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### RETIREMENT CHALLENGES FOR FINANCIAL ADVISERS



by **Robert Pozen**, at . Posted on July 19th, 2011

#### [Retirement Challenges for Financial Advisers](#)

By Robert Pozen and Theresa Hamacher

The retirement landscape is changing dramatically for financial advisers. As they prepare to help clients navigate this environment, advisers will need to wrestle with a variety of issues. Among them: what's the right default option for defined contribution plan participants? What type of investment products and strategies are most appropriate as clients move from the wealth accumulation to the distribution phase of their financial plan? And what role will Social Security play in a client's retirement income?

If the U.S. is to succeed in making retirement plan coverage as universal as it is in countries such as Australia, it must get the questions of automatic enrollment and default options right. In our view the current trend toward target date funds as the default presents problems.

To help employees reach their retirement income goals, behavioral economists have suggested that employees should automatically be enrolled in a 401(k) plan on the day they become eligible to participate without having to hand in a form first. Only those workers who didn't want to contribute would have to take action by filling out paperwork; workers would have to opt out rather than opt in.

When companies actually tried out automatic enrollment, the results bore out the theories. These programs boosted 401(k) participation significantly, particularly among lower-income workers and minorities. Congress endorsed this approach when it passed the Pension Protection Act of 2006, which included provisions that allow 401(k) plans to include automatic enrollment as long as participants can opt out if they wish.

In any plan with automatic enrollment, the default fund option becomes critical, as it will be the sole investment of any plan participant who does not make a choice. In the last few years, the most popular default option for 401(k) plans has been a lifestyle, or target date, fund. For younger workers, a target date fund holds a high percentage of stocks relative to bonds, but that percentage declines as the cohort of workers ages and nears retirement. Since 2006, assets in target date funds have risen from \$70 billion to \$330 billion.

In our view, however, target date funds are inferior as default options to a balanced fund with 60% of its assets in stocks and 40% in bonds, rebalanced each year. The net returns of a balanced fund are likely to be higher than those of a target date fund. It is impossible to predict over the 20 to 40 years of a worker's career when equity markets will do well, so future expected returns of a balanced fund are roughly the same as the expected returns of a target date fund. Yet the expenses of the target date fund are higher, in most cases by 15 to 30 basis points per year, so its net returns are likely to be lower than those of a balanced fund.

Also, many participants in 401(k) plans do not understand the risks involved with their target date funds. Some participants believe that target date funds are guaranteed not to lose money in the decade before they reach 60. In 2008, such target date funds incurred significant losses with a wide dispersion of negative results. This dispersion is due to the significant differences among fund managers in the equity portion held by their target date funds as they approach the normal retirement age of their investors.

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By contrast, investors in a balanced fund know what they are getting – 60% stocks and 40% bonds. To avoid a sharp downturn in the equity markets during the last decade of their working years, plan participants can move assets from the balanced fund to a government bond or money market fund. But this decision will be based on their own investment objectives, time horizon and appetite for risk.

A third problem with target date funds as the default option in a retirement plan is they assume that everyone born in the same year will have the same investment needs when he or she reaches 60. Of course, this is not true. Some workers will need current income so they will want to hold mainly bonds. Other workers will have other sources of monthly income and hope to build up assets for their grandchildren, so they will want to hold mainly stocks.

When workers come close to retirement, the robotic quality of target date funds works against prudent decision-making. At that time, workers should not assume that their retirement needs will be satisfied by a target date fund; they should make a considered investment decision that makes sense for them. This type of individualized decision-making is implicitly encouraged by plans with a balanced fund as the default option.

#### *From Accumulation to Distribution*

As Baby Boomers start to approach retirement, many will become more interested in how to distribute their retirement assets than how to accumulate a larger nest egg. As a result, they will look to financial advisers for help with distribution planning – figuring out how much to take out of a retirement account, how to minimize the taxes on those withdrawals and how to incorporate the distributions into an estate plan.

At the same time, Baby Boomers will seek out investment strategies that help them balance the need for income today with the need to continue to grow assets and protect against a loss of purchasing power through inflation – both of which are critical for financing withdrawals tomorrow. They'll also be looking for ways to hedge their longevity risk – a very real risk, since the combination of the trend toward earlier retirement and the reality of increased life expectancies means that retirement income must cover a longer time span.

Advisors will need to provide their aging clients specialized technical tools and expertise, including:

- Information on the complex rules governing required minimum distributions
- Advice on integrating beneficiary provisions into an overall estate plan
- Tools that allow investors to look at all their sources of retirement income – including an employer-based plan, an individual retirement account, a variable annuity, and Social Security.

To meet the needs of Baby Boomers close to retirement, financial advisers should offer a combination of fixed and variable annuities as well as systematic withdrawal plans from mutual funds. Fixed annuities can help reduce a client's longevity risk, while variable annuities might be promoted as a way to invest distributions from retirement accounts while continuing to accrue income on a tax-deferred basis. Fund companies have also introduced *managed payout funds* that seek to generate a regular monthly income from assets, though this income stream is not guaranteed.

#### *Whither Social Security?*

In planning for retirement, anyone age 60 or older can rely on the current schedule of Social Security benefits. None of the reform proposals would reduce in any way the Social Security benefits of anyone already receiving monthly paychecks or who would start receiving them in 2017 or earlier.

After 2017, however, there is a substantial possibility that the existing benefit schedule for Social Security will be gradually revised to restore its solvency. Without reforms, Social Security will become insolvent around 2037 and benefits will be automatically cut by roughly 25%.

Over the next few years, Congress will seriously consider three main approaches to Social Security reform:

- Limit the growth of Social Security benefits for high earners (\$90,000 per year and above) to the rise in the consumer price index, rather than to the rise in wages to which benefits currently are indexed, since wages rise faster than prices over time. The schedule would stay the same for low earners (\$30,000 per year and below), while the rise in middle earners' benefits would fall somewhere in between.
- Increase the normal retirement age for Social Security — currently 66 and rising to 67 by 2027 – possibly to 69 by 2077. Such an increase would only partially reflect the projected rise in life expectancy of the average American. From 2027 to 2077, life expectancy for Americans is projected to rise by 7 to 9 years.
- Change the income level on which Social Security taxes are levied. These taxes, borne equally by the employer and the employee, now apply to the initial \$106,800 of a worker's earnings. Some have proposed that the first \$150,000 or \$170,000 of a worker's earnings be subject to the full 12.4% of Social Security taxes. If these taxes are applied more broadly, however, a fairer approach would be to impose a surtax of 1% to 2% on all wages above \$106,800.

To sum up, financial advisers must cope with major changes in the retirement landscape. They should help their clients in the accumulation phase choose appropriate investments in their 401(k) plans, rather than being swept into robotic default options. And financial advisers should help their clients during the distribution phase formulate a plan including investment products specifically designed to meet their

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