

## **The Retirement Income Purchase Not The Home Purchase Is The Largest Lifetime Financial Transaction For Most Participants**

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Ordinary consumers and retirement plan participants must make extraordinarily complex financial decisions on a daily basis, yet there is now growing evidence that consumers are rather poorly informed when they make many consequential economic choices [Clements, J., “Plan Paralysis: Why a Wealth of Choices in 401(k)s May Not Make Investors Rich,” *Wall Street Journal* (May 4, 2005); and Madrian, B., and Shea, F., “The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior,” *Quarterly Journal of Economics* 116, no. 4, 1149–1187, (2001)]. Prior surveys unfortunately reveal that financial illiteracy is widespread among the U.S. population [Mitchell, O., and Utkus, S., “Lessons from Behavioral Finance for Retirement Plan Design,” Pension Research Council Working Paper, Wharton School, (2003); and Mitchell, O., and Lusardi, A., “Financial Literacy: Evidence and implications for Financial Education,” CREF-TIAA Institute, May 2009]. If Americans have difficulty with only a handful of simple financial or investment questions, it is likely they have far more trouble with issues of much greater complexity. [Lusardi, A., and O. Mitchell, “Baby boomers retirement security: The role of planning, financial literacy and housing wealth,” *Journal of Monetary Economics*, 54, 205–224. 2007] It is true that retirement planning is outside the day-to-day activity and expertise of most participants, but that does not mean it is can be reduced to a simple transaction. Instead, the participants should receive information and assurances throughout their working lifetimes, indicating that a competent fiduciary understands the complexity of the problem and is modeling a more effective solution for them.

Recently, plan sponsors and vendors have increasingly tried to “simplify” the 401(k) process for most participants. This is in response to multiple behavioral finance studies which consistently documented that most participants were overwhelmed by the decision-making process [Mottola, G. and Utkus, S. “Red, Yellow, and Green: A Taxonomy of 401(k) Portfolio Choices,” Pension Research Council Working Paper, June 2007; Choi, J., Laibson, D., Madrian, B., and Metrick, A., “For Better or for Worse: Default Effects and 401(k) Savings Behavior,” NBER Working Paper 8651, (2001); and Choi, J., Laibson, D., Madrian, B., and Metric, A., “Defined Contribution Pensions: Plan Rules, Participant Decisions, and the Path of Least Resistance,” NBER Working Paper 8655, (2001)]. So, the trend has been to simplify—as much as possible—basic decisions, such as signing up for the plan, how much to save, and basic asset allocation.

Since enactment of the 2006 Pension Protection Act (PPA), many participants are automatically enrolled and defaulted into an investment portfolio merely based on their birth date. This has had the adverse impact of subliminally communicating to the participants that the retirement income purchase process must be straightforward. However, one fact cannot be simplified: *the sheer size of the retirement income purchase is beyond the scope of most employees to understand, model, and manage.*

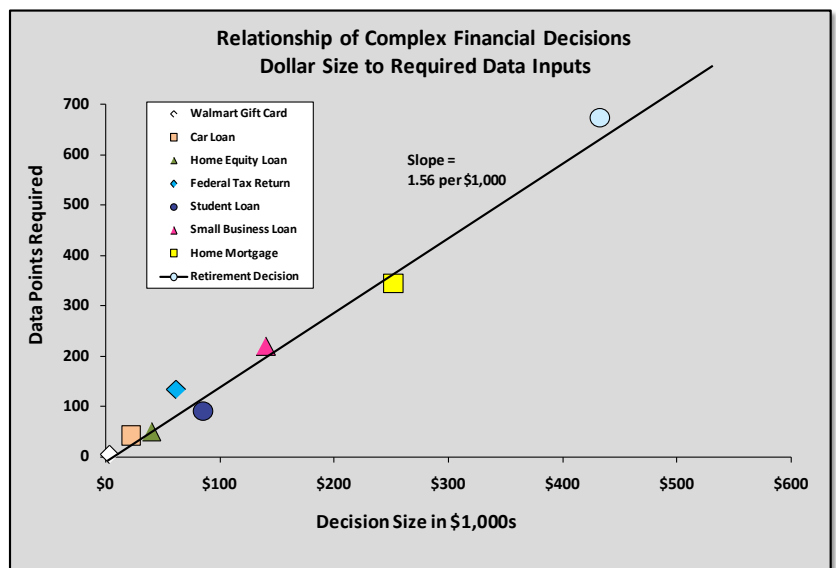
To illustrate the size of the retirement income purchase, the median household income, various loan transactions, and home value in the U.S. were used [U.S. Bureau of Labor and U.S. Census Bureau statistics for 2008]. During 2008, median household income in the U.S. was \$61,355. The median home purchase price in January 2008 was \$251,550. The number of issues (i.e., “data points”) considered by the average consumer buying a Wal-Mart gift card were five, a consumer considered as many as 344 issues when entering into a standardized Freddie Mac home mortgage application. There was a significant amount of consistency in the data points required per \$1,000 of decision size. The range was a low of 1.37 data points for the home mortgage to 2.18 on a typical Federal tax return. These figures actually

understate the magnitude of the problem, because they do not include many of the accompanying interim calculations. The average of the decisions was 1.56 data points for every \$1,000 increment in the financial decision.

