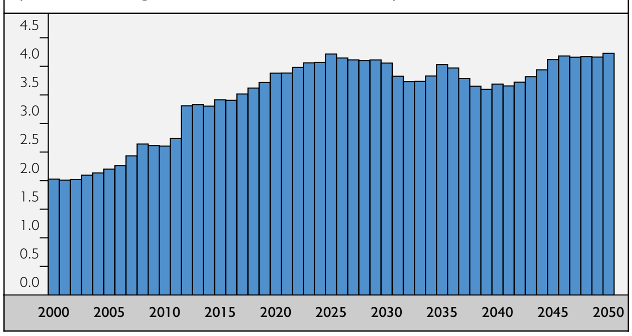
Dr. David Kelly
Managing Director and
Senior Economic Advisor,
Putnam Investments

(How to avoid) Waltzing broke into retirement

In the year 2000, 2 million Americans celebrated their 65th birthday. In 2012, 3.3 million Americans will reach this milestone. In 15 years, the number of 65-year-olds should swell to 4 million, bringing the total number of Americans age 65 and older to 58 million, up from some 38 million today. The inexorable march of the baby-boom generation into their retirement years is upon us. With all the questions that pervade financial markets and financial planning, this graying of America was the one certainty, which makes it all the more regrettable and alarming that so many Americans are financially unprepared for what comes next.

THE BABY BOOM TURNS 65

(Americans age 65, 2000–2050, Millions)



Source: U.S. Census Bureau Projections.

Many millions of Americans will never get to retire or will retire into relative poverty. The gap between rich and poor in America has contributed to this fact, and business and market cycles haven't helped. But the truth is that much of the problem stems from our investment behavior. We don't save enough of what we earn. We don't invest enough of what we save. And we don't diversify what we invest. Current retirement savings vehicles such as 401(k)s have the potential to fund a comfortable retirement for most American workers. But to achieve that potential requires discipline, perseverance, and prudence — all of which makes getting consistently good financial advice critical in turning a retirement savings plan into a comfortable retirement income.

The looming threat of unfunded retirement

In survey results released earlier this year, fully 51% of workers age 55 and over reported having less than $100,000 in savings and investments outside of their primary residence and defined benefit pension plans. More than one quarter of those surveyed had less than $10,000 saved. These numbers tally quite well with the Federal Reserve's Survey of Consumer Finances, which showed that in 2004, 50% of households headed by someone age 55 to 65 had total financial assets of less than $78,000 outside of defined benefit pension plans.[1]

Given any prudent rate of withdrawal, retirement savings of less than $100,000 can hardly make a meaningful contribution to a retirement income, so it appears that roughly half of American workers on the brink of retirement are going to have to rely primarily on Social Security and defined benefit plans.

However, for many this income will also fall short. In 2005, the average monthly Social Security check covered only 42% of pre-retirement earnings for the average 65-year-old. Moreover, this situation is likely to deteriorate in the years ahead as the age of eligibility for full Social Security benefits rises to 67, as an increasing share of Social Security payments become subject to income tax, and as Medicare Part B premiums rise, absorbing an ever-larger share of the average Social Security check.[2]

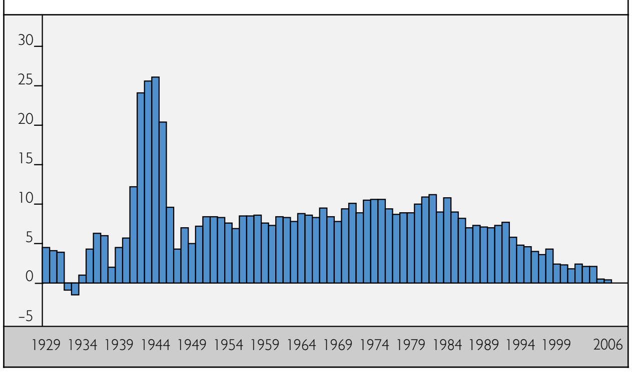
Nor can most Americans rely on defined benefit plans. While 63% of current retirees receive some income from a defined benefit pension plan, only 41% of workers report that they or their spouse currently have this kind of plan, a number that falls every year.[3] The sad reality is that tens of millions of Americans are not going to achieve the very reasonable goal of a comfortable retirement. How did we end up in this predicament, and what can individuals do to avoid the pitfalls of retirement planning?

The savings slide

The first cause of America's retirement income problem is that we simply don't save enough. In 2006, the personal savings rate fell to 0.4%, its lowest level since 1933, when the savings rate was actually negative. This measure includes both employer and employee contributions to retirement plans but excludes capital gains. The exclusion of capital gains does mean that the savings rate statistics paint too dire a picture of the financial health of the household sector. Over the last quarter century, we have seen huge gains in the value of both financial assets and real estate, reflecting these capital gains.

