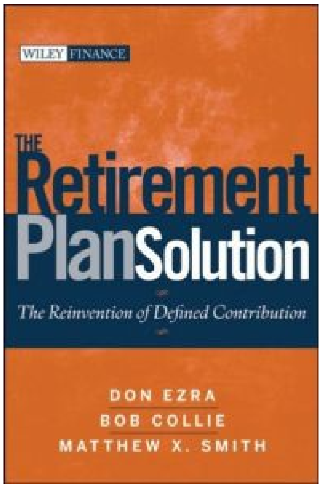

Book The Retirement Plan Solution

The Reinvention of Defined Contribution (Wiley Finance)

Don Ezra, Bob Collie and Matthew X. Smith
Wiley, 2009

Recommendation

Many American companies have eliminated, or are now eliminating, their defined benefit (DB) pension plans. They are substituting defined contribution (DC) plans, under which employees are primarily responsible for their own retirement savings. Since this is the new lay of the land, you need to know how to assess your DC plan. Focusing on the primary traits of one type of DC plan – U.S. 401(k) pension savings accounts – experts Don Ezra, Bob Collie and Matthew X. Smith explain the latest version-two (or "DC 2.0") plans. *BooksInShort* recommends this book to human resources (HR) and benefits professionals, retirement plan sponsors and consultants, financial planners, policy makers and all those who hope to retire one day with money from a defined contribution plan. While the book concentrates primarily on U.S. retirement plans, HR professionals from other nations still will find useful retirement planning information here.

Take-Aways

- Most people in advanced societies regard a financially secure retirement as a basic right.
- Since people are living longer, retirement planning is increasingly important.
- Many companies are switching from defined benefit (DB) retirement plans to defined contribution (DC) retirement plans. In the U.S., that primarily means 401(k) plans.
- With most DC plans, employees, not businesses, contribute nearly all funding.
- Individuals are responsible for planning and funding their own retirements, but often people withdraw their money too soon or don't even contribute to a 401(k).
- Your 401(k) contribution and any investment returns become your retirement income.
- Today's revamped DC plans ("DC 2.0") enable people to make better financial-planning and investment decisions.
- DC 2.0 plans are designed for retirement pensions, not for general savings.
- Companies should help people understand how far their funds will go after retirement and how to derive the most benefit from their 401(k) accounts.
- Although advice varies, many experts recommend retiring with 80% to 85% of your preretirement income, with 40% to 45% coming from a DC plan.

Summary

The Evolution of Retirement

People did not always expect to retire and spend their senior years at leisure. Indeed, it was not until 1889 that German Chancellor Otto von Bismarck introduced a retirement program for his nation's workers. One of the first such plans in history, it promised German laborers an income for life if they retired at 70. This didn't help most Germans, since at the time the majority lived only to age 45. Today, however, many middle-class people in developed nations assume they will enjoy retirement without having to continue to work for enough money to cover their costs. Since people are living longer than ever, this scenario is becoming an increasingly expensive goal.

> "The idea of an active retirement as a right has today become a generally accepted idea in the United States and in developed countries around the world."

American retirement schemes used to be based primarily on defined benefit (DB) plans, where employers promised specific benefits and pooled pension funds for future individual payment as people retired. Now companies are replacing (or have replaced) DB plans with defined contribution (DC) plans, where firms track each worker's money separately and make preset deposits, usually a percent of the employee's salary that the worker matches or exceeds. DC plans cost employers less than DB plans. Both types assume that your retirement income will combine your investment returns with the deposits you and your employer put into your DC plan. Yet, "in the DC system, people do not know how much income their plans may provide."

> "Wealth management is for the wealthy, but retirement planning should be for everyone."

Most DC setups in the U.S. are 401(k) plans, named after their enabling legislation. Corporations are reassessing and redesigning these plans. The updated versions are called "401(k), version 2.0" or "DC 2.0." The major changes in 401(k) plans came about when companies stopped treating them as adjuncts to traditional DB plans and began to see them as replacements. This is the primary method U.S. private-sector workers ¬use to set aside money for retirement. In fact, 47.5 million people now have these plans. Unfortunately, 401(k) plans have serious drawbacks. For instance, many employees never enroll in the first place and most people make poor investment decisions. Some experts think 401(k) fees are too high but, even so, taking money out of a 401(k) plan is usually simple, so people do it routinely – thus wrecking their retirement security.

