

Chapter 1

America's Savings Challenge

“The best time to plant a tree was 20 years ago; the second best time is now.”

—Chinese Proverb

We Don't Save Enough

As many an NFL star can attest, it can be easy to have wealth in the short term but not keep it for the long term by spending beyond your long-term means. This problem plays out across U.S. society. The allure of advertising and broad availability of debt don't help. It can lead to a bias toward spending, rather than saving, to try and keep up with the neighbors. This often comes at the expense of long-term security.

Unfortunately, the numbers for savings rates in the United States are poor relative to both history and other countries. As you can see from Figure 1.1,

up until the 1980s, the U.S. savings rate was comfortably around 10 percent. Since the 1980s, the savings rate has fallen and now trends around 5 percent. Recessions generally cause the savings rate to spike, but the long-term trend in the United States is clear. The savings rate has basically halved.

This rate is lower than all but a handful of developed countries. Of course, adjustments need to be made for demographics and the degree of “safety net” that a government offers to replace the need for saving for emergencies such as unemployment or healthcare costs. However, even after considering both factors, it seems clear that the U.S. savings rate is insufficient for many to achieve a comfortable retirement.

Social Security presents an additional risk. In the United States, the amount Social Security expects to pay out exceeds the amount coming in. As the report of the Trustees of Medicare and Social Security report:

Neither Medicare nor Social Security can sustain projected long-run program costs in full under currently scheduled financing, and legislative changes are necessary to avoid disruptive consequences for beneficiaries and taxpayers.¹

The numbers of Social Security don’t add up due to demographic trends. America has a rate of immigration that keeps its population, on

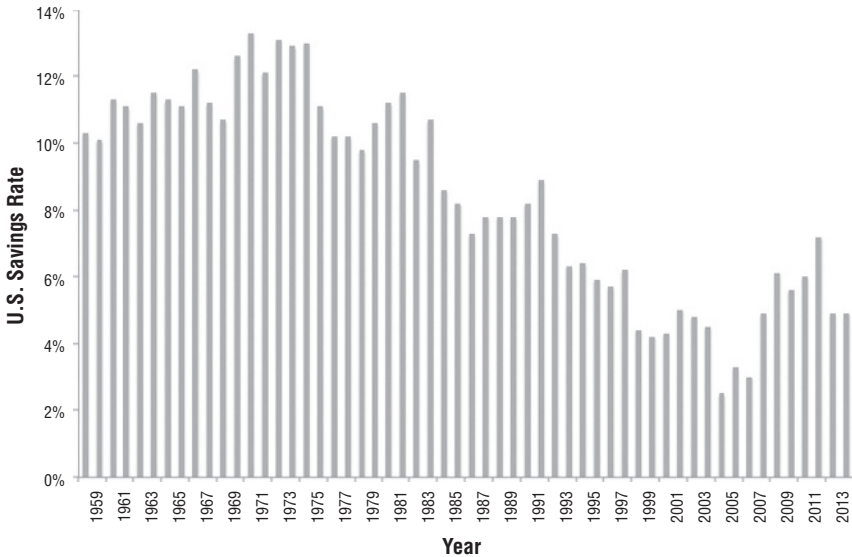


Figure 1.1 US Personal Savings Rate

Source: US. Bureau of Economic Analysis

average, younger than in many developed countries because immigrants tend to be younger than the average population. Despite this, the average age of the U.S. population is approximately 37,² and there will be increasingly more people in retirement than are working. That's a problem because the system is generally expected to balance what gets paid in (contributions from workers) with what gets paid out (payments to retirees). As retirees become a larger proportion of the population the balance breaks down. The Social Security problem is something that can be addressed with political will. However, doing so will likely mean a higher retirement age and potentially lower payments. As a result, reliance on individual savings is likely to increase.

Many people are ill prepared for retirement. Northwestern Mutual runs an annual study on the topic and finds that 42 percent of U.S. adults have not spoken to anyone about retirement, and that people are generally more comfortable talking about death or sex than retirement topics.³ Often, those who have limited confidence in their retirement also describe themselves as having "debt problems," according to Employee Benefit Research Institute (ERBI) research.⁴

The Key Change in America's Retirement Planning Process

It used to be different. Previously, defined benefit plans avoided this problem; an employer took responsibility for retirement outcomes of their employees and the investment allocations to meet those needs.

Over time, the emphasis for most nongovernment employers has switched to providing contributions that employees can use to plan for their own retirement in 401(k) plans and similar tax-efficient vehicles. However, this apparently simple switch conceals a fundamental transfer of risk. Whereas previously employers bore the risk of their employees having a successful retirement, now employees carry the risk. The employer was once on the hook for providing a payout in retirement; now they no longer guarantee any payout in retirement. If the employee makes poor investment decisions or doesn't save enough, then their employer isn't going to step in and help when retirement comes. And, of course, most people are untrained in investment management.

An employer can be expected to bring in the expertise to understand investment allocations and cost minimization in retirement choices.

