

# THE JOURNAL OF RETIREMENT

VOLUME 4, NUMBER 4

SPRING 2017

<b>GEORGE A. (SANDY) MACKENZIE</b>	Editor
<b>MITCHELL GANG DEBORAH BROUWER</b>	Production Editor Production/Design
<b>BARBARA J. MACK</b>	Content Director
<b>SYLVIA LANG DENISE ALIVIZATOS</b>	Head of Marketing Marketing Manager
<b>RYAN C. MEYERS VICTORIA KUNZ</b>	Account Manager Account Manager
<b>ALBINA BRADY</b>	Agent Sales Manager
<b>DEWEY PALMIERI</b>	Reprints Manager
<b>CHERLY BONNY</b>	Customer Service Manager
<b>BEN YARDENI NICOLE FIGUEROA</b>	Finance Manager Business Analyst
<b>MARK LEE BRUCE MOLINA</b>	Advertising Director Digital Advertising Operations
<b>DIANE ALFANO DAVE BLIDE</b>	Chairman and CEO Publisher

The financial difficulties facing many of the country's state and municipal pension plans are well known. Their current difficulties—and the difficulties of private defined benefit (DB) plans—have been some time in the making, and observers have identified a number of causes for them, including overly generous benefits, increasing life expectancies, and inadequate funding. In “Floods and Deserts: *Why the Dream of a Secure Pension for Everyone Is Still Unattained*,” Stephen Sexauer and Laurence Siegel offer another explanation for developments since the turn of the century. They argue that a behavioral foible known as anchoring led to the unjustified belief that the unprecedented stock market returns of 1980–1999 would continue.

The authors produce convincing evidence of the exceptional character of stock market returns in this period, when markets were rising at an annual rate of 18.5% compared with an historical annual average of about half that. A strictly rational investor would not have assumed that these exceptional rates of return would persist. However, the incentive to avoid sponsor and employee contributions and the common perception that the new economy was really new caused plan sponsors to “anchor” their expectations of rates of return on the most recent period, and not on the historical average. In effect, a propensity to anchor beliefs about future developments on the recent past, even if these developments were exceptional, meant that a tendency for more caution was overridden. As the authors put it, plan sponsors believed that markets, not sponsors and employees, would pay for plan benefits. In addition to the impact of inappropriate anchoring, the recent drop in interest rates to historically low levels, which they characterize as defying 3,800 years of history, has further unbalanced public pension plans.

The authors are convinced of the superiority of the defined benefit pension over its alternatives. They praise the DB plan as “...the best system yet devised for spreading the income from one's working life over one's whole life.” Public pensions should not be phased out. Instead, efforts should be made to put them on a sound financial footing. Plan sponsors should avoid anchoring on the current ultra-low level of interest rates, just as they should have avoided anchoring on unsustainably high financial market returns. In addition, gains in the productivity of public sector workers can be exploited in part by channeling them into higher contributions to public pension plans.

Projections of the amount of money a retiree must have accumulated by age 65 (or some other suitable age) for a secure retirement often assume a fixed period of retirement, like 20 or 25 years. Other projections make life expectancy in retirement stochastic. In contrast to the treatment of longevity risk, and in spite of the considerable concern

that older Americans have regarding medical costs, these are often scanted in retirement planning exercises. In “Health State and the Savings Required for a Sustainable Retirement,” W.V. Harlow and Keith Brown consider the impact of health on retirement finances from two different angles. The first of these is the indirect impact of a person’s state of health on his longevity, and the second is the impact of state of health on medical expenses. The authors use a model in which both the date of death and asset returns are stochastic, and they explore the impact of six different diseases (cancer, cardiovascular disease, diabetes, high blood pressure, high cholesterol, and nicotine-related illnesses) on the amount of savings at retirement that is needed to reduce the probability of running out of money to no more than 10%.

