

THE JOURNAL OF RETIREMENT

VOLUME 1, NUMBER 1

SUMMER 2013

GEORGE A. (SANDY) MACKENZIE	Editor
HARRY KATZ	Video and Print Production Director
DEBORAH BROUWER	Production/Design
CATHY SCOTT	Editorial Manager
LAURA PAGLIARO	Marketing Director
SHARON CHIEN	Marketing Manager
ERIN SCANLON	Global Digital Sales Manager
ASHLEY POSNER	Account Executive
WILLIAM LAW	Regional Sales Manager
DEWEY PALMIERI	Reprints Manager
VINCENT YESENOSKY	Head of U.S. Fulfillment
CHERLY BONNY	Customer Service Manager
BEN CASTLE	Finance Manager
SEAN CASEMENT	Business Manager
DAVE BLIDE	Associate Publisher
BHUVNA DOSHI	Digital Advertising Operations
JANE WILKINSON	President & CEO
ALLISON ADAMS	Group Publisher

For most Americans, financing a secure retirement has never been easy. For lower-income households, Social Security may replace enough of the income they had while working that little additional saving is necessary. However, Social Security was never intended to be the sole source of retirement income, particularly for middle-income households. Moreover, its benefits may be cut in the not too distant future.

In the past, many Americans could supplement Social Security with the income from a traditional employer-provided pension. The decline of the defined benefit pension means that working Americans will need to rely on 401(k) and other defined contribution (DC) pension plans; or failing that, on their own savings. Although the traditional pension was never quite the secure and ample source of income in retirement that its supporters claimed it to be, it was particularly valuable to anyone who spent a career with only one or two employers. Long-term members of such a plan could look forward to a pension in retirement that would last as long as they did, with a survivor's benefit for his or her spouse and, usually, with disability benefits thrown in. The combination of Social Security and the annuity paid by a traditional pension would normally replace a large share of working income. The traditional pension is not, however, well suited for a highly mobile labor force. The 401(k) plan is much better suited in that respect, which is one of the reasons it has largely replaced the traditional pension in the U.S. private sector. At any given time, however, only about half of the country's labor force has been covered by a pension of any kind.

Americans face daunting challenges to achieving financial security in retirement. Three in particular stand out: how to save enough, how to earn a decent rate of return on those savings, and how to make the retirement nest egg last for the rest of one's life. Surmounting these challenges is daunting, particularly without a pension plan.

Achieving an adequate saving rate faces two obstacles. The first is figuring out how much to save, which is no mean feat. The second is sticking to a saving plan. Surmounting the first obstacle requires either financial sophistication or a competent financial advisor. Surmounting the second requires willpower. America is a society of spenders, not savers, and it is easy to blow off the idea of saving. Like St. Augustine, who wanted to be chaste, but not just yet, we want to start to save, but not just yet. Saving is in fact a necessary but

THE JOURNAL OF
RETIREMENT

tiresome habit; as with flossing one's teeth, no great harm is done by occasional lapses. The difficulty is that lapses can easily harden into a habit. Human beings naturally worry about the here and now, not what might happen to them in a quarter of a century. This understandable concern for the present can mean that preparing for the future is neglected. Membership in a 401(k) plan can undoubtedly encourage the habit of saving, but it does not ensure that enough wealth will be accumulated to support an adequate level of spending in retirement.

That brings us to investment. When even experts can disagree—about the riskiness of the stock market, whether the share of risky assets in someone's portfolio should decline as he or she ages, or the need to take more risk to compensate for current poor performance of safe assets such as Treasury bonds—less sophisticated investors will find themselves in a quandary. The evidence suggests that many investors make basic mistakes, selling the winners in their stock portfolio and hanging onto the dogs, when the rational thing to do might well be the opposite. The work of behavioral economists tells us that investors, having taken the plunge and invested in mutual funds or other financial instruments, tend not to revisit and change their asset allocation periodically.

When it comes to financial markets, ignorance is most definitely not bliss, but it is quite common. Many Americans cannot tell the difference between a stock and a bond, for example, or the difference between nominal and real interest rates. Even those more sophisticated investors can be in the dark about the basic properties of their investments. A recent investor survey found a surprisingly high percentage of respondents believed that target date funds offer a guarantee, or simply failed to understand the significance of a TDF's landing point.

