



Next Generation Retirement Planning

Interview with Robert C. Merton

Employers around the world have discovered how expensive it is to offer defined benefit plans and are converting to defined contribution plans. But DC plans in their current form are ineffective because most people aren't comfortable deciding how to invest their retirement savings. Employees need new and better ways to manage the risks they face when planning for retirement.

Motivated to come up with a solution that works better for both companies and their employees, Dimensional launched Dimensional Retirement, a business unit dedicated to providing leading-edge retirement products and services to plan sponsors and financial advisors. Dimensional Retirement's first offering is a low-cost managed account solution for DC plans that aims to help employees achieve inflation-protected retirement income.

The managed DC concept was developed by Nobel laureate Robert C. Merton. We interviewed Professor Merton to hear his perspective on the retirement industry and to learn more about the financial science that has gone into Dimensional's Managed DC solution.

Professor Merton, how did you get interested in retirement savings issues?

I've been working on household lifecycle finance for my entire professional career. Through my work, I learned that most people would like to have an income in retirement that enables them to sustain the standard of living they enjoy in the latter part of their work life. They also need that income to be protected from inflation.

Unfortunately, it appears that fewer and fewer people

are likely to have enough income for a good retirement. Defined benefit plan participants used to be confident that their employers would provide them with an adequate retirement paycheck, but that confidence has been shaken as their plans have been frozen or closed. DC plan participants, too, are at greater risk than was previously expected. The more I looked at this problem, the more inspired I was to find a way to solve it.

What do you see as the beginning of the end for defined benefit plans?

In my view, most DB plans were vulnerable from the outset because their accounting treatment systematically underpriced the cost of the benefits and understated the risk to the plan sponsor that guaranteed those benefits. That mispricing ultimately makes the plans unsustainable, but rising stock markets throughout the 1990s masked that vulnerability until the period between 2000 and 2002. In those years, the combined effects of an extensive stock market decline and a steep decline in interest rates caused DB plan assets to fall substantially and DB plan liabilities to increase substantially, putting the plans under intense financial pressure. Companies in weak industries, such as airlines and steel, were forced to close their plans, and some were driven to bankruptcy. Strong companies came to realize how large a risk exposure their DB plans created and began reexamining the viability of continuing to provide these benefits.



Professor Merton is the School of Management Distinguished Professor of Finance at the Massachusetts Institute of Technology and University Professor Emeritus at Harvard University. He also serves as Resident Scientist at Dimensional.

So plan sponsors turned to defined contribution plans?

Sponsors adopted DC plans to replace closed or capped DB plans by default. However, DC plans were never designed to provide core retirement benefits. In the beginning they were largely supplemental for higher paid workers to increase their retirement benefits beyond their DB. With more widespread adoption of DC plans, participants—from brain surgeons to assembly line workers—are being called on to make complex financial management decisions that they have not had to make in the past, they aren't equipped to make now, and, even with education, they will not be capable of making in the future. Their

even if they never actively participate in their retirement planning.

Don't they have to manage their own plan?

This is a managed account, so they don't make investment choices. And although the solution is capable of handling large numbers of employees at low cost, it is highly customized for each individual in important ways.

We achieve this customization by taking an integrated approach. Some information about the participant—such as gender, marital status, age, and salary—is

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situation is like being a surgical patient who, while being wheeled into the operating room, has the surgeon lean down and say, "I can use anywhere from 7 to 17 sutures to close you up. Tell me what number you think is best." That is not only a frightening decision for a patient to be faced with, but it is one that most people are poorly qualified to make. All of this points to the need for a next-generation retirement solution.

How did you get started?

We started by examining the needs of the people who have the largest stake in retirement planning: plan participants. Their need is to be able to sustain their lifestyle after they retire. To achieve that goal, they will need retirement income that is protected against inflation. They also need to make sure that this income is available no matter how long they live.

Our understanding of participants' needs was our core design element—the foundation on which we built. The solution is designed to ensure that plan participants will have a reasonably high probability of achieving the income they need,

provided to us by the recordkeeper. These data are used by the employer to create default settings for retirement age, contribution rate, desired target retirement income protected for inflation and minimum risk income level. The model also incorporates each individual's expected Social Security payments, existing DB plan rights, existing DC plan balances, and expected future DC plan contributions. Our algorithm uses all of this, plus simulations for equity prices, interest rates, and annuity prices, to create an optimized asset allocation strategy for each person. The participant's investment allocation is revised dynamically in response to changes in income, accumulations, contributions, and market conditions.

Our goal is to maximize the probability that the participant will be able to purchase a specific life annuity, protected from inflation, at his or her targeted retirement date. Of course, participants can choose alternative options at retirement if it's in their best interest to do so.

THE SOLUTION IS FULLY INTEGRATED TO INCLUDE:

- ▷ Implementation support
- ▷ Robust, easily configurable reporting tools
- ▷ Educational materials for plan participants
- ▷ An engaging online retirement planner
- ▷ Asset allocation strategies that are customized for each individual
- ▷ Professional investment management
- ▷ Access to a range of payout options

You mentioned that participants are able to further personalize their accounts. How do they do that?

All of this dynamic asset management optimization takes place without requiring the participant to be involved in the process at all. If, however, the participant chooses to become engaged and actively provide input into the process, then he can further customize his program by changing the income goal, contribution rate, retirement age, and minimum risk income level to better fit his needs.

When participants log in to their accounts for the first time, they see a preset target for their retirement income. They also see feedback from us about the probability that they will achieve this target. If they don't like what that feedback says—if the probability of success is too low—we offer ways to improve it.

There are only three things they can do: save more, work longer, or take more risk. That's it.

We don't talk with the participant about rates of return, asset allocation, or rebalancing. That isn't meaningful to him. What is meaningful is how much income he'll have to live on in retirement. Once the participant tells us what he wants, and what he's willing to do to get there, we take care of investing.

What about employers? What's in the Managed DC solution for them?

Employers want plan participants to be able to retire with adequate income. This solution gives them a very simple but effective way to help their employees aim for that benefit, without the risks that come with DB plans.

Is the Managed DC solution available now?

The Managed DC solution has been in place in Europe with a global electronics company and a global semiconductors company for about six years. It's now being implemented with a multi-employer pension provider in the United Kingdom. Implementations in the United States will begin in the fall of 2011.

So is your work done?

That's an easy question to answer: No, our work will never be done. We plan to make continuous improvements to the Managed DC solution to ensure that it always incorporates the best that financial science has to offer. We intend to provide plan sponsors with a solution that they will never have to replace. ■



Reprinted from Dimensional's inaugural July 2011 *DC Dimensions* magazine. To read other articles from the magazine or for more information about Dimensional's DC services, please visit us at <http://dfaus/u/3ds>.

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