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HOW SENIORS CHANGE THEIR ASSET HOLDINGS DURING RETIREMENT

By Karen Smith, Mauricio Soto, and Rudolph G. Penner

This paper examines the changes from 1998 to 2006 in the asset holdings of those who were 60 and older in 2006. It was motivated by a concern that the substitution of defined contribution (DC) retirement accounts for defined benefit (DB) plans may create too much of a challenge for the investment management skills of the older population in that most will end up having to plan their rate of spending so that they do not end up impoverished should they live longer than expected. They can, of course, use DC accumulations to buy annuities, but few do, because imperfections in annuities markets make annuities overly expensive. The paper also asks whether tax law significantly affects withdrawals from particular types of accounts. Withdrawals from DC accounts, such as IRAs and 401(k)s, are taxable and one would expect oldsters to delay such withdrawals as long as possible. However, minimum withdrawals are required after age 70 1/2 and we wanted to observe the importance of this provision.

During the period studied, stock prices fluctuated wildly and a bubble developed in housing prices. The irrational exuberance in the stock market of the late 1990s was followed by a crash after 2000 and then a subsequent recovery, which peaked in 2007. The net wealth of the older population outside of Social Security and DB wealth rose significantly between 1998 and 2006, primarily because of the increase in housing values. This suggests that seniors were careful about spending their capital gains either out of inertia or because they wisely realized that the gains were likely to be transitory. In either case, it put them in a better position to withstand the crash that followed in both housing and stock markets.

More generally, our results indicate that most of the older population is extremely cautious in formulating their spending plans as they age. This may be because of a very strong bequest motive or because of a concern that they will face emergency expenditures, most probably related to health care. However, the conservatism is so extreme, especially among the more affluent, that one cannot avoid the suspicion that many are unnecessarily forgoing consumption.

According to the results of our regressions, the nonannuitized assets held by the top quintile of the income distribution actually grew in value up to age 85, all else equal. In the three middle quintiles, asset values fell slightly with age, but at such a slow rate that households were likely to die long before exhausting their wealth. These results refer to averages in the various income quintiles. Undoubtedly, there are some in the population who spend too lavishly while others are very clearly being too conservative.

The picture changes significantly when we observe those who were in the bottom quintile of the income distribution in 2006. They spend down their annuitized assets quite quickly and end up relying on Social Security, DB pension plans, and welfare payments during their retirement. For those at the bottom who have worked fairly steadily at low incomes through their lifetime, Social Security generally provides an adequate replacement rate, especially for married couples. That may not be the case for those who have had low incomes because of an erratic work history.

Tax considerations are most relevant for those in the top quintile of the distribution. It is, however, difficult to tease out the effects of tax law because the more affluent accumulate all types of assets as they age. There is some weak evidence of tax effects in that they disproportionately accumulate assets in retirement accounts from which withdrawals are taxable. They definitely do reduce the value of retirement accounts after age 70 when withdrawals are mandated. The middle quintiles do accumulate more in retirement than in other accounts as they age and they do reduce retirement account values after age 70.

In general, the results of our analysis are reassuring. The substitution of DC for DB plans creates investment management challenges for older households, but they typically respond very cautiously and it appears as though most in the top five quintiles of the income distribution will end their lives with assets to spare. Of course, our analysis provides no information on how well they manage their DC assets during most of their working lives and there may be many above or below average oldsters who spend too much or too little during their retirement. Even the average may be too cautious. This suggests that more intensive financial education can be valuable for all groups, both during their working lives and in retirement.

The heavy dependence of the lowest quintile on Social Security and on other safety net programs suggests that we must be cautious when Social Security is reformed, as it must be eventually. To the extent that the growth of benefits is slowed, there is an argument for protecting the lowest income groups by resorting to devices such as progressive indexing, a minimum benefit, or perhaps some increase in the generosity of SSI.

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Center for Retirement Research at Boston College

Hovey House, 140 Commonwealth Avenue, Chestnut Hill, MA 02467-3808

phone 617.552.1762 fax 617.552.0191 crr@bc.edu www.bc.edu/crr