What about the risk of outliving one's savings? Let's suppose we arrive at retirement—the old-fashioned kind, when work ceases altogether—with a nest egg that we think will generate an adequate level of income for, say, 20 years. Are we home and clear? Not really. How do we know how long we are going to live? An insurance company actuary could tell us that our life expectancy is a little less than 20 years, but who's to say that we could not live longer? To deal with that particular risk, when planning our retirement finances we might have assumed that we would retire at 65 and live to 100. But what if we don't? Haven't we scrimped

for nothing? A life annuity, which provides insurance against living too long, can be the right way to deal with this uncertainty, but deciding to buy one, or how much to invest in one, raises its own issues. Even if a retiree wants to maintain control of her capital and make periodic withdrawals, she has to decide how to allocate her nest egg over the rest of her life. In the *Inferno*, Dante consigns the “hoarders and the squanderers,” those who kept no proportion in their spending, to the fourth circle of Hell. A retiree trying to live on a nest egg is confronted with exactly these perils—spending too much, and risking destitution; or too little, and being unnecessarily miserly.

The Journal of Retirement intends to publish articles that will help dispel the ignorance and uncertainty that surround the financial aspects of retirement, and to enhance the welfare of older Americans. Its articles will cover the whole range of issues that can arise around retirement security: the implications of a lack of financial literacy, what influences the decision of individuals to save or invest their money in a particular way, and attitudes toward annuities and other instruments that provide lifetime income. *JOR* will also include articles on the merits of different investment strategies, the properties of new financial instruments, the regulatory framework applying to pensions and retirement savings, and the role of public policy in fostering retirement security.



This inaugural issue, whose articles have been written by leading experts in the area, reflects the broad range and scope to which *JOR* aspires. The authors come from academia, the financial sector, think tanks, and consultancies. The article by Mark Warshawsky surveys the range of lifetime income products on the market, from traditional life annuities to longevity insurance and other recent innovations, analyzes their historical and recent payout patterns, and considers their implications for plan sponsors who want to provide lifetime retirement income to their members. The article by Jeffrey Brown, Jeffrey Kling, Sendhil Mullainathan, and Marian Wrobel applies behavioral economics to shed light on a basic financial decision, in this case the behavioral impediments to a decision to buy an annuity. They conclude that potential annuitants find annuities more attractive if they are presented in a consumption framework that stresses their insurance aspects, rather than an investment framework. Guarantees also influence buyers' prefer-

THE JOURNAL OF
RETIREMENT

ences. These findings have obvious implications for the way a plan presents its distributional options. The study by Alicia Munnell, Tony Webb, and Francis Vitagliano from the Center for Retirement Research of the potential impact of a proposed change in the fiduciary status of broker-dealers is a comprehensive and possibly controversial treatment of a difficult issue. It finds that the benefits from eliminating 12b-1 fees outweigh the costs, although neither are particularly large. The article proposes more substantial changes to the regulatory framework, with a view to enhancing plan member safeguards.

Anna Rappaport tackles an important public policy issue in her discussion and analysis of the consequences for the provision of disability insurance in the shift away from the traditional pension to the 401(k) plan, the IRA, and other DC plans. Americans tend to underestimate both the incidence of disability and its financial consequences, and the move to DC plans is reducing the number of working Americans who have a retirement benefit coordinated with disability coverage. Rappaport stresses the great importance of disability insurance not only for providing current income, but also for keeping retirement saving on track. The need for comprehensive disability coverage is all the greater if the working lifetimes of Americans are going to lengthen.

Because of the importance of unexpected or heavy medical costs for the finances of older Americans, *JOR* will include articles dealing with this and related issues. The empirical study by Sudipto Banerjee presents evidence for the view that older Americans' precautionary saving is directly related to their personal experience with medical costs, and that precautionary saving accounts for more than half of the wealth of elderly single Americans. Banerjee suggests that, given their apprehension about high medical costs in the future, those older Americans who have incurred high medical expenditures will choose to constrain their general expenditure unless they can obtain additional health insurance.

The move to DC plans has also increased the importance of benchmarking: the systematic comparison of the performance of a plan to that of an appropriately chosen benchmark used to measure and judge risk and return, a practice not yet widely adopted for target-date and other retirement portfolios. Daniel Cassidy, Michael Peskin, Laurence Siegel, and Stephen Sexauer address this issue, empha-

sizing that benchmarking should apply not only to the accumulation phase but also to the distribution phase of a retirement plan.

JOR will publish both technical studies of investing in retirement, as well as articles that explain what advice ought to be given to individual investors, whatever their degree of financial sophistication. David Laster, Anil Suri, and Nevenka Vrdoljak pinpoint some basic and costly mistakes that individuals investing for retirement tend to make: notably, overspending, "playing it safe" by avoiding equities, failing to address longevity and inflation risks, and failing to adhere to a retirement plan.

