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This, the 18th issue of *The Journal of Retirement*, offers the reader the usual broad range of articles on retirement issues. The lead article by Meir Statman is entitled “Standard and Behavioral Life-Cycle Theories and Public Policy.” It contrasts a behavioral approach to saving, spending, and retirement planning with the standard approach (often referred to as the neoclassical approach) to life-cycle economics.

The article begins with a brief description of the orthodox approach, contrasting it with the behavioral approach. The orthodox approach assumes, not unreasonably, that households would like if possible to maintain a relatively smooth profile of consumption (personal expenditure) during their lifetime. This requires that they estimate their average lifetime income and save when their income is relatively high, which allows them to spend more than they earn in bad years. In the neoclassical model of economic behavior, short-sightedness and a lack of self-control are not issues, and all different types of income are seen as equivalent sources to finance spending.

The normal people (as the author puts it) depicted in behavioral life-cycle theory have difficulty estimating average lifetime income and struggle with issues of self-control. The article includes an interesting example of the incidence of bankruptcy among NFL players, who do not lack for lifetime income. The behavioral approach assumes that people imply rules of thumb (cognitive shortcuts) to avoid being derailed by a lack of self-control and miscalculation. For example, people are typically reluctant to encroach on their savings or even to spend income from capital. A mental rule stipulating that capital should be preserved may not be optimal in a neoclassical sense, but it may serve the purpose of keeping spending in line.

The article has a brief but interesting discussion of what economists refer to as the annuity puzzle—the fact that annuities are not very popular despite their theoretical attractiveness as providers of longevity insurance. This may be explained in part by an unwillingness to part with lump-sum capital, as well as a tendency to be more concerned by the prospect of early death than by impoverishment in extreme old age, which is harder to conceive.

The behavioral approach, as the author explains, provides a rationale for public policy interventions to increase saving for retirement. Social Security is obviously paternalistic—not contributing is not an option. Measures to encourage workers to participate in employer-provided retirement plans or to increase the level of their contributions to those plans are libertarian-paternalist. Suitability regulations that require that brokers have reasonable grounds for believing that their recommendations are suitable for a clients’ financial situation and needs are another example.

The article addresses a number of important additional issues. Statman cites evidence suggesting that the much-discussed retirement crisis is not a general crisis, but rather affects mainly the poor and the middle class who have unsteady incomes or problematic self-control over their spending. He also considers the merits of a mandatory defined contribution (DC) plan and the importance of distinguishing between financial literacy and actual financial behavior. The development of correct financial habits is what is important.

Studies of the timing of retirement among U.S. labor force participants have generally found that blue-collar workers retire earlier than white-collar and professional workers. This pattern is thought to reflect the greater physical demands made on blue-collar workers compared to the rest of the labor force. However, physical abilities, like explosive strength and gross body coordination, are not the only qualities that decline with age. Cognitive abilities, like memory and inductive reasoning, also tend to atrophy, even if certain other cognitive skills are mostly preserved. If cognitive and other nonphysical skills can deteriorate over time, then there may be some white-collar and professional occupations whose members are prone to early retirement. In “Beyond Blue Collar and White Collar: Age-Related Decline, Occupation, and Retirement Timing,” Anek Belbase, Geoffrey Sanzenbacher, and Christopher Gillis test this proposition.

Their first step is to make use of a databank that enumerates the most important skills for each of the more than 900 occupations that are considered. Information on the rate of decline of the different skills is then applied to determine the susceptibility of each occupation to decline. This information is then merged with data on retirement behavior from the Health and Retirement Survey (HRS).

In their hypothetical example for budget analysts, some 12 of the 52 abilities included in the databank are rated at a relatively high importance level (at least 3 out of 5 points). Using the information on declining abilities, it is found that 3 of the 12 abilities decline rapidly. The relative importance of these 3 abilities (the sum of their individual ratings) is then compared with the relative importance of all 12 abilities. The higher the combined importance of the 3 key abilities relative to

the importance of the 12 abilities initially identified, the higher is what the authors term a *susceptibility index*. If the relative importance of the 3 key abilities is 14, and the sum of the scores for the 12 abilities initially identified is 50, then the value of the susceptibility index is 14/50, or 0.28.

The susceptibility index ( $SI_{ij}$ ) is included in a probit equation taking the following form:

$$\varphi(Y_i) = \alpha_0 + \alpha_1 SI_{ij} + \gamma X_i + \varepsilon_i$$

where  $X_i$  is a vector of demographics and other controls, and the subscript  $j$  stands for occupation. The article presents results using different sets of controls (variables that could affect the age of retirement independently of any decline in abilities) and three different retirement ages (prior to age 63, 65, and 67). The results of these regressions demonstrate that the susceptibility index is a significant predictor of earlier-than-planned retirement in most specifications (the exception being the regressions for retirement at age 63). It remains a significant indicator of early retirement even when the sample is confined to white-collar workers. One particularly interesting finding is that some white-collar occupations are clearly affected by declines in ability, whereas at least some blue-collar occupations are not, although it remains true that blue-collar workers are more susceptible in general. These findings have implications for a policy of further increases in Social Security’s normal retirement age.