> "The trend from DB to DC is virtually universal, not just an American phenomenon."

See your 401(k) as a pension plan, not a savings plan. To encourage this mind-set, the plan's paperwork should explain its long-term fiscal projections transparently, based on current contributions. If the probable amount is not adequate for retirement, the text should warn plan holders accordingly so they increase their contributions.

> "The 401(k) plan is undergoing a complete redesign in corporations across America."

In most DC plans, workers save 7% of their earnings, while their companies contribute 3% in a partial match. Is that 10% of earnings enough to sustain retirement? Unfortunately, calculating how much money people need to save for a comfortable retirement is difficult. Aon Consulting and Georgia State University report that a person earning $30,000 annually will need $27,000 (90% of working income) each year of retirement. Social Security would provide a portion (59%) of it. A person who earns $60,000 annually will need 78% of that to retire and will get only 46% of it from Social Security. The best baseline is that most U.S. workers should retire on 80% of preretirement income, with 40% of that coming from a DC plan. Some experts consider that too low and recommend 85% of preretirement income, 45% of which comes from a DC plan.

> "McKinsey & Company reports that almost half of baby boomers expect to work past 65."

Investment returns are vital to your retirement income. In DB plans, investment profits should account for 80 cents of each benefit dollar, with the other 20 cents coming from 401K contributions. The spread is wider in DC plans, with 90 cents from investments and 10 cents from the plan. Investment returns are unpredictable. Small annual declines can hurt your 401(k), so be prepared to exercise these options:

- **Change how much you save** – If your returns are small for a while, save more later.
- **Change when you plan to retire** – Such a safety valve may be necessary.
- **Lower your expectations for retirement** – Your retirement security correlates directly with your 401(k) investment returns. If your returns are not good, that clearly affects the security of your retirement.
- **Invest wisely** – Balance carefully. People often must assume more risk in order to realize higher returns.

> "Most people have two simple motives once they retire: to continue to live in the lifestyle to which they have gradually evolved, and to leave something for their children."

The "10/30/60 rule of thumb" illustrates the role of investment returns in retirement income. It says that for each retirement dollar in a DC plan, slightly "more than 10 cents" comes from worker contributions, a little more than 30 cents comes from accumulated investment earnings and slightly less than 60 cents comes from investment earnings during "decumulation" – the conversion of pension assets accumulated during your working life into retirement income.

Save Early and as Much as You Can

Since investment returns are uncertain, long-term investment is the best plan. Start putting money into your 401(k) plan as early as you can. The sooner you begin, the more you can afford to accept risk (if you can handle it psychologically), which provides the opportunity for higher returns. Accepting risk is harder when you begin to save and invest later in life. Obviously, what you spend as a retiree also determines how long your money will last. The usual recommendation is to spend 3.5% to 4.5% of your investment portfolio annually, figuring in inflation.

> "Once we have reached age 60 or 65, the average ones among us are likely to live for a long time."

To amass the best retirement income, save as much as possible. Enroll in your firm's 401(k) plan. Some companies have automatic enrollment, an important element in DC 2.0 plans. Workers with low incomes may find it hard to save, and those who begin saving later in life face an uphill fight to accumulate enough to retire securely. Frequent job changes also complicate your savings. Some employees close their 401(k)s when they move to new jobs. That triggers a 10% tax penalty. Try not to borrow or withdraw from your 401(k). It is a retirement savings vehicle, not a means of funding short-term emergencies. Employers can eliminate provisions that enable early withdrawal and can establish plan rollovers as the default position for people who change jobs.

Investments

Most untrained people do not invest successfully, so leaving investment decisions up to DC plan holders is not the best tactic. Workers who handle their own investment choices don't do as well as their companies' hired experts. Corporate fiduciaries should educate plan holders about why planning their own investments is not wise. Companies should provide investment expertise as part of the default 401(k) option and encourage employees to choose it. Professional DC 2.0 investors generally follow the idea that opportunities to amass more money and increase your retirement savings should drive your investment choices.

