MENU

Pensions crisis

Pensions pain: disaster is avoidable

Overhauling the design of pension plans and saving more are critical to healthy retirements

The Long View

The crisis is on a vast scale but there is time both to save more for our old age and to look at the mechanisms of the pensions industry © FT montage; AFP/Getty; Dreamstime

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by: **John Authers**

If we have done our job properly, you should by now be scared out of your wits. The FT has spent the last week examining a serious problem (http://www.ft.com/pensions-crisis?ft_site=falcon&desktop=true) for all of us — that lower bond yields mean higher strain for pensions.

(The reason, for those who have not been reading, is that lower yields make it more expensive to buy a guaranteed stream of income from bonds (https://ig.ft.com/sites/pensions-interestrates-explainer/). Thus companies and governments who have promised their employees a fixed pension, or so-called "defined benefit" plans, face a growing shortfall which must somehow be filled. And it means savers in modern "defined contribution" plans, who have no guarantees and have mostly failed to save enough so far, risk an impoverished old age).

The scale of the problem is dizzying. It is exacerbated by the fact that future returns on US stocks, the world's most popular asset class, are likely to be weaker because they are so expensive. And yet they look cheaper than bonds.

Now, it is incumbent on me to come up with some solutions. As this is the long view, I will concentrate on defined contribution plans. In the short term, many employers face a serious problem plugging pension deficits. But most of us face a tougher future where the risks of retirement financing will lie squarely with us, and not with our employers.

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While a technical actuarial problem carries a real risk of a social crisis, there are opportunities. Disaster is avoidable.

First, the problem is partly caused by the good news that we are living and maintaining our health for longer. It is not the worst hardship to expect to work a few years longer than our parents did. That increases our nest egg and reduces the time over which it has to be spread.

Second, compound interest is our friend. Small increases in the amount we save make a difference when compounded over a working lifetime. So we need to save more.

Third, the underlying driver of low yields is low inflation. If (big if) this continues, then our savings will hold their value more than they used to do.

Fourth, there is the matter of how we save. We need to get more bang for our buck. That means cutting down on fees wherever possible (http://next.ft.com/content/415a7ad6-6a8e-11e6-ae5b-a7cc5dd5a28c). It also means timing the market sensibly. It is never a good idea to take the risk of being out of the stock market altogether (even during the 2008 disaster this would have risked missing the dramatic bounce back in the spring of 2009). But it does make sense, within bands, to maximise allocations to investments that look cheap (as emerging markets do now), and minimise allocations to those that look expensive (such as US stocks).

It also requires exploiting pension plans' greatest advantage; that they have time on their side. Globally, there is a need for better infrastructure, and a lack of funds from straitened governments to pay for it.

The most successful public defined benefits pensions — such as those in Canada — hold infrastructure. (http://next.ft.com/content/99075c68-68f9-11e6-a0b1-d87a9fea034f) They are pools of patient capital to aid public investment. Defined contribution plans do not. The reason for this brings us to the most important point — the design of DC plans needs to be rethought, totally.

Interactive

Pensions' painful arithmetic (https://ig.ft.com/sites/pensions-interestrates-explainer#interactive)

(https://ig.ft.com/sites/pensions-interestrates-explainer#interactive)

Bond mathematics and the scale of pension deficits explained

DB plans were well designed for a world of shorter life expectancy, high yields, high returns and long careers spent with the same company. They are now obsolete. But DC plans in many countries are not plans at all — they are a tax incentive to buy mutual funds. They have some of mutual funds' advantages that a pension fund does not need — like the ability to buy, sell or switch between funds at any time — but lack advantages that pension funds should enjoy, such as the ability to buy illiquid assets.

This must be fixed. There is no reason why young investors' long-term savings should not go into funding infrastructure, or clean energy, or other beneficial investments for the future. The funds to do this will be less liquid than a mutual fund, and that does not matter.

A second critical issue, beyond investing and accumulating assets, is to manage the "decumulation" phase, when savers start drawing their income. That can no longer be about buying bonds, thanks to low yields. It will have, increasingly, to be about selling stocks and other long-term investments. The plans need to be structured so that savers have clear guidance on how much of their fund it is safe to draw down each year. A large statement on retirement with a "target" (http://next.ft.com/content/83f1dcea-6a02-11e6-ae5b-a7cc5dd5a28c) or "maximum" annual withdrawal might be a good idea (as would earlier strong guidance, or even compulsion, towards saving more).

The recent British reform to allow savers to take more of a lump sum at retirement is a confident and irresponsible step in exactly the wrong direction.

One final point. Reading the mass of feedback we have received, (http://next.ft.com/content/8a54a0c6-648b-11e6-a08a-c7ac04ef00aa) it grows clear that the issue of pensions divides us, particularly along generational lines. Many view it in moral terms. This is all wrong. We are all in this together, whether we are generationally lucky or not. We can wait for a social disaster of widespread poverty for the elderly — or we can adapt, design a new system for a new economy, and treat a long-lived, low-inflation world as a blessing.

More from the FT pensions series (http://www.ft.com/pensions-crisis):

Podcast: The dark future A dramatic decline in bond yields has added to the pressures of longer lifespans and falling birth rates to create a looming social and political pensions crisis. John Authers and Robin Wigglesworth discuss the looming crisis (http://podcast.ft.com/2016/08/22/explaining-the-global-pension-crisis/)

Pensions: Low yields, high stress In the first article of a series, the Financial Times examines a creeping social and political crisis (http://next.ft.com/content/8a54a0c6-648b-11e6-a08a-c7ac04ef00aa)

Canada quietly treads radical path on pensions Retirement funds push beyond bonds and stocks (http://next.ft.com/content/99075c68-68f9-11e6-a0b1-d87a9fea034f) in search of better returns

Target-dated funds are welcome but no panacea for pension holes TDFs (http://next.ft.com/content/83f1dcea-6a02-11e6-ae5b-a7cc5dd5a28c) help pension plans but face challenges of fees, asset allocation and benchmarks

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