The crisis in retirement planning

Angela Ashton | PortfolioConstruction Forum | 03 September 2014

"The crisis in retirement planning" by Robert C. Merton, *Harvard Business Review*, July-August 2014

Robert Merton, 1997 Nobel Prize winner, MIT Professor of Finance, Professor emeritus at Harvard University and "resident scientist" at Dimensional Fund Advisors (DFA), has recently penned an article about his views on retirement planning in the US. Although some of his comments are US-centric, there are some interesting take aways for Australian practitioners.

Throughout all developed countries, we've seen a movement from the old Defined Benefit (DB) world to a Defined Contribution (DC) world. In fact, Australia has the highest rate of DC penetration of any country globally.

The beauty of DB funds - for investors - is that they provided security of income throughout retirement at a very reasonable level, often 70% or 75% of final salary. In that paradigm, people didn't need to think about the lump sums accrued. They only thought about retirement income needs.

The move to a DC world transferred investment risk from the pension provider to the individual, in the process forcing individuals to be far more responsible for difficult financial decisions that will affect their retirement. As financial advisers know, most people are not sufficiently informed to make those decisions. A DC world has also changed investor's focus from their retirement income stream to the value of a lump sum, returns and investment volatility. That is, it moved the focus from monthly income to net worth and annual investment returns.

In his paper, Merton argues that this change in focus is flawed. Valuing all assets at market can provide a skewed picture as to their ability to generate income. Take, for example, an annuity. It looks a little like a very long dated bond, but with no capital repayment (think of the payments as being part income, part capital return, if you wish). The income stream is steady, but if it were valued constantly, you would find the capital value could be very volatile because it is valued using current interest rates. Because it is so long dated, it would be very sensitive to even small changes in interest rates. An investor judging his/her retirement benefits based on the lump sum value of the annuity would be given a very different message to an investor thinking about the income they would receive in retirement from the annuity.

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In contrast, in the DC world, US Treasury bills (or cash, here in Australia) are considered the risk free asset. However, in terms of income for retirement, the income derived from this asset class can be very volatile, depending on interest rates.

So what should be done?

Merton suggests that the changes required are not necessarily huge. Practitioners should still use a mix of risky and non-risky assets to meet client objectives, he argues - but, risk should be defined as the ability to meet the income objective and the risk free asset should be something that resembles an inflation-indexed deferred annuity. Of course, these don't exist in Australia - but that's ok, because Merton argues that you don't need to buy one anyway, you just need to accumulate the amount needed to do so. (To my mind, this raises the original issue - the amount needed to buy this type of asset will change with interest rates. But I am happy to concede that Merton has a Nobel Prize and I don't, so I may have missed something.) You can then effectively replicate the annuity by buying a "ladder" of bond-like securities with no coupons, due to mature throughout retirement. Again, no products like this exist in Australia. The closest thing that comes to mind are Endowment Bonds, but they have the downside of having income inferred each year, so there is a tax expense.

Another important issue is that of investor engagement in retirement planning (or superannuation). Currently, investors are asked to specify a level of risk and/or a lump sum amount required for retirement. But most investors don't understand or know what they need. So they end up in default options, or balanced funds.

Merton believes education is good, but the intricacies of what is really required for investors to make truly informed decisions is difficult to teach. It requires a lot of time and an expectation that people can become fairly expert. In some cases, this may be an unfair expectation. Merton draws the analogy of asking people technical details about the car they want. Most people have no idea. But car makers have found a way to communicate to buyers that turns technical details into customer benefits. This makes a lot more sense to people.

Further, Merton argues that it may not be ideal for all investors to become highly engaged. For example, the annual DALBAR studies show us that "engaged" investors systematically underperform managed funds.

Merton outlines the following approach to retirement planning as a result:

- The first question that should be asked of the investor is how much income is needed in retirement (in my mind, this could be a loaded question- it is likely investors will anchor off current salaries. I guess that may be a lesser evil than using the lump sum approach, in Merton's view at least).
- From that point, most practitioners can do most of the calculations for what is required to meet those goals, within some type of probability (I'm assuming this could be done for a range of portfolio risk levels). In this circumstance, investors

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need to worry about three things in ensuring they meet their retirement goals - how much they need to contribute to their superannuation or retirement funds, how long they wish to work, and how much income they require in retirement. If the probability of reaching the retirement income goal is not sufficient in the mind of the investor, they can work out which lever they want to tweak - work longer, contribute more or lower their income goal.

- The portfolio during retirement can be set up in the following way:
  Firstly, a minimum guaranteed income should be set. For this part of the retirement income stream, a very safe investment should be used, such as a highly rated inflation linked annuity. This has the disadvantage of not being flexible, but does provide basic income throughout the investor's life (some would argue Australia's pension system takes this role, but I think it pays to be cautious about expecting this to be available in the same way it is now, in 20 or 30 years)
  Then, a second income stream, probably invested in a safe asset, such as a bond ladder, is designed to provide a conservative, flexible income stream. This can be cashed out in the case of emergency.
  Lastly, any desired additional income can be funded through more risky investments.

Although we may or may not agree with Merton's prescription, I think the magnitude of the change in mind-set that is required in the DC world has been underestimated. It is true that a large proportion of people struggle with the concepts they need to navigate a DC world. Methods that can be used to overcome this very important issue should be discussed and debated, for the good of all investors. To my mind, Merton's paper adds some interesting grist to that mill.

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