THE SAVINGS RATE IS AT ITS LOWEST LEVEL IN 73 YEARS

(Personal savings, % of disposable income, 1929–2006)



Source: U.S. Bureau of Economic Analysis.

But the decline in savings rates shouldn't be ignored for two important reasons. First, even though Americans have seen big increases in their wealth in the last 25 years, much of this has come from declining inflation. But precisely because of low levels of inflation, these assets tend to have much lower yields than in the past. Someone facing a long retirement needs income, not just assets, and finding high-yielding assets in a low-inflation environment is difficult.

More important, there is a huge gulf in the savings behavior of Americans, depending largely on their income levels. Indeed, in 2005, all of the net saving done by the household sector was done by people in the top 20% of the income distribution.[4] According to a survey of plan sponsors, in 2005, only 70% of eligible workers were participating in 401(k) plans, down from 80% six years earlier, and they were setting aside just 6.9% of their salaries, down from 8.6% in 1999.[5] Saving is hard, particularly in a society that promotes consumption at every turn. But it is an essential first step to achieving a financially comfortable retirement.

The risk in cash

Given how hard many Americans find it to set aside money for retirement, it is a near-tragedy how conservatively much of that money is being allocated. At the end of 2005, some 18% of the money sitting in retirement accounts, or over $500 billion, was in cash or stable-value funds.[6]

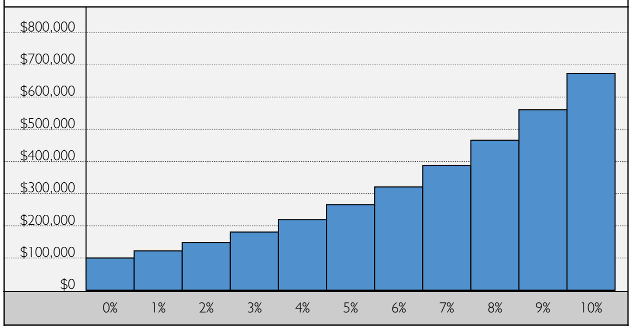
While Americans hold much more cash than that outside of retirement accounts, this $500 billion is particularly galling because it is almost certainly being misallocated. It is entirely reasonable for someone to keep money in short-term accounts for short-term expenses or for emergencies. But these are long-term retirement accounts and for Americans to hold 18% of retirement assets in cash makes no sense at all.

Here are two possible reasons for this massive allocation toward cash: procrastination and risk aversion. Procrastination is particularly damaging in plans that direct money to stable value accounts as a default option. Many people either don't pay attention or don't realize the cost of the decisions they are making. After all, cash accounts today can pay 5%, and the stock market in the long run might provide an average total return of 9%. One might reasonably wonder, 5%, 9% — what's the difference?

And of course, in any one year there isn't much difference. But over 20 years, 5% compounds to 165% while 9% compounds to 460%. That is a 295% difference in total return on money invested today. For long-term investors, cash is a killer.

THE RATE OF RETURN REALLY MATTERS

(What 20 years does to $100,000 at different rates of return)



Source: Author's own estimates.

The other reason many investors hold money in cash is because they are risk averse and dislike the volatility in the stock market. But the truth is that some risk is unavoidable and the biggest risk facing many investors is their own good health. Most people in America are aware of the steady increase in average life spans seen here over the last century. But what's really remarkable is the spread. Based on 2004 data from the Centers for Disease Control, the average person turning 65 today has a 5% chance of making it to their 100th year.[7] And for many people who are lucky to live that long, if they don't get their money to grow, they won't get their money to last.

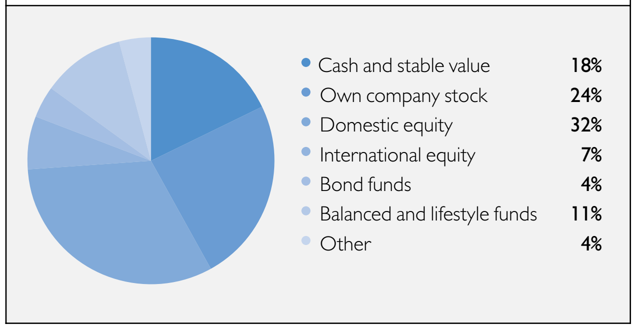
The need to diversify

The third obstacle to success in retirement investing is a failure to diversify properly. One manifestation of this is the still very significant presence of company stock in retirement plans. At the end of 2005, some 24% of money in retirement plans was invested in company stock. It is, of course, in the interest of many companies to encourage their employees to have an ownership stake in the company. However, from the employees' perspective, having too much wealth tied up in one's company represents a significant risk.

