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Challenging Old Paradigms—What Are You Going to Do?

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The Long-Term Financial Planning Summit: Challenging Old Paradigms was held on March 25, 2012, the day before the SOA Investment Actuary Symposium. The summit was initiated by the SOA Investment Section in collaboration with the Forecasting and Futurism, Social Insurance & Public Finance, Long Term Care Insurance, and Pension Sections. Though sponsored by the Society of Actuaries, this "think tank" was attended by many non-actuaries including economists, academics and members of PRMIA (Professional Risk Managers' International Association) and the CFA (Chartered Financial Analyst) Institute.

The intent of the summit was to serve as an initial step in addressing issues related to long-term expectations. To put the "issues" in context, the following is extracted from the introduction of the summit materials:

> *For several decades, expected returns have served as the crux of "long-term" financial planning for individuals, pensions, and many social programs. Unfortunately, after a decade of sub-par returns, it is evident there are shortcomings to this approach. Equity returns were essentially flat in the 2000's, yet annual expected returns for the asset class commonly hovered around 10%. What other key assumption has been off by more than 15,000 bps within a decade?*
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> *Historical returns often serve as the foundation for establishing future return expectations. However, it's debatable whether historical returns are even relevant. We live in a complex global economy. Technological advances can change our perception of reality in an instant and can drive not only how global wealth is allocated among and within countries, but also how the global population is distributed. We are arguably reaching a point where the world is reaching peak natural resources as it relates to population growth, food, water, and energy. Debt historically was used to generate funding of opportunities to produce growth in these natural resources. A portion of the results of expected economic growth were then used to repay the debt, as it were. Can this paradigm work today and into the future? Even more, economic cycles are driven by demographics and technological advances yet, at the same time, are one of the largest drivers of how both factors evolve. Improving our understanding of these relationships, and recognizing the weaknesses of traditional expected return methodologies, should lead to more realistic expectations and to more sustainable social policies.*

Clearly the task of addressing the above is daunting.

During the day the issues were approached from multiple angles. Methodologies used in interpreting historical returns were discussed, both common practice and pitfalls (which are often the same!). Key factors were analyzed, including demographic trends, government/entitlement programs, technology, and geopolitical considerations. Methods to define return expectations absent historical information were reviewed. Finally, there was significant discussion (and debate) around what a "sustainable" system would encompass, including consideration of social programs, tax incentives to savings, mandated savings/benefits, etc.

While many of the topics discussed apply generally, the main focus of the day revolved around pension plans and their funding levels. Numerous observations were shared such as the impact of substitution of DC for DB plans (transferring risk to the plan participants), and substitution of cash balance plans (which in general present a reduction to the "funding" provided by the plan sponsor). Most significantly, funding levels, both as determined using "traditional" approaches, and as "required" under current regulation (which evolved from these traditional practices), were contrasted against what "modern" valuation techniques would indicate. While the actual amount of funding will not be known until the last benefit is paid, virtually any comparison of the "old" versus "new" approaches, at least in our current financial environment, results in much higher

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funding requirements using the new approach. Inertia, combined with lack of appetite to recognize potential shortfalls, perpetuates adherence to the historical methods by both politicians and private plan sponsors.

A fundamental conclusion emphasized during the summit is that approaches used historically, and still very much in use, may end up being woefully inadequate. Should this be the case there would be dire consequences to most government retirement plans and most private DB plans. By extension, DC and cash balance plans could also end up being insufficient to meet most retiree needs, as the premises underlying the "funding" requirements of these are also derived from similar historical methodologies.

Of course not all is doom and gloom. With improved technologies, increasing GDPs, economic growth, etc. even apparently low funding levels may still be sufficient. But enter demographics. In the United States and most of the "developed" world, there is a demographic headwind that culminates in fewer working members of society relative to the total population. All else equal, GDP per person will be expected to decrease. The repercussions are painfully obvious: even if a retiree had "enough" funds, who would

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provide his or her medical and other services? The answer is a diminished working force that, via supply/demand, would simply drive up the cost that the retiree pays. Thus the retiree might never have enough funds, or at a minimum, would need to defer retirement and/or supplement retirement with part-time work.

But what about immigration, you ask? Sure, a developed country such as the United States may be able to import a working force, but this then raises at least three further questions: 1) worldwide, does such a workforce exist? i.e., do the demographics support this possibility AND is this population capable (through education, training, and proximity) of providing this labor? 2) what price would such a workforce (if it exists) demand? and 3) what would be the societal repercussions of large-scale shifts of people from different cultural backgrounds (both good and bad)? These are not easy questions to answer. From a demographic perspective there may be sufficient worldwide labor; but at this time, it is concentrated in "developing" parts of the world. To capitalize on this potential labor force would require significant investment in these nations.

So, as a person with a strong interest in forecasting and futurism, how do I "size up" the possibilities that exist for me? Where will I, a typical U.S. citizen a couple decades from retirement, end up? Should I (selfishly) focus on "me and mine" or subscribe to the adage that "a rising tide raises all ships?" From my perspective, I view the question as, "What specific actions can I take to potentially better my personal situation, without causing detriment to others?"

Perhaps I am already doing enough: I maximize my 401(k) contribution and I try to save some additional amount of my

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salary each year. I also support my children's education (so they can, ironically, demand more money from my generation at some future date), and I contribute to and volunteer at charities that promote improving peoples' contributions to society (temporary shelters, (re)training and education, defense of children, etc.). The above is maybe a good start, but attending this summit got me thinking about further possibilities including directing some of my savings/investments/charitable contributions into areas such as 1) infrastructure of developing nations, 2) technological advances focusing on delivery of services (i.e., so fewer people are needed to perform the same amount of work), 3) promotion of the family unit (however one defines "family," the underlying premise being one of mutualism), and 4) general improvement of quality of the environment, and hence living conditions, via clean water, green energy and environmental/resource conservation. I've also recommitted to my savings regimen and am making my home as comfortable as possible. I plan to stay there a long time, ideally provided for, at least in part, by my family.

To what I extent I follow through on these ideas remains to be seen. Everybody's approach will be different, and no one has a crystal ball. Perhaps all this discussion will be moot if a Black Swan (asteroid impact, plague) strikes the earth tomorrow. Absent cataclysm, will world governments still exist in 30 years, and if they do, will the demands of an older generation indenture the workforce? Will the workforce have the ability to meet such demands? Even with ability, will the workforce be willing to meet such demands, or will rebellion ensue?

So what are your thoughts? What are YOU going to do (if anything)?

These are not rhetorical questions. I welcome your ideas. Responses may even be published (anonymously if you wish) in the next newsletter. ▼