However, evidence suggests that employees can chase historic returns and use basic strategies such as investing 20 percent across each of five options that are present, even if some choices are very similar and some are not, or loading up on stock in their employer, since they are familiar with the company. These sorts of errors may seem trivial, but can translate into worse investment outcomes when compounded over decades. Other errors, such as significantly overpaying for investment advice or investing in dubious asset classes, can have far worse consequences.

Of course, advice is available, but while employers could find some of the best consultants available and spread that knowledge and benefits over thousands of workers, employees typically seek advice one on one, which is less efficient because it doesn't scale across a large group of people, and can cost as much as 2 percent of the employee's assets to get solid, if fairly generic, retirement advice. The problem of high-cost investments is discussed in detail in a later chapter, but unlike other goods and services, with investment advice you typically pay for the advice with the very savings you have, so high costs can make it hard to achieve your investment goals. This is unlike other purchases because with investment advice you are reducing your rate of return with the fees you pay in order to attempt to increase your rate of return—a direct contradiction. This is why keeping costs low matters.

How Financial Innovation Helps

Fortunately, just as the landscape for retirement support has changed, so innovation has enabled employees to get a better deal. Exchange-traded funds (ETFs) are a critical ingredient here. Unlike mutual funds, which have cost and tax inefficiencies, ETFs often provide the building blocks to assemble a robust portfolio at low cost. In conjunction, algorithmic advice can scale practically infinitely using technology. This provides portfolio management techniques that previously were the reserve of secretive quantitative teams to be publicly available. This means both the instruments and the techniques to ensure a successful retirement are now broadly available. The benefit here is not in lowering the costs of an existing service, but in expanding the reach of that service. Previously, even with relatively high fees, it simply wasn't economical for a financial advisor to serve a client with less than half a million in assets.

The percentage of assets to make it worth the advisor's time would eat into the client's investment returns and provide only a meager return for the advisor. This meant that prior to digital investment services, most of America was in the painful position of not necessarily wanting to manage their own investment portfolios, but often having to do so because there were few other viable choices open to them.

The Magic of a 15 Percent Savings Rate

However, we should remember that even the smartest techniques and lowest fees cannot solve the savings rate problem. Prospective returns can be improved but there is no magic wand. With a 6 percent rate of annual growth, you can double your money in 12 years, but if you save nothing, you'll still end up with nothing at the end. That's true however long you have to save and however well balanced a portfolio is on offer.

And, unfortunately, the savings challenge is getting harder, not easier. The global increase in life expectancy is a good thing, but it puts a lot more pressure on your retirement dollars that now have to last years longer than previously. Retirement actually is a relatively new phenomenon. Previously, people would quite literally work until they died. At the end of the Second World War, the average life expectancy of an American at birth was 65, meaning that many would have no retirement at all. Now, for those born in 2010, it is just over 78.⁵ That is an increase of 13 years over two generations, and so retirement moves from being a short period to something most people can plan on experiencing for a decade or longer. The moves for an increased retirement age are unsurprising in the context of this stark improvement in life expectancy and quality of life for the elderly. Figure 1.2 shows U.S. life expectancy at age 65 over time, and the trend of increasing life expectancy is clear: this puts a greater burden on retirement savings as the retirement period lengthens.

Without proper planning, retirement may also be a luxury. This is an understandable outcome if Social Security diminishes in significance and savings rates remain at low levels. Increasingly, retirement is being delayed or potential retirees are continuing to work in old age. In the past two decades, the proportion of Americans expecting to retire after age 70 has more than doubled, from 9 percent to 26 percent, according

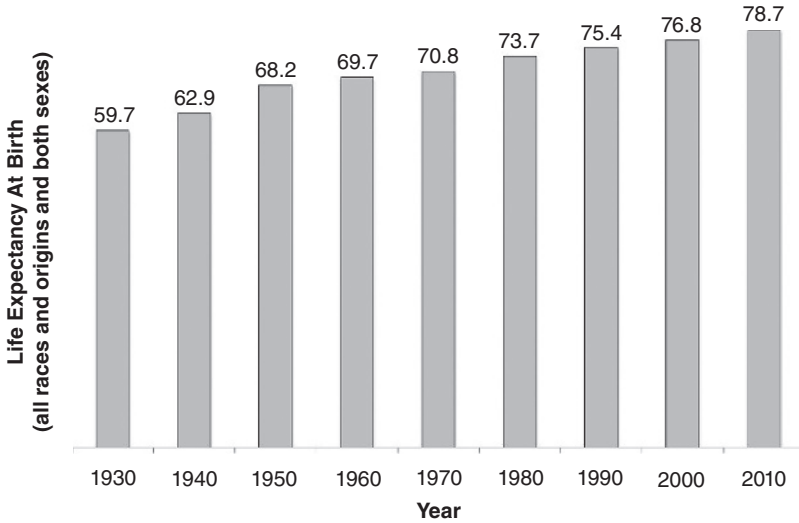


Figure 1.2 Life Expectancy in the United States since 1930

Source: Centers for Disease Control and Prevention

to EBRI data⁶ from 1991 to 2015. Sometimes this is a lifestyle choice to remain active and engaged and avoid the abrupt lifestyle shift that retirement can represent. Now, 1 in 10 workers expects to carry on working into old age, and never retire, that figure has more than doubled recently, up from 4 percent in 1991. However, for many, delayed retirement is likely to be an economic necessity given the harsh reality of low savings rates.

