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IN THIS ISSUE

Chairperson's Corner

Notes from the Editor

A View From The Pension Staff Fellow

Perspectives from Anna: Women and Financial Security

American's Reactions to Longevity Risk

The World Future Society 2009 Conference: Issues

AMERICANS' REACTIONS TO INCREASED LONGEVITY RISK

By Wendy Weiss

Americans have heard the statistics. So they know they will live longer than previous generations. But many of them do not understand the implications of their increased life span. Behavioral economists and the Society of Actuaries 2007 Risks and Process of Retirement Survey Report provide statistics to document the gaps in understanding. I will develop this argument from my professional experience, by describing Americans' decision-making and behavior with respect to employer sponsored Defined Contribution (DC) Plans and IRAs. Their thought patterns and actions raise a set of issues that actuaries may want to consider as they assume their professional responsibilities of giving advice to pension and retirement plan sponsors.

I will offer the perspectives from the other side of retirement plans–the employee. I will describe the way that the employee thinks about the level of his/her contributions to retirement accounts; acts when his/her retirement account statements arrive in the mail; and considers the adequacy or inadequacy of these account balances for the income s/he will need in the future

My comments are based on eight years of work as a financial advisor, listening to individuals as they react to proposals to invest a larger percentage of their earnings for the future and develop a plan for their retirement years.[1]

The material is presented in question and answer format, followed by additional detail for the interested reader and concludes with a short analysis of the findings, framed to meet the needs of the Society of Actuaries' audience.

When Americans make decisions about the level of their contributions from their salaries, what influences their

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My conversations with middle class and relatively affluent individuals tell me that it is a rare employee who contributes the maximum allowable by law to his/her DC plan, and/or IRA.

The rationale for contributing a relatively small portion of income to a DC plans varies. Many individuals say that they cannot afford to set aside much money from their income. Some do not contribute at all, especially those with incomes at or below the median American income. Individuals who have incomes well above the median make surprising decisions. They do not seem to understand the tax benefits, including the reduction in their Adjusted Gross Income, with the potential for shifting them into a lower tax bracket. What most do is restrict their contributions to three percent of their annual income, or whatever their employer offers as a match.

Another observation: The individuals I talked with rarely increased the percentage of their income that is automatically deducted from their paycheck and deposited into their DC plan account. The percentage was usually set when they were first employed, and the decision is rarely revisited.

IRAs. The people I met did not automatically contribute to an IRA for themselves or a spouse. The issue is *not* necessarily insufficient discretionary income. When asked to contribute they often decide based on the availability of an immediate tax deduction. Even if their income for the tax year is too high to receive that deduction, they will generally decide not to invest an additional $5,000 (in 2009) in their IRAs.[2]

How do Americans think about the amount of funds held in their retirement portfolios?

People I talked with did not spend very much time thinking about their retirement accounts. Most held IRA and 401(k) accounts with multiple institutions and/or employers. Their spouse/partner may have multiple accounts as well and often they did not sum the total of their retirement holdings.

Many did not even open the envelope when their account statements arrived. Many choose not to look at the value of their accounts or their portfolios of IRAs and 401(k)s (which may be held at varying employers) on a regular basis. Outright "fear of opening the envelope" and seeing the drop in the balance often drives behavior when markets drop and newspapers run front page stories on market volatility.

Balances held in DC plans are often not very high. In 2009, the average 401(k) balance was $50,200, a decline of 27 percent from the balances of

$69,200 in 2007.[3] In 2010, 54 percent report that they hold less than $25,000 in total savings and investments. There is variation of course as 56 percent of the individuals aged 24-34 have account balances with less than $10,000. By contrast, 46 percent of those aged 55 and older hold account balances that were greater than $100,000.[4] Nevertheless, individuals nearing retirement–who are accustomed to enjoying a life style supported by income of $100,000 or more–might not want to look at, nor think about, whether they have sufficient assets to provide a comfortable income for 15-30 years of retirement.

