Terminal Wealth Dispersion, Life Expectancy and Individual Retirement Accounts

Terminal wealth dispersion is the technical term that describes the variability of the future value of investment portfolios. This inevitable variability means that no one knows what the value of their investment portfolio will be when they reach retirement age or at any time during their retirement. And the uncertainty of individual's life expectancies compounds this problem.

Hedging against the risks associated with these two factors places an onerous burden on individuals. Although this hedging could result in a very comfortable retirement, if one can afford the hedge and their timing is right, the potential downside risk is so great that it may be deemed unacceptable by many individuals. So one has to ask "Do individuals really prefer to forgo a sure but modest retirement income and play the odds with their retirement savings in hopes of being very well off in retirement?"

With individual accounts, individuals lose the benefit of the pooling of risks. The two risks that force individuals to over-save are investment risk and the risk of living beyond the average life expectancy. In both cases the outcomes, terminal wealth and life span, are highly variable. When the risks are pooled for a large number of individuals over many overlapping life spans, the average outcomes are highly predictable, which is what makes traditional pension plans work so well.

Traditional pension plans exist, for all intents and purposes, in perpetuity. This being the case, they can build reserves during good times in the financial markets and weather the bad times, thus enabling them to make consistent payouts to retirees regardless of the timing of their retirement. Unfortunately, individuals do not get to choose their holding periods or the years of their retirement and must take whatever comes along, and what comes along might be good or it might be bad. Thus individuals must set savings goals that are sufficiently high to hedge against the risk of the average return of an investment portfolio over its holding period falling well short of that which would be expected very long term.

The relatively short duration of individual's holding periods leave them very susceptible to the effects of market cycles, which are notoriously unpredictable in amplitude and frequency. Being broadly diversified mitigates this risk but does not eliminate it, as it's entirely possible for a worldwide bear market to occur during one's holding period. Then at the end of the holding period for wealth accumulation, a second holding period begins, which will be the term of retirement, and this second holding period carries the same risks as the first, but at a time in life when there is no source of income to make up for portfolio under-performance.

The other component of risk that individuals must hedge is the risk represented by the uncertainty of one's life span, which means that individuals must aim even higher when setting their savings goals. The managers of large pension plans can depend on retirees living on average for only the average life expectancy of employees who reach retirement age. The average life expectancy for someone who reaches the age of 66 is currently 82 years, and 66 is currently the age when workers are eligible for full Social Security benefits, which makes it a reasonable baseline. Based on those assumptions, the average term of retirement would be 18 years and pension plans should only have to be funded to the extent necessary to cover the cost of this average term of retirement.

Individuals, however, don't know how long they're going to live, so they must over-save to ensure that they don't run out of money before they run out of time. This need to over-save is independent of the first need, thus the need to over-save is compounded, i.e., an individual needs to save enough to cover the cost of living well beyond the average life expectancy and the targeted amount of savings at retirement age must be great enough to ensure with a reasonably high level of certainty that the actual amount on hand at retirement is at least the bare minimum necessary to get by on.

A popular estimate of the term of retirement for which individuals must plan is 30 years. Saving enough to cover the cost of a 30-year retirement is a much greater burden than saving for an 18-year retirement, but planning on a shorter retirement exposes individuals to tremendous risk. It also exposes taxpayers to tremendous risk, as individuals who outlive their savings will undoubtedly require some form of public assistance to make ends meet and are likely become wards of the state when they become physically incapable of caring for themselves.

An individual who bases their retirement saving on living to the age of 96 but only lives to be 82 will have forgone a lot of pleasures in life, such as travel, fine dining and better vehicles, that they could otherwise have enjoyed. But many individuals just don't have the level of income required to support the saving rate necessary to amass the wealth required to hedge against the downside of terminal wealth dispersion and the possibility of living well past the average life expectancy. For them it's not a matter of forgone consumption, it's a matter of going through life with the knowledge that they are likely to spend their golden years living in abject poverty and that that will be their reward for 40 or 50 years of hard work. And it gets worse!

Some economists now believe that within 15 years or so, 100% of Social Security benefits will be spent on medical expenses: Medicare Parts B and D premiums, copayments, uncovered expenses and medigap insurance premiums. If that becomes the case, anyone without substantial savings or a defined benefit pension will be looking for public assistance the day after they retire.

With the situation already at this state, adding private Social Security accounts to the mix would be like throwing gas on a fire, as individual Social Security accounts carry the same risks as other individual retirement accounts. Those who have tried to kill Social Security since its inception find private accounts very appealing. But, not so coincidentally, most of them seem to be in the enviable position of not needing Social Security to support their retirement. More recently, younger workers, too, have come to oppose Social Security, but not for the same reason as the traditional opponents. Young workers may be crushed by the burden of social Security and may never receive any benefits from the system. Those who oppose Social Security simply because it's a social program should be expending their efforts on reforming it rather than killing it.

If Social Security had been managed like a pension plan rather than a pyramid scheme, its current situation wouldn't be so dire. Indeed, it might very well be a fully funded, functional system. CalPERS and other large public employee retirement plans have operated successfully for decades, with success being defined as being able to meet their obligations, not having an adverse effect on the financial markets, no scandalous events attributable to malfeasance by the plans' sponsors and being free of influence from elected officials. There's no reason that Social Security can't also be managed in such a manner. It would literally take an act of Congress to do this, but the hardest part for Congress would be letting the system run without their interfering with its operation.

Passing off the burden of retirement to individuals was a great deal for corporations but it's a very poor deal for most individuals, and extending individual accounts to include the Social Security system would only make a bad situation worse. It's not a poor deal for *all* individuals because there will be some who can afford to save a substantial portion of their income and whose holding periods will coincide with bull markets, thus putting their wealth in the upper range of their terminal wealth dispersion, and who also live a long, healthy life. They will be the ones who benefit from over-saving and living beyond the average life expectancy, but they may end up forfeiting a portion of their wealth in the form of taxes to support the less fortunate. I don't believe that is what the public expects from a well-conceived system.

About the Author

Mike Kennedy created and operates Your Complete Guide to Investing in Mutual Funds, a comprehensive resource for individual investors, where you can learn how to factor terminal wealth dispersion into your financial plan.