Opinion: The Replacement Ratio Dinosaur—A View From Jurassic Park

By Fred Munzenmaier

The article "Replacement Ratio: The Dinosaur of Retirement Planning" (February 2019 issue of *Retirement Section News*) pokes a stick through the fence at us dinosaurs in the Replacement Ratio Cage here at Jurassic Park.

Of course, the term dinosaur has come to mean something that is unwieldy in size, anachronistically outmoded, or unable to adapt to change.

At least two other recent publications have mentioned the need to evolve from overdependence on replacement ratios:

- The Aon/Hewitt white paper, "The Changing Nature of Retirement" (*https://www.aon.com/attachments/human-capital-consulting/2017-HRE-march-issue.pdf*) and
- An article from the Society of Actuaries' *International News*, "Replacing the Replacement Rate: A Better Way to Determine Retirement Income Adequacy." (*https://www.ryerson.ca/content/dam/nia/about/isn-2017-iss-71-macdonald.pdf*)

SOME HISTORY

As one of the dinosaurs in the retirement industry, my own magnum opus was inventing and carrying out the first Aon/Georgia State University replacement ratio study. It was 1988, and Aon was Alexander & Alexander (A&A). Not widely known, there was a third partner. A large corporation funded part of Georgia State's involvement along with A&A. The corporate partner withdrew its name from the study when it was determined that some of their union-negotiated plans did not generate the replacement ratios found in the study.

The three partners (A&A, Georgia State, and the anonymous corporation) agreed that a replacement ratio study based on real data using academic research protocols would be valuable in at least six ways, to wit:

1. We wanted to pin down many of the numbers in the report of the President's Commission on Pension Policy (circa 1980) that were, at best, out of date or at worst, plucked out of the air. A&A presented its findings in a booklet titled *The Replacement Ratio Puzzle—The Missing Pieces Are Found*. Georgia State published its own paper, *The RETIRE Project Report*. I like to think this study became the best known of its kind in the actuarial community at that time.

2. It was a busy time for dinosaurs who were later herded into the Defined Benefit Plan Cage at the Park. Replacement ratios were very helpful in designing or redesigning the benefit formulas in defined benefit plans where "on average" outcomes are important.

3. At the time, there was still optimism for a formal national retirement income policy envisioned in the President's Commission report. Thirty-plus years have passed, and little hope remains for that.

4. Almost every time there is a change in the income tax laws, Social Security, or Medicare, there are retirement needs implications. By changing these components in the replacement ratio formula accordingly, one can gauge the impact of such changes on retirement income needs.

5. At the individual level, replacement ratios provided a target to shoot for when a person considers his or her accumulated and future savings in combination with Social Security and any employer pension. In other words, looking at replacement ratios might be a first step for an individual to examine their behavior early in their career to confirm they were on track for a comfortable retirement.

6. Union negotiations. The corporate partner was very interested in this topic. They cared about the welfare of their hourly workers. If they were spending too little or too much on retirement benefits for any group of employees, then replacement ratios were a way to measure it, on average. Sometimes, replacement ratios indicated they were providing too much, and dollars could be reallocated to other areas such as health care. Replacement ratios were a valuable piece of information for our partner at the bargaining table.

WHY POKE AT THE REPLACEMENT RATIO?

The three partners never claimed that replacement ratios were the be-all and end-all of retirement planning, particularly at the individual level. They recommended that adjustments be made when analyzing the needs of specific individuals.

I see no reason why replacement ratios must fight with the concepts explained in the articles that are the reason for this article. Each of the concepts along with the replacement ratio concept are reasonable and provide tools for planning at the individual level. Every person approaching retirement faces a different set of circumstances. Use the tools that best fit the situation.

To counter what appeared in the recent articles, I would highlight:

- The replacement ratios are fully transparent. You know where the data comes from, and you can see each component of the formula. A person can adjust the ratio to his or her situation accordingly. How do you come by the 4 percent rule or the 11 times rule, respectively advocated in the dinosaur article and the Aon white paper?

- Pre-retirement needs versus post-retirement needs vary a lot by pre-retirement income level. Social Security varies dramatically by income level. The rules promulgated in the articles do not seem to fully take these factors into account.

- The new concepts are defined-contribution oriented while replacement ratios are slanted toward defined benefit. Similarly, replacement ratios help most to guide in the buildup toward retirement. The new articles focus on how to manage your savings after you retire. This seems to be the main criticism of replacement ratios.

- Unfortunately, we are far more in a defined contribution world these days. Lest we forget there are still many public sector and union-negotiated defined benefit plans. Millions of active employees are still covered by these plans, and replacement ratios can be helpful to people fortunate enough to be covered by one.

OLD VERSUS NEW

The term *dinosaur*, as used, connotes old, outdated, antiquated, archaic, dead, old school, extinct. But are we to disregard the wisdom of great philosophers like Yogi Berra just because it's from a long time ago?

Facetious, of course. But principles explained by the oldest of retirement planners, Ben Franklin, still work great. Read *The Way to Wealth* from 1758, and *The Art of Making Money Plenty:*

- Work hard, and be honest.

- Spend a penny less each day than you earn.

Since the glory days of replacement ratios, I have muddled my own way into retirement. I believe lessons from Ben Franklin are as valuable as new-fangled replacement ratios or other concepts.

The words of Franklin—old, but still good.

IN CLOSING

Aon/Hewitt and Georgia State University seem to have given up on replacement-ratio study updates. I encourage them to review the six motives for the original study that were already noted. There remain very good reasons for replacement ratios. The *Consumer Expenditure Survey* data are there and cheap to obtain. I speculate that the spreadsheets are prepared and waiting for new data.

Why not? ■

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