New Insights Into What Is Known About Retirement Planning

Recognizing factors that could impact a more secure future.

By Anna M. Rappaport

The following article is based on a new paper, "Public Misperceptions About Retirement Security", which sheds light on areas where public knowledge and preparation for retirement planning and finances are inconsistent with key facts. This paper was sponsored by the Society of Actuaries Committee on Post-Retirement Needs and Risks and is a joint project of the Society of Actuaries, LIMRA International, and Mathew Greenwald & Associates.

The results of misperceptions are important in light of the growth of profit sharing and other defined contribution plans. Some of these plans offer significant contributions and build-up of assets without employee action, but many of them require employees to save their own money and make investment decisions. This article will review ten misperceptions about retirement saving and will discuss some implications for employers as they decide how to manage their defined contribution plans and communicate with their employees.

1. Saving too little

Most workers have not tried to estimate how much money they will need for retirement. Moreover, those who have calculated this amount often underestimate it. There are related factors when using calculations that are important for defined contribution plans: determining how much retirement income is needed, estimating when that income will first be needed, and accumulating a lump sum sufficient to sustain that income, including the impact of inflation. It should be noted that no matter what kind of plan is in place, considerable savings are required for an adequate retirement income. Approximately 12 percent to 15 percent of employment income saved over a long career, in addition to Social Security, should produce a sufficient nest egg for retirement. An annual contribution of 3 percent to 5 percent of employment will simply not be enough for a reasonably comfortable retirement.

2. Not knowing when retirement will occur

Many workers are forced to retire unexpectedly and are unprepared. Major reasons for earlier retirement include loss of a job, poor health, or family members in poor health needing help. It is usually impossible to predict when one of these events may occur.

3. Living longer than planned

As individuals learn to manage their own retirement funds, they may not understand that focusing on life expectancy is a limited and potentially misleading measure when applied to a personal situation. In fact, some retirees will live long beyond their personally estimated life expectancy, with a substantial risk of outliving their savings. About half of the population will live past average life expectancy.

4. Not facing facts about long-term care

Many retirees underestimate their chances of needing long-term care. There is a tendency to think that others will more likely require long-term care. Relatively few employees or retirees have purchased long-term care insurance or can afford to self-insure an extended long-term care situation.

5. Trying to self-insure against long life

Although survey responses indicate that workers find guaranteed lifetime income attractive, in practice they usually will choose to receive retirement plan benefits in a lump-sum form whenever given the choice. As a result, they forgo opportunities to receive a lifetime pension or annuity, often failing to recognize the difficulty of self-insuring their longevity. It is not clear from the data available what strategies are most commonly used to spread resources to provide income that will last a lifetime, and more study is needed in this area. The SOA Committee on Post-Retirement Needs and Risks is considering how best to gather more information to assess these approaches.

6. Not understanding investments

Due to the growth of defined contribution plans and of investment choice within these plans, many employees now have the opportunity to manage investments for retirement and the responsibility that goes with that opportunity. However, many of them misunderstand investment returns and how investment vehicles work. A series of studies of 401(k) participants sponsored by the John Hancock Life Insurance Company shows that participants have major gaps in knowledge about plan investments. For example, many of them think that stock is part of a money market fund, and many think that company stock is less risky than a diversified investment portfolio. The repeated studies show that in spite of bad experience with company stock in some highly publicized situations (e.g. Enron), these perceptions have changed little over time.

7. Relying on poor advice

A significant portion of retirees and pre-retirees do not seek the help of a "qualified professional." Yet when asked in surveys they indicate a strong desire to work with a financial professional. Employers also have found that when they offer investment advice the percentage of employees who use the advice is low.

8. Not knowing sources of retirement income

Workers misunderstand what their primary sources of income will be in retirement and may be disappointed when trying to live on the available income. Many retirees find that they are much more dependent on Social Security than they expected to be. As a result, they may be ill-equipped to deal with both anticipated and unanticipated needs and challenges.

