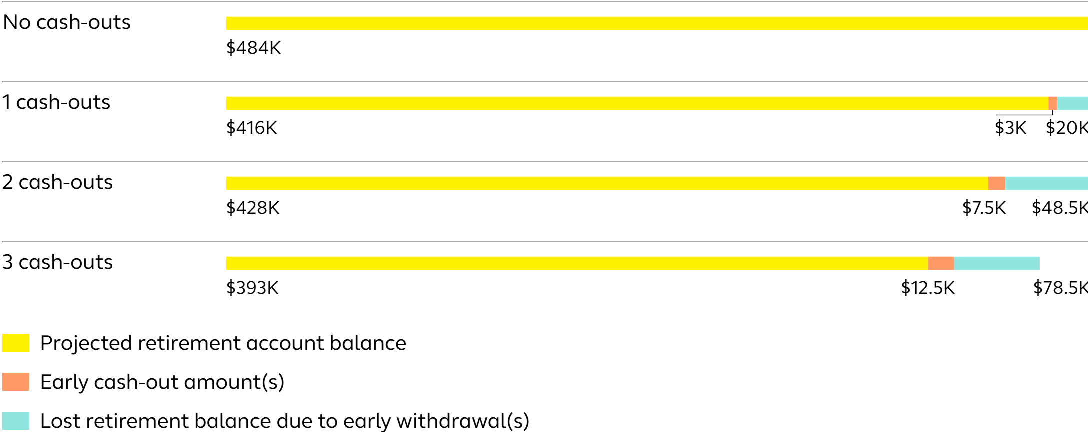
Small cash-outs now can translate to large losses in future income

Data shows that young people with small balances are least likely to roll over retirement accounts and most likely to cash out their retirement accounts when changing jobs. To illustrate the impact these cash-outs can have on future retirement income, we projected the retirement accounts for a new-to-the-workforce employee.[6]

Consistent savings throughout the working career can produce a sizeable retirement account. In fact, if we assume no leakage, the projected balance at age 67 can be almost $500,000. Simply taking one early cash-out can have damaging consequences, while taking three small post-termination cash-outs can lead to a nearly 20% reduction in a projected age 67 balance.

One cash-out at age 24 of $3,000 leads to:	a **$23,000 (5%) loss** in projected age 67 balance (roughly half a year of additional working wages)
An additional cash-out at age 26 of $4,500 leads to:	a **$56,000 (12%) overall loss** in projected age 67 balance (roughly 1 year of additional working wages)
A third cash-out at age 28 of $5,000 leads to:	a **$91,000 (19%) overall loss** in projected age 67 balance (roughly 1.5 years of additional working wages)

Impact of cash-outs on projected retirement accounts



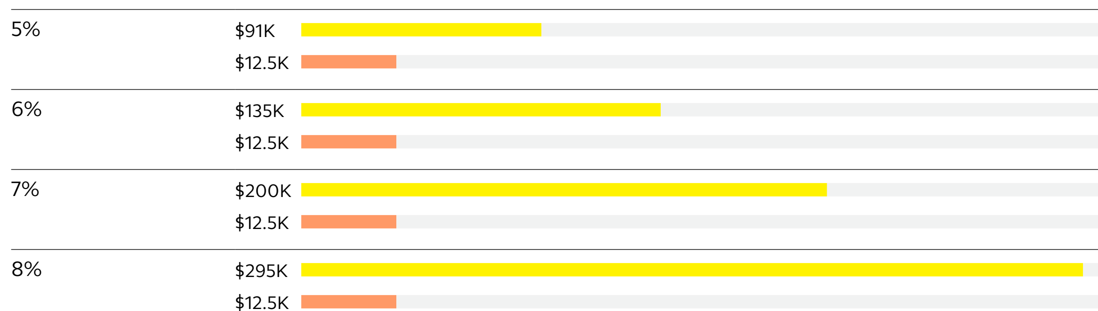
[6] For purposes of these projections, we assumed that a 22-year-old starts saving at 3% and escalates 1% each year to 6%. The plan matches 50 cents-per-dollar on the employee contributions. Contributions are made throughout the year. Interest was assumed to be 5% per year. The individual's initial compensation was $25,000 and grew by 2% each year. Retirement was assumed to be at age 67. Unless otherwise stated, no other leakage occurred from the account.

Small cash-outs now can translate to large losses in future income

As disheartening as these numbers are, they may paint an overly optimistic picture of the situation for at least two reasons:

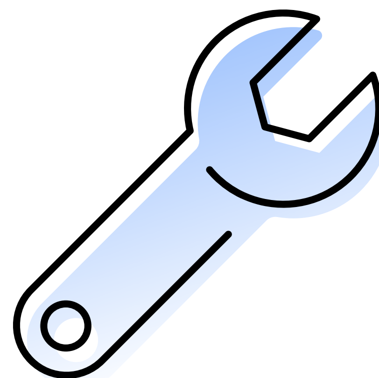
1. First, these projections assumed a modest net-of-fees return of 5% per year. Alight's 2020 Universe Benchmarks shows that for the decade of the 2010s, the median return earned by participants was almost twice that. Higher returns would make the impact of the early cash-outs even more profound. For example, if we assumed the person earned 7% each year, the impact of the three cash-outs would be almost $200,000; a 25% reduction in projected retirement income.
2. Second, the amounts shown for the cash-outs do not reflect the impact of any taxes or withholding. Generally speaking, taxes on 401(k) balances are treated as income and would incur federal and state taxes. Most of the time, people who take money out pre-retirement are also charged a 10% penalty tax. So, if anything, the amounts shown for the cash-outs in the projection can be viewed as an overstatement of the money the person would receive.

Cash-out impact by annual interest earned



New tools may help reduce this leakage

One reason for the high prevalence of small amount cash-outs is the fact that most plans will automatically cash out terminated employees with vested balances under $1,000.[7] In other words, if people with a few hundred dollars in their account do nothing, they will be paid their balances and will no longer participate in the plan. About 60% of companies will also force out participants with balances between $1,000 and $5,000, but legal rules require the amounts to be distributed to IRAs instead of cash to the individual.[8]



Fortunately, there are emerging tools that can make it just as easy for participants to have their retirement accounts follow them from employer to employer. Retirement Clearinghouse (RCH) offers a solution called RCH Auto Portability. Auto portability is the routine, automated transfer of small accounts from a former employer's plan to a current employer's plan. This creates a new default option for employees to provide an easy path to keep assets earmarked for retirement. This also benefits plan sponsors as auto portability will help reduce uncashed checks and missing participants while ultimately driving higher account balance averages. Alight Solutions is pleased to be an early adopter of RCH Auto Portability, and it is our hope that this feature will be likethe proverbial flapping of the butterfly's wings — a small, almost unnoticeable item that can have major implications for the future.

[7] Alight Solutions 2019 Trends & Experience in Defined Contribution Plans report that shows 96% of plans will force out former employees with vested balances of less than $1,000.
[8] Alight Solutions, 2019 Trends & Experience in Defined Contributions Plans

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