Financial Decision	Transaction Size	Decision Data Points	Data per \$1,000
Walmart Gift Card	\$50	5	n/a
Car Loan	\$22,000	42	1.91
Home Equity Loan	\$40,000	50	1.25
Federal Tax Return	\$61,355	134	2.18
Student Loan	\$85,000	90	1.06
Small Business Loan	\$140,000	220	1.57
Home Mortgage	\$251,550	344	1.37

**Average                      1.56**

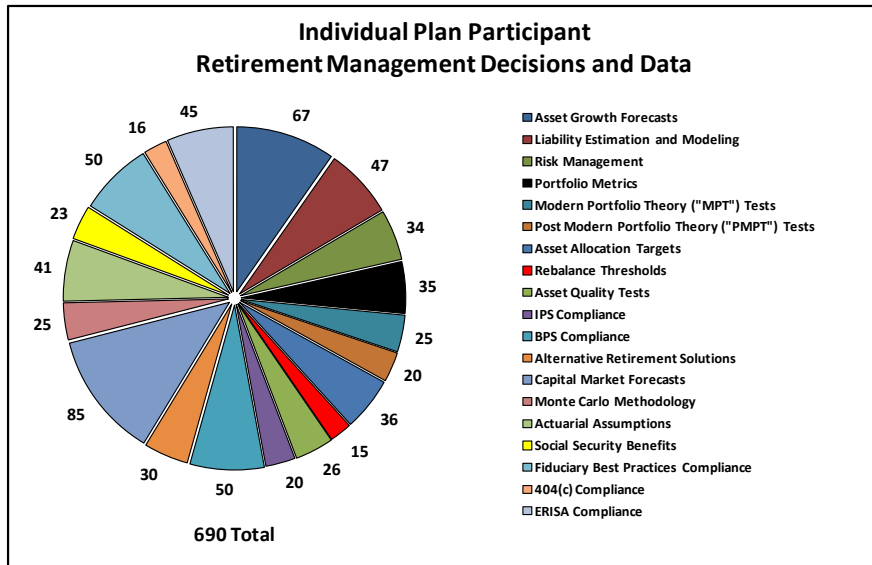
The largest financial purchase most Americans will make is their retirement income purchase. As an example, a worker earning \$61,355 (the median income) would need \$432,124 in current dollars to replace 70 percent of his or her income when counting his or her Social Security Benefit. If an average of 1.56 data points is needed for each \$1,000 purchase, the retirement income purchase would be expected to require at least 673 data points (432 x 1.56).



Planning for retirement is a complex undertaking, requiring the consumer to gather, process, and project data on compound interest, risk diversification, actuarial events, portfolio optimization, capital market forecasts, inflation, and other assumptions about future asset market performance. Unlike the mortgage decision, the retirement planning decision is not a one-time event. The consumer must regularly assess his or her progress to help ensure that the plan remains on track. When circumstances change, consumers must make new forecasts, carefully study choices available, and actively implement any necessary adjustments. This is difficult for consumers for two reasons. First, they lack the actuarial and financial market skills. Second, even if they model a correct solution, they must overcome inertia and actively implement the new plan. Because inertia is the predominant participant behavioral trait, it is very difficult for individuals to implement a different solution.

