ACHIEVING RETIREMENT SECURITY IN AN ERA OF UNCERTAINTY:
Three Important Steps

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While the goal of achieving retirement security is arguably more challenging than at any time in the last 50 years, this paper focuses on steps that can improve retirement outcomes.

THE CHALLENGE:
Achieving retirement security in an era of uncertainty

The Center for Retirement Research (CRR) at Boston College reports that the percentage of U.S. working-age households at risk of being unable to maintain their pre-retirement standard of living once retired rose from 30% in 1989 to 51% by 2009.¹

There are multiple reasons for this trend. Many individuals are simply not saving enough. Those who are have seen their retirement nest eggs battered over the past 12 years by volatile financial markets, including two major bear markets in stocks. Social Security, though it continues to play a key role for retirees, is providing less retirement income for many of them due to an increase in the Full Retirement Age and increased taxation of benefits.²

Even as American workers struggle to save for retirement, its cost keeps rising. Longer life spans, low interest rates, and rising healthcare costs are part of the problem, as is the shift away from traditional defined benefit pension plans in favor of defined contribution plans, which transfer the risks associated with generating retirement income from employers to individuals.

Longevity risk has always been a challenge for retirees, but today it is becoming more pronounced. Men 65 years old can now expect to live nearly four years longer than their counterparts in the 1980s. Women age 65 can expect to live two years longer.³ Because

² Center for Retirement Research at Boston College, “Just the Facts on Retirement Issues, #6”, February 2003, p. 3.
retirees are living longer, they must save more—and make what they do save last longer.

The demise of many defined benefit plans, which pool risks among many workers, has magnified this challenge. Participants in defined contribution plans, such as 401(k)s, are responsible for creating their own retirement security, which means they must accumulate larger sums to manage longevity and market risk than they would need if those risks were distributed across a pool of their fellow employees in traditional pension plans.

Low interest rates have been a particular retirement hazard for the past three years. When rates are extraordinarily low, it is harder for retirees to generate income and for pre-retirees to accumulate assets. To make up for lower investment returns, pre-retirees again must save more.

They also must save more to meet the rising cost of healthcare. For a married couple retiring at age 65, out-of-pocket healthcare expenditures are now projected to total $197,000.4 Factor in nursing home costs, and that figure swells to $260,000.5 Yet even as healthcare costs skyrocket, employers are continuing to eliminate subsidies for retiree healthcare or are discontinuing that coverage altogether.

The cost of retirement is rising due to:

- Longer life spans
- Transfer of risk associated with generating retirement income from employers to individuals
- Low interest rates
- Rising healthcare costs

Clearly, workers need new tools to improve their chances of building a financially secure retirement. The good news? Many are already available.

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5 Ibid.
Reasons for optimism: three important steps toward retirement security

Individuals and institutions can take three important steps to improve Americans’ retirement security prospects.

1. Improve saving and investing behavior

Defined contribution (DC) plans already have a lot going for them. Americans have saved over $4.5 trillion in DC plans and another $4.7 trillion in IRAs, with much of the latter amount originating from rollovers from DC plans.6

However, only about half the U.S. workforce is offered a pension or retirement plan at their place of employment.7 Several proposals have been made that would significantly expand coverage, including one calling for the widespread creation of Multiple Small Employer Plans (MSEPs). MSEPs would allow employers with fewer than 100 employees to pool resources under a single DC plan, resulting in lower costs and simplified administrative requirements; however, legislative action is needed to spur their broad adoption.8

The Employee Benefit Research Institute reports that workers in their 60s who participated in their 401(k) plans for at least six years had increased their savings, on average, to $144,000 by 2009 from $100,000 in 2003.9 While that number is not where it needs to be, it is a good foundation upon which to build.

The passage of The Pension Protection Act of 2006 paved the way for greater adoption of automatic features in DC plans, such as automatically enrolling participants as well as automatically escalating contribution amounts. These plan enhancements harness the power of inertia to improve saving behavior.

In addition to saving adequately, Americans need to invest wisely. After suffering severe stock market losses in the past two bear markets, many people are now wary of investing in equities. In one study, 44% of investors said they will never put more money into the stock market.10 Yet the current low interest rate environment suggests that individuals will likely need the potentially higher returns that equities can provide to reach their retirement income goals.

Saving and investor behavior will improve if the end goal is properly positioned. Since DC plans are fast becoming the only work-based retirement plan for many workers, it is critically important that individuals track their savings progress based on what their DC savings can generate in terms of future retirement income. Simply put, the outcome must be framed in terms of income.

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The reality is that defined benefit plans and their lifetime income guarantees are never coming back for many in the private sector. To compensate, American workers need access to similar income guarantees in the defined contribution plan and retail investment markets. These guarantees are available. New products have emerged over the past decade that allow individuals to create their own personal pensions while transferring the associated risks to financial services firms. Those firms can manage those risks through pooling strategies as well as through hedging programs that would be difficult, if not impossible, for individuals to put into place.¹¹

Unlike traditional annuities, these new products do not require investors to surrender control of their assets in exchange for a stream of guaranteed payments. Instead, investors retain control of their savings and investment decisions. They can start, stop, and adjust payments as they wish, or even withdraw their assets entirely if their income needs change. While withdrawing assets earlier than scheduled can reduce future payouts or guarantees, research has shown that retiring workers appreciate this control and flexibility with respect to their retirement wealth.¹² Among other things, it allows them to increase or decrease their income based on out-of-pocket healthcare expenditures or other unexpected expenses.

