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A Retirement Crisis?

Until the middle of the 20th century, retirement planning was simple. Once mom and dad could no longer live independently, they moved in with one of their children. In 1935, President Roosevelt signed the Social Security Act; putting the federal government in the business of keeping mom and dad in their house, and out of yours.

During World War II federally mandated wage controls led employers to offer retirement and medical benefits to attract workers. Many business leaders realized that no company could provide medical and retirement benefits to its employees in perpetuity. From the end of World War II into the 1970s America was the world's economic powerhouse. Global competition was irrelevant. The cost of doing business was the cost of doing business in America. Companies had more employees than retirees and defined benefit pension plans proliferated. These plans offered workers a known retirement age and a guaranteed income in retirement. A retiree's pension benefit was based on years of service and final salary. Funding and investment risk were borne by the employer. The percentage of private sector workers with access to a defined benefit plan was approximately 25% in 1950 and reached a high point of about 50% in 1960.

Most baby boomers saw their parents retire with three sources of income – called the three-legged stool of retirement - Social Security, a defined benefit pension, and retirement savings. For these retirees, retirement planning was simple. Live on your Social Security, your monthly pension check and the interest from your savings. Don't touch the principal. Live happily ever after.

In 1978, Congress created defined contribution plans – such as 401(k)s and 403(b)s, permanently changing the pension landscape. These plans were originally viewed as supplements to traditional pension plans. Consequently, workers were given substantial discretion over whether to participate, how much to contribute and how to invest. Over the past 40 years, employers have been moving away from defined benefit plans to defined contribution plans, shifting the savings burden and investment risk to employees. Today, few companies offer defined benefit plans to new employees. Many companies have terminated their defined benefit plans during bankruptcy, but we've also seen financially sound companies eliminate or freeze their defined benefit pensions. This was inevitable for three primary reasons –

- **To reduce workers' total compensation in the face of intense domestic and global competition**. US companies compete against foreign companies, many of whose employees are covered by government-sponsored pensions, and new domestic companies that do not offer their employees a defined benefit pension.
- **To maintain existing employee compensation levels in the face of growing health care costs**. Total employee compensation includes salary, FICA taxes, pension contributions and insurance premiums. Rising health insurance costs for employees and retirees is a financial burden for many companies. While underfunded pension plans have been well documented in news reports, underfunded retiree health-care commitments are a problem lurking just around the corner. Unlike pension plans, promised retiree health benefits have no pre-funding requirement.
- **Market risk, regulatory risk and longevity risk make defined benefit pension plans unattractive to employers.** Employers are responsible for making contributions on an ongoing basis to fund future pension benefits. Increasing longevity in the retiree population necessitates higher funding during an employee's working years. If market declines lead to pension plan underfunding, federal law requires injection of additional funding to make up the shortfall.

Conventional wisdom assumes that employees were better off when defined benefit plans were the dominant retirement savings vehicle. But even at their peak, less than half of private sector employees had access to these plans. According to the American Enterprise Institute, 70%-90% of employees who worked for a company that offered a defined benefit pension did not qualify for a retirement benefit because of strict vesting schedules requiring many years of service. Additionally, there is no portability in these plans. Workers forfeit all years of service when changing employers.

The big drawback of defined contribution plans is that employees assume the burden of funding and managing the portfolio and assume all investment risk. Most have no training, interest, spare time or knowledge for the task at hand. The introduction of target date funds (TDF) as the default option in 401(k)s provides employees with a portfolio manager who makes all allocation decisions. An employee planning to retire in 20 years can invest in a 2040 fund which contains a diversified portfolio of individual funds. The fund manager will change the mix of stocks and bonds over time - aggressive today and more conservative as retirement approaches. Vanguard notes that in the 401(k)s that it manages, the 77% of participants who invest in TDFs have greater portfolio diversification and trade less than workers who forgo TDFs and select plan funds on their own.

The chief benefit of defined contribution plans is portability. Unlike past generations, few workers today will spend their career with one company and assets in a prior employer's 401(k) can be rolled over to a worker's IRA or current 401(k). Vanguard notes that the average 401(k) deferral, including both employee and employer contributions, has averaged 10.6% over the past 15 years. In a 40-year career, a 10% salary deferral and a 3% employer match, if properly invested, will grow large enough to fund a retirement with annual income similar to a typical defined benefit plan.

