

ABSTRACT

We investigate the effects of different equity exposures of the default fund in a defined contribution pension plan with universal coverage. Using Swedish individual-level data on financial portfolios inside and outside the pension system, we document a strong relation between default investing in the pension system and limited stock market participation outside the pension system. Motivated by this finding, we build a life-cycle portfolio choice model to investigate the effect on default investors' welfare of different designs of the default fund. We find that leverage (i.e., an equity share above 100 percent) is warranted in the sense of expected utility. The expected gain in consumption of moving from 100 to 150 percent is in the order of four percentage points during every year in retirement. The loss of a shift from 100 to 50 percent is of the same order. We also explore the implications from the introduction of a universal pension fund (i.e., abolishing individual choice of equity exposure in the pension plan). Current active investors either gain or lose from such a reform, depending on the equity exposure of the universal fund. In expectation, active investors gain more from leverage than default investors. On the contrary, if the equity exposure of the universal fund is below 100 percent, active investors do not lose as much as default investors. We attribute this effect to active investors' greater ability to use their savings outside the pension system to compensate for the equity exposure inside the pension system.