The debate over the relative merits of traditional defined benefit (DB) plans compared to defined contributions plans like the 401(k), or cash balance (CB) plans, shows no signs of losing steam. Much of this debate centers on state and local plans, the last stronghold of DB plans. Recently, the pension plan of California’s school-teachers, CalSTRS, has attracted the attention of critics of the traditional plan. CalSTRS is one of the biggest plans in the country, with an active membership of about 438,000. One pointed criticism of this plan is that it discriminates against young teachers with short tenures. In “How Do California Teachers Fare under CalSTRS? Applying Workforce Tenure Analysis and Counterfactual Benefit Modeling to Retirement Benefit Evaluation,” Nari Rhee and William Fonia present considerable evidence to demonstrate that this claim is false. Their analysis

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suggests that the key to the differing views may lie in the way that pension plan members are counted.

Consider a school with 100 teachers, of whom 10 can be expected to retire in a given year. The school hires 60 new teachers during the year to fill the 10 positions left vacant by the retirees, but only 10 of the 60 new hires are still with the school by the year's end. This means that 160 teachers were on the payroll at some point during the year, and more than a third of these had a tenure of no more than a year. If instead we consider the average tenure of the faculty at a particular date, and we assume that teachers who did not quit early will stay on for 30 years, then only 10 teachers have a tenure of less than one year. The others have tenures ranging from 1 to 30 years. The teachers who quit before a year is up receive a return of their contributions, plus interest. Critics of the traditional pension argue that they are shortchanged and would have done better with a DC plan. However, their tenure is so short that whatever loss they suffer has to be modest. The authors find that most teachers achieve substantial tenure.

The authors test the relative attractiveness of alternative pension plans given California teachers' tenure pattern and find that 85% of active teachers would be better off under the current system than they would be under an ideal 401(k)-type plan, and that 76% would be better off under the status quo than under a CB plan with investment returns identical to the DB plan. Dollars and cents aside, the authors argue that a DB plan, by encouraging long tenure, is well suited to this workforce.

The standard theory of index investing starts from the premise that investors, especially unsophisticated investors, cannot beat the market. Their best bet is a combination of index funds that achieves an appropriate trade-off between risk and return. In recent years, however, a new approach to investing has arisen, known as smart beta. Smart beta strategies assume that investors can beat the market—in effect, that certain stocks are systematically undervalued.

In “Life-Cycle Investing and Smart Beta Strategies,” Bill Carson, Sarah Shores, and Nicholas Nefouse provide a guide to this form of investing and discuss how its performance compares with the more conventional approach. The smart beta approach actually begins with

a conventional equity-bond glide path. The smart beta glide path is what the authors describe as an overlay on the traditional glide path. The traditional glide path determines the broad asset composition of the smart beta glide path (although the share of equities can rise somewhat over time), but the smart beta glide path determines the types of equities and bonds that are held within these broad asset classes.

The smart beta approach alters the composition of a more conventional portfolio to overweight stocks that are more likely to beat the market over the long run and provide a higher return at the same risk. Such undervalued stocks include value and quality stocks, momentum stocks, and small-cap stocks. The fixed-income component of a smart beta portfolio could include an exposure to the Barclays Fixed Interest Balanced Risk index (a smart beta fund), which seeks to balance risk between interest risk and credit risk. It corresponds to the Barclays U.S. Aggregate Index, which places special emphasis on interest rate risk. Other fixed-interest asset classes are also introduced. As the investor ages, the composition of the smart beta glide path shifts from a return-enhancing strategy to a minimum-volatility strategy, which aims to provide the same return as the conventional glide path at a lower risk.

In the empirical section of the article, the authors compare the performance of Morgan Stanley Capital indexes with the corresponding smart beta version (see Exhibits 5 and 6). They find that the smart beta indexes have usually outperformed their cap-weighted counterparts. For example, between January 2007 and December 2016, the MSCI World ex-USA Diversified Multi-Factor index (so called because it reflects changes to its allocation that have increased the weight of quality, momentum, small-cap, and value stocks) notched an annual return of about 4% with an annualized volatility of about 19%. The MSCI World ex-USA index had the same volatility, but it recorded a return of only 2%. In concluding, the authors state that they have shown that a traditional equity-bond glide path can be enhanced by incorporating smart beta strategies.

Although accumulating sufficient capital to fund retirement is a challenge for many Americans, particularly for those who do not contribute regularly to retirement savings plans, the decumulation phase can

be problematic even for households with apparently adequate retirement nest eggs. Managing the decumulation phase requires that difficult decisions be made about how much risk the portfolio can bear and a sustainable rate of withdrawal. Most strategies focus on withdrawal and assume a static investment allocation. In “Autonomous Portfolio: A Decumulation Investment Strategy That Will Get You There,” Ioulia Tretiakova and Mark Yamada propose a novel investment strategy and put it through its paces while experimenting with a number of different spending strategies.

