Retirement Security in the 21st Century

Considerations and Risks in Building the Infrastructure

A Retirement Security Institute white paper, September 2007

Preface

People in general need to be educated, with a clear understanding, about the risks they face in retirement. Building one's personal infrastructure for a secure retirement requires knowledge on a variety of fronts. The environment today for the retiree is more complex, but not unmanageable. Corporate reductions to retiree benefits have created greater uncertainty for upcoming and current retirees. It is widely known that the entitlement spending in Medicare and Social Security are on an unsustainable path. The competition brought by more globally-connected economies is impacting Middle America in new and different ways. More proactive steps will be needed in this new retirement paradigm.

By being sufficiently educated and with proper planning, most people approaching retirement and those already retired can be prepared for the challenges and navigate change.

The risks in this new retirement paradigm must be considered and weighed. Each person will find different meaning in the information presented by this white paper and is encouraged to reach their own conclusions. By design, the paper is at times heavy on fact; in other places, new concepts may dominate. This is to facilitate individual thought and reflection on these matters. Regardless, building the infrastructure requires being open to new concepts, possibilities, information, and changes in executing a plan. Of course, maintenance of one's personal retirement infrastructure will be required as needs change and the landscape shifts.

Why the infrastructure metaphor?

Infrastructure is a system of resources which provide essential support, right-of-way, or services to allow people to conduct the activities of their lives better. Think of bridges, roadways, ports, electric generation facilities or water utilities. These resources allow us the chance to live in modern ways with certain expectations and efficiencies. The same is true of our nation's financial infrastructure—banking, insurance services, and stock markets. We need to better develop our retirement security infrastructure in America to adapt to 21st century challenges. This can and should be done on an individual level right now.

About this white paper

The purpose of this white paper is to educate professionals, policymakers, and decision makers faced with the issues of retirement. Hopefully, it provides a new framework, some novel ideas, or at least a roadmap of some of the latest research and data affecting retiree populations for further research.

This paper was written by Jennifer Warren, M.Sc. of the London School of Economics, with over fifteen years of research and writing experience in health care, financial, and policy issues relating to retiring populations. She also combines her knowledge of economics, politics, and global finance as it relates to retirement security issues.

About the Retirement Security Institute (RSI)

The RSI's mission is to provide credible analysis and meaningful information about retirement security issues, focusing on health care and financial matters. The RSI is a knowledge company which produces a synthesis of research, information, and new ideas for both professionals serving the retirement market and retirees who need useful, straightforward information. See www.retirementsecurityinstitute.com

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America is at a crossroads as the large baby boom generation heads toward retirement. Retirement security is not what it used to be. Retirement costs more, lasts longer, and has different risks than for generations past.

Armed with knowledge, Americans can develop the infrastructure to safely cross the bridge of retirement. For well over a decade, both public and private sectors have known that the time of reckoning was coming—a time when responsibility would be needed by both sides to relieve financial pressures and ensure greater security for Americans. The current path of entitlement spending is unsustainable and another path which might prove more realistic is not clearly visible for those needing guideposts to make decisions. The key forces to consider include: demographics, the overall economic climate and outlook, the political aspects of budget and policy directions, and how these forces are interplaying and creating new scenarios. The retirees most vulnerable to these changing forces are the bulk of retirees—Middle America.

" We owe it to those who will retire over the next couple of decades to promise only what the government can deliver. The present policy path makes current promises, at least in real terms, highly conjectural."

— Former Federal Reserve Bank Chairman Alan Greenspan before the Joint Economic Committee of the U.S. Congress, November 3, 2005.

Retirement Security

Retirement security is the acquiring of knowledge about the factors which allow for a worry-free retirement and the implementation of actions necessary to develop such an informed plan. The main insecurities in retirement are declining health, insufficient assets and income to live comfortably, and the longevity prospects of outliving one's resources. A Fidelity research brief says 48% of workers consider health care, routine or long-term care, to be the greatest risk in planning for retirement, even beyond outliving their savings. Fifty-four percent of baby boomers and pre-retirees consider retiree health care costs to be their greatest risk to retirement security.

A recent study by Barbara Butrica of Boston College shows how retirement security changes over the course of retirement. Changes in assets, income, marital status, health, and living arrangements impact security over the course of retirement. Boomer retirees are more likely to have college degrees and many years of work experience compared to current retirees, born between 1926-39. With a baseline age of 67, thirteen years into retirement, at age 80, both current and boomer retirees are much less likely to be married, in good health, or working. However, boomer retirees are slightly more likely to be healthy than current retirees. By 80, of both types of retirees, just over half will be married; this is mainly due to the death of a spouse.

The study indicates boomers are expected to begin retirement with considerably more wealth than generations past. Between ages 67 to 80, family wealth is projected to decline by more than one-third for both retiree groups; current retirees' wealth may decline from $672,000 to $430,000 and boomers from $898,000 to $591,000. Social Security and defined benefit wealth is annualized in these calculations; at age 67 the typical retiree has $315,000 in Social Security wealth vs. $159,000 at age 80 based on life expectancies. Defined benefit wealth is $121,000 at age 67 and $49,000 at age 80. However, pension wealth may be different than projected by this study given the lump sums many boomers will be managing upon retirement through 401(k) rollovers into individual retirement accounts (IRAs). If Social Security benefits decrease, the numbers will change some as well.

Financial wealth or assets is a critical component in retirement security. This is the money, under the retiree's control, which must be the most wisely invested or utilized. Financial wealth, beyond Social Security or pensions, is a key variable and vehicle that accomplishes security goals. Thus, where one gets advice becomes crucial. Retirement security relies on it. A Fidelity

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With past trends in dumping pension liabilities, the Pension Protection Act was passed to tighten controls for firms that fall short in their contributions. Traditional employer-paid pension plans (single-employer), not defined-contribution plans like the 401(k), were underfunded by some $450 billion in 2005, changing to $350 billion in 2006. The new reforms are designed to close loopholes which have allowed such underfundings. But most firms are moving away from the defined benefit plans of pre-baby boom generations to defined contribution plans such as the 401(k).

State and local governments' retiree benefits mirror the private sector. On the state and local levels, post-employment benefits' trends are equally noteworthy. New accounting rules are revealing large unfunded liabilities in retiree health care, life insurance, and other post-employment benefits. A report by Credit Suisse estimates $558 billion in unfunded liabilities for the fifty states and $951 billion for local governments—a staggering $1.5 trillion. These same unfunded liabilities for S&P 500 firms were $326 billion in 2005 in comparison. This is yet another "bomb" the analysts write. The other time bomb is of course entitlement or health care spending, likened to a "tsunami" according to David Walker, Comptroller General of the US.

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Globalization is changing many of the economic relationships that we have relied upon. For example, from 2004 onward, energy and commodity prices have risen to meet the higher demand of growing economies such as China and India. When global demand steps up in this way, higher prices of these resources result in the US, thus increasing the potential upward pressure for prices overall. Globalization has held inflation lower than it would be otherwise, but it is a moving target with so many variables and finally being examined within a US/global economic context. Thus, globalization is impacting overall economic performance more in terms of supply and demand for capital and therefore investment returns, and standard of living through pricing of goods and purchasing power. These equations will continue to evolve over time as the US economy continues adapting within a more interconnected world economy.

Inflation rates weigh in heavily with retiree planning because of their ability to erode asset values and fixed incomes over time. Inflation rates have been kept in check over the last decade by the Federal Reserve Bank (Fed) and by the disinflationary economic outcomes of globalization, competition, and productivity gains from technological advances. Further monetary policy tightening has occurred since 2004 with inflation lurking, and short-term interest rates have risen