In a similar vein, few individuals sit down each year and tally their assets, calculate their Net Worth and develop a careful plan to increase asset levels or decrease the amount of debt held. Many of the Baby Boomers I advised held large mortgages and increased their debt through home equity lines of credit, etc. during the housing bubble. Published data indicates that these clients were typical. After the economic crisis, with the accompanying decline in housing prices and increasing job loss, many individuals have begun to review and reduce the amount of debt they hold.

If they don't make careful decisions about their contribution rates, and don't like to look at their balances, how can Americans be realistic about their longevity risk and take the appropriate action?

In my eight years of financial advising, talking to hundreds of clients who invested with me, a surprising few had run careful calculations to see if their assets would be adequate to fund a lengthy retirement. The EBRI 2010 Retirement Confidence Survey also finds that less than half, or 46 percent, of the workers aged 45 and older have not conducted retirement needs calculations. Some, aged 35 or older, may have at least attempted calculations.[5]

It is important to make detailed calculations–totaling the assets held and then running scenarios that test whether individuals and/or couples would outlive their assets. As actuaries probably know, it takes simple calculations to make projections about longevity and likely rates of investment return on all assets.

As advisors, we are faced with the need to help people understand reality but be diplomatic so that they do not end the conversation before we start planning. In the context of retirement account balances that average $50,200 (and are likely to be lower than a client might need), we begin *tactfully* and carefully with simple income replacement ratios using the client's statements about their present set of expenditures. Then we compound inflation on income needs and consider the impact of taxation

cutting into the yield from assets. Finally, we consider the impact of estimated Social Security income the individual or couple will enjoy.

The resulting report shows the positive and *negative income* flows from the projected date of retirement to the date of projected end of life. It states clearly the number of years, after retirement age, that the individual is likely to enjoy his/her desired income and the point at which they would outlive these assets.

In these calculations, the shift from positive to negative income often occurred seven or more years after the date of retirement. When the individual read that, s/he generally responded with stunned silence.

There were some variations. One individual clearly did not understand the value of compounding interest over a 20-40 year period, i.e., a long lifetime of work. This person wanted to contribute $75,000 each year for the next seven years. She thought that would be sufficient to enjoy the income to which she was accustomed, about $125,000 annually, beginning at the end of those seven years stretching 30-40 years. When I presented the calculated projections, she got very angry. I was unable to continue the conversation or work with her further.

Another individual had the presence of mind to jokingly break the silence after he reviewed the projections. Seeing that his income would only last to age 72 he looked up and quipped. "Oh. I guess that's the age I have to commit suicide."

Retiring early. Actuaries, who understand longevity risk more readily than the average American, may be surprised to hear that before 2008 (as they had done before the year 2000) many individuals expressed great interest in retiring at age 60, or 55 or even at age 50. These individuals are somewhat distinct from the "typical worker." They often hold retirement savings of a few hundred thousand dollars, no credit card debt or very little and have equity in their homes so they hold a relatively reasonable mortgage. They have not run the calculations to confirm their decision, and turned to me to do so. When they see the numbers for 20-30 post retirement years, they are often shocked to see that they would not have sufficient income.[6]

Delaying retirement. Individuals with small retirement accounts or none at all, simply assert that they would keep working past age 65. The decision to delay retirement has also become more prevalent since the market dropped in 2009.[7] While this is prudent, given the small average holdings, this plan may not work. Their jobs might be out-sourced, their company could merge and decide their contributions were redundant, or they could face unemployment as the result of a recession in their industry

or the economy as a whole. In fact, many Americans are involuntarily retiring earlier than they had planned because of the changes in the job picture. The recession of 2008-2009 should provide a lot of new statistics, as well as personal stories.

Analysis

My experiences with DC plan participants' decision making, rationales, and actions taken and *not taken* by intelligent Americans raises issues that actuaries might want to consider. Americans recognize that they face longevity risk. Yet they generally have not thought long and hard about the fact that they will have to fund their very lengthy period of retirement. And they do not take adequate steps to manage or reduce that risk.

