

Meaningful Information for Retirement Planning

Plan participants need to know how choices will impact outcomes

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MAKING EFFECTIVE DECISIONS REQUIRES HAVING INFORMATION

about the impact of a decision on potential outcomes. For investors saving for retirement, a key decision is how much to save to meet retirement spending (or consumption) goals. To make this decision, investors need estimates of (1) how much consumption their savings can sustain in retirement and (2) the uncertainty around it. This information is crucial because it gives investors a yardstick to measure their retirement readiness. By itself, however, an estimate of retirement readiness is not enough to help achieve retirement goals. The investment solution needs to be tailored to the investment goal.

Consider, for example, an investor using a retirement calculator that shows he is on track for his goal of \$40,000 per year of retirement consumption. How will the \$40,000 estimate change over the next 10 years? This estimate is meaningful only if it is unlikely to fluctuate a lot in the future. So the investor needs a solution that reduces uncertainty. The strategy needs to manage market, inflation, and interest rate risks because each one can affect his ability to sustain retirement consumption. Having the right risk management strategy makes the estimated spending information meaningful in consumption terms.

Dimensional believes that, with the right goal and risk management framework, investors are more likely to transition seamlessly from accumulation to retirement, when assets will be used to provide real (inflation-adjusted) consumption.

Research shows that providing information to plan participants about the effect of their own choices on expected outcomes helps them make better decisions.¹

EXHIBIT 1 INCREASING LEVELS OF CLARITY ABOUT RETIREMENT INCOME



For illustrative purposes.

Dimensional’s My Retirement Income Calculator

Dimensional has designed a tool—the My Retirement Income Calculator—that provides participants the ability to see how present and future consumption are related. The calculator estimates a median of future income and the uncertainty around this median.

To estimate the effect of uncertain market returns, in addition to the median, the calculator shows a higher level and a lower level. The higher level is an estimate of the 75th percentile of projected income (if market returns are greater than expected), while the lower level is an estimate of the 10th percentile of projected income (to give participants an estimate of the risk they may face in case of poor market performance).

Exhibit 1 illustrates a potential path to retirement for a hypothetical user. As retirement approaches, the participant

is assumed to have an increasing allocation to inflation-protected bonds matched to their retirement horizon. This strategy is designed to manage the uncertainty around how much retirement consumption the participant can afford from accumulated savings. As a result, the range narrows around the median retirement consumption estimate. Why? The assumed asset allocation is less exposed to equity risk and seeks to hedge the effects of future interest rate changes or inflation on expected retirement consumption. This approach also implies that the retirement consumption estimates are less sensitive to assumptions about expected global equity and bond returns.

Having the right risk management framework is crucial to striving toward a successful outcome. The framework provided by the calculator gives participants the information needed to calibrate their retirement expectations.

The type of information shown in Exhibit 1 is also useful to participants who want to annuitize part of their portfolio at or before retirement. For example, a participant could use the income estimates to plan for withdrawals over the first 20 years of retirement and to plan for how much to invest in a lifetime annuity that starts paying after year 20.

Plan Design Considerations

These tools—the right risk management framework and information in consumption units—are also useful to plan sponsors and consultants. Plan sponsors, advisors, and consultants can use them to prepare reports that include personalized information on the retirement readiness of participants. They can also use the calculator to evaluate the effect of plan features on expected outcomes.

1. See hub.dimension.com/exLink.asp?10764622OZ22G58I54078715.

IMPORTANT: The projections or other information generated by the My Retirement Income Calculator regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. Results may vary with each use and over time. Actual retirement incomes may vary significantly. Past performance is no guarantee of future results. See key assumptions and other important disclosures on the calculator web page: us.dimension.com/defined-contribution/retirement-calculator.

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