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The fundamental problem with retirement funds

Investors are being told the wrong thing.

Patrick Cairns / 3 April 2018 00:39 **22 comments**

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According to Alexander Forbes, just 6% of South Africans will be able to retire comfortably. Not only is that an alarming statistic, but it's not getting any better.

Despite the local financial services industry spending large amounts of money on consumer financial education, retirement outcomes don't seem to be improving.

"We've been trying for years to do financial education in South Africa and its had almost no effect," says John Anderson, the head of client solutions at Alexander Forbes. "Lots of money has been spent by the financial services industry with good intent, and the impact has been virtually zero."

How many retirement fund companies have given serious thought to why this might be? Why are people not changing their behaviour despite all the efforts being made to educate them?

Nobel laureate and resident scientist at Dimensional Fund Advisors, Professor Robert Merton, believes that the answer lies in addressing a fundamental problem.

"It isn't that people are dumb or that we don't know how to educate them," says Merton. "We haven't been giving them meaningful information."

The wrong measure

The key issue is that when reporting to investors on their retirement savings, most funds have been showing how much members have accumulated as a lump sum. This is, however, not what people are saving for.

"We require funds to report to members the value of their pot, but that's the wrong measure," says Merton. "Your goal in retirement is to sustain the standard of living you have enjoyed in the latter part of your working life. And standard of living is an income measure. We're showing people the wrong thing, and it has lots of very dysfunctional aspects."

This has nothing to do with how intelligent investors are, whether they understand risk and return dynamics, or what they know about asset allocation. It is simply that investors are being given information that is not meaningful.

"We have seen that if you show people the value of their savings as an income in real terms, they understand it," says Merton. "If they are making R10 000 a month and you show them they are on track to get R2 000 per month, they can see that there's no way

they are going to be able to live on that. Also if they take their money out when they change jobs and spend it, they can see that they are going to reduce their income to zero."

This is meaningful, and it therefore drives meaningful changes in behaviour.

Investor behaviour

"You have to change the framing to get to the right objectives," says Shaun Levitan, the chief operating officer at Colourfield. "In the past, we tried to educate people based on the pot. Personal advice was given based on their account balance."

This has not only created confusion, but encouraged poor investor behaviour.

"We've seen many people move their retirement savings out of default funds and into something conservative because the equity market is negative and they see their lump sum going down," says Levitan. "And many of them never go back in."

Investors worrying about the impact of short-term volatility on their retirement pot think that bonds and cash are safe investments since their capital is secure. However, if what they were shown was not a lump sum, but a projected income at retirement, they would see something else entirely.

"You frame things completely differently by asking what they need to live on," says Levitan. "Then risk becomes a tool to help them reach that objective and cash becomes the most risky asset because it will never give them the long-term return that they need."

Priorities

Showing the value of a retirement fund as a lump sum only, also leads to people seeing it as money that can be accessed.

"We train people to treat their retirement provision as if it's a savings account," says Levitan. "And so they treat it the same was as they treat a bank account."

This is why so many people cash out their savings when they move jobs. It's also the reason that many retirees prioritise leaving some of this money for their heirs instead of using it for what it's really there for – generating an income.

"If you don't take care of yourself you can't help anybody else," Merton says. "Of course if you have enough for your own retirement and you have something extra you may want to give it to your children, a charity, or society, but a bequest is a luxury."

Alexander Forbes has adopted this approach in its Clarity retirement fund products. The key measure shown to fund members, on an individual, personalised basis, is their expected income at retirement.

"We don't show a return against a SWIX or Alsi benchmark," says Anderson. "We show a rands and cents income.

Merton believes this is an approach that all retirement funds must look at.

"It's a process change," he says. "Only give people meaningful information and meaningful choice. This is the way that things are going to go."

AUTHOR PROFILE

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