9. Failing to deal with inflation

Inflation is a fact of life, and workers often rely on regular pay increases to maintain their lifestyles. Social Security is inflation-indexed, but private benefits are not. Consequently, after retirement, it can be particularly difficult to keep pace with the cost of living.

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10. Not providing for a surviving spouse

Many married couples fail to plan for the eventual death of one spouse before the other. There is a significant decline in economic status at the time of widowhood for many widows. This can have serious consequences, especially when the survivor is the wife. Many widows outlive their deceased husbands by 15 years or more.

Solutions for Employers

The paper, *"Public Misperceptions About Retirement Security,"* provides applicable data and an expanded analysis of each of these 10 misperceptions. For reference purposes and to spark further thought, all of the studies used in the paper are listed in the endnotes. While the paper looks at the public at large and does not focus directly on employee benefit plans, there are a number of lessons for sponsors of defined contribution plans. These lessons also remind us of the value of these plans. Some key things to keep in mind include the following:

- Left alone, many people may not save enough (or maybe not at all) for a secure retirement. An employer can help improve the chances of employees saving enough by adding matching contributions, providing strong default options in plans, encouraging maximum participation, and educating its workforce on retirement planning and investment considerations. Customized retirement planning information can be particularly helpful.
- Whenever there are matching contributions on employee savings, employees will benefit by to participating in the program.
- Traditionally, defined contribution plans that offered choices were based on the idea that choice is good, and the more choices employees offered, the better. In the last few years, behavioral finance has taught us that too much choice is confusing, and that no matter how attractive and informative the educational materials, many employees will not be engaged. Some employers have determined that the most effective way to ensure security is to create "auto-pilot" plans. These plans allow choice, but the default options provide for safe harbors resulting in significant amounts of savings, sometimes with annual increases, and offering a diversified portfolio. The employees who do not actively elect to join the plan are not left out as they would be under traditional plans.
- Payroll deduction is a very valuable feature of employer-sponsored

defined contribution plans. Savings are deducted first, before the paycheck is deposited into the employees' bank accounts, and employees do not need to make an active election each month to save. Rather, once they start to save, contributions are continued until the employee chooses to stop them.

- Education is critically needed, even if there are segments of the working population that will not take it seriously. The employer is ideally situated to offer education to employees and has the advantages of regular communication channels plus a position of credibility and authority. In addition, when peers participate, the message has more credibility. Friends, peers and family are often viewed as an important source of advice.
- Employees often do not have a sufficient financial background to make appropriate investment decisions when given the choice. The employer, by selecting a limited number of options, offers prescreening and fiduciary due diligence. In addition, the employer can offer education about investment mixes appropriate for different situations and/or personal advice.
- Employer plans are often a better deal for employees from an administrative and expense perspective. The fees that an individual must pay when saving on their own are generally higher than in a 401(k) plan.
- Employer defined contribution plans cannot make longevity risk go away, but many larger and well established companies offer a combination of a defined contribution and defined benefit plan. This combination serves as a portfolio that helps employees address longevity risk.
- Employees who seek to manage their own money in retirement will choose different spending patterns. While some will do fine, others may not use their assets in the best way. Some will spend too fast and need to cut back later and/or run out of assets. Others may spend too slowly, cutting back more than they need to and missing out on some of what they can enjoy in retirement. Retirees who are afraid to use their assets may experience a greatly reduced standard of living. Employers can help employees understand the implications of different withdrawal strategies.

This paper serves to reinforce for the reader the importance of employer plans. Managing retirement savings completely independently is a daunting task for many, including those with fairly sophisticated financial education and training. Having the help of an employer makes it much more achievable.

The full paper, *Public Misperceptions About Retirement Security,* can be found on the Committee on Post-Retirement Needs and Risks Web page located on the Society of Actuaries Web site at: www.soa.org.

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