The Basics

Retirement? Good luck with that

The stock market's crash has revealed the US retirement system's holes with painful clarity -- and middle-class Americans may be forced to make some big adjustments.

[Related content: investing strategy, retirement, 401k, pension, Social Security]

By MarketWatch

The destructive effects of the financial crisis may be waning, but your retirement account won't soon forget. Savers lost 40% or more in the downturn -- a collective $2.1 trillion disappeared from 401k and IRA assets in 2008 alone -- and while the recent stock market recovery may feel good, it's done little to stem a mounting crisis in the retirement system in the United States.

It's not just investments that are the problem: Social Security needs financial resuscitation, and the bursting of the housing bubble that helped spark the financial crisis vaporized the home equity many people were counting on to fund their golden years. Corporations are curtailing traditional pensions, and older Americans are being forced to work longer to make up the difference.

Where does this leave our retirement plans? Ask a middle-class American when he plans to retire, and more often than not you'll get a wry chuckle and "I'll be working until I die." The attempt at humor masks what may be close to reality for some people.

The retirement-savings system in the U.S. is "a failed experiment," said Teresa Ghilarducci, the **Bernard Schwartz** professor of economic policy at the New School for Social Research in New York.

The U.S. system is "headed for a serious train wreck," said John Bogle, the founder and former chief executive of the Vanguard Group, in testimony to a House committee hearing on retirement security in February.

Separately, Ghilarducci and Bogle have called for substantial changes to the current system, but even those who like what we've got now say it needs improving -- and certainly demands better financial education be offered to savers.

"Many people are very overwhelmed with the notion of retirement," said Gregg S. Fisher, the president and chief investment officer of Gerstein Fisher, a financial advisory firm. "How much do we need to put away? Where should it go? How should I invest?"

Living-standard shock

Of course, people's retirement outlooks vary widely. Some 20 million workers still participate in traditional pension plans and employers pay pension benefits to millions more retirees (that doesn't even count government-sponsored public plans), according to Boston College's Center for Retirement Research.

Those workers are sitting a lot prettier than the more than half of U.S. families that aren't covered by any kind of pension at their current jobs, according to the Employee Benefit Research Institute, a nonprofit, nonpartisan group. Still, even a well-prepared person may get thrown off by a job loss or unexpected health care costs. (Average medical costs in retirement can run into the six figures even for those covered by Medicare, according to EBRI.)

And those lucky people with traditional pensions likely are wondering how long the money will last as the financial crisis shreds employers' ability to fund such plans for the long haul. (Read "Companies' pension problems could hit taxpayers.")

Video: Managing your faltering 401k

Defined-contribution plans such as 401k's have largely taken the place of traditional pensions: 67% of workers say they have a DC plan, up from 26% in 1988, while 31% of workers participate in traditional pensions, down from 57% in 1988, according to EBRI.

But while lower-income workers face a worrisome retirement reality all their own, middle- and upper-middle class workers likely face the biggest living-standard shock. That's because lower-income people can replace a good chunk of their pre-retirement income with Social Security, and high-income people generally have enough personal savings. But middle-class workers may see their relatively comfortable life change drastically come retirement.

"People in the middle and upper-middle have highly variable rates of savings," said Eric Toder, a fellow at the Urban Institute, a nonprofit, nonpartisan research center in Washington.

Social Security will take up some of the slack, but the program was never intended to provide full wages. It replaces about 57% of lower-income workers' pre-retirement wages, about 43% of medium-income earnings and 35% of higher-income earnings. A replacement rate of 70% to 75% usually allows retirees to maintain their **standard of living**, according to a report by the Center for Retirement Research.

And Social Security's and Medicare's financial outlook means that future retirees likely will find the programs pay even less. Without changes, the Social Security trust fund is expected to run out in 2037, and Medicare will be broke by 2017. The financial outlook for both programs has worsened as the recession and 6 million job losses have shrunk tax revenues.

Continued: Welcome to risk

You could argue that whatever system we have now is better than nothing, and before the creation of Social Security in 1935, few people other than government workers had retirement-savings plans. Of course, back then, shorter life spans made retirement savings less crucial.