Securing a guarantee of lifetime income on certain earmarked assets eliminates longevity risk for retirees. It also reduces market risk. This can be particularly valuable in the years just before or after a person retires, since severe market losses at that time can cripple a retirement portfolio and dramatically reduce the amount of income it subsequently generates. Prudential research indicates that new retirees are particularly vulnerable to early investment losses, since they often stop working in the optimistic environment that follows a stock market advance—only to face an increased risk of a market correction when stock prices revert to the mean.¹³

Beyond mitigating longevity risk and market risk, guaranteed lifetime income products make retirement security more attainable by lowering its cost. Prudential research has found, for example, that adding a guaranteed minimum withdrawal benefit for life to

In a recent Prudential survey, 84% of investors indicated that if they had an investment product with guarantees, they would likely stay in the stock market even if they experienced short-term losses.

¹³Prudential Financial, “Why Do Individuals Retire When They Do and What Does It Mean for Their Retirement Security”, July 2011, p. 3.
a target-date fund could, for a typical 401(k) plan participant, reduce the amount of assets needed to generate a given amount of retirement income by 36%.14 This guaranteed minimum withdrawal benefit would assure that participants continue to receive income for life even if their retirement assets were exhausted due to longer-than-average lifespans and/or poor investment performance. If participants were to self-insure against those risks, they would have to accumulate a much larger account balance.

Guaranteed lifetime income products may also help by raising the risk tolerance of investors. In a recent Prudential survey, 84% of investors indicated that if they had an investment product with guarantees, they would likely stay in the stock market even if they experienced short-term losses.15

Actual investor behavior appears to bear this out. Prudential found that 401(k) investors who adopted a guaranteed minimum withdrawal benefit as part of their investment portfolio were much more likely to have stayed invested in equities during the 2007–2009 bear market, thereby reaping the rewards when stock prices rose sharply after the March 2009 stock market bottom.16

Individual investors are beginning to recognize that guaranteed lifetime income products can be an important part of a retirement portfolio. In a recent survey, nearly 7 in 10 said products that provide guaranteed income, protect against market losses, and participate in market growth are appealing.17 In 2010 alone, sales of variable annuity products with guaranteed lifetime income features totaled $81 billion.18

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16 Prudential Financial, research on participants with and without in-plan GMWB (IncomeFlex) from December 2007–April 2011.
3 Optimize Social Security decisions

Although Social Security benefits have been decreasing due to increases in the Full Retirement Age and the taxation of benefits, Social Security still has a critically important role to play for retirees. Inflation-adjusted income from Social Security still accounts, on average, for nearly 40% of retirees’ income.19 In its research report “Innovative Strategies to Help Maximize Social Security Benefits”, Prudential described little-known ways for individuals, married couples, widows, and widowers to maximize the value of their Social Security options as well as lower the taxation of their benefits.20

In particular, the report noted, married couples should plan their claiming decisions together to take full advantage of the worker and spousal benefits available to them. Many valuable planning options become available once a spouse reaches his or her Full Retirement Age, which is currently 66. Married couples also should consider how delaying the claiming of Social Security can provide higher lifetime income to a widow or widower in the form of a future survivor benefit. Creating larger streams of income in the form of Social Security may also lower lifetime taxes paid in retirement, since Social Security income receives preferential tax treatment under current law. As a result, retirees may be able to stretch their retirement resources over a greater number of years.

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19 Employee Benefit Research Institute, EBRI Notes, Volume 31, No. 6, June 2010.
Although achieving retirement security has become more challenging, there are steps that individuals and institutions can take to significantly improve retirement security prospects. Improving individuals’ saving and investing behavior, increasing access to and utilization of guaranteed lifetime income products, and optimizing Social Security benefits can all make retirement more affordable, attainable, and secure.

Many are in a position to help:

- **Employers** can offer DC plans, add guaranteed lifetime income solutions to those plans, and encourage participants to focus on savings goals related to retirement income rather than to specific accumulation amounts. Further, they can adopt automatic enrollment and automatic contribution escalation features within their DC plans if they have not already done so.

- **Policymakers** can make it easier for employers to offer guaranteed lifetime income options within their DC plans by creating clear safe harbors that ease the current fiduciary concerns of some plan sponsors. Policymakers also can adopt regulations that require DC plans to project a future monthly income amount on participant statements, which would make it easier for plan participants to gauge how well they are meeting their retirement savings goals. Finally, policymakers can pave the way for greater retirement plan coverage by passing legislation that encourages the adoption of coverage solutions such as Multiple Small Employer Plans.

- **Financial services** firms can continue to parlay their risk management expertise into products that protect against market downturns, allow participation in market upside, and offer a stream of income in retirement that cannot be outlived—all without requiring individuals who use those products to sacrifice flexibility and control.

- **Financial advisors** can educate their clients on the role that guaranteed lifetime income products can play in achieving a more secure retirement. They also can help individuals understand their Social Security claiming options as part of a comprehensive financial plan.

- **Finally, individuals** can take ownership of their own future retirement security if they have not done so already, and work with their financial advisors and through their DC plans to create their own personal pensions through the use of guaranteed income products. Individuals also can build a strong foundation for retirement security by considering the importance of proper savings and investing behavior, guaranteed lifetime income, and optimal Social Security decisions.

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Recent Prudential Financial papers that touch on the topics mentioned above include:

Leveraging Multiple Small Employer Plans to Close the Retirement Coverage Gap, March 2012.


What Employers Lose in the Shift from Defined Benefit to Defined Contribution Plans…and How to Get it Back, July 2011.

Why Do Individuals Retire When They Do and What Does It Mean for Their Retirement Security? July 2011.

Meeting Investment and Retirement Challenges: The Next Chapter, June 2011.


