The need for retirement income solutions is greater than at any time in recent history because Americans are living longer and retiring at a faster pace than ever before. At the same time, retirement plans providing guaranteed lifetime income are on the wane, shifting the burden from companies to individuals on how to spend down their savings in retirement. As a result, an increasing number of Americans face the prospect of meeting highly uncertain retirement income needs over a long, indeterminate horizon. Just as the planning horizon is unknown, so too are the income needs—while some costs decline in retirement, health care costs are typically much higher for retirees, introducing additional complexity into the retirement planning equation.

In the face of this uncertainty, retirees on average are underspending rather than overspending their retirement wealth. In this paper, the first in a series, we present the scope of the problem. In future papers, we will look at a range of potential solutions to help meet varying investor income needs in retirement.

From Defined Benefit to Defined Contribution—Changing Plan Landscape

The change in the retirement landscape from a preponderance of defined benefit retirement (DB) plans to defined contribution (DC) plans has significant implications for retirement investors. The effect is that most retirees have transitioned from certain knowledge of their income through retirement to an uncertain income stream over an unknown horizon. This is an acute problem today, when DC plans are the dominant retirement vehicle for most American workers, and DB represents a smaller proportion of workers.

According to the U.S. Department of Labor, the number of private DB plans peaked at just above 175,000 in the early 1980s and has declined ever since, while the number of DC plans has grown from around 200,000 in 1975 to more than 650,000 today. In 1975, 33 million Americans participated in a private DB plan and 40 years later, some 36 million. By comparison, in the same time frame, DC plan enrollment has gone from just 11 million to over 100 million.

As of 2016, the latest period for which data were available, DC plans accounted for more than $5.7 trillion in assets with the plans receiving contributions and paying out benefits in excess of $450 million annually.

From Accumulation to Decumulation

The transition from DB to DC has significant implications for retirement investors. DB plans solved one aspect of the retirement income problem effectively by providing a regular, perpetual payout through retirement. DC plans, in stark contrast, put the burden squarely on the individual plan participant to solve both the accumulation and decumulation problems.

The focus of DC plans has understandably been on accumulation—one must first have retirement assets to distribute. This focus has yielded significant benefits. Target-date funds (TDFs) solve many classic retirement investing problems—providing long-horizon strategic asset allocation, diversification, professional management and systematic portfolio rebalancing.

Retirement plans themselves are now often well-structured to address many behavioral investing errors. Examples of progress include providing TDFs as a qualified default investment alternative (QDIA) in retirement plans, forcing participants to opt out rather than opt in, and using advanced paternalistic features such as auto-enrollment and auto-escalation to improve participant outcomes. As a result, plan design and TDFs have contributed to significant progress in solving the accumulation problem. But there is no comparable “solution” in terms of plan structure and investment options to address decumulation.

Uncertain Planning Horizon Increases Complexity

Nor is the scope of the problem to be underestimated—Americans are retiring in record numbers thanks to the baby boom demographic, while lengthy modern life expectancies extend the income-planning horizon well beyond the retirement date. Consider that the number of people retiring each year has doubled since 2000, with 10,000 Americans a day reaching age 65 (full retirement age), according to the Pew Research Center. By 2030, every member of the baby boom generation will be age 65 or older.

Not only is the number of retirees rising, but so is life expectancy. Back in 1946, when the first baby boomers were born, the average life expectancy for men and women was just 64 and 69 years. A husband and wife retiring today at age 65 have life expectancies of 84 and 87 years, respectively. (See Figure 1). Life expectancy, however, measures the 50th percentile of the distribution, meaning that one-half of all retirees will live beyond these projections. Planning is even more complicated for couples, where there is a 50% probability that at least one spouse will be alive at age 92 assuming both are 65 today. In financial planning speak, this means the income planning horizon is long and cannot be known in advance.

What’s more, longer life expectancies increase the complexity of the retirement planning problem. It is important for our purposes to note that in the U.S., not only is the share of population aged 65+ increasing, but this population spends 2.5 times more on average on health care compared with the broad population on a per capita basis. If you compare health care costs for those 65+ versus those ages 19-64, it jumps to greater than three times.²

Overspend or Underspend? The Uncertainty’s the Thing…

The oft-repeated criticism of DC plans is they leave retirees at risk of overspending—that is, running out of money in retirement. But Employee Benefits Research Institute (EBRI) data indicate the problem might be the other way around—after roughly two decades in retirement, the majority of Americans avoided drawing down their balances. The EBRI study indicates that even individuals with less than $200,000 in non-housing wealth at retirement—the lowest retirement wealth bracket in its study—had depleted on average only about one-quarter of their assets.³
So, while the risk of overspending is real for some, the reality is the opposite—the majority of DC plan participants underspend. What's not entirely clear is whether participants do so intentionally, as a preference to say fund a bequest, or because they are simply unsure how much they can safely withdraw. Whatever the reason, the ideal outcome would be to find the retirement planning golden mean—not over- or underspending but providing retirees with advice and solutions to manage their income needs effectively in retirement.

Indeed, according to an EBRI survey, plan participants expect their workplace retirement savings to be an important source of income in retirement. The bottom line is that there is a strong need for solutions and advice for both current retirees and pre-retirees to help individuals successfully navigate the financial complexities of retirement. This would be the financial planning sweet spot—using the assets and financial vehicles at retirees’ disposal to take intentional risks and decisions to achieve desired outcomes. We will discuss a variety of these retirement income strategies in our next paper in the series.