Your savings rate makes a big difference to your retirement outcomes. Without Social Security payments, if you are able to earn 6 percent in real terms on your savings and spend 80 percent of your prior income in retirement and save consistently over 30 years, then a 5 percent savings rate, which is the around the current average savings rate in the United States can be expected to last around five years, which is shorter than most can expect to live in retirement by many years. And remember, many will live longer than the average life expectancy. A 10 percent savings rate may last around 16 years on similar assumptions. However, if you are able to save 15 percent or more from your income, then the same analytical framework suggests that you may be able to fund retirement from your savings indefinitely, since at a certain point the real income on the money you saved covers your retirement expenses. This is the ideal

goal, since at this point you have sufficient financial security, even if you beat the odds and live much longer than actuarial tables would suggest.

Figure 1.3 shows life expectancy in the United States if you live to age 65. There's a good chance most people have 20 years of retirement, but longer periods of up to 40 years are quite possible. Jeanne Calment of France has the longest documented life span, living to be 122 years.

Of course, this is a relatively simple analysis, with Social Security or other strategies like selling your home and moving to a smaller one excluded. However, it does assume that you are able to live off 80 percent of your pre-retirement income.

One hidden benefit of a high savings rate, such as 15 percent, is that you are training yourself to live off less than your full income, which is helpful come retirement. Conversely, if you are using debt to finance expenses, then you are probably living off more than your income, which makes saving for retirement harder still. That's why a 15 percent savings rate is a good rule of thumb because you are not only building up a healthy nest egg, but you are living off 85 percent and that means your lifestyle is less expensive to fund in retirement than if you were spending 100 percent of your salary.

However, savings rates vary crucially with time to retirement. The preceding analysis assumes 30 years to retirement, for example, someone

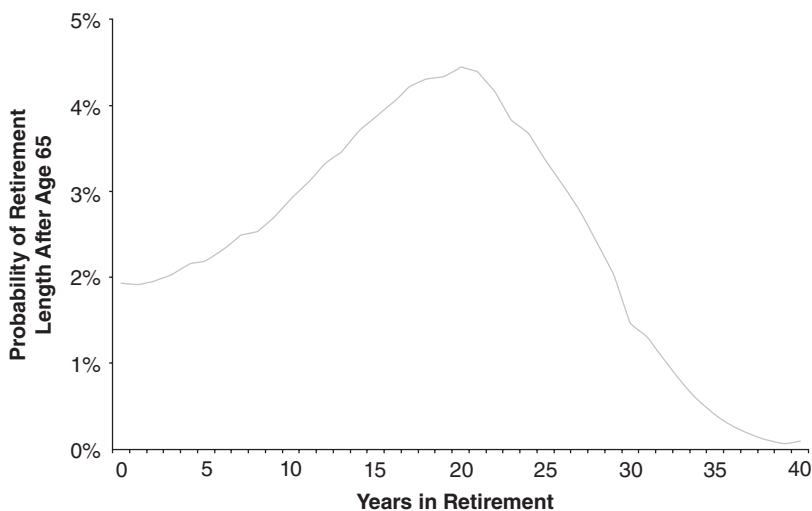


Figure 1.3 Years in Retirement

Source: National Vital Statistics System, 2007 U.S. Data for Both Sexes, FutureAdvisor Analysis

at age 34 looking to retire at 65. If you have more time, then your savings rate will be lower, but if you are older, then a similar savings rate won't meet your goal.

So America has a retirement problem. Savings rates are falling as life expectancy increases and the ability of Social Security to fully fund itself is in question. Fortunately, digital investment advice offers part of the solution in helping savers make robust investment decisions, but even the smartest investment systems cannot be effective if savings rates remain at very low levels.

KEY TAKEAWAYS

- America's savings rate is low relative to history.
- As life expectancy has increased, retirement has increased from a period of a few years after working to potentially many decades for some. Savings have not kept pace with this change.
- Saving 15 percent of your income over 30 years is ideal for a comfortable retirement.

Notes

1. Social Security and Medicare Board of Trustees, "A Summary of the 2014 Annual Reports," 2014.
2. Lindsay M. Howden and Julie A. Meyer, "U.S. Census Briefs, Age and Sex Composition: 2010," May 2011.
3. Northwestern Mutual, "2014 Planning and Progress Study."
4. Employee Benefit Research Institute and Greenwald and Associates, "Retirement Confidence Survey," 2015.
5. Elizabeth Arias, "National Vital Statistics Report," United States Life Tables, 2010.
6. Employee Benefit Research Institute and Greenwald and Associates, "Retirement Confidence Survey," 2015.