Combine the growth in private pension plans during World War II with Social Security and you get a veritable golden age of retirement savings, at least for those -- never more than about half the work force -- who participate in workplace plans.

Now, thanks to the slow death of the traditional pension and the rise of 401k-type plans, one thing is clear: Workers are increasingly responsible for managing their retirement investments. Some say that's a major problem.

"For 30 years we thought that if we gave people financial advice that over time they would learn something," Ghilarducci said. "But just as we can't expect people to excise their own molars or do their own surgery, we can't expect them to professionally manage their money over a long period of time."

Others agree risk is an issue. "People are being exposed to risk that they're not even aware of, and they're being told don't worry about it, as long as it's far in the future everything will be all right," said Zvi Bodie, a professor of finance at Boston University's School of Management and co-author of the book "Worry-Free Investing."

"That's complete nonsense," he said. What matters, he said, is the risk that on the day you need the money your investments have tanked.

Change in the air?

The recent market crash is a sharp reminder of what can go wrong. Sure, the **S&P 500**'s ($INX) almost 35% rebound since March is good news, but it's not enough to make savers whole. From its peak in October 2007 through last March, the S&P 500 lost almost 49%.

Shave 49% off a $100,000 investment and you'll need a 96% gain just to get back to even. Younger savers can overcome that hit with time, but it's a lot tougher for people close to retirement and nigh impossible for retirees forced to pull money out to live on just as the market swoons.

Video: Managing your faltering 401k

As for tapping into home equity in retirement? While homeowners' equity did rise in the second quarter, U.S. households lost real-estate wealth for nine consecutive quarters before this second-quarter gain, according to the Federal Reserve. Moody's Investors Service said recently that it'll take 10 years before housing prices regain their peak.

U.S. household net worth is down $12.2 trillion from the high in 2007, thanks to the stock market crash and the housing market meltdown.

The retirement-savings crisis is not going unnoticed. The Obama administration, the AARP and many academic researchers, see automatic workplace-plan enrollment as the first step to pumping up retirement savings. Forcing workers to opt out of their 401k's rather than waiting for them to opt in dramatically raises participation rates (inertia leads most people to stick with the plan).

The president has proposed at least two retirement-savings laws (Congress has yet to act on either). With "automatic IRAs," employers who don't offer a workplace plan now would enroll workers in an IRA to which workers could contribute via their paycheck. Obama also wants to expand the savers' credit, which rewards people who put money aside for retirement. (Read "A call to savings" for more.)

Some are calling for more-extreme changes.

Continued: That nagging problem

In February, Bogle, the Vanguard founder, spoke in favor of defined-contribution plans, but decried the inadequate savings rates and steep costs, among other problems. He called for a Federal Retirement Board to oversee the system and look out for participants' best interests.

Ghilarducci, the economist, proposes reducing the tax break for 401k's by lowering the maximum annual contribution to $5,000, then using the tax revenues to create mandatory guaranteed accounts for all. The government would contribute $600 annually to every account; people would contribute 5% of income annually. The government-managed account would belong to the individual and would be in addition to Social Security. Ghilarducci said capping 401k contributions would pay for the plan.

One of Ghilarducci's gripes with the current system is that retirement-plan tax breaks go largely to higher-income earners; she'd like to see the government's largesse spread more equitably. Looking at all types of tax-advantaged retirement plans, people with incomes above $104,000 enjoy 80% of the tax breaks, according to research co-authored by Toder, of the Urban Institute.

It's not hard to find people who disagree with Ghilarducci's approach.

"The idea of centrally planning peoples' investment strategies is not appropriate and is going to take away from the beauty of the system, which is really one of self-determination," said Mike Francis, the president of Francis Investment Counsel in Pewaukee, Wis.

A seismic shift

Currently, he said, people can choose a low-risk, low-return plan (which may require a higher savings rate) or they can take on more risk to get more return.

Plus, in surveys, employees usually say they like their 401k plans. Also, workers can take their 401k to new jobs, unlike traditional pensions. That's important in economic times like this, Francis said.

"You could argue," he said, that the millions of people who've lost a job in the recession "are meaningfully better off having participated in a defined-contribution program than they would have been in a defined-benefit plan."

