America's Looming Retirement Crisis

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America's looming retirement crisis--Insufficient savings is just part of the problem, experts say. When traditional pensions were jettisoned, so was the assurance that money would last until death.

"Our nation's system of retirement security is imperiled, headed for a serious train wreck. That wreck is not merely waiting to happen; we are running on a dangerous track that is leading directly to a serious crash that will disable major parts of our retirement system." -- John Bogle, Feb. 24, 2009

If, several years before the financial and credit crisis hit, someone had told you that the housing market was preposterously overvalued and derivatives were headed for cataclysm, would it have been worth paying attention to? The answer's pretty clearly yes, ain't it? Of course, some of the best minds in finance -- from Warren Buffett to Yale housing economist Robert Shiller -- did. It's just that hardly anyone listened.
Now there's another crisis building. It's just as big. Again, some of the best thinkers in the financial world are warning about it. (Yes, Buffett's one of them.) And yet again, as is often the case with gathering storms, most of us are doing our best to ignore the warning signs. Americans lost almost one-quarter of their retirement savings last year. But even if there were no market drop, we'd still be facing a disaster.

The urgent quotation at the top of this story come from John Bogle, founder of the Vanguard group of mutual funds and father of the low-cost stock-index fund -- the simplest and most cost-efficient tool yet devised for individual investing in stocks. Of all the people who've thought longest and best about individual investing, Bogle has to rank near the top. For decades before the financial crisis ripped open the country's retirement accounts, Bogle was tirelessly warning people away from their brokers' fads and follies.
Bogle's voice is now one of the loudest and most cogent of those calling for a rethinking of American retirement. He made the remarks above to a congressional panel looking at the security of American savings. Like much of what is said about retirement, Bogle's words passed by without much attention. But much of what he has to say is seriously worth listening to.

Over the past two decades, we've embarked on what is essentially a novel experiment, replacing the pension plans of the past with a patchwork of individual accounts. We had sound reasons for this: Letting people choose how much they save for retirement instead of counting on their employers to give them a decent pension if they put in enough time makes sense. But if the basic idea of personal responsibility for retirement is appealing to most, the reality is a lot thornier.

By this point, there is hardly anyone left who hasn't heard of a 401k or doesn't know that they should open one. With some tweaks to the rules for 401k enrollment, the Obama administration is hoping to get participation in individual retirement plans up to 80% of Americans.

The bad news from Bogle, though, is that the way it's set up now, the 401k isn't the panacea that policymakers across the spectrum hope it will be. What's wrong with the 401k?

Simply having a retirement account is not enough. Much of the discussion this past year has focused on getting more workers to open a 401k. The problem is that the big majority of retirement accounts don't really hold nearly enough money.

According to Bogle's numbers, the median IRA has $55,000 in it. By his calculations, that's enough to provide a steady income of $2,200 a year -- less than $200 a month. That's it. The typical 401k holds only $15,000.
Bogle argues that to reach the level of income they hope for in retirement, Americans need to put 15% of their earnings in retirement accounts each month for their entire working lives. Very few do.

One of the biggest differences between individual accounts and traditional pension plans is that they transfer what Bogle calls "longevity risk" from pension funds to individuals. What that means in practice is that.
Right now, we have no good solution to this. In theory, you should be able to put your money into an annuity at retirement that'll cover this risk. But as Bogle points out, there are virtually no annuities that will let you do this at a low cost. So now your underfunded retirement account looks even worse.

We all know the financial advice about putting retirement assets in safe investments as we grow older. But in practice, we don't come close to following it. Most retirement fund assets are in equities. And it doesn't get much better for people approaching retirement: According to Bogle, 30% of them currently have 80% of their IRA investments in stocks. What this means in practice is that some people (not many, Bogle thinks, as most people make terrible investment decisions) will do very well. And others, such as the people retiring this year in the wake of the massive stock market drop, will do very badly. It's what Bogle calls investment risk, and like longevity risk, moving from pension plans to individual instruments such as a 401k or an IRA has transferred that from corporations to retirees.

Bogle proposes the beginnings of several solutions to our retirement problem. Clearly, finding ways to nudge people to put more money into retirement accounts is part of the answer. But it's only a small part. It does nothing for longevity risk and nothing to distribute investment risk. Pension funds did that: If you happened to retire the year the market crashed or if you lived to be 90 years old, that was OK, because your risks were shared with people who retired in other years or failed to live as long.

As it stands now, 401k plans do nothing for those risks. On the contrary, many of the bad practices that Americans have fallen into, such as putting much of their retirement money in their own employer's stock, exacerbate them. Bogle points to several tools -- the creation of annuities that would work a lot like pension plans to level investment and longevity risk -- that would help give Americans the equipment they need to manage their retirement. But developing those tools and making them widely available right now just aren't on the political agenda. And Bogle (who wryly urges casting the "money changers" of Wall Street out of "the temple of finance") warns that we shouldn't expect them to come from the big financial companies.

We're already witnessing the beginnings of a retirement catastrophe now: You can see it if you look at the growing number of older Americans who have kept working into their 60s and 70s or gone back into the work force. Without a dramatic change not just in the amount of money that we save but in how we save, it will get much worse.

In the 1980s, Britain launched what turned out to be a disastrous experiment in asking people to take responsibility for their retirement investments without giving them the tools to do it. We're now well on our way to repeating it on a much bigger scale. Without it, we're facing a one-two punch in the retirement future. The first punch is the shortage of savings. The ensuing punch is the added investment and longevity risk that the new model of retirement brings. Unfortunately, it's a potential disaster as big as the mortgage and credit crisis we are currently enduring.