Actuaries have had a positive impact. Many individuals do contribute to DC plans and so begin to build the assets that they will need to fund their retirement. But during the 20-40 year span that they earn incomes, they choose to invest a small percentage of their earnings for their future, rather than max out. And they fail to regularly increase their contribution rates.[8] They rationalize this by pointing to the absence of aid from larger entities–employers who do not provide 401(k) match benefits and the U.S. government that does not provide a big enough tax break in the year of contribution to an IRA.

I infer that they emphasize the short-term benefits of a match, and a deduction. At the same time they seem to prefer to enjoy the increase in their discretionary income that a low contribution rate offers. I see a mismatch between their short-term perspective and their need to fund their longer life span. They generally lack a long-term perspective to meet the demands that longevity poses.

Do they lack an understanding of the fact that their future retirement income will have to come from the proceeds of their DC plans, other investments (liquid and illiquid, such as real estate) and/or Social Security?

The low level of contributions to retirement accounts as well as the continuing low balances would suggest that. They do not think hard enough about the adequacy of these balances to fund their future retirement, often avoiding "the envelope." Furthermore, they tend not to increase their level of contributions over time, even as their income rises.

When meeting with an investment advisor, they do press for a higher investment return. They often want a double digit positive return that may be "too good to be true." The figures preferred–15, 20 or even 30 percent–are returns that in fact are historically too good to be true. They are not part of an overall investment strategy to project whether their assets will

be adequate. A recommendation that they should increase their contribution levels today, to augment the positive impact of compounding interest over decades and their income tomorrow, often meets with silence or a look at a spouse.

While repeated high double-digit returns would have a positive impact on their retirement nest egg, the level of realism is a bit troubling. For instance, many said they want to retire early. While such a preference is understandable, what is problematic is their lack of appreciation of the long-term feasibility of this option. In my experience as an advisor, I have found that it is a rare individual who has determined whether his/her assets–in retirement accounts, investment accounts, and less liquid assets such as real estate–can generate the type of income s/he will need over a very long-term.

So, when Americans think about their increased longevity, and the financial requirement that they fund their old age, they seem to be challenged. Their perspective focuses less on the long-term demands of longevity. They think and act in ways that emphasize short-term issues. It is this mismatch between their short-term perspective and their need to fund a longer life span that I find most troubling. They need a long-term perspective to meet the demands that longevity poses.[9]

Actuaries who understand the perspectives of the individuals who depend on their advice may be able to develop the tools to help these individuals ready themselves for longevity's demanding challenges.

Footnotes

[1] Most of my clients held retirement accounts with balances that ranged from $80,000 to $450,000, but little in accounts outside retirement savings.

[2] Often they are unaware that the laws have changed and that they can contribute to a 401(k) as well as an IRA, and also make a contribution for a non-working spouse. When told that they have the option to enjoy deferred taxation on gains by investing in an IRA, very few agree to contribute. It is more likely if they have a sufficient sum in another investment account that does not enjoy the tax status of a retirement account, they simply shift a sum from their investment account to the IRAs.

[3] Employee Benefits Research Institute (ERBI). February 2009. "The Impact of the Recent Financial Crisis on 401(k) Account Balances." *EBRI Issue Brief,* No.326.

[4] Employee Benefits Research Institute (EBRI). *2010 Retirement Confidence Survey*. Fact Sheets #3 and #4.

[5] Employee Benefits Research Institute (EBRI). *2010 Retirement Confidence Survey.* Fact Sheets #3 and #4.

[6] The most recent EBRI retirement confidence survey (Fact Sheet #2) reported that this preference for early retirement was high in 2000, and suggested it was very high recently, before the recent crisis. But, there has been a shift away from this preference. In 2010, 24 percent reported they would postpone retirement, up from 18 percent in 2008.)

[7] The EBRI fact sheet #2 report that figures rose from 14 percent in 2008 to 24 percent in 2009.

[8] The new proposals for mandatory 401(k) contributions with "opt out" possibilities go a long way to resolve this problem. So do the proposals for automatically increasing contributions rates over time.

[9] Here I concur with behavioral economists as well as the SOA's publications on *Understanding and Managing the Risks of Retirement*.

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