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BOOK REVIEW

How Persistent Low Returns Will Shape Saving and Retirement

EDITED BY OLIVIA S. MITCHELL, ROBERT CLARK, AND RAYMOND MAUER

Reviewed by Anna M. Rappaport, FSA, MAAA

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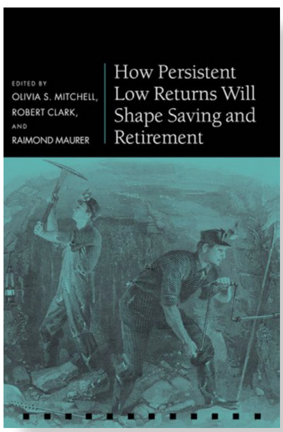

Editor's Note: How Persistent Low Returns Will Shape Saving and Retirement*, edited by Olivia S. Mitchell, Robert Clark, and Raymond Maurer, is a compendium of research studies sponsored by the Pension Research Council at The Wharton School.*

Rates of return have a variety of different impacts on retirement planning and saving. This book provides a multi-faceted look at different aspects of this issue including the amount that individuals need to save under different interest-rate scenarios, investment strategies, and intelligent risk taking in a low-return environment, the interaction between low investment returns and retirement decisions, global employee benefit trends, and low returns as an encouragement to work longer. It focuses on issues in both defined benefit and defined contribution environments. The book responds to a number of years of low returns and makes one think about the extent to which longer-term history is a guide to the future. This book is central to the work of financial advisors because the interest-rate environment affects financial planning, retirement decisions, and investments.

The book shows how low returns affect planning for retirement, making investments, potential spending strategies, making decisions about work and retirement, and how these different aspects of retirement interact. Here are some of my main takeaways:

- Low returns must be offset by other actions in order to achieve retirement security. Strategies include the following: save more while working, retire at a later age, spend less in retirement, manage assets effectively, and take more risk in the hope of earning more on savings. Some of these strategies probably would be looked on as bad news by people who do not want to save more, retire later, or spend less in retirement.
- Rates of return have a big impact on how much one needs to save. That means anyone running a retirement planning calculation needs to be aware of the rate-of-return assumptions used in the calculation. The user should be able to decide that the return is appropriate.
- The earlier one saves, the more time there is to earn an investment return. Which investments are used really matters. The reasonable choices in a low-return environment are different and the choices may not be easy.
- In defined contribution plans, some choices are packaged into target-date funds or other combinations. It may not be easy to understand these choices and how they are affected by a lower-return environment.
- Low returns make retirement annuity purchases more expensive, but not necessarily more expensive relative to other investments.
- Expenses probably do not decline in low-return periods, but they become more important in terms of how they affect net returns.
- Low returns and population aging in combination push people to work longer. Working longer may not be easy for some, but it will be essential for many.
- The bottom line is that low returns make the job of the advisor more challenging.

Below, I discuss several chapters that I found most helpful with the greatest application for advisors.

DECIDING HOW MUCH TO SAVE

One interesting chapter entitled "Low Returns and Optimal Retirement Savings" showed how the amount needed for retirement varies with the assumed rates of return. Moving from historical averages to the current low returns when estimating needed retirement savings boosts the required saving rate by about 50 percent for lower-income households, and it nearly doubles what higher-income households need to save. The structure of Social Security benefits is a big factor in the difference by type of household, because Social Security benefits replace a higher fraction of pre-retirement earnings for the lower-wage population.

INVESTING IN A LOW-RETURN ENVIRONMENT

Another important chapter entitled "Intelligent Risk Taking: How to Secure Retirement in a Low Expected Return World" suggests several strategies to improve investment returns in defined contribution plans. The authors focus on achieving a 5-percent real rate of return. The approaches discussed include long-only style-tilted strategies, risk parity strategies, and alternative risk premia. I note that strategies that are suitable for defined contribution plans also may be applicable to individual investors. However, individual investors do not have the benefit of a plan sponsor having pre-screened investment options for them.

