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You Don't Always Die When You're Supposed To

Sigma's principals are baby-boomers. We grew up in the Ozzie and Harriet era, watching the Ozzies of our world work for 30 years or more at BigCorp, retire, and receive a fixed monthly pension payment that continued until Ozzie (or in a good plan, both Ozzie and Harriet) died. Each year, BigCorp reviewed the adequacy of the investment pool funding the pension. If financial market returns were high enough that the plan was fully funded, BigCorp didn't need to make any contribution that year. If returns were disappointing and the plan was under-funded, BigCorp had to write a check to bring the funding in line with projected needs.

While now "in control," 401(k) investors have given up the benefit of the law of large numbers.

In the 1980's, traditional pensions gave way to defined contribution plans, like 401(k)'s, with no guaranteed pension payments. You and/or your employer make contributions unrelated to any actuarial or retirement needs calculation. You, rather than your employer, bear the risk of disappointing returns. You also have the possibility of winding up with a retirement account worth more than a traditional pension. If you die, what remains in the account can be left to your heirs.

Why the switch away from traditional pensions? Corporate management disliked the uncertainty of the pension liability and the risk of under-funding. Pension accounting is notoriously labyrinthine. On the employee side, people were switching jobs more often – both Ozzie and Harriet tended to have several jobs throughout their careers instead of just one. With long vesting periods in traditional pensions, job-hoppers could wind up with no pension at all. Congress could have made traditional pensions portable, but this would leave the accounting uncertainty. Instead, employees were sold on the concept of being "in control" of their retirements. They also got the psychological benefit of an account with their name on it rather than an intangible promise of future income.

With this shift, however, employees gave up a huge advantage – the law of large numbers. Using life expectancy tables, BigCorp knew when, on average, its employees would die. Harriet might live 30 years beyond her life expectancy, but Ozzie might die early. With thousands of employees, life expectancies for the group were likely to match the tables. But *you* have very little idea of when *you* are going to die, and your retirement "plan" bears the risk that you may live to be 105 years old. Average life spans don't matter to you – all that matters is how long you actually live. Come to think of it, those average life span tables were calculated when Ozzie and Harriet were likely to smoke and drink heavily, eat fatty foods and never exercise.

Similarly, BigCorp structured its traditional pension to last through both long-term bull and bear markets. Periods of dismal returns in the markets such as the 1930's and 1970's would be offset by periods of wonderful returns such as the 1950's and 1990's. *You*, on the other hand, bear the specific risk of the specific market returns during *your* retirement. Long-term average market returns cease to be of any importance or comfort as you approach retirement – all that matters is the period you actually live through. Even if you address the life expectancy problem by buying an annuity with the proceeds from your retirement account, the amount available to purchase the annuity is affected by short-term returns. If your account declines the year before you retire and purchase an annuity, your living standard declines by a like amount for the rest of your life.

***Diversification makes up
for ignorance.***

Investment theory preaches the virtues of diversification. By pooling large numbers of employee lives and encompassing long periods with many market cycles, traditional pensions were “diversified” in that they didn't rely on when one person died or the specific period of one person's retirement. Your 401(k) plan or IRA, however, is not diversified with respect to life spans or market cycles. You bear the additional, uncompensated risk of your single life expectancy and the financial market returns during the single period as you approach and enter retirement. Since experience with these plans has coincided with the biggest bull market in U.S. history, this “sacrifice” has been painless – so far.

With a traditional pension, BigCorp's management received an annual actuarial report indicating the funding status of the pension fund. Congress receives a report every year indicating the funding status of Social Security. But participants in 401(k) plans receive no similar report relating to their retirement funding status. This information gap exists because you don't realize what you have given up and don't demand the information. Congress sets IRA and 401(k) contribution limits with a view towards the national budget, not the funding required by the participants.

Investor performance typically lags investment performance by a wide margin. Greed leads us to buy high and fear leads us to sell low. In 401(k) plans, the focus usually is on the performance of the investment options in your plan, not how your account is actually doing. If health insurance, another employee benefit, were treated similarly, the human resources department would hand out some drugs and surgical instruments with information regarding their efficacy and tell you to have at it. Employees are no better investment wizards than they are doctors – it just hasn't been obvious while a long bull market covered up the mistakes.

If you want your life after career-end to be as pleasant as that enjoyed by Ozzie and Harriet, or just receive an analysis of your retirement plan, contact us. The doctors are in.