The Economist

Over to you

Workers need to fend for themselves

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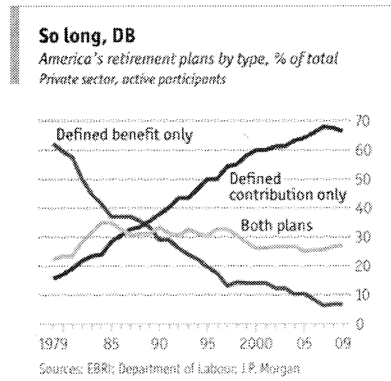
THE RICH WILL always have a comfortable retirement; the poor will be supported by the state. For the people in the middle, the best hope of a decent pension has traditionally been to find a job that offered a final-salary pension and then stick around for the rest of their careers.

For private-sector workers, such jobs have become a rarity. "Defined-benefit plans are going the way of the dodo," says Olivia Mitchell of the Wharton Business School in Philadelphia. Over the past ten years global assets in DB plans have grown by just 2.9% a year, whereas those in defined-contribution plans have increased by 7.5%, according to a Towers Watson study. Between 1979 and 2009 the share of employees in DB pension plans in America fell from 62% to 7% of the total (see chart), according to the Employee Benefit Research Institute (EBRI), whereas those in DC plans rose from 16% to 67% (the rest had a bit of both). Assets in American DC schemes, also known as 401(k) plans after the subsection of the tax code that created them, were worth $2.8 trillion at the end of 2009.



With a DC pension, nearly all the risk is passed to the employees. James Poterba at the Massachusetts Institute of Technology, points out that a DC plan forces them to make a set of decisions, such as their contribution rate and their asset allocation, for which they may not be equipped. "A very large proportion of the population has no interest, knowledge or time to direct their 401(k) plans. They are known as the unengaged majority," says Kristi Mitchem of State Street Global Advisors, a custody and fund-management firm.

The danger is that employees will underestimate the size of the pension pot they need and overestimate the investment returns they will achieve. The cost of providing pensions has risen over the past decade; investment returns have been poor and interest rates have fallen. Lower interest rates are important because pension providers are, explicitly or implicitly, buying annuities (guaranteed lifetime incomes) for their clients. A report by Charles Cowling for Politeia, a think-tank, found that last year it cost £25.50 to buy a British annuity that paid £1-worth of pension a year. In 1990 it could have been bought for £12.70.

Logically, therefore, employees should be contributing more to their pension pots. But in the shift from DB to DC the reverse has happened. Employers contribute around 20-25% of payroll to DB plans. The combined total of contributions (by employers and employees) to DC plans in America and Britain is around 9-10%. The amount put into a plan largely determines the resulting pension, so the current level of DC contributions will not deliver anything like the old final-salary pensions. The average account balance in American DC plans at the end of 2009, according to the EBRI, was just $58,351. But that may sound gloomier than it is, because the median age of DC plan members is only 45, with many years to go to retirement; and some may have other sources of retirement income, such as DB schemes.

Another way to get at the numbers is to look at employees who were consistent members of DC schemes over a period of ten years. The EBRI puts the average balance of such people at $131,438 in 2009, up from $67,420 in 1999, which amounts to a compound growth rate of 7%. That would suggest that the growth in balances has largely been driven by contributions. Even employees in their 60s who had been members of DC plans for 30 years had accumulated pots of less than $200,000, enough to generate a sustainable income of perhaps $10,000 a year. That is not a huge reward for 30 years of thrift. Seth Masters, chief investment office of Alliance Bernstein, puts the numbers in perspective: "If our industry is to be successful [in generating a decent pension], people have to be retiring with pots of $750,000 to $1 million."


Michael Morgenstern

The figures look even worse given that members of DC plans tend to be among the better-paid. A 2007 paper for the National Bureau of Economic Research found that among families with earnings above $100,000, over 87% were eligible for a 401(k) plan; among those earning less than $25,000, under 36% were.

Even if contribution levels improve, the results of DC plans will be highly variable because they depend on the investment performance. That means two workers with identical career paths and salaries could end up with very different pensions.

The choice of funds within the pension plan is therefore extremely important. After the collapse of Enron, an American energy company, it turned out that many of its workers had invested their pensions in company shares. They lost everything.

Pot luck

To avoid such problems, most employers offer a diversified plan. In Britain the portfolio which employees are allocated if they do not make their own selection will have a mixture of equities, government bonds and other assets, and will be structured in such a way as to become less risky over time as employees near retirement. This reflects the fact that most Britons use their pension pot to buy an annuity.

In America the fastest-growing part of the market is target-date funds, which build a savings pot matched to the employee's chosen retirement date by investing in a range of assets. The EBRI says that in 2009 some 77% of all DC plans offered such funds; of those employees who had the option, some 46% took it. This is a huge business for the three fund-management companies that dominate the sector, Fidelity, T. Rowe Price and Vanguard.

In America very few retired people buy an annuity. They can wait until they reach the age of 70 and six months before they even have to turn their pension pot into income; then they get it by selling part of the fund each year. Target-date fund managers therefore regard themselves as selling a product that runs "through" rather than "to" retirement. Managers say that this justifies more exposure to equities since investors need some protection against inflation.

But this higher equity exposure comes at a price. In 2008 funds with a

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2010 target suffered losses of 20-30% as the stockmarket plunged. Critics think this shows the danger of steering employees towards equities. "Defaulting people into target-date funds is a violation of the employer's fiduciary responsibility," says Lawrence Kotlikoff at Boston University. "Stocks are not safer in the long run. Their variability just gets bigger."

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Derek Young, the chief investment officer at Fidelity's target range, argues that investors should take the long view. Continuing exposure to equities allowed Fidelity's 2010 fund to rebound with the market; since its launch in 1996 the fund has delivered annual returns of 6.8% after fees. Research by Vanguard shows that only 2.5% of target-date holders sold out of their funds (and thus realised their losses) in 2008. Target-date funds may be better than the alternatives, since otherwise investors may take too much or too little risk. As target-date funds became more popular, the share of DC plans invested in the employer's stock fell from 19% in 1999 to 9% in 2009. But even a well-diversified portfolio will not help if too little is invested in it.

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