But there's still that nagging problem: A huge amount of risk is being put on individuals' shoulders. Bodie says 401k's are fine as long as savers invest the right way -- for Bodie that means not putting essential assets at risk in the stock market.

His choice for retirement plans: Treasury inflation-protected securities. "What anybody wants," Bodie said, "is a supplement to their Social Security benefits -- something that is protected against inflation, is guaranteed for life, and doesn't have the same political risk as Social Security."

In the end, it may be that baby boomers simply pay a steep cost for living at a time when defined-benefit plans started disappearing. As the retirement-savings system goes through a seismic shift, young adults today are seeing the mistakes their parents made -- most notably, failing to save early and often.

Younger people will "learn a lot of lessons about the stock market. They won't expect a job for life. They'll probably be more self-reliant," said Frank Haines, the chief investment officer with Christian Brothers Investment Services in New York.

"If you can do it at a young enough age, the power of compounding is very, very powerful," he said. "Unfortunately, it's the generations in their 30s to 60s who probably weren't instructed to do that as much as they should have been."

This article was reported by Andrea Coombes for MarketWatch.

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jweese
Wednesday, September 30, 2009 8:00:33 AM

Two words: Personal Responsibility. Why should I rely on anyone to fund or manage my retirement? Afterall, it is my money and my future so why should I leave it up to someone else? I have been forced to pay into Social Security since I started receiving a paycheck only to be told I will get approximately 70% of my benefits in retirement (even less if inflation kicks in) by 2040. I take the time to educate myself about the various investment options that exist today. I spend many an hour tending to my investments much like a gardener with his vegtables. Why then should I be punished by a public (i.e. Socialist) system where my hard work supports those who choose not to educate themselves on their investment options? Personal responsibility - it is what made America!!!

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Diyah1967
Wednesday, September 30, 2009 10:53:18 AM

I'm on the older end of Generation X. All through high school our teachers told us not to rely on Social Security or a pension when we retire. I've always kept this in mind when I think about and plan for retirement. Yeah, I may have lost a good chunk of my retirement savings; however, I'm realistic enough to understand that I'll be working for a long, long time before, or even if, I can retire. Now I'm trying to show this to my children.

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zeke1
Wednesday, September 30, 2009 11:03:33 AM

I love people like jweese who have an extremely simplistic answer for everything. His line of reasoning runs like this "It's my health, why should I leave it to someone else (like a doctor)?" Or my car, why should I let someone else maintain it? Personally, I can fly jet fighters and heavy jets like airliners. Can jweese? After all, why should he leave flying a passenger jet to someone else? He/she should learn that too. The point is everyone has particular skills that are useful to others. I know many, many individual investors who worked their butts off researching and making investment decision that for reasons far beyond their ability to control went sour. One I know lost a million. Frankly, it's more than a bit self centered to expect everyone else to do what I can. And to run screaming through the night at the word "socialism" displays a very large lack of knowledge.

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Crashnburn5590
Wednesday, September 30, 2009 11:04:29 AM

I'm with jweese. I screwed up on my 401K when I was in my 20's, but learned from my mistakes. I've made other financial mistakes, and learned from them. I've also gotten lucky, and been willing to take risks.

There are two kinds of risks. One is that you'll invest too riskily, and the money will be gone when you need it. The other is too conservatively, and there won't be enough money when you need it.

TIPs by themselves fall into the second risk category. At best they preserve the buying power of the dollars you put into them, but they only grow at the what the government says is the rate of inflation; but that's understated from the true rate of inflation. I have 10% of my portfolio in TIPs, as an inflation hedge. I also have 10% domestic non-TIP bonds, and 5% foreign bonds.

You need to have equity exposure to grow your earning power faster than the inflation rate. That's why I have 75% equity exposure. Ideally, when bond prices go down, equity prices are going up, and you sell some equities to buy more bonds. And, when bond prices are up, equity prices are down, so you sell bonds to buy equities.

Its hard to time the market, so you keep your portfolio "eggs" in a lot of baskets. When some basket values go up, you sell parts of those baskets so you can buy more baskets whose values have gone down. This is Modern Portfolio Theory (MPT) in a nutshell.