Assuming that the nest egg must fund an annual income of \$100,000, the authors estimate that a healthy 65-year-old male who has not contracted any of the six diseases needs to have accumulated \$1,820,000. A healthy woman needs a little more because of her longer life expectancy. Because of their impact on life expectancy, three of the diseases actually reduce the required nest egg for a male by substantial amounts: in the case of cancer, to \$1,424,100; diabetes, to \$1,217,700; and nicotine-related illnesses, to \$1,430,000.

The analysis turns to the issue of costs incurred by a healthy 65-year-old person with Medicare and Medicare supplemental insurance (Medigap), and the impact on costs of the six diseases. A healthy male and a healthy female could expect to incur post-retirement medical costs with a present value at age 65 of \$143,800 and \$156,300, respectively. Because of its impact on life expectancy, cancer lowers those costs to \$135,400 and \$137,800, respectively. Diabetes and nicotine-related ailments have even greater effects.

Given the impact of illness on life expectancy, calculations of the type the authors make could be very valuable adjuncts to retirement planning. One limitation is that it is typically not easy to predict the onset of serious illness. Suppose, for example, that I have reached my 60s and am healthy, but then contract a disease that cuts my life expectancy down to five years. If I have been up to that point on track for a sustainable retirement, I would have surplus funds (or at least the probability of ruin would drop substantially). However,

not having been able to predict my illness, I could not have altered my planned saving accordingly.

“Improving the Defined-Contribution System: *The U.S. Can Learn from Other Countries’ Approaches to Helping Retirees Convert Their Savings into Lifetime Income*,” by Aron Szapiro, is a comparative analysis of defined contribution systems in the United States, Canada, the United Kingdom, Switzerland, Chile, and Singapore that tries to explain why some countries with DC systems have little or no regulation of distributions at retirement while others do. The United States clearly belongs in the first camp, where it is joined by the United Kingdom, Australia, and Canada. Chile, Switzerland, and Singapore are in the second camp. In both Chile and Australia, employers enroll their workers in a DC plan. In Chile, DC plans are offered by six pension fund administrators and are not employer-based. In Australia, workers may contribute to a plan offered by a financial institution or one offered by their industry. In Switzerland, plans are employer-based, and in Singapore, the National Provident Fund is operated by the government. Notwithstanding the similarities at the accumulation phase across these countries, their regulation of the distribution phase differs markedly. In Chile, retiring workers can elect either a systematic withdrawal program or life annuity, but the terms of these two products are set to give an advantage to the life annuity. A partial lump-sum withdrawal is also possible provided the funds that remain in a worker’s account are sufficient to finance the purchase of an annuity that generates a stipulated minimum income. In Switzerland, the division between a lump-sum withdrawal and an annuity is determined by the employer, but where there is a choice, annuitization is encouraged by a high payout rate, which is fixed by the government.

The author believes that the success countries have had in encouraging annuitization or systematic draw-downs may be explained by how unified the regulatory function is, and how centralized the retirement finance industry is. He characterizes regulation as fragmented in the United States and the United Kingdom, and the industry in these two countries as decentralized (there are a large number of employers, which can result in a proliferation of accounts with different options). In Chile, like most smaller countries, regulation is unified, and workers

have only one account. In Switzerland, regulation is also unified, although there are a fairly large number of employers. The author contends that the greater the number of options an employee faces, the harder it is for policymakers to offer retirees a consistent set of choices. The comparisons this article makes across countries are very instructive, and there are undoubtedly lessons for the United States. That said, a country's political and social environment undoubtedly has a bearing on the prevalence and popularity of annuitization.

The retirement benefit from Social Security provides a significant share of the income of older Americans, particularly those of modest means. The decision of when to claim and some related decisions are among the most important financial decisions older Americans will make, and it is vital that they get clear and accurate information on their options, and that they understand these options. In "Do People Get the Information They Need When They Claim Social Security? Evidence from Observations of the Social Security Administration Claims Process," Laurel Beedon, Lilia Chaidez, Susan Chin, Mark Glickman, and Joel Marus provide an extensive review of surveys of the knowledge of future benefit recipients of Social Security's rules, and also report on the results of observing 30 in-person claims at Social Security field offices.

