

HOW IMPORTANT IS ASSET ALLOCATION TO RETIREMENT SECURITY?

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Introduction

Financial planners devote considerable energy to advising Americans how to invest their retirement savings. Of course, wise investment of one's hard-earned money is important. But the fact is that many Americans have saved very little – the typical household approaching retirement has less than \$100,000 in 401(k) and other financial assets. Thus, for many people, even perfect investing is unlikely to have a significant effect on their well-being in retirement.

Fortunately, people have a number of other levers that can affect their retirement security. And these strategies – unlike the stock market – are within the individual's control: working longer, using a reverse mortgage to access home equity, and controlling consumption when the kids leave home. Moreover, even for many with substantial assets, these non-financial levers may be as powerful as asset allocation in attaining retirement security.

This *brief*, adapted from a recent paper, compares the non-financial levers to asset allocation to determine the relative power of each strategy in boosting retirement preparedness. The first section describes

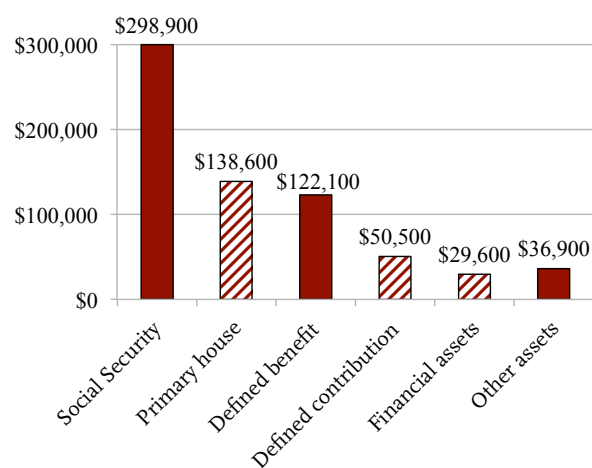
the potential benefits of the non-financial strategies. The second section summarizes the methodology used to compare their effectiveness with asset allocation. The third section presents the results. The conclusion is that, for the population as a whole, asset allocation is less potent than the alternatives, particularly working longer. And, even for those with substantial financial assets, it is less important than one would expect.

Retirement Levers

Preparing for retirement can be a daunting task, especially for workers approaching traditional retirement ages, who tend to have only modest 401(k) balances and few other financial assets (see Figure 1 on the next page). Traditionally, financial planners have emphasized the benefits of properly allocating assets between stocks, bonds, and cash to match a household's circumstances. But other alternatives may be equally or more effective.

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FIGURE 1. WEALTH HOLDINGS OF A TYPICAL U.S. HOUSEHOLD, AGES 55-64, 2007



Source: Authors' calculations based on U.S. Board of Governors of the Federal Reserve System, *Survey of Consumer Finances*, 2007.

Working Longer

Working beyond age 62 – the earliest age of eligibility for Social Security benefits – is a powerful way to increase retirement security.¹ The strategy works in three ways. First, it dramatically increases an individual's monthly Social Security benefits – by at least one third for delaying retirement until age 66 and by at least 75 percent for delaying until age 70. Second, working longer gives pre-retirees more time to contribute to their 401(k)s, which builds up a bigger nest egg. Third, working longer shrinks the period over which retirement assets need to be stretched. Someone who works 40 years and is retired for 20 years has a work-to-retirement ratio of 2-to-1 – just two years of work are supporting each year in retirement. By working five additional years, the ratio improves to 45 working years to 15 retirement years, or 3-to-1.²

Tapping Home Equity

The typical U.S. household approaching retirement has nearly \$140,000 in home equity (see Figure 1), making it the largest asset outside of Social Security. Yet few seniors tap their equity to help support their retirement consumption. Reverse mortgages allow those age 62 or older to extract their home equity while remaining in their home. This loan must be

repaid when the retiree moves to another living arrangement or dies. The amount that can be borrowed depends on the borrower's age, home equity, and current interest rates.

Spending Less

For households in their 50s, who are typically in their peak earning years, it is tempting to boost spending and live it up a bit – especially for couples whose children have left home.³ However, tempering this urge and keeping a lid on spending boosts retirement preparedness in two ways – one obvious and one not. First, households that are able to cut their budgets can save more in their 401(k)s before retiring, expanding their nest egg. The less obvious benefit from spending less is that it reduces what households need for their day-to-day expenses today, thus lowering the bar for maintaining their lifestyle in retirement.

The remainder of this *brief* compares the three non-financial levers to asset allocation to determine how they stack up in boosting households' retirement preparedness.

