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This Nobel Economist Nails What's Really Wrong with Your 401(k)

Penelope Wang **June 29, 2014**

Retirement plans are doing it all wrong, says Robert Merton. He ought to know. His hedge fund nearly brought the down the global economy.

In the 30-plus years since 401(k) plans were first introduced, they've faced criticism for everything from the risks employees face to the fees they pay to poor investing options. Now Robert Merton, a Nobel Prize-winning economist, says 401(k)s are headed for a

If anyone should know about a potential crisis, it's Merton. Along with his fellow Nobel laureate Myron Scholes, Merton co-founded and sat on the board of Long-Term Capital Management, a hedge fund that was managed based on complex computer models. Under the leadership of co-founder John Meriwether, LTCM's massive failure nearly brought down the global economy in 1998.

Now Merton is saying that 401(k)s are headed for trouble, but for very different reasons. In particular, he argued at a recent Pensions & Investments conference, 401(k)s take exactly the wrong approach to retirement investing by emphasizing account balances and investment returns, thereby encouraging savers to amass the largest portfolio possible, which pushes them to take too much risk. That's an approach he calls "la-la land."

Instead of focusing on wealth creation, 401(k)s should emphasize the level of income employees can expect to receive in retirement, Merton says. By knowing whether they are on track to that goal, workers will make better saving and investment choices.

One of the best ways to be assured of steady future income is to invest in an inflation-adjusted annuity, Merton says. But current 401(k) regulations do not allow deferred annuities as an investment option. Merton argued in a recent Harvard Business Review article that this barrier should be changed.

Meanwhile, workers are encouraged to invest in Treasury bills for safety, which they appear to deliver — if you look at year-by-year returns. But if you consider the income that T-bills would provide in retirement, as measured by the amount of deferred annuity income they would purchase, they are nearly as risky as the stock market. "The seeds of the coming pension crisis lie in the fact that investment decisions are being made with a misguided view of risk," Merton writes.

Even so, he isn't recommending that investors hold only deferred annuities to achieve their income goals. Instead, he suggests investing in a mix of stocks as well as bonds and deferred annuities. Over time, that asset allocation should shift based on the likelihood of achieving the investor's income goal. At retirement, the worker would have enough money to buy an annuity that would provide the target salary replacement amount. But the choice would be left up to the employee. Still, Merton clearly has an opinion about what option is best, as a recent MarketWatch article noted. "When we take a risk, it's generally for a good reason. You wouldn't normally put yourself in harm's way for no reason," Merton writes.

Problem is, figuring out the right portfolio strategy, and when to make those shifts, is a tough challenge for the average investor. And not so coincidentally, Merton has a solution, which is to rely on professional investment managers to handle this for you. An MIT professor, Merton is also the “resident scientist” at Dimensional Fund Advisors, which offers a 401(k) plan that focuses on producing a reliable income stream. (For more on DFA’s approach, see “The End of Investing.”)

The DFA connection aside, Merton’s insights are well worth considering. Along with Scholes, he won the Nobel in 1997 for a landmark options-pricing theory, called the Black-Scholes model, that is still widely used. (Economist Fisher Black passed away before the Nobel was awarded.) And in his call for 401(k) reforms, Merton has plenty of company. A growing number of academics and 401(k) providers advocate an income approach. So does the U.S. Labor Department, which intends to require plan providers to present investors with statements showing their projected income in retirement. Some investment groups already do.

Even if your 401(k) plan doesn’t offer income projections, you can get find calculators online that will give you estimates. Just remember, they are only projections, and if you don’t keep checking your assumptions, models can steer you astray. Just ask Robert Merton.