The article's review of the surveys makes clear that older Americans could generally be better informed about their Social Security options and how their benefits are determined. For example, although the majority of participants in one survey knew that delaying a claim increases the benefit, 62% underestimated the benefits of delaying a claim from the earliest retirement age to full retirement age. In another survey, only 7% of participants knew that benefits were calculated using the 35 best earnings years. In a third survey, half the participants scored a "D" or an "F" in a general assessment of knowledge of Social Security.

Social Security's rules can be very complicated, which underscores the importance of advice and guidance for older Americans as they make their choices. However, based on the evidence of the in-office claims applications the authors observed, it is often the case that key information is not provided to claimants. In particular, claims specialists appeared to have a bias

in favor of early claiming, even when a delayed claim might be beneficial. In addition, the workings of the retirement earnings test—that benefits reduced between ages 62 and 65 if earnings exceeded the prescribed limit would result in a higher benefit once the full retirement age was reached—was not always explained. The online claims process was judged to be more informative than the in-person process, although it too has gaps. The authors conclude that although the Social Security Administration's claims process for the most part provides accurate information and avoids overt financial advice, there are some definite gaps. Improvements to the claims process could definitely enhance the welfare of retired Americans.

It is commonly observed that women's financial investments tend to be more conservative than men's, and that this difference in behavior helps contribute to a disparity in wealth. Stock market risk is not, however, the only risk that women face. In "Too Little or Too Much? Women's Economic Risk Exposure," Christian Weller and Michele Tolson argue that women in general confront more economic risk than men do. Economic risk includes the risk of unemployment or salary declines, asset risk—fluctuations in the value of financial assets and real estate—and what the authors term caregiver risk—the risk that women may be obliged to quit a job or reduce working hours to care for a chronically ill relative. Real estate investments are more risky than is often admitted, and women may hold a higher share of their assets in real estate. Wage or salary risk is more of an issue for women, because their earnings fluctuate more. In their analysis of risk, the authors distinguish between hard-to-avoid risk and easier-to-manage risk. Stocks can be diversified, but the obligation to provide home care for an ailing relative cannot typically be transferred to another person. The authors also propose measures that take into account the way risks interact: concentrated risk is a combination of high savings, unemployment, and caregiving risks; diverse risk exposure occurs when at least one of the three risks is present.

The authors test their hypothesis with data from the Federal Reserve's Survey of Consumer Finances. In general, they find that women are more exposed to risk than men. For example, 14% of women experience concentrated risk exposure, compared with only

6% of men. Caregiving risk exposure is a particular problem, and the authors suggest a number of measures that might alleviate it, including elder caregiving tax credits and paid time off. The empirical work that the authors present in this article is quite detailed, but the article's conclusions are definitely worth pondering.

New regulations enacted by the previous administration require financial advisors to act as fiduciaries in their dealings with their clients: that is, they must act in the best interests of their clients. In "To Roll or Not to Roll: *A Framework for Assessing the Benefit of IRA Rollovers*," David Blanchett and Paul Kaplan propose a number of fiduciary criteria that could guide advisors of clients who are considering rolling over their assets from an employer-provided DC plan to an individual retirement account (IRA). The article addresses how cost, investment opportunities, the quality of any services provided, and other considerations should affect the choice between staying in a plan and rolling over to an IRA. They note that there is considerable differential among plans as regards cost, with some plans having fees that exceed 4% of assets. In such cases, a rollover could save the client a lot of money. The authors also note, however, that most plan members are in larger plans, which have lower costs.

An IRA may also offer its investors investment options that the client's plan lacks, which could allow her to enjoy a higher expected rate of return with no additional risk. That said, it is also important to compare the IRA's portfolio with the best possible portfolio within the plan. The quality of the advice provided to IRA investors is also a relevant consideration. Finally, a rollover decision should take into account the financial strength of the employer and the access to assets. The authors emphasize that the right decision cannot be one-size-fits-all: it must be tailored to the special circumstances of the client. They also emphasize that there are aspects of the decision that do not lend themselves to quantification.

