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Robert C. Merton on Retirement Trends

Nobel laureate addresses questions about wealth vs. income, risk measurement, and interest rate challenges

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Professor ROBERT C. MERTON[1] is the School of Management Distinguished Professor of Finance at MIT Sloan School of Management and University Professor Emeritus at Harvard University. He also serves as Resident Scientist of Dimensional Holdings Inc. In the past six and a half years, Professor Merton has traveled the globe discussing ways to help investors achieve better retirement outcomes. Last summer he took a 50-day journey to three continents, 11 countries, and 16 cities, where he spoke to sovereign wealth funds, regulators, industry leaders, and institutional investors. We spoke with Professor Merton to find out what he learned on his travels and to get his views on trends impacting retirement around the world.

In "The Crisis in Retirement Planning," an article in the July–August 2014 edition of the *Harvard Business Review*,[2] you state, "Our approach to saving is all wrong: We need to think about monthly income, not net worth." Does this important issue still keep you up at night?

ROBERT MERTON: It surely keeps me up at night because the challenges still exist and it's a global problem. The primary concern for employees saving for retirement is whether they will be able to maintain the standard of living they enjoyed in the latter part of their working careers throughout retirement.

The focus needs to be on the amount of income a defined contribution (DC) portfolio can generate during retirement. In other words, instead of reporting the net asset value (NAV) of a portfolio to an investor we need to report the amount of income that can be funded with dedicated retirement assets.

Wealth and income are different. If you measure wrong, there are practical implications, such as misleading people and giving them false indicators of achieving a successful retirement. If retirement income is the goal and you measure risk by using volatility of NAV instead of volatility of retirement income, then you cannot possibly manage risk correctly. We need to get this right.

What is the best way to manage retirement income risk?

MERTON: Most target date or risk-based DC solutions tend to put employees nearing retirement in shorter maturity bonds. But short-term bonds are more

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1. Robert C. Merton is a consultant to Dimensional Fund Advisors LP.
2. "The Crisis in Retirement Planning": *hbr.org/2014/07/the-crisis-in-retirement-planning*.

risky than almost any other asset if the goal is retirement income. A better way to manage income risk is to use inflation-protected instruments, such as Treasury Inflation-Protected Securities (TIPS), that can match the duration of the retirement income need (liability). This approach isn't new. In fact, defined benefit plans have long regarded income risk as the most important risk to manage.

Are you seeing a global trend toward DC plans making retirement income the goal?

MERTON: When I give my talk about retirement income as the goal, eyes start to widen and there is this "aha" moment because it becomes so obvious to them. Yet there is still much work to be done in the US and abroad. A critical step will be when the regulators of DC plans require disclosure of retirement income and how it changes (as they do now for NAV).

In the inaugural issue of *DC Dimensions* in July 2011, you shared your views on the "Next Generation of Retirement Planning." Since then, what's changed?

MERTON: The good news is that the underlying principles still hold up today (see box, below). Since 2011, more firms have developed, or are in the process of developing, retirement solutions that embrace these principles, both in the US and abroad.

What does the retirement landscape look like in Asia?

MERTON: Every country in Asia is different, but one trait they share is that GDP is growing in the majority of regions. The good news is that this offers a higher standard of living. The bad news is it puts more pressure on the financial and retirement system to move with it. There is increased demand for financial products and services in Asia as a result. Asia has the ability to leapfrog current technology and offer a leading-edge financial and retirement system. This is the type of growth environment in which you can get things done to create amazing opportunities.

Why do you think interest rates remain low around the world?

MERTON: Some think rates are artificially low as a result of unorthodox monetary policies throughout different regions, such as the US, UK, Europe, and Japan. Others believe we are in equilibrium, meaning even if quantitative easing (QE) and/or unorthodox monetary policies cease, there is no reason to believe that interest rates will suddenly pop up to traditional levels. I don't take a stand on either argument but just suggest some ideas for why rates remain low.

If interest rates stay low, how do we generate retirement income?

MERTON: The reality is that if you need income, that doesn't change whether rates are low or high. When they are low, it will cost you more to achieve the same level of income. Assume you plan to retire and buy a certificate of deposit (CD) with your $300,000 account balance. If interest rates are 3.5%, you would generate around $10,500 a year in retirement income. If rates are 1%, your wealth buys $3,000 a year. That's a 71% drop in income. The best advice I can give is to prepare and have a plan for how you will be able to maintain your lifestyle even in a low-rate environment.

Guiding Principles for a Better DC Solution

1. Make replacement income the goal for retirement.
2. Measure retirement income shortfall risk.
3. Make efficient use of dedicated retirement assets.
4. Customize income goal based on salary, age, human capital, and retirement assets.
5. Take account of changes in market and personal conditions.
6. Be effective for members who are unengaged.
7. Provide only meaningful information and actionable ways to improve retirement outlook.
8. Offer seamless transition from accumulation to payout phase.
9. Offer robust, scalable, low-cost investment strategies.

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