Today, only about 25% of civilian workers have access to a defined benefit plan. This has caused much handwringing from pundits who claim that America faces a "retirement crisis" because workers are not saving enough to maintain their lifestyle in retirement. An April 2019 report on CNBC noted that the average 401(k) balance for those age 65 and older is only $58,035, a sure indication that *"there is a retirement crisis in America where most will be unable to afford a solid life."* But are American workers really doing a poor job of saving for retirement? As a percentage of salary, more money is being saved today than ever before. According to the American Enterprise Institute, total employee and employer contributions reached an all-time high in 2017 – 12.8% of employee salaries. A September 2019 report issued by the Empower Institute, "The Overstated Retirement Crisis", takes a close look at American workers' retirement readiness. Some noteworthy takeaways from the report include –

- Each generation of retirees has been financially better off than the previous generation. At the peak of worker coverage in defined benefit plans, total retirement savings were 48% of total employee annual wages, according to the Federal Reserve. In 2017 total retirement savings were more than 337% of total employee wages. Surveys of workers with access to a workplace retirement plan indicate that they are happy with their retirement plan accounts. In 1980, 38% of private-sector workers had access to a pension plan at work. Today, 71% of civilian employees have access to either a defined benefit or a defined contribution plan and 80% of married couples have at least one spouse with access to a retirement plan.
- The media is quick to report any new study that promotes the idea that America is facing a retirement crisis. But few of these studies are peer-reviewed and often contain glaring methodological weaknesses. The $58,035 average 401(k) account value for those over age 65 noted in the CNBC report sounds ominous – until we consider that most retirees have significant assets outside their 401(k) - including 401(k) assets from previous employers that have been rolled into IRAs. According to the Investment Company Institute, defined contribution plans and IRAs account for only about 40% of all retirement assets. A more accurate analysis of retiree financial health must include Social Security and pension benefits, home equity, brokerage accounts, IRAs and cash reserves.
- Access to retirement plans has increased since 1978. Most Americans work in small companies and these employees have benefited most from the availability of defined contribution plans. In 1981, only about 4 million workers in companies with fewer than 100 employees had access to a retirement plan. Today, 97% of all 401(k) plans are in businesses with less than 100 employees. It's likely that few of these employees would have had access to any retirement plan before 1978.

In summary the report notes: *"Far from existing in a state of crisis, the retirement system, as a whole, positions Americans for a successful retirement. The retirement services industry has many players who compete in the marketplace of ideas, helping to ensure the system remains robust, competitive and flexible."*

According to the Social Security Administration, almost 90% of retired Americans receive a Social Security benefit. Social Security provides a solid income foundation for retirees who have only a small amount of savings. According to the Congressional Budget Office, for the lowest quartile (25%) of income earners, Social Security will replace 85% of their pre-retirement income. Although members of this group may not have significant savings, they may not need them to maintain their pre-retirement standard of living. Retirees with a defined benefit pension and a Social Security benefit likely do not need a large amount of retirement savings.

Today, 100 million American workers are covered by defined contribution plans with assets in excess of $7.5 trillion. If defined contribution plans are creating a retirement savings crisis, it isn't showing up in surveys or government data. In the Federal Reserve's Survey of Consumer Finances, more than half of retiree households state that they spend less than their income and only 15% state that their spending exceeds their income. In a recent Gallup poll, nearly 80% of retirees reported having enough money to live comfortably. In a recent Vanguard survey, only 10% of those nearing retirement and 4% of retirees describe their own situation as a "crisis". Out-of-pocket health care costs are always a concern for retirees, but health care out-of-pocket costs have stayed stable at about 10% of total retiree household income since 1984.

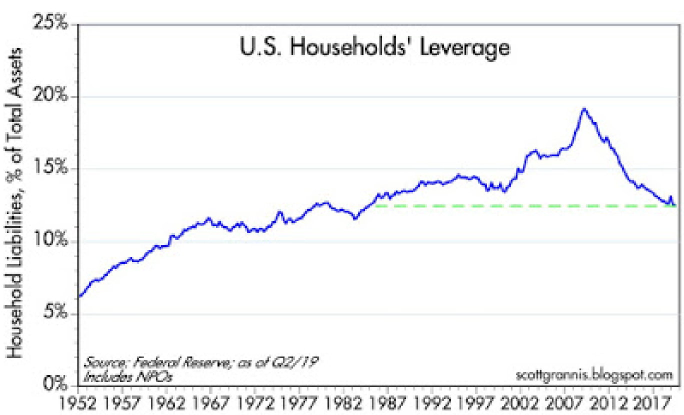
If there's a retirement savings crisis, it is in the retirement plans run by state and local governments whose underfunded pension liabilities guarantee that they will not be able to provide retirees promised benefits. A 2017 study in retirement savings published by the World Economic Forum concluded that 75% of the retirement savings gap in the United States is in public sector defined benefit plans. Public sector employees under age 50 who are being promised a defined benefit pension would be wise to save as if the benefit will be significantly less than what is being promised.

