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Another Nobel Laureate in Economics Who Is Focused on 401(k) Plans - Part 3 of 3

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By Jack Towarnicky

In October, we focused on Richard Thaler, the 2017 Nobel Laureate in Economic Science. In December, we highlighted Franco Modigliani, the 1985 Nobel Laureate. Today, we extend our thanks and admiration to Robert Merton, the 1997 winner for his work on difficult to price investments (derivatives, options, corporations, etc.). Professor Merton was the Keynote Speaker at the 2017 PSCA National Conference. His focus on retirement has centered on many issues, including but not limited to:

- The mismatch between a retirement saver's goals and the metrics she uses to measure results, and
- American workers' inability to manage their own retirement preparation.

Long Term vs. Short Term

In terms of the mismatch, Professor Merton asserts that a saver's primary concern is "Will I have sufficient income in retirement to live comfortably?" In contrast, and as required by regulations, the performance metrics which drive our everyday 401(k)/403(b) investment decisions are asset values, growth, and risk (in terms of volatility of asset values). Our mandated disclosures require descriptions of relative investment risks and investment objectives. They emphasize the account balance and current period investment returns – which encourages savers to take too much risk with a goal of amassing the largest portfolio possible. Professor Merton once described this approach as "la-la land". He concludes that most savers' funds are not being well managed relative to retirement income objectives.

Focused on the Short Term - My Biggest Mistake in 31 Years As A Plan Sponsor

In behavioral economics, there is an accepted heuristic or rule of thumb about "loss aversion" – losses are more powerful, psychologically, as gains (however, some now challenge that assertion, see: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3049660). In my last plan sponsor role, I decided to change the frequency of our 401(k) plan statement (issued annually each July since plan inception in 1968) to quarterly, to send a statement to all participants confirming balances, allocations, etc.

In October 1986, we issued our first quarterly statement. Oh, the phones rang! The stock market had slightly declined and interest rates increased – depressing bond values. Because contributions always exceeded investment losses or because term vested participants did not receive statements, no prior statement had a minus sign, no prior statement showed a decline in the account balance!

In response, many changed their investment allocations to the guaranteed investment contract – missing out on very positive equity investment performance. I had inadvertently and unintentionally refocused participants on the short term - "sentencing" some to more years of work and saving.

Financial / Investment Capability

In terms of capability, Professor Merton identified the challenges everyday Americans face in managing their individual account retirement savings plans (link: https://hbr.org/2014/07/the-crisis-in-retirement-planning):

- Putting relatively complex investment decisions in the hands of individuals with little or no financial expertise is problematic.
- (Financial and investment) decision making is pervaded with behavioral biases.

He states that if you ask someone what their Social Security benefit is, an informed individual may respond with a monthly income number, while a similar question about a 401(k) will prompt a mention of an account balance and, if recent, investment volatility (market gain or loss). Where the 401(k) goal is lifetime income, the relevant risk is retirement income uncertainty, not portfolio value. Dr. Merton notes that under conventional investment metrics, an annuity would almost certainly look too risky. As interest rates change, an annuity's market value fluctuates. For instance, in 2012, the annuity for a 45-year-old fluctuated by 30%.

Increased Account Balance = Reduced Pension Benefit = Big Screw-up

In 2002, we changed our final average pay (FAP) pension formula to a cash balance formula. One long service, age 65+ employee benefitted greatly. Her accruals had been suspended under the final average pay formula because it capped participation service. However, the cash balance formula had no participation service maximum. In 2002, she projected her monthly pension benefit starting October 1, 2006 – the retirement date she had long ago selected – the date she completed 50 years of service!

In 2005, my CEO fielded a complaint from this worker's Congresswoman. Our participant claimed the longer she worked, the more her pension declined. It was true, sort of. Interest rates had been declining, so, the monthly life annuity benefit generated by an ever increasing cash balance was less than her 2002 projection (but still more than provided under the final average pay formula).

ERISA effectively encourages individual account investments that are highly risky from an income perspective. For example, "riskless" investments like T-Bills and GIC's are very risky in terms of retirement income. Comparatively, an annuity's retirement income does not fluctuate. So, there is a big disconnect about risk. A 401(k) can incorporate a number of financial goals, lifetime income, a legacy, etc. Where lifetime income is the goal, Professor Merton recommends defining risk from an income perspective, using deferred, inflation-indexed annuities as risk-free investments. He would not commit participants to an annuity purchase. Instead, he recommends investment fiduciaries focus less on wealth-maximizing investment strategies and more on income risk management strategies that seek to provide more certainty around the investors future retirement income. He recommends managing the risk-free part of the portfolio in such a way that, at benefit commencement, participants could purchase a retirement income stream that supports their target standard of living regardless of what happens to interest rates and inflation.

In our individual account marketplace, people must provide for their own retirement. Dr. Merton suggests plan sponsors consider alternatives likely to improve participants' chances of successful retirement preparation – without requiring everyday workers become financial experts.

Thank you Professor Merton!