Are We There Yet?

Accumulating adequate retirement income is a challenge, but target date solutions and the 80/10/5 rule may help DC plan members reach their goals

By Peter Walsh

With the erosion of assets in many retirement portfolios in recent years, plan sponsors are starting to wonder if members might never be able to retire. Many are looking for strategies that will allow their employees to build a truly self-funded retirement plan over the long term, despite the near-term market volatility.

Target date or lifecycle solutions seek to minimize risks to retirement savings through diversification. These investment vehicles have increased steadily in popularity in Canada over the last several years. In the past year, these solutions have experienced growth of approximately 30%, with most of the growth in the pension plan market, according to Morningstar Direct (asset growth from Oct. 30, 2010, to Oct. 30, 2011). They are designed to accumulate capital early in a plan member's career and become more conservative as the member nears and enters retirement through an automatic asset allocation roll-down, known as the glide path.

But just as all target date solutions are not created equal, neither are the risks that plan members face. When looking for target date solutions to help members retire with an appropriate level of retirement savings, plan sponsors can't consider portfolio performance alone; they must look beyond market benchmarks to examine the investment processes and philosophies behind the strategies.

Identifying the Risks

The first challenge that target date plan members face in achieving their retirement savings goals is longevity. According to Statistics Canada, average life expectancies at birth for Canadians have risen by more than 10 years over the past half-century, to age 81 as of 2008. In some instances, Canadians could have a retirement that is as long—or longer—than their working lives. The longer the length of retirement, the more assets investors will need to accumulate in order to maintain their target salary replacement ratios and withdrawal rates.

A second challenge is inflation. While inflation in Canada has hovered around a relatively modest 2% in recent years, the erosion of purchasing power caused by even a moderate rise in prices can do much greater damage when compounded over two or more decades of retirement. To put it another way, 2% average annual inflation over a 25-year retirement could wipe out 40% of the retiree's purchasing power, unless the retiree has planned for it.

Market volatility poses another challenge. Canadian financial markets have not been immune to the wild swings in valuations that have affected much of the developed world. And when a retirement portfolio declines in market value, the asset base that a retiree can draw upon for income shrinks accordingly.

So how can target date plan members manage these risks over the course of their active investing years and build an adequate asset base in their portfolios by the time they are ready to retire?

Managing these risks on a consistent basis is one of the hardest things that an individual investor can do. One of the fundamental benefits of target date portfolios is that there are investment professionals responsible for managing the asset allocation of the portfolios, and ensuring that it balances the twin needs of growth and capital preservation. And while target date funds (TDFs) are affected by market fluctuations, these funds generally have lower volatility because of the diversification among asset classes inherent in their structure.

Planning for Success

One rule of thumb for successful target date retirement investing is known as 80/10/5. This philosophy was developed by leading thinkers on retirement income planning, including those from notable institutions such as Princeton University and Boston College.

80% A lifecycle portfolio's goal is to help participants achieve an 80% final salary replacement ratio during retirement, which includes public plan contributions.

10 times In terms of savings, participants will need to accrue approximately 10 times their final salary before entering retirement, which the TDF glide path is designed to help achieve.

5% Achieving the 10-times replacement ratio may allow participants a 5% real withdrawal rate during retirement. Some investors may seek a higher or lower real withdrawal rate and, as a result, may adjust this and the other two factors in the formula to achieve their personal goals.

Investors younger than age 62 should generally focus on accumulating an asset base that is equal to or greater than 10 times their final salary. For investors between the ages of 62 and 72, the emphasis should be on sustaining an acceptable salary replacement ratio with a 5% real withdrawal rate. Investors older than 72 should focus on capital preservation.

Plan sponsors that choose to follow the 80/10/5 philosophy should help individual plan members to understand these guidelines and keep their retirement savings on track. They should also look beyond benchmarks of target date portfolio performance against standard strategy peer groups, market indexes or asset allocation categories, closely examining the processes and philosophies that underpin the solution.

Furthermore, plan sponsors should keep in mind that TDFs are a complement to—and not a substitute for—sound investment advice. While the automatic asset allocation shifts featured in TDFs may help members meet long-term needs for growth and income, other types of advice, such as retirement income planning, are outside of the mandate of a target date strategy. Investors may want to consider discussing their financial plan with an advisor early in their active investing years.

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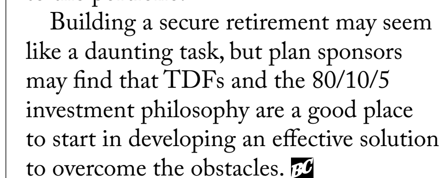
The outlook today is for an extended period of heightened market volatility and relatively low investment returns. As scary as this may be to investors, two features of target date strategies are important to consider in a volatile, low-return environment. First, a target date strategy, by design, is a long-term investing proposition with the goal of mitigating short-term volatility and the risk of losses through a long-term diversified asset allocation approach. Second, as with any portfolio managed by investment professionals, its focus is on sourcing and adding investments with the best potential for adding value to the portfolio.

Building a secure retirement may seem like a daunting task, but plan sponsors may find that TDFs and the 80/10/5 investment philosophy are a good place to start in developing an effective solution to overcome the obstacles.



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