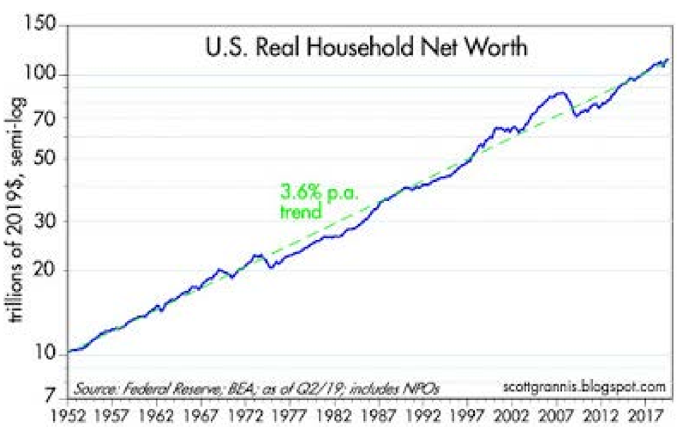
In the News

In early July, a €3 billion offering of 2.9% Italian government bonds maturing in 2067 was almost six times oversubscribed. A stampede of investors eager to loan the Italian government money at 2.9% for 48 years? The world has gone mad.

In the three years ending November 30th, the S&P 500 Index registered 115 new all-time highs. This year's 28th all-time high occurred on December 13th. Investors typically react to new all-time highs in one of two ways. The first reaction is fear. "Stocks are at an all-time high, they must be overvalued and ready for a big decline." The other reaction is jubilation. "It's time to put more money into stocks!" Sticking with your financial plan is important when stocks are declining, and your emotions are screaming "Sell!" But it's just as important to stick to your plan when things are going better than expected. A new high means that if you sell today, you'll get a better price than if you sold yesterday. That's all it means. It's not a signal to start tinkering with your portfolio.

It was widely reported that total US household debt reached almost $14 trillion at the end of the second quarter of 2019. This debt consists primarily of mortgages, car loans, student loans and credit card debt. This is an all-time high and a really big number, so it was reported as really bad news.





But once again, one number, a numerator, doesn't tell the full story – we need to know the denominator. To get a true picture of the debt burden of US households, we must know the value of assets owned by US households. Total US household assets also reached an all-time high of $113 trillion at the end of the second quarter. That's almost double what it was at the depths of the Great Recession in 2009, while debt is only 10% higher, according to the Federal Reserve. This chart from Scott Grannis' blog, gives a clearer picture of the US household debt burden. Total household liabilities, as a percentage of total assets, is the lowest it's been since 1987. Household debt service relative to after-tax income is tied for the lowest on record since the Fed started tracking this data in 1980. This good news shouldn't come as a surprise. The unemployment rate is hovering near a 50-year low; job growth remains robust; wages are growing faster for low-income workers than high-income workers and private-sector wages and salaries are up 5.2% from a year ago.

This chart shows US household net worth since 1952 in 2019 dollars. In other words, assets minus debts on an inflation adjusted basis. US real household net worth has increased at a 3.6% annualized rate since 1952 and is currently at an all-time high. You'd think all this good news would be the subject of large font headlines, but apparently good news doesn't attract eyeballs, ears and clicks or validate the relentless negativity of the financial media.

It's that time of year when prognosticators offer stock market predictions for the upcoming year. A year ago, few saw the excellent returns produced by domestic and international stocks in 2019. The rest won't let their failed forecasts keep them from regaling us with their predictions for 2020. Make it your New Year's resolution to ignore all forecasts.

Well, another year has come and gone. There's just one more thing to say in 2019. "Merry Christmas to all and to all a good night."