The 10 to 20 years leading up to retirement are generally considered to be the critical years for attaining retirement security. Saving has to be adequate as do investment returns, and excess volatility in returns should be avoided. In "The Role of Long-Maturity TIPS in Retirement Portfolios," Steve Sapra and Niels Pedersen

focus on the asset allocation decision, and they make the case for a portfolio composed 100% of long-maturity Treasury Inflation-Protected Securities (TIPS).

The authors take the case of a worker age 55 as of September 2005 who already has enough savings to put him on track for a secure retirement at age 65. The performance of long TIPS over the 10 years ending in September 2015 is compared with that of cash, equities, core bonds, and the liability entailed by targeted expenditure in retirement. The long TIPS portfolio kept pace with the retirement liability. Only equities outperformed long TIPS, but the volatility of this asset class is about double that of long TIPS. The article's simulation exercises yield conclusions that are similar to the historical analysis. (The authors acknowledge that TIPS do not deal with longevity risk.)

By acquiring TIPS at the appropriate maturity, capital losses can be avoided when securities need to be cashed in. With 10 years to go before retirement, fluctuations in the value of accumulated saving at retirement could be avoided by investing in 10-year TIPS. Longer maturities would reduce the impact of interest rate fluctuations on sustainable spending on retirement. The authors effectively argue that the volatility of the return to long TIPS is low enough to justify giving up the higher rate of return expected with a portfolio of equities. The authors address the situation of would-be retirees who are not on track to retire when they want to, suggesting that a more aggressive investment strategy might be necessary. (Saving more and postponing retirement might also be part of a revised strategy of achieving a secure retirement.)

In manufacturing, a white label product is one that is manufactured by one company and marketed by other companies under their own brand names. In the world of defined contribution pensions, a white label fund (WLF) is a fund of funds, with the funds all in the same investor class. For example, a plan might offer a U.S. equities fund that is made up of several U.S. stock funds. These funds are usually actively managed, although a combination of active and passively managed funds is also possible.

In "White Label Funds: *A No-Nonsense Design Handbook*," Rod Bare, Jay Kloepfer, Lori Lucas, and James Veneruso make the case for the inclusion of a WLF in a

THE JOURNAL OF  
RETIREMENT

DC plan, while at the same time explaining the demands these funds make on plan governance. They explain that it may be easier to use a WLF to increase the size of a particular asset class than to add additional funds. They also argue that it is easier to replace an underperforming manager from within a WLF than it is in the case of a stand-alone fund, and that the structure of a WLF gives fiduciaries more control over fees. By reducing the number of funds among which participants make choices, the process of choice becomes less fraught. WLFs are not necessary for purely passive management, however.

The authors survey at some length the governance and administrative issues that must be addressed if a WLF is to be successful. They note that the plan's fiduciaries will need to be able to defend the choice of a WLF. The authors also argue that, although a WLF

can simplify the asset allocation choice by reducing the number of individual managers and funds, it makes sense to break up the equity component of the plan into the standard subclasses of large cap U.S. stocks, small cap U.S. stocks and broad non-U.S. stocks. Lumping these subclasses into one comprehensive class would probably result in underinvestment in equities. The article includes a very interesting discussion of the appropriate structure of a non-U.S. equity fund, and it provides an in-depth discussion of the nitty-gritty of record-keeping and accounting. This article should be a very helpful guide for plan sponsors considering this relatively new investment vehicle.

**George A. (Sandy) Mackenzie**  
Editor

### ***Publisher's Note***

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 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](http://www.ijor.com). Thank you, and I hope you enjoy this and future issues of *The Journal of Retirement*.

**Dave Blide**

**Publisher, Institutional Investor Journals, [dblide@ijournals.com](mailto:dblide@ijournals.com)**