VOL. 26, NO. 2 SUMMER 2013

BENEFITS LAW JOURNAL

From the Editor

The Myth of the Average Retiree: Helping Employees Prepare for an Unknown Future

A person with one foot in a bucket of ice water and the other in a bucket of boiling water is, on average, comfortable. So it goes with retirement planning. Historical averages are used, since the future is unknown, to help workers with their saving, investment, and retirement planning decisions. But workers also should be made aware that they will face unavoidable risks over an unpredictable future and, alas, that the only surefire way to mitigate the danger of running out of money in retirement is to save more and work longer.

Yet most guidance is based on the assumption that the future will look like the past—as demonstrated by checking any one of the myriad of retirement planning Web sites, seminars, articles, and self-help books—or even a sit down for a one-on-one with a financial advisor. Thus, taking history as a guide, the average participant can expect to earn a 10 percent return on US stocks and a 5.5 percent return on bonds (based on 1926 to 2012 performance); endure a 3.23 percent rate of inflation (based on 1913 to 2012 consumer price indices); and, upon retiring at age 65, live to age 85.7 for a male and 87.6 for a female (or age 90 for the longer-lived of a 65-year-old couple). Then, armed with this "knowledge" and taking the participant's current salary, and assuming his or her spending in retirement will equal a fixed percentage of final salary (many programs use 80 percent), the crystal ball software will spit out a recommended annual savings target, investment allocation and *the number* that person must have squirreled away to retire comfortably.

If everything works out on average, those recommendations will be spot on. But averages have very little to do with predicting what will happen to an actual person. In reality, half of retirees live beyond their life expectancy, investment markets can tank right after a couple hits their savings goal and retires, or some similar "black swan" event can occur.

The problem with relying on averages to plan for retirement is cogently explained in a recent paper sponsored by the Society of Actuaries that offers some ways to help workers confront the unknown.[1] For example, the authors calculate that an "average" 65 year old couple needs a $170,000 nest egg, in addition to Social Security, to comfortably retire. However, to be prepared for nonaverage occurrences, that same couple would need four times more savings—$686,000—to have a 95 percent chance of a comfortable retirement. That extra $516,000 is a cushion to protect them against the possibility of a stock market crash, a long illness, runaway inflation, etc. And that still leaves a 5 percent chance that something will go really wrong and the couple will go broke.

Of course, the folks writing cookie-cutter retirement planning software fully understand the weakness of historical averages. But products are oversimplified to be more easily applied to, and understood by, employees. The first and most difficult task in employer-sponsored financial education is engaging employees long enough to do any planning. Including more accurate but complex financial metrics would likely confuse or turn off most participants. While most programs do include stochastic forecasting to help account for the probability that above- or below-average stuff will happen, and allow employees to revise their life expectancy, investment return, and inflation assumptions (although how many participants are capable of properly making these adjustments?), the "law" of averages still guide the recommendations.

In the end, it is definitely preferable for a plan participant have a goal of reaching his or her *number*, even if it might be the wrong number—at least the person is saving. Also, even if an employer provided every worker with a team of actuaries, economists, health professionals, insurance consultants, and financial advisors at his or her beck and call, the experts still can't predict the future and the retirement dream might become a nightmare.

Instead, retirement education should stress that every retiree faces a specific set of unpredictable factors in planning for retirement:

- Investment performance (no explanation needed);

- Inflation (which can particularly hammer folks with a pension, annuity, or lots of bonds);

- Health risks (getting seriously ill at a relatively young age and needing long-term care);
- Government risks (tax law changes, medicare, or social security benefit cuts); and
- What can only be called "shit happens" (accidents, floods, storms, meteors, broken down cars, leaking roofs).

These risks can't be planned for and may sometimes work in a retiree's favor (bull stock market, good health). But it's clearly better to retire with extra money on hand than to run short, and employees can be made aware that whatever they think their *number* should be, it should be even larger.

Besides saving more, there is another obvious change most employees can make that is guaranteed to work—delay retirement. Shockingly, surveys show that many workers do not understand the triple play benefits of postponing retirement:

1. More time to save;
2. Higher Social Security benefits from the extra years worked, plus actuarial adjustment (same for those lucky folks covered by a pension); and
3. A shorter period that the nest egg needs to last.

People who want to work but can't find a job, or whose health prevents them from working, can't help themselves by working longer. But everyone else, particularly workers who were out spending when they should have been saving, should take advantage of this strategy. Even those who don't particularly like their job and fantasize about beginning the life of leisure should be prepared to keep on working—or develop a taste for cat food.

Without a functioning crystal ball, financial education will continue to be based on averages, adjusted for the randomness of events. But workers should be made to understand that the nice and neat calculations are simply guesses. They must understand that the only certainty is uncertainty and their own retirement is unlikely to be "average." However, there are two effective but simple actions every worker can take that are *guaranteed* to make his or her retirement more secure: save more and retire later.

David E. Morse
Editor-in-Chief
K & L Gates LLP
New York, N.Y.

NOTE

1. Measures of Retirement Benefit Adequacy: Which, Why, for Whom and How Much?; Bajtelsmit, Rappaport and Foster, 2013.