The authors present and explain an approach, based on a stochastically dominant dynamic decision theory algorithm, that intuitively takes more risk when behind its accumulation target and less when ahead, while considering a balance between wealth and the probability of ruin (itself a function of wealth and the withdrawal rate). Their dynamic constant risk (DCR) approach is premised on maintaining a constant risk for the portfolio as a whole, as measured by the portfolio’s standard deviation, rather than a constant mix of assets or a predetermined glide path. This assumption implies that the share of risky assets should decline when volatility increases, and vice versa. The share of equities is constrained to a maximum of 60% on the grounds that retirees would be uncomfortable with higher exposures.

The authors report on a number of simulations that compare their approach to other investment strategies for various withdrawal rates. The simulated equity and bond returns and rates of inflation are based on historical data on U.S. financial markets. The simulations assume a constant withdrawal rate. Except for very high equity allocations above the article’s 60% maximum, the DCR strategy dominates these other strategies; for any given probability of running out of money, the strategy supports the highest withdrawal rate. Another set of simulations compares the performance of the DCR under various spending rules, in particular the relationship between the size of the income stream they generate and the probability of ruin. The spending rules adjust the withdrawal rate in various ways for above- or below-average performance of the stock market. To level the playing field in this comparison—necessary because the pattern of withdrawals will vary from one rule to another—withdrawals are weighted

by the probability of surviving to the year the withdrawal is made. A similar adjustment is made for legacies. A fixed withdrawal rule yields the worst result, and a hybrid spending rule devised by the authors is best. The authors stress that their strategy’s superior results are underpinned by targeting sustainable income rather than following the industry’s standard approach of trying to maximize returns.

Financing long-term care (LTC) raises some extremely difficult issues. Most Americans choose not to obtain private LTC insurance, which is perceived as available only for the better off. As a result, the majority of Americans who will ultimately need LTC will rely on Medicaid. Medicaid imposes both an income test and an asset test. Despite partial exemptions for a principle residence and some other assets, and the exclusion of a small part of income, many older Americans find that they must spend down most of their financial assets, and they are expected to devote most of their income to financing LTC. Many older Americans are unaware of the financial requirements Medicaid imposes, and they receive a nasty shock when they realize that so much of their assets must go to finance LTC. Complicating matters is the fact that the need for LTC and the length of stays in facilities is hard to predict.

In “Avoiding the Medicaid Trap: A Step-by-Step Guide to Estate Planning,” Candice Correia, Richard Sayre, and Jessica Allen explain in straightforward language how a sound estate plan can preserve a household’s assets when a household member needs to apply to Medicaid for LTC benefits. Their article does not go into great technical detail on the finer points of estate planning. Instead, it explains in general terms the legal documents that can make up a plan, the importance of gathering medical and other general information on the family member who may come to need LTC, how to identify a knowledgeable and honest estate planning specialist, the need to follow the estate plan once it is prepared and keep it up-to-date, and the importance of consulting an attorney before transferring assets. They also explain that the process of applying for Medicaid is complex and offer some tips on finding a suitable facility. This practical and very helpful article stresses that the process of estate planning for elder care is both complicated and strenuous. Older Americans and their families should not wait to

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learn how to navigate estate planning and Medicaid's rules until the need actually arises.

*The Journal of Retirement* has aimed to cover every possible financial aspect of retirement security, including generational issues and prospects for future retirees. However, no article we have published has delved into other aspects of retirement, like the psychological or social. With this issue, we include an article whose principle subject is the difficulties many people approaching retirement experience in making up their mind to retire and the problems they face with the transition. "The Psychology of Retirement: A 'Can't Let Go' Syndrome" by Yukiko Inoue-Smith focuses specifically on the experience of university faculty, with which she is particularly familiar, but her article has a broader application.

In the case of faculty members who are particularly busy with teaching, research, and other activities, there is a concern that retirement may lead to a loss of identity and a feeling of aimlessness. The basic concern is that retirees would be going from a state in which their time is structured and their days full of interesting and worthwhile projects to a state of more or less complete idleness.

University faculty typically have a substantial pension plan, and it is easy for most of them to keep

working past a normal retirement age to build up their nest egg. The issue is typically not whether they can afford to retire, but whether retirement appeals in any way. Inoue-Smith notes the importance of extending pre-retirement planning to encompass its emotional aspects. Graduated retirement could also ease the transition. No one doubts the tremendous importance of adequate financial planning, but the importance of smoothing the transition from full-time, or even more than full-time, work should also be recognized. Inoue-Smith's survey of the issues has relevance for other walks of life, too, including members of the professions and primary and secondary school teachers.

Finally, I would invite readers to read my review of a comprehensive study of the design and management of DC plans. The book is *Successful Defined Contribution Investment Design: How to Align Target-Date, Core, and Income Strategies to the PRICE of Retirement*, by Stacy Schaus, who is a member of the *Journal's* advisory board, assisted by Ying Gao.

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

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