

The Future Shock of Retirement

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The authors examine recent research that suggests the retirement-age population in the United States is more prepared for retirement than has been generally believed. They find that retiring middle-class households are dependent mainly on preretirement wages, U.S. Social Security, and home equity values; personal savings and employer-sponsored retirement plans play a lesser role. The authors also conclude that middle- and upper-middle-class households are vulnerable to shocks. Therefore, the authors apply such adjustments as reducing wealth for increased medical costs and the portion of home equity that relates to housing consumption.

The authors study wealth data for the U.S. population aged 51 to 61 to determine whether their income will support their retirement needs beginning at age 62, as current research suggests. Existing research is supported by three methods for assessing “adequate” income: income replacement rates (e.g., the 70 percent rule of thumb), comprehensive wealth analysis (e.g., annuitized total wealth), and optimality analysis (e.g., a life-cycle approach). Study findings show that, on average, retirees reduce their spending for employment-related costs and restaurant dining but not for other types of expenditures.

The authors use wealth data from the Health and Retirement Study conducted every two years by the University of Michigan. The sample is restricted to 3,424 households whose oldest members were between the ages of 51 and 61 as of the latest update in 2004.

The authors divide the sample into 10 classes based on total comprehensive wealth, with adjustments as needed. Comprehensive wealth includes human capital (i.e., the expected present value of wages earned up to age 62), U.S. Social Security income, defined-contribution plans (DCs) and IRAs, defined-benefit plans (DBs), personal savings,

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non-financial assets (which include home equity), life insurance and annuities, and gifts and inheritances. Wealth is converted to an annual annuitized income for each of the 10 classes to ease comparisons and to facilitate the sensitivity analysis.

The wealth data indicate that middle- and higher-class households are dependent mainly on preretirement wages, Social Security income, and nonfinancial assets, including home equity, for retirement; personal savings, IRAs, and employer-sponsored retirement plans play a smaller role. For example, for households in the seventh-wealthiest decile, 75 percent of their wealth is composed of wages, Social Security income, and nonfinancial assets; the remaining 25 percent of their wealth includes 5 percent in personal savings, 8 percent in DCs and IRAs, and 10 percent in DBs. Households in the lowest decile are even more dependent on Social Security and home equity, with Social Security representing 47 percent of their wealth. For the wealthiest decile, Social Security represents 10 percent of wealth and DBs represent 17 percent. Home equity accounts for 9–14 percent of wealth for all deciles.

The authors stress that many factors can affect wealth, such as reduced Social Security or Medicare benefits or lowered pension plan and real estate values. They state that Social Security and Medicare are not sustainable at the current levels given longer life spans and the increase in the retirement population relative to the working population. They also note that the range of wealth outcomes for households has increased as a result of the trend from DBs to DCs.

They examine two adjustments to wealth—a \$7,000 decrease in annuitized income for Deciles 6–10 based on a “means-tested” reduction in Medicare and a 50–60 percent reduction in home equity for all deciles based on the portion of equity that most likely will be used for housing costs (i.e., the imputed rental cost of living). Home values are not reduced for price declines. These results show that households in Deciles 6–8 lose between 20 and 28 percent of their total wealth and become even more dependent on preretirement wages because they have comparatively little in savings, investments, and employer-sponsored retirement programs. Deciles 9 and 10 lose 16 percent and 9 percent of their wealth, respectively. The increased dependence on preretirement wages is a dangerous financial condition for many households.

The authors suggest that government, the private sector, and individuals can help solve the retirement problem if they work together. Government has considered reducing Social Security benefits and increasing contributions, privatizing Social Security, and nationalizing health care. Accepting that DBs are unlikely to be embraced in the future, employers can design DCs to incorporate vital features of DBs and help steer participants in the right direction. Financial advisers can express wealth in terms of annuitized income, and insurance companies can develop less complex and more cost-efficient annuities. Also, individuals can take a more active role in planning for their retirement needs.

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