The remaining three articles deal with more technical investment issues. Wade Pfau uses simulations to appraise the performance of a portfolio with Guaranteed Minimum Withdrawal Benefit, or GMWB, which Mark Warshawsky analyzed in his study, in comparison with a portfolio with no guarantee but a less aggressive asset allocation. Because the GMWB provides a guarantee in nominal and not real terms, it cannot guarantee the real value of withdrawals. Partly as a result, the guaranteed portfolio performs worse in declining markets than the ordinary fund, but better in buoyant markets, where its more aggressive asset allocation works to its advantage.

Investors obviously have to be concerned by financial market performance. Matthew Kenigsberg's article demonstrates the importance of taking account of the interaction of financial market performance with the tax regime and inflation. It is the real after-tax rate of return to investments that ultimately matters. The author calculates the after-tax real total return on a portfolio composed 60% of large cap stocks and 40% of bonds over the period 1926-2011, assuming that capital income is taxed as ordinary income to make the calculations tractable. The results are surprising: In particular, the Depression years were not as bad as generally thought, while the 1940s were much worse, and the 1970s were disastrous. Kenigsberg then uses his calculated rates of return to compare the hypothetical retirements funded by qualified accounts—both traditional and Roth—over two very different historical periods: one in which tax rates and inflation began low and rose rapidly, and one in which they began high and fell sharply. The effects of "real return" assets are also examined. Perhaps a basic message to be drawn from this painstaking research is how uncertain the financial world is, and how difficult

THE JOURNAL OF
RETIREMENT

it is to plan. The low inflation of recent years may not last, and taxes may have to rise. But Kenigsberg shows that the historical experience implies that strategies may be devised to counter these uncertain conditions.

The final article by Yuan-An Fan, Steve Murray, and Sam Pittman deals with the basic issue facing any retiree: how to avoid running out of money in retirement. The authors present a model of investing where the asset allocation adapts to the funded status of a retiree. In contrast to using mean and variance, the authors use ending surplus and shortfall of spending goals to measure risk and reward, which guide investment decisions. Unlike a predetermined strategy, such as constant shares of the various asset classes or a predetermined reduction in the share of equities (as used by many Target Date Funds), the authors' model reacts to new information as the market unfolds, keeping the allocation in alignment with an investor's funded status.

The area of retirement security attracts passionate interest from experts in many fields: economics, actuarial science, finance, law, investment management, and public policy. *JOR*'s mission is to foster research on retirement security by academics, practitioners, and policy makers in all these areas that will lead to policies and practices that enhance the welfare of older Americans.

JOR is eager to publish high-quality papers that are of interest to the retirement security research, policy, and practitioner community. If readers would like more information on how they might contribute to *JOR*, they should contact me at sandymackenzie50@gmail.com.

George A. (Sandy) Mackenzie
Editor

Publisher's Note

Institutional Investor is pleased to launch the first practitioner journal dedicated to the study and advancement of retirement strategies, policy, and solutions. Retirement education, income, planning, policy, and products are critical to the welfare of the world's aging population. *The Journal of Retirement* will be an important source of critical retirement research. It will centralize the dialogue between leading practitioners, academics, and policy makers.

I would like to thank David Laster for working with me to see through *JOR*'s launch from idea to fruition and Betsy Massar for her research to make sure that *JOR* was filling a critical need in the market. I am honored to have the opportunity to work with Sandy Mackenzie as Editor of *JOR*. I also appreciate all of the time that many of the industry's thought-leaders spent with me to shape *JOR*'s launch. Thank you also to the IJournals team for all of their hard work to launch this exciting new journal.

Institutional Investor, the publisher of *The Journal of Retirement*, wants to extend a special thank you to Bank of America Merrill Lynch for its support of the launch of *The Journal of Retirement*. Please note that no sponsor has influence on the editorial content found in *The Journal of Retirement*. Representatives from any firm are encouraged to submit an article to our independent Editor, Sandy Mackenzie, for review and prospective acceptance into the publication. All editorial submissions, acceptance, and revisions are the sole decision of Mr. Mackenzie. The editorial submission guidelines are found on the last page of the publication and online at www.ijor.com. Thank you, and I hope you enjoy this and future issues of *The Journal of Retirement*.

Allison Adams
Group Publisher, Institutional Investor Journals, aadams@ijournals.com