Methodology

The analysis uses data on working households aged 51-64 from the *Health and Retirement Study* (HRS), a nationally representative panel survey of older households conducted every two years since 1992.⁴ The key measure used in the analysis is a household's replacement rate – retirement income as a share of pre-retirement income. Determining the retirement readiness of each household involves three steps: 1) identifying a target replacement rate, which would allow each household to maintain its pre-retirement standard of living; 2) projecting a replacement rate for each household based on its own circumstances; and 3) comparing the target and projected replacement rates. This exercise is done for each household at each age from 60 to 70.⁵

For the first step, target replacement rates were drawn from Georgia State University's RETIRE Project, which provides rates that vary based on marital status and income (see Table 1 on the next page). Targets are less than 100 percent of pre-retirement income because retirees pay less in taxes and no longer need to save for retirement, among other factors. The rates from the RETIRE Project were adjusted to reflect the fact that a significant proportion of the sample will have either repaid their mortgage by

TABLE 1. TARGET REPLACEMENT RATES FOR HOUSEHOLDS, BY EARNINGS AND MARITAL STATUS

Pre-retirement earnings	Two-earner couple	Single earner
\$20,000	94%	88%
\$50,000	81%	80%
\$90,000	78%	81%

Source: Palmer (2008).

retirement or be able to repay all or part of the balance outstanding at that time by drawing on financial assets.

Armed with retirement income targets, the next step is to calculate the projected retirement replacement rate that the household will achieve at each age from 60 to 70 if it continues on its present course, maintaining its current saving rate and asset allocation and not taking a reverse mortgage. Total income at retirement in this baseline scenario consists of Social Security, employer pensions, and income from financial assets. Social Security benefits are calculated using the HRS Social Security earnings records.⁶ Pension income is based on the 1998 and 2004 HRS imputed data for employer-sponsored pension plan wealth in current jobs. Household financial wealth invested in stocks, bonds, and short-term deposits is assumed to earn real returns of 6.5 percent, 3.0 percent, and 1.0 percent, respectively, from the date of the HRS interview until retirement. At retirement, the household is assumed to purchase a nominal joint or single life annuity with its financial assets, including 401(k) and IRA balances.

In the third step, the projected replacement rate at each age is compared to the target rate for each household. If the projected rate is below the target, the household is falling short in its retirement preparedness. The aggregate result for all households at 62 is the baseline measure for assessing the impact of the four levers.

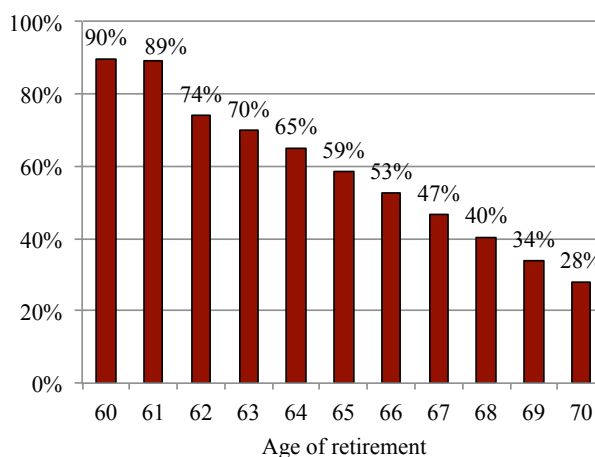
The levers are then applied as follows. The effect of working longer is determined simply by comparing the percentage of households falling short of their target at age 62 to the results for a later age, such as 67. The other levers are applied separately for each year as alternatives. The reverse mortgage lever assumes a household takes the maximum available loan given

the age of the younger spouse and the house value, and opts for the loan proceeds as a lifetime income amount.⁷ The “control spending” strategy assumes that the household increases its 401(k) contribution rate by five percentage points, which produces a commensurate decline in its replacement rate target. The asset allocation lever assumes that households invest all of their retirement saving in equities, earning a 6.5 percent real return, and face no costs associated with the increased risk. This assumption of “riskless equities” is designed to give the asset allocation strategy an unrealistic advantage over the other options. The notion is that if asset allocation does not dominate the other levers with “riskless equities,” it would never dominate.

Comparing the Levers

Figure 2 shows the results for the full sample of households from ages 60-70. As noted above, the power of working longer is shown simply by comparing the percent falling short for different retirement ages. For example, at a retirement age of 62, 74 percent of all households fall short of their target replacement rate. But delaying retirement to age 67 dramatically reduces this figure to 47 percent. One key reason is the boost from higher monthly Social Security benefits.