I'd messed with investing until I discovered MPT, but hadn't had much success. Now, I'm doing pretty well. It takes a couple hours a weekend to keep up with it. The time I spend on it is well rewarded.

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sailorretired
Wednesday, September 30, 2009 11:18:44 AM

I agree with jweese. Its all about the choices you make over a lifetime. Today you better be able to finance both retirement and your medical care. I retired in Dec 2008 at 57. I have not touched my 401K although I could since after 55 if retired withdraws are not subject to penalties unlike an IRA which requires you to be 59 1/2. A 401K only makes sense up to the employer match anything over that amount is better invested elsewhere.

Think like Warren Buffet. I own my home because I paid off the 30 yr mortgage in 25. I don't have a gararge so I don't accumulate things I don't need. I do not have cable TV or a cell phone, so no monthly payments to drain my savings. I was able to purchase a new car since retiring even though I didn't use the clunker hand out. I won't see any SSA money for 5 years.

But I do enjoy retirement, I travel and basically do whatever pleases me. I pay over $400 a month for medical insurance.... So yes you can retire if you have the right mindset and learn to save and not spend. I raised 5 kids including paying for college without loans. It is possible but it requires forward thinking. You have to always ask yourself where do I want to be in 5, 10 and 20 years, then do what it takes to get there. More government programs are not the answer.

What I fail to understand is how corporate America has cut pensions and health care for the workers but is still not competitive in the world markets. Seems they like the Wall Street bankers are all driven by greed. Thats not what made this country great and will be our downfall if we don't get it under control.

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Meggis1
Wednesday, September 30, 2009 11:19:14 AM

I agree. We have worked for years setting up various investment instruments including long term care insurance(look into it in your 30s and 40s since premiums will be lower and most people are still insurable). With the price of homecare, it will protect other assets. If you buy, make sure it is indexed for inflation and has compound interest. If you don't use it, it becomes a pool of money which grows over time. It can be used for anything. A difficult pregnancy where you need help at home, an accident etc. It isn't just for old people. Problem is, people are not informed. Talk to someone. Pick their brain You don't have to buy from them but you just might once you understand just what vehicles are out there... The keys are: curiosity, linked with caution, connected to education.

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chosen_one1
Wednesday, September 30, 2009 11:21:50 AM

Lmao suddenly everything is Obama fault ..Seriously why can't people believe that we were headed down this road a long time before bush or obama came into office, we just chose to look the other way when warning signs were going off ..... i been investing in social security for at least 4 yrs now .. im 25 and regardless of the dire predictions these people are making i guarantee you when it is time for me to retire social security going to be there

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endthefed
Wednesday, September 30, 2009 11:24:46 AM

What a joke. How kind would it be for the government to give me $600 a year with what will be a hyperinflated currency. I'm a 22 year old graduate that luckily found a job and contributes $8,000 a year to my 401k. Let me manage my money and let the government continue to claim what a great job they did in "fixing" a economy on the brink of collapse. Also, let's punish our generation for being responsible and doing what the previous generation never did. I sure wish I had the change to leverage everything.

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nanok
Wednesday, September 30, 2009 11:27:29 AM

Obama has drilled us right in the ass. Bailed out his buddies and the stimulus was a payoff for the fraudulent election. But our 401's took it right straight up the ole pooper!

IMPEACH OBAMA!!!!!

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The total cynic
Wednesday, September 30, 2009 11:31:13 AM

Stefan, the far left ideologues screwed the economy up?? The Republicans took control of congress in the mid 90's then had the presidency from 2001 to 2008 and during that time the mantra was that business could regulate itself better than government, hardly a far left ideology. Finance grew into a major part of our economy during this period and debt was their method of making money. Finance pushed government into a period of de-regulation and a wide variety of new financial instruments grew including a huge growth of derivatives which were a main part of the resulting collapse. As in past history when capitalism is left with little regulation it tends to implode. Even chairman (Bubbles) Greenspan finally admitted that he was wrong to believe that business could regulate itself. So the idea that far left ideology caused this crises is complete BS.

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