This danger was made painfully clear to the 11,000 employees of Enron Corporation who were laid off in 2001 as the company collapsed. In Enron's case, 60% of retirement plan assets were in Enron stock, and many employees had all of their 401(k) assets in Enron.[8]

RETIREMENT FUNDS HAVE BIG ALLOCATION ISSUES

(Allocation of retirement fund assets, year-end, 2005)



Source: PSCA's 49th Annual Survey of Profit Sharing and 401(k) Plans.

There are other diversification problems. One is home-country bias. Even after five years in which international investments had beaten U.S. investments, just 7% of U.S. 401(k) assets were in international funds at the end of 2005. In normal times, it is often recommended that individuals allot 20% of their stock portfolio to international investments. Given the booming world economy, reasonable P/E ratios overseas, and the prospects for a further decline in the U.S. dollar, U.S. investors probably should be overweight rather than underweight in international today.

And finally, there is the tendency to double up on winning bets and cut losing bets. At the end of 1999, when U.S. stocks were relatively expensive, 53% of 401(k) assets were in equity funds and 5% were in bond funds. At the end of 2002, when bonds were expensive and stocks were cheap, just 40% of 401(k) assets were in equities and 11% were in bond funds.[9] It is human nature to want to add to your winners and cut your losers. However, from an asset allocation perspective, this is just another way of saying you are going to buy high and sell low — a formula guaranteed to underperform a more pedestrian buy-and-hold strategy.

The value of advice

For millions of Americans, the prospect of entering their retirement years without adequate resources is a daunting reality. Some will downsize their lifestyles, some will depend more on their children, some will work long into what they thought were going to be their retirement years. Many will worry much more and enjoy life much less than they deserve after a lifetime of effort. There is a limit to how much we should beat up on ourselves for this predicament. American workers are generally smart, hard-working, and generous. But we live in a culture of consumption, and the information purveyed by the financial news media is generally one of fear and fads that almost mock a balanced, long-term approach to investing.

The Pension Protection Act of 2006, with its features encouraging automatic enrollment and automatic allocation, is an important step in the right direction, and over time should lead to better allocations. Moreover, there is no doubt that 401(k) and other retirement plans can do the job. If we consistently save enough early enough, balance our investments, and rebalance when markets get out of whack, we should be able to save enough to achieve a comfortable retirement.

But getting good advice from a knowledgeable advisor is invaluable. Many of us know we should live healthier lifestyles, and we even know roughly how to do it. But in a world where there is never enough time, nutrition labels go unread and the StairMaster® gathers dust in the basement. For employers who truly have the long-term interests of their employees at heart, it isn't enough to have a 401(k) plan — there also has to be a plan to get workers to participate appropriately in the plan. For this reason, the best defined contribution retirement plans should come with an active advice component to give workers the discipline to save enough of what they earn, the courage to invest enough of what they save, and the prudence to diversify what they invest.

Diversification does not assure a profit or protect against loss. It is possible to lose money in a diversified portfolio.

---

[1] *The Retirement System in Transition: The 2007 Retirement Confidence Survey,* Employee Retirement Benefits Institute, April 2007, page 10, Figure 7. *Recent changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances,* Table 5B.

[2] *Social Security and the Stock Market: How the pursuit of market magic shapes the system,* Alicia Munnell and Steven Sass, 2006, page 12.

[3] *The Retirement System in Transition: The 2007 Retirement Confidence Survey,* Employee Retirement Benefits Institute, April 2007, page 5.

[4] *Current expenditure surveys, 2005,* Bureau of Labor Statistics. 2005; *Defined Contribution Market Needs,* The Spectrem Group, February 2006.

[5] *Current expenditure surveys, 2005,* Bureau of Labor Statistics. 2005; *Defined Contribution Market Needs,* The Spectrem Group, February 2006.

[6] *49th Annual Survey of Profit Sharing and 401(k) Plans,* Profit-Sharing Council of America, page 32, *and Flow of Funds Statistics of the United States,* Federal Reserve Board, Table L.118.c.

[7] Author's own estimates based on 2004 data from the Centers for Disease Control and assuming continued declines in age-specific death rates at the same pace as over the last 20 years.

[8] "Company stock slams 401(k)s", article by Martine Costello, *CNN/Money,* December 2001.

[9] *401(k) Plan Asset Allocation, Account Balances and Loan Activity in 2006,* Investment Company Institute, August 2007, page 18.

II555 247350 9/07