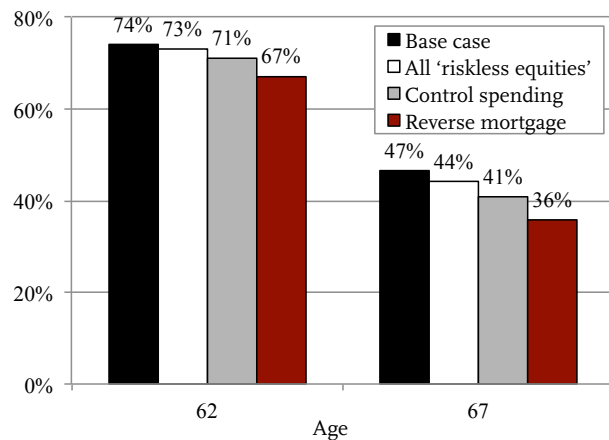
FIGURE 2. PERCENT OF ALL HOUSEHOLDS FALLING SHORT OF TARGET BY AGE AT RETIREMENT



Source: Munnell, Orlova, and Webb (2012).

Next, the other levers – reverse mortgage, control spending, and riskless equity investment – are added as separate options to gauge their effect on the baseline in each year. Figure 3 shows the results at ages 62 and 67, including the base case. For example, at age 62, the percent of households falling short drops by 7 percentage points if households take a reverse mortgage and by 3 percentage points under the control spending strategy. In contrast, investing assets in “riskless equities” shaves off only 1 percentage point. The age 67 results show a larger effect for each of these strategies, but the pattern is identical. Asset allocation remains the least effective option, even with the “head start” from assuming that equities are riskless.

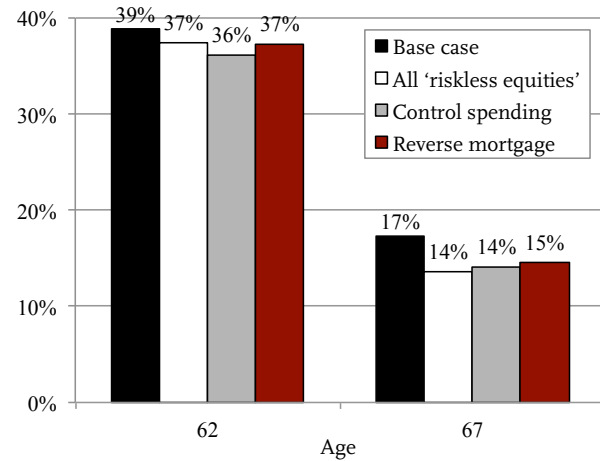
FIGURE 3. PERCENT OF ALL HOUSEHOLDS FALLING SHORT OF TARGET BY LEVER, AGES 62 AND 67



Source: Munnell, Orlova, and Webb (2012).

Of course, it is not surprising that asset allocation is less effective than the alternatives given that most households have only modest financial assets. Therefore, the analysis was then narrowed to the top decile of the wealth distribution, which includes households with more than \$500,000 in financial wealth. Since these households are wealthier, a lower share fall short at age 62 even in the base case – just 39 percent (see Figure 4). If top-decile households worked to 67, the share falling short plummets to 17 percent. But, interestingly, the alternative levers of a reverse mortgage, controlling spending, and riskless asset allocation have roughly equivalent effects on wealthy households. So, even for the high-wealth group, asset allocation is no better than the other levers.

FIGURE 4. PERCENT OF TOP-DECILE HOUSEHOLDS FALLING SHORT OF TARGET BY LEVER, AGES 62 AND 67



Source: Munnell, Orlova, and Webb (2012).

Conclusion

The traditional emphasis on the importance of asset allocation might lead one to believe that the best way to improve retirement security is to adopt the perfect mix of stocks and bonds. However, households nearing retirement have more effective levers available that tend to fly under the radar: delaying retirement, taking a reverse mortgage, and controlling spending. Each one – particularly working longer – is a more potent alternative than asset allocation for most households. Thus, financial planners will be of greater service to their clients if they focus on a broad array of tools for boosting retirement security.

Endnotes

- 1 See Munnell, Golub-Sass, and Webb (2011).
- 2 Munnell and Sass (2008).
- 3 Coe and Webb (2010).
- 4 For an overview of the HRS, see Juster and Suzman (1995).
- 5 For more details on the methodology, see Munnell, Orlova, and Webb (2012).
- 6 When the earnings records were not available, earnings histories were imputed using current earnings, earnings at first HRS interview, and final earnings in previous job.
- 7 The proceeds from the lifetime income option are based on January 2012 interest rates and typical closing costs and expenses. For homeowners with a mortgage, the household uses its financial assets to clear its mortgage debt at retirement. If financial assets are insufficient to clear the mortgage, the household takes part of its reverse mortgage in the form of a lump sum, reducing the amount payable under the reverse mortgage lifetime income option.

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