MoneyMarketing

It's the income, stupid

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Tailored managed DC can offer optimal strategies both sides of retirement argues Nobel prize-winning academic Professor Robert C Merton. John Greenwood hears how we need to change.

Prof Robert C Merton

Forget fund values – income is all that matters, and it should and can be delivered through scalable annuitisation and drawdown strategies tailored to the individual's needs, without the necessity of delivering full financial advice. That is the message of Professor Robert C Merton, resident scientist at Dimensional Holdings.

You could be forgiven for thinking 'well he would say that, wouldn't he', given the fact that Dimensional launched a managed DC liability-driven investment product last autumn. But a glance at Merton's CV, which reveals credentials such as a Nobel prize for economic sciences for his work on derivatives and his post as School of Management Distinguished Professor of Finance at Sloan School of Management, MIT and it becomes clear he's worth listening to.

Merton has outlined a strategy for delivering an income-oriented DC solution that integrates the pre- and post-retirement phases of workers' lives. While his perspective has clearly been formed from his experiences in the US, its principles are readily transposable to the burgeoning UK DC environment. Given how much further down the DC line the US is than the UK, it is a viewpoint well worth hearing.

His first premise is that DC needs to be completely redesigned, with the focus on growth in fund values needing to be almost entirely purged from our system. Confusing the need for a pot of money with the need for income can lead to very expensive mistakes he argues.

"You cannot say wealth goals are approximate to income goals. Imagine you are a 45 year old and you are going to retire at 65. In returns of income, what is the risk free asset? It is an asset, fully guaranteed, that 20 years from now starts paying you a level income for the rest of your life, corrected for inflation. I created one of those, called a real annuity, and from 2003 to 2012 I ploughed the monthly returns and we saw swings of -17 per cent and +15 per cent, on a risk-free asset. Yet when you measure this asset in terms of income, there's no risk. So when someone says we can approximate an income goal with a wealth goal, as a practical matter, it doesn't even come close," says Merton.

"Or since 2008, suppose someone was lucky enough to have £1m to live off. If they had been very conservative and had bought bank CDs, six or seven years ago they would have told you their income was 4.5 or 5 per cent and they would have got £45,000 to £50,000 a year. Now you say to them, congratulations, I have preserved your £1m. But they say, yes and I am getting £4,000 to £5,000 a year. I can't live on that," he adds.

Merton argues that the culture of interpreting pensions in terms of fund values has developed because the DC sector has emerged from the mutual fund industry.

"The government benefit doesn't give you a pot. The most intuitive thing for people is income. Income correlates with standard of living, in every aspect. Even in Pride and Prejudice, when Jane Austen evaluates Darcy and all the other men, she didn't say he was worth £200,000. She said he was worth £10,000 a year," he says.

Merton envisions a DC system whereby the focus is shifted towards achieving the real, inflation-corrected retirement income that retirees need. That means a move away from the risk concept typical in current DC schemes of investment risk or capital loss and the volatility of returns, towards income outcomes.

Individuals' own tailored strategies can be assessed by asking four key questions – what is your desired income target; what is the minimum income that would be acceptable if you do not reach your desired target; how much money are you willing to contribute on top of employer contributions and when do you plan to retire. These questions can be asked through simple online tools.

For those members who will not even be engaged enough to answer these four questions, default answers can be constructed from information held about them, including age, gender, salary, current balances and possible other sources of income including state benefits, other pension rights and future contributions.

All this data is then used to create an asset allocation strategy targeted to an inflation-linked duration-matched fixed-income portfolio that will be required to achieve conservative target income with 96 per cent probability. Excess available assets, for those savers lucky enough to have them, are used to target desired income. Shortfalls are flagged to the individual.

Then when the individual reaches retirement, Merton's strategy continues seamlessly, with the individual securing income in three tranches, dependent on how he or she can afford to risk being without it. Level 1 is guaranteed income for life, the minimum the individual can afford to live off. Level 2 is conservative income, managed on the basis of a 96 per cent probability of

achieving that income. Most retirees will life off level 1 and level 2 income in Merton’s world. But those with more than enough can elect to take greater risk through a third tier of more aggressive assets.
Merton’s solution introduces the potential for both annuitisation and drawdown being offered through defaults where the individual has either asked for or had imposed on them a tailored solution that is, arguably, more suitable for their needs than a simple vanilla default fund. While today’s small DC pots may almost all end up in annuities, it won’t be long before something more complex will be required.
Merton proposes making decisions on behalf of individuals to the extent that the law permits, arguing that doing the best you can for people is better than simply washing your hands and saying it is too complicated and risky.
He says: “I would propose setting the default level 1 income based on two factors – the available academic research about the replacement rates that will be required for different salary levels to meet their basic needs in retirement and the years of service from enrolment until retirement, or earlier termination, and other variables, including contributions and account balances.”
The remainder of their assets would be moved into level 2 income, which could be interpreted as meaning it is placed in some form of managed drawdown strategy. Such a non-advised, low-cost managed drawdown strategy is understood to be in the long-term plans of the product development team at Dimensional.
His thoughts reflect ideas bubbling under in UK workplace pensions, yet they come at a time when auto-enrolment is being put in with a very light focus on outcomes. It is as though providers and policymakers are scared to tell people just how little they are going to get for fear they will leave their scheme immediately.
This approach, says Merton, is not only misguided, but also dishonest and irresponsible.
“From a regulator, politician or employer’s point of view there will never be a time when it’s a good time to tell them the truth,” he says.
“Our system kicks out a report saying if your plan drops below a set level, this is what you have to do to get to this goal. You may not like it but you at least can do something about it. It’s like a doctor’s report. All of us want to hear we are in perfect shape. But do you want the doctor to say that if there is something wrong with you?” he says.
He argues a dose of honesty might not be as unpleasant as we might think. “For young people who say they don’t want to save now, the message is that one way or another they are going to have to pay for their retirement, so they may as well start early and make the most of tax breaks and employer contributions. That way they will have more to spend in your thirties, forties and fifties.”
And the UK’s auto-enrolment project means we have an opportunity to start getting things right.
“All these people coming to pensions for the first time are virgins. That is a good thing because you can take them and say what income they are going to get. Yes there is a page saying what the fund is worth if they liquidate it, but that is at the back, not at the front.
“Take these virgins and don’t let them learn bad habits. Particularly for the groups that matter most, talk to them about income. If you don’t do this right, everything you have to do is going to be an uphill battle. This is actually a great opportunity.” Prof Robert C Merton