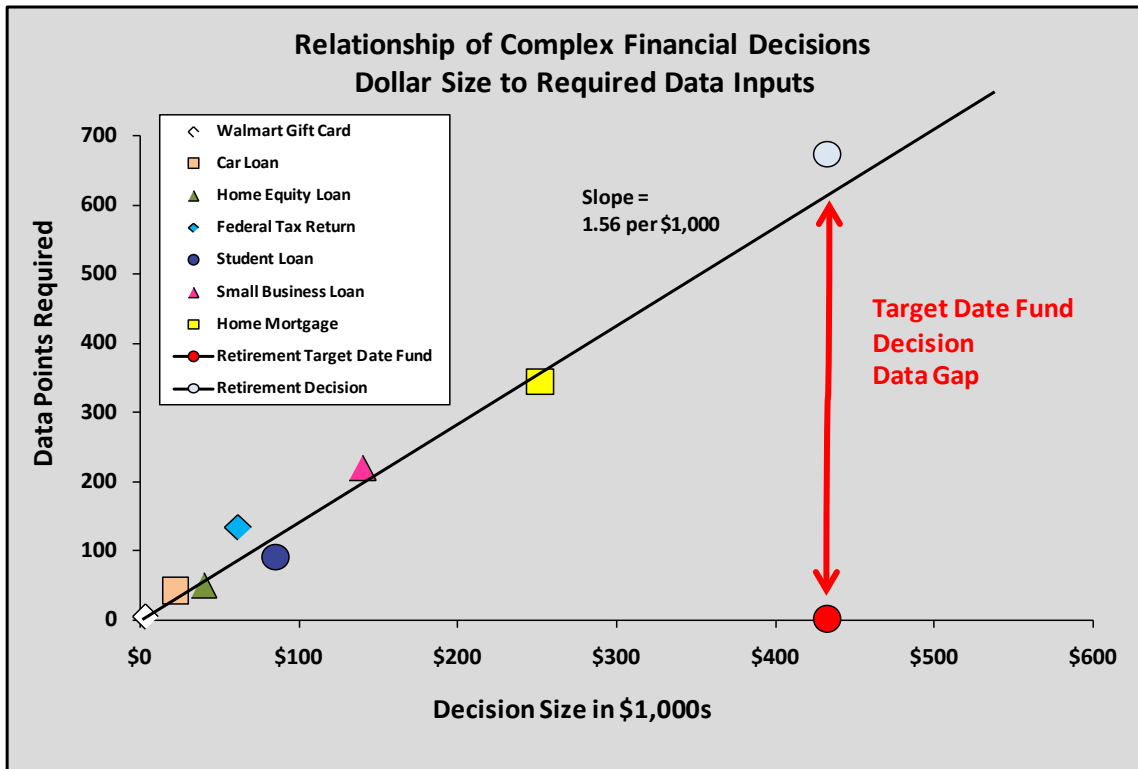
The retirement decision is made even more complex because it involves two very different components—the accumulation phase and the distribution phase. The two events possess very different dynamics that are only now becoming better understood through rigorous academic and industry research. In other words the plan participant must work hard and plan carefully throughout the working lifetime to build the assets that will be needed at the beginning of retirement. Then, at retirement, the participant must convert those assets to a steady income that will support the desired lifestyle in retirement. That, too, takes a second careful plan, because the retirement income has to last as long as the participant does.

In fact, the retirement income purchase covering both the accumulation and distribution phases involves at least *690 data points* that deal with capital market forecasts, portfolio theory, portfolio optimization, asset allocation, fiduciary best practices, and compliance with the Investment Policy Statement and Benefit Policy Statement, among others. In addition, this is not a one-time event but a lifetime ongoing challenge where these calculations must be periodically repeated and forecasts updated.



Most investors and retirement plan participants have great difficulty mathematically converting the desired monthly or annual income for the duration of their retirement into the required lump sum that must be available at the beginning of retirement. Generally speaking, most consistently underestimate the lump sum figure, believing that savings equal to two or three years of pre-retirement income will be sufficient to provide replacement income at retirement. On an actuarial basis, the lump sum figure is several times that lay person estimate.

For most 401(k) plan participants, the accumulation needed for the retirement income purchase is a much greater dollar amount than the purchase price or even current value of their home. Consider how little time and data are collected for the retirement purchase, as compared to the home purchase. The retirement industry has tried to respond to the information gap with target date funds that require no data input other than birth date. The portfolio is based upon the investment and accumulation needs of an "average" participant, even though many portfolio managers of these funds may have absolutely no idea what the real participant needs or wants. This is true at the beginning of the process, during enrollment, and continues all the way through the working life to the end point of living off the portfolio in retirement.



The Department of Labor recently empowered a working group to help understand the difficulty plan participants have with processing complex financial information and making good financial decisions [Department of Labor Working Group: “Report of the Working Group on Financial Literacy of Plan Participants and the Role of the Employer,” U.S. Department of Labor, 2007]. Experts testified that there is substantial illiteracy in the U.S. workforce. A significant amount of testimony that was presented to the working group indicated that the following items are misunderstood by participants and those planning for retirement: life expectancies, asset allocation, capital market forecasts, inflation, risk, basic investment returns, and a host of other variables that must be taken into consideration to arrive at the proper retirement income replacement calculation. While these concepts are misunderstood by participants, they are essential for proper retirement planning.

The working group desired that some type of illustration show a benchmark of final salary. The working group even tried to create a “dumbed down” minimalist forecast. It was the view of the working group that this minimalist forecast could use a retirement age of 65, historical inflation rates, historical 10-year rolling market averages, and current contribution rates to arrive at a plan accumulation number. Using IRS annuitization rates, the replacement of final salary could be at least benchmarked. It was further believed by the working group that this number expressed as both a dollar amount and as a percentage of projected final salary could be provided to participants in such already existing disclosures as the Summary Annual Report, Summary Plan Description, or Employee Benefit Statement.

This would, of course, be better and more useful information than what most participants are doing, but it would fall short of generally accepted actuarial practices and prudent investment management fiduciary standards. While this information is useful and valuable, it is absolutely insufficient to meet the needs of employees who need to follow practical procedures during a lifetime of saving for retirement and then enter into a daunting transaction at the end of that process to meet their retirement needs.