INTERVIEW

Retirement Planning: Expert Advice for Long-Term Investing

Laurence Siegel on longevity annuity contracts and aggressive saving. How Vanguard and Uncle Sam can help.

By AVI SALZMAN
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Larry Siegel, director of research at the CFA Institute Research Foundation, a nonprofit think tank in Charlottesville, Va., has been studying retirement for decades. He has a long history of helping individuals and large institutions make investment decisions.

Siegel is a senior advisor to the boutique New York investment firm OCP Capital, and spent 15 years in the Ford Foundation’s investment division. His writing has been published widely, from his book *Benchmarks and Investment Management* to dozens of articles penned for financial journals. In a piece published in February in the Financial Analysts Journal, titled “After 70 Years of Fruitful Research, Why Is There Still a Retirement Crisis?” he reviews decades’ worth of research, and argues for a flexible combination of defined-benefit and defined-contribution retirement plans, as well as retirement investment programs unrelated to employment.

Like many retirement experts, Siegel is worried that Americans aren’t saving enough or drawing down their retirement accounts in an intelligent way. In an interview with *Barron’s*, he highlighted strategies that can help private-sector workers make a nest egg last for decades—even if they have the good fortune to live past 100 years old.

*Barron’s: Is America’s retirement system broken?*

**Siegel:** It is broken, but not irretrievably broken. It isn’t godawful for everyone. It is great for some people and terrible for others. You can have two guys sitting next to each other in two offices making the same paycheck and doing the same work, and because of different savings rates and different investment results, one can retire with $3 million and the other with $100,000.

*Is it really true that the average person retires with less than $100,000 in savings?*

It is more than that, but not dramatically more. The median retirement account is less than $100,000,
but that includes many young people. At retirement, the median account is between $100,000 and $200,000. But the median masks a huge variation from multimillionaires to people with literally zero.

**How do we make the system work better for those with less?**

There are three levers: Save well, invest well, and de-accumulate well. I remember a line from the movie *Bull Durham*: Baseball isn’t such a tough game. You just throw the ball, hit the ball, and catch the ball. Well, it turns out it is tougher when somebody else is playing against you. So you have three things that sound easy but are difficult.

Saving well means a high savings rate when other people have a low savings rate. You can’t buy the biggest house and send your kids to the most expensive college unless you are quite wealthy, because you’re also saving money for retirement, and that is hard.

**How much should people be saving?**

The work I’ve done shows that with a zero capital-market return in real [inflation-adjusted] terms, you need to save close to 30% of your income.

**Wow, that’s a serious chunk of your paycheck. Does that include the employer contribution in defined-contribution plans?**

It does. You are trying to stretch the income from a 40-year career over at least 70 years. The way to stretch it is to save almost half of it. As the investment return improves, the percentage it is necessary to save goes down quickly. So 15% is plenty if you can earn the historical rate of return on assets. That’s 6.7% for Standard & Poor’s 500 stocks, and 2.6% for long-term Treasuries.

But, can you? The stock market is high. The bond market is absurdly high. Saying that you can earn a real rate of 2% on your stocks, bonds, and other assets combined improves things a lot, although I would like to see a little more saving because markets go down as well as up.

**How many people are actually socking away 30% of their annual income?**

I studied this about a decade ago with data from 1999, which was the latest we could get. At the time, about 6% of people were contributing more than 15% of their salaries, including the employer contribution. About 22% of non-highly-compensated employees contributed at least 10%. The highly compensated aren’t allowed to put as great a percentage in the plan as other employees, but they can invest privately. This doesn’t show up in the data.

**What can be done to increase the savings rate?**

There are behavioral tricks that can be used to help people achieve their goals. An example is auto-enrollment in a retirement plan, and auto-escalation. If you don’t express a preference when you take a new job, the company just puts you in its plan and you default to a savings rate—say, 6%—plus whatever the employer’s match is. If the match is also 6%, then you are up to 12%, and that’s starting to be real.

