JEFF CHAN

DC INDUSTRY FOCUSED ON 'THE WRONG METRIC'

By Sonya Felix

Funded ratio should replace account balances as the priority, prof argues

Unlike the promise by defined benefit plans of a stream of income during retirement, their defined contribution counterparts focus more on the accumulation of assets.

And that's a problem, according to Robert Merton, a professor of finance at the Massachusetts Institute of Technology's Sloan School of Management.

Merton, who spoke at *Benefits Canada's* Defined Contribution Plan Summit in Vancouver in February, warned the industry's emphasis on return on investment, rather than a stream of income in retirement, is dangerous and increases the likelihood of a major crisis as baby boomers retire. "A good retirement goal should be an inflation-protected income for life that allows you to sustain the standard of living you enjoyed in the latter part of your working life," he told the audience during the three-day event in downtown Vancouver.

"So instead of wealth accumulation with no specified goal, DC plans need to focus on a specified desired income goal."

Such an approach requires the industry to adopt a different mindset for coming up with an investment goal, measuring risk and success and creating an asset allocation strategy. For example, rather than measuring risk according to the volatility of portfolio returns, Merton suggested focusing on the funded ratio to show the potential risk of an income shortfall.

The funded ratio is a better indication of success than the account balance, he noted. In contrast to generic asset allocation strategies, Merton prefers a dynamic approach with customization according to age, income and the funded ratio. The focus should be on improving the funded ratio while managing income volatility, he suggested.

"It's also important to make the most efficient use of all retirement assets," he added. "Typically, people look at what's accumulated in the DC account, but other assets need to be taken into account, such as an existing DB plan, social security and future contributions. Future contributions are actually the biggest asset and are low risk relative to the income goal."

Although target-date funds are now a common default for many plans, Merton said using age as the only variable isn't a good investment strategy, if the goal is to sustain the standard of living in retirement. Customization of portfolios should instead consider factors such as salary, age, gender and assets.

"Average isn't good enough, because everyone has a different situation," he said.

Merton acknowledged that member disengagement is an ongoing concern for the pension industry. He insisted, however, that a retirement savings plan should be effective, even for those who have little active involvement in it.

"If a plan depends on interaction, then it is a flawed design," he said, suggesting that a good default option isn't paternalistic but is enabling for members.

"Down the road, members will become engaged but they must get to a good place, even if they don't do anything in the meantime."

Once members take a greater interest, instead of asking about asset allocation and fund selection, they need meaningful information and simple choices that focus on adequate retirement income. "Given their goal and what they have saved so far, saving more, working longer and taking more risk are the only ways to ensure they will have the income they need," said Merton.

"If you change those three things, it will affect the chances of getting to the goal. Showing the value of the account is the wrong metric. What should matter is the funded ratio. It is less complicated and provides immediate feedback on the chance of getting to your goal." BC

Sonya Felix is a freelance writer based in Qualicum Beach, B.C.

FIVE TIPS FOR ACHIEVING THE GOAL OF AN ADEQUATE, INFLATION-PROTECTED INCOME FOR LIFE

1. Set replacement income as the retirement goal
2. Offer robust, scalable, low-cost investment strategies
3. Make efficient use of all dedicated retirement assets
4. Measure shortfall risk by income, not wealth and volatility
5. Customize goals based on salary, age, gender and assets

Source: Robert Merton