Retirement Planning Software and Post-Retirement Risks: Executive Summary

DECEMBER 2009

SPONSORED BY

PREPARED BY

John A. Turner
Pension Policy Center

Hazel A. Witte, JD

This report provides a summary of the full report with the same main title.

Executive Summary

Retirement plan software packages used by consumers and financial professionals offer individuals the opportunity to do longer term planning that they could not manage without the help of support tools. However, perhaps in part because of the difficulty of the task, they fall short in their objective to provide adequate analysis of post-retirement risks. The packages, in particular the consumer packages, need to do a better job of helping the user focus on and understand key issues such as rates of return, life expectancy and the length of the planning period, timing of Social Security benefits receipt, use of home equity in retirement, and survivor's benefits.

This study, sponsored by the Society of Actuaries and the Actuarial Foundation, assesses the extent to which retirement planning programs help users understand post-retirement risks. We review a selection of the software programs most commonly used by consumers and financial advisors. The path-breaking 2003 study sponsored by the Society of Actuaries, InFRE and LIMRA served as a baseline (Sondergeld et al. 2003). We examine twelve non-randomly selected retirement planning software programs. Five of the programs are available for free over the Internet (identified in the study as consumer programs). One program is available to consumers for a fee, and six programs are designed for use by financial planners for their clients (identified in the study as professional programs).

While we find improvements in the ease of use of programs (online web interface, easy input screens) and utilization of Monte Carlo analysis to highlight risk, we also find that some of the same issues and weaknesses identified in the 2003 study continue today. Some of the remaining problems may reflect lack of consensus on how to address issues, and some may reflect the complexity of the issues. Nonetheless, improvements can be made that would address these issues, as suggested in this report.

Major Findings

Our analysis indicates that while programs offer planning tools to consumers that they would not otherwise have, improvements generally are needed. Key findings on financial planning software programs related to the post-retirement period include:

1. Results and information that is output varies widely across programs.
2. Consideration of the planning period and the handling of longevity risk varies considerably among the programs.
3. In terms of planning, there is often a pro-equity and pro-risk bias, particularly in consumer software.
4. Consumer software should take into account the results of behavioral finance studies indicating that many users have a low level of knowledge about financial issues. For instance, certain studies suggest that individuals tend to overestimate rates of return and underestimate life expectancy, a combination that would lead to having inadequate resources in retirement when this information is provided by unsophisticated users.

5. The failure of some programs to take into account fees on investments overstates net returns and may result in rates of return that are generally not attainable.
6. Programs often overstate gross rates of return because individual investors tend to under-perform the market due to the timing of their investments.
7. With the exception of financial market risks, most programs do a poor job of evaluating the risks that retirees face and in fact they often obscure potential risks.
8. Programs generally under-represent and do not encourage focus on extreme events, such as the possibility of multiple risks occurring at the same time; for example, a stock market decline of 50 percent and a decline in housing price. While sophisticated users can run scenarios to investigate these possibilities, behavioral economics suggests that most users will not do so.
9. Most software programs we examined inadequately estimate the level of Social Security benefits users are entitled to, and at the same time they do not direct consumers to the Social Security administration website, where they can obtain an accurate benefit estimate at no charge. The age at which Social Security benefits are taken is an important decision for most people, and could be better addressed in most programs.
10. Software programs usually do not evaluate the possibility of annuitization (converting assets into lifetime income annuities) as an option to reduce risk nor do they focus on different options for timing of payouts.
11. There is inconsistent treatment of housing as an asset for use in financing retirement consumption.
12. The programs generally do not consider variable rate mortgages.
13. The programs generally do not take into account the risk of retiring earlier than expected, which is significant due to unexpected poor health of the worker or dependent or due to job loss, compounded by the difficulty that older workers often have in finding new employment.
14. The programs generally fail to consider inflation-indexed bonds as an investment.
15. The programs often have a "one size fits all" approach, failing to take into consideration different life expectancies of people. Studies have shown great variability in life expectancy across different population groups.
16. The programs usually do not include a statement of suitability helping users understand what questions it will answer well. Furthermore, there is a wide variation in the structure of different software.
17. Programs generally need to better address the income needs of survivors and issues for couples.
18. Programs, particularly consumer programs, should improve their checking for input errors.

Recommendations

Long term planning is important for individuals as they contemplate retirement. The software programs evaluated in this study provide a tool and means for retirement planning, but often do not adequately help users in answering key questions they are facing. Software vendors should focus efforts on providing better treatment of the following key program inputs: longevity assumptions, rates of return, Social Security benefits, housing and target consumption, including target consumption for survivors. As well, vendors should strive to make other improvements as described in the Major Findings of this report.