You should also commit to a plan called Smart, or Save More Tomorrow. In this case, you commit a portion of future raises to the savings plan, so that if you get a 4% raise, 2% goes into savings and the 6% savings rate becomes 8%. But since it is 8% of the old pay, it is a little less than 8% of
the new pay. Gradually, you can lift it, and the numbers build over time. If you use those two techniques, you are beginning to get realistic savings numbers. You can’t force people to do it, however, because it is their money, and they are allowed to spend instead of save.

**Should people be investing these savings in target-date funds, which are an increasingly popular option in employer-sponsored retirement plans?**

A well-engineered target-date fund is better than an undiversified portfolio set up by a novice investor. Generally, they are managed competently, but there is no guarantee. If you don’t mind a commercial comment, Vanguard’s target-date funds are managed well. They don’t hold alternative investments—just stocks and bonds. The cost is minuscule, and costs are what eat you alive in any investment.

Vanguard doesn’t offer fancy options in its target-date funds, unlike the fancy-pants investing that has taken over the world. Alternative investments can get very silly, very fast.

**If you save well and invest well, it seems the spending part should be easier. Yet, even people with healthy retirement-account balances run out of money. Why?**

It is easy to see how that happens. You have a lifestyle that is hard to change, and let’s say it costs $400,000 a year. As you get older and go through a long period like this, with essentially zero real returns, you aren’t making any new money. But you have saved $4 million and you think you’re rich.

In the past 15 years your equity account has had a zero real return. If you had a $4 million account and spent $400,000 a year, you would run out of money in 10 years. While you might try to cut your spending to $300,000, it’s like a dog chasing its tail. You never quite get to equilibrium in your account because you don’t want to change your lifestyle. You figure you’ll do it later if you have to, and you won’t be alive then, anyway. Then, surprise, you are!

The very, very rich don’t have to worry about this. It is hard to spend $100 million. But it isn’t so hard to spend $5 million or $10 million.

**What is the best strategy to guard against outliving your savings?**

You want to divide your money into two piles, but not the usual two piles wherein one guarantees the minimum amount you think you’ll need, and the other is used to speculate. Instead, one pile is a deferred annuity, which would total about 15% of your saved assets. That’s to cover your cost of living after age 85. The other is a pile for conventional investing, for the years between 65 and 85. Breaking your retirement assets into these two piles lessens the problem of saving for an unknown period of time. Twenty years is a manageable number. You can think about it without going crazy.

**What makes this the best way to save for retirement?**

Let’s say you give all your money to an insurance company that issues annuities to generate an income. If you need the money back, you can’t have it. But if you only give 15% of your money to an insurance company, and that’s to cover your later years, you can save and invest the other 85%. Even if you find out that you are going to die before age 85, giving 15% to an insurance company hurts a lot less than giving 100%.
Where can investors buy deferred annuity contracts?

There isn’t much of a market for these sorts of annuities. It totals about $12 billion, and there are about a dozen issuers. One reason the market isn’t bigger is that insurance companies don’t know how to hedge the risk. If longevity has been increasing, they need to know they can make the payments.

I am not going to make a recommendation because I haven’t done the due diligence, but if you search for a QLAC [qualified longevity annuity contract], you’ll get a list of providers and they will offer to provide quotes. QLAC is the Internal Revenue Service term for a deferred annuity. The government created a new tax break last year allowing a retiree to use the purchase of a QLAC up to certain caps to satisfy the required minimum distribution, or RMD [the mandated withdrawal rate from a retirement account when the owner reaches age 70½].

How much do these contracts cost, and what sort of payout are you likely to get?

If you buy one at 65 that will start paying out when you’re 85, you’ll get a great price. I recently got a quote for a little over $40,000 a year in payouts for a cost of $100,000, invested at age 65. The reason it seems inexpensive is that most people don’t live to collect the money, or don’t collect it for very long.

How can the government encourage this kind of saving?

I would like the government to allow the purchase of a QLAC as a tax-free transaction within an individual retirement account or 401(k) account. I would also like to see a standardized contract. People would be able to comparison-shop much more easily, and insurance