

# Focusing on a 'pot of money' for your retirement can be misleading

LAURA DU PREEZ

South African retirement plans that are designed to provide you with "a pot of money" at retirement have completely the wrong focus, a Harvard professor and Nobel prize winning economist currently on a visit to South Africa, says.

Instead of aiming to deliver, measuring your progress towards, and managing the risk to, an amount accumulated by the time you reach retirement, your fund should focus on the income you require to maintain your standard of living into retirement, Robert Merton, a finance professor at the MIT Sloan School of Management and emeritus professor at Harvard University, says.

Last year, Merton wrote an article titled *The Crisis in Retirement Planning for the Harvard Business Review* in which he outlined the problem that has arisen as a result

of the global move from defined-benefit retirement funds to defined-contribution funds.

Defined-benefit funds promise you an income defined in terms of your salary in your last few working years. Defined-contribution funds promise to deliver at retirement only your contributions, those of your employer and the growth on these.

But Merton says the move to defined-contribution funds has shifted the focus from the income you will receive to the provision of a pot of money at retirement and protecting that pot of money close to retirement, with a number of negative implications.

Merton is in South Africa to assist local investment manager Colouredfield in developing income-focused strategies for defined-contribution funds. He also

addressed trustees and advisers at the launch of the annual Benefits Barometer research findings by

retirement fund administrator Alexander Forbes.

Merton says the goal of saving for retirement is to maintain your standard of living, and this is best measured by the income stream your savings will generate, not by how much money you have in a pot.

He says the trustees of your pension fund should choose an appropriate level of your income (or replacement ratio) to target and give you feedback on how on track you are to reaching that goal. When you reach that goal, Merton says, your fund should remove the risk to your income by moving your savings into investments such as inflation-linked bonds, which can provide the income you will need in retirement.

Getting the goal and the measurement of your progress to that goal wrong can be pretty serious for you, the member, he says. He gives the example of a man who reached age 60 in 2012 with a lump

sum sufficient to buy a pension of R10 000 a month. If that man worked an extra year before retiring and invested his retirement savings in the money market for a year, the value of the pot of savings would have been retained.

But if, after working for the extra year, the member tried to purchase the annuity, he would have found that it had decreased to R7 500 a month. This was a result of interest rates coming down and the cost of the annuity going up – in one year, there was a decrease in his income of 25 percent, Merton says.

The focus on the wrong goal of retirement savings is perpetuated by laws and regulations that oblige your fund to show you the value of your savings, rather than the income you could buy with it, and how it has changed over time.

Merton says that if your fund shows you how much money you have saved, it is dangling a carrot in

front of you that you are likely at some stage going to want to get your hands on.

If, instead, your fund told you the value of the income your savings will provide at retirement, you may be less tempted to withdraw your savings on resignation, and do so only in cases of dire need.

Currently, most fund members withdraw their retirement savings when they change jobs. This is regarded as a leading cause of members reaching retirement with insufficient savings to maintain their standard of living.

Merton also believes that your fund should offer you an individual retirement plan, because each member's needs and goals differ.

Some members join a fund with greater savings than others, and members' careers progress at different levels, with some enjoying promotions that increase their income.

Planning for the average is not appropriate for the individual. The technology is now available for funds to provide low-cost individualised retirement plans that can be tailored to your goals, Merton says.

This individualised plan can be constructed without any input from you, and can be amended whenever you are ready to engage with your retirement fund about your needs and goals, he says.

Merton says it is only when you are older that you are likely to know how long you will work, what income you will need in retirement and whether or not you will provide for a spouse.

When you do engage with your fund, it should be able to give you meaningful choices, he says. It should not ask you to choose the asset allocation of your investments or to pick funds from a list. The only choices you should be making are

about the income you want in retirement and how you will get there, Merton says.

The factors you should make choices on are:

- ◆ How much you save each month – if you consume less and contribute more, you are more likely to achieve your goal;
- ◆ How long you will work; and
- ◆ How much investment risk you are prepared to take within the prudent levels set for retirement funds.

Merton says that if your fund has a good plan to help you achieve your income goals, approaching retirement will be much less stressful for you in your later working life.

However, he says, a good plan is no replacement for too few resources. If you contribute too little – for example, only two percent of your income – you won't retire comfortably.