MarketWatch

June 24, 2014, 2:00 PM ET

401(k)s face 'crisis,' says Nobelist Merton

Since the dark days of 2008, employers have taken some steps to fix the 401(k), the backbone of the nation's private retirement-savings system. But Nobel laureate Robert C. Merton says that in the rush to upgrade these plans, plan sponsors and administrators have overlooked one big problem: They are managing these plans with the wrong goal in mind.

Merton says a crisis is coming for 401(k) investors.

"The seeds of an investment crisis have been sown," the MIT professor of finance writes in an article in the July-August issue of Harvard Business Review, which was published Tuesday. "The only way to avoid a catastrophe is for plan participants, professionals, and regulators to shift the mind-set and metrics from asset value to income," writes Merton, who won the Nobel Prize in Economics in 1997.

In recent years, employers have tried to improve 401(k)s by introducing features such as automatic enrollment and products including target-date funds. But in his article and in a recent interview with Encore, Merton said these moves weren't likely to be sufficient. To fix the 401(k), he argues, employers and the financial services companies that manage these plans must get past the ongoing obsession with two things: Account balances and annual returns. These metrics, Merton says, are far less important than one other: The amount of sustainable income an employee can expect to receive in retirement.

By disclosing annual income, instead of (or in addition to) an account balance, Merton says, employers will help employees quickly and easily calculate how much of their annual salary they can expect to replace in retirement, together with Social Security. As a result, employees will be better able to take action to ensure they are on track to retire as planned.

But that's only half the battle. In order to accurately calculate how much retirement income a participant's 401(k) balance will purchase, the plan sponsor must assume the money will be invested in an inflation-adjusted deferred annuity or long-term U.S. Treasury bonds. These investments, Merton writes, ensure "spendable income" that's "secure for the life" of the bond or annuity and are "the very assets that are the safest from a retirement income perspective."

That's not to say that 401(k) money shouldn't be invested in stocks. In fact, Merton says, 401(k) investment managers should invest participants' savings in a mixture of "risky assets," including equities, and "risk-free assets," such as long-term U.S. Treasuries and deferred annuities. Moreover, the investment manager should shift the investment mix over time to optimize the likelihood of success.

Employers, he says, should begin by asking employees not about their tolerance for investment risk, but about their expectations for income needs in retirement.

If the investments are managed well, the employee – upon retirement—should have enough money to buy a deferred, inflation-indexed annuity that (together with Social Security) will replace his or her salary in retirement. Retirees who don't want to buy an annuity don't have to. But once they achieve their retirement income goal, he says, they'd be foolish to leave their money at risk in the stock market.

"Think of risk as a tool," he writes. "When you don't need it, get rid of as much of it as you can because it's costly. 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 has also been working with mutual fund manager Dimensional Fund Advisors to turn his ideas about 401(k) reform into a commercially viable strategy. For more on those efforts see this recent Forbes article by Matt Schifrin.

This post was updated to include additional information about Robert Merton.

Anne Tergesen covers retirement for The Wall Street Journal. Follow her on Twitter @AnneTergesen.