STRATEGIES TO OFFSET THE IMPACT OF LOW RETURNS

In the chapter titled "Investing for Retirement in a Low Return Environment: Making the Right Decisions to Make the Money Last," the authors explore the interactions between savings rates, retirement ages, and replacement rates. The discussion comments on the different challenges at low- and high-income levels, and for people in different age groups. Policies to encourage longer work include the possibility of being able to claim retirement benefits on a partial basis as well as phase-in to retirement.

IS HISTORY A GUIDE TO THE FUTURE?

A history and discussion of the Federal Reserve's role and policy in setting interest rates is the subject of the chapter entitled "Politics, Independence and Retirees: Long-term Low Interest Rates at the U.S. Federal Reserve." A key challenge facing advisors and others who recommend investments and make planning calculations is how much weight to place on longer-term history versus other factors when comparing investments and determining expected longer-term returns.

WORKING LONGER IS AN IMPORTANT STRATEGY

Rising labor force participation rates for older people are occurring primarily because of actions that individuals take. They often do so without well-defined paths.

For this reason, advisors must consider how they can help clients focus on work options and how to help them exercise these options. Some employers already are preparing for an aging workforce, as discussed in the chapter "Helping Employers Become Age Ready." The author notes that, by 2050, almost one-quarter of the global population will be older than age sixty, almost three times the mid-twentieth-century figure.

In the chapter on "Challenges and Opportunities of Living and Working Longer," the authors explore the various factors pointing to longer work lives, including gender. When people reach their early sixties without adequate retirement savings to maintain a living standard, they must evaluate the possibility of working longer. Alternative paths to retirement include bridge jobs and working part-time. Reducing one's living standard is also an option.

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IMPACT ON EMPLOYEE BENEFITS OF THIS ENVIRONMENT

Stepping back from the U.S. context, the chapter on "Global Developments in Employee Benefits" overviews major trends and highlights their similarities across a number of countries. The biggest shift is from defined benefit to defined contribution approaches toward paying for retirement income. This is a development now paralleled in health benefits. The chapter emphasizes that employees are becoming more interested in working for employers who do have an ongoing role in benefits, especially because of concerns that government-provided benefits may be cut. Advisors may have an opportunity to help clients with these choices, assisting them in comparing benefits offered when clients change employers, or move into partial or full retirement.

ACTION STEPS AND TIPS FOR ADVISORS

Areas for action:

- Low returns play a central role in setting planning assumptions, retirement saving decisions, selecting investments, and identifying alternative strategies for achieving retirement success.
- When returns are low, advisors have multiple opportunities to help clients achieve retirement. In particular, the advisor can help discover alternative paths for each client and lay out new options for the client to consider.
- Potential responses to low returns include retiring later, and whether to work in a post-retirement setting.
- This new economic environment will require advisors to rethink the scope of their practices. If they find they must contend with new issues outside of their direct practice, they

may need to provide reference materials, refer to other services, etc.

- Depending on the advisor's business model, there also may be business opportunities related to dealing with new services provided.

Choosing investments:

- Advisors must devote close attention to the "new normal" economic environment. Alternative investments may help improve the situation during a period of low returns.
- The rising role of fees and charges will require careful evaluation of net returns and risk.

Planning issues:

- Using too low a rate of return in a planning calculation early in life could overestimate what someone needs to save; conversely, too high a return will underestimate needed saving rates.
- Advisors would do well to understand the tools used in retirement planning calculations, including the reasonableness of assumptions embedded in these tools.
- An advisor should understand the assumptions used in planning tools used for clients and be comfortable that they are appropriate for the task at hand. One should not assume that results based on historical experience will be appropriate for the next two or three decades.
- Disclose assumptions with appropriate caveats for the client.
- If the calculation uses a deterministic approach, the advisor should consider providing results based on multiple scenarios.

Employee benefit-related issues:

- Advisors can help employees make decisions about their employee benefits. Many plans include choices that can have a material impact on retiree well-being.
- When clients switch jobs, an advisor can help evaluate old versus new benefits and how to respond if the benefits provided differ importantly. Advisors also can help clients identify which benefit issues are important to them when considering a new job.
- Defined benefit plans become more valuable to employees during a time of low interest rates. However, low returns also may threaten the funding levels of defined benefit plans and make plan sponsors less interested in continuing such plans.

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