DC 2.0 plans are oriented toward a “target date solution,” so exposure to risk declines as the participant gets closer to retirement. Program planners set this target based on several factors, including when the employee begins to make 401(k) contributions, the planned retirement age, the salary amount and growth potential, and so on. Fiduciaries should also be aware that reducing the fees related to DC 2.0 plans could translate into more effective usage. People often are overconfident about planning for retirement. The Employee Benefit Research Institute says only 47% of more than 1,000 workers surveyed knew how much money they would need to retire comfortably. Yet, 61% of them were certain they’d have enough. Often, people think that they don’t have to worry about retirement now and that they have plenty of time to plan later. People also tend to be irrational about financial planning and investing. For example, they buy stocks after their values increase, not before. Also, many people discount the importance of future events, so they do not save in the present. As a result, they plan poorly (or not at all) for retirement. Firms should incorporate financial literacy into their DC 2.0 default choices.

DC Plans Are Not Just for Americans

DC plans don’t exist only in the U.S. For example, Australia has a sophisticated DC national culture. The Australians achieve more than 90% employee participation, and they control leakage by not allowing borrowing from retirement accounts. The government mandates a 9% employer contribution; unions are advocating for 15%. Most employees contribute 3% of their pay and less than 2% of participants make their own investment decisions. The government matches up to 150% of voluntary contributions from low-income workers. Holland and Canada use a “collective DC” model that defines employer contributions and adjusts benefits according to amount of those contributions. Such plans do not pay lump sums and are portable when people change jobs. Often, national DC plans take one of these forms:

- **“The bank savings model”** – You save minimally under a DC plan because you are accumulating money elsewhere. You withdraw all your employer-plan savings upon retirement. Many employees with DB plans also adopt this model.
- **“The fund supermarket model”** – As in the U.S. and Australia, your DC plan is your primary retirement savings vehicle. This makes successful investing very important.
- **“The retirement income model”** – This is the most effective model and has 100% employee participation. Everyone puts as much money into retirement accounts as possible. Investment returns are good. Money is available for full retirements. This plan relies on solid projections of achievable retirement income from all sources combined.

Post Retirement

A DC 2.0 plan should help participants accumulate retirement wealth in the form of income for life, not a huge lump-sum payment. A simple DC 2.0 plan is always better than a complex one. Employers’ other DC 2.0 goals include establishing employee goodwill and improving retention rates. Certain metrics, such as participation rate, the period of time from when employees join the firm and when they enroll, and how much workers save, let you measure the effectiveness of your plan. While companies cannot control retirees’ decumulation, they should guide retired employees as much as possible in financial planning for their DC payouts. How former employees fare during retirement will affect how current workers perceive the DC 2.0 plans and how many of them choose to participate.

> “If you run out of money before you run out of life, it really matters a lot.”

Because employers are seldom involved with their firms’ retirees, many benefits managers do not worry about how DC plans handle decumulation. This should change, since payout growth occurs after the employee retires. Three factors (“dials”) play crucial roles in decumulation:

- **Spending** – To know what you can comfortably spend during retirement, list all your assets and liabilities on a single sheet of paper. Deduct liabilities from assets to establish your net worth. List your annual or monthly expenditures. Note your income sources before and after taxes. Another method is to project spending to equal your after-tax income (minus any savings). Decide what kind of life you will want once you retire. Do you hope to take expensive trips and own a lavish condo, or to stay home and live modestly? Estimate how far your assets will go toward fulfilling your hopes. Identify any gaps. Adjust your current spending and retirement planning accordingly.
- **Protection during longevity** – Determine if you need to retire later than you originally planned so you can save more money. Or, do you want to purchase a special investment (like an “immediate annuity”) that will provide funds over a longer time period? If this appeals to you, put off buying such an annuity as long as possible because the value of hedging against the risk of longevity increases as you age.
- **Investment** – You cannot control how much return you will get from your investment. However, you can control your investment asset allocation. Think broadly in terms of liquid assets (bonds, stocks and cash), risk-free annuities and additional assets, like home equity. During decumulation, you face two types of risk: “investment risk” and “longevity risk.” Of course, the decisions you make about investments and other retirement planning choices depend on your assets. Numerous new “decumulation products” can protect you during retirement, including guaranteed minimum withdrawal benefits and advanced life deferred annuities.

About the Authors

Award-winning author **Don Ezra** is an investment strategy director for Russell Investments, where **Bob Collie** is an expert on U.S. and U.K. pension plans. **Matthew X. Smith** has written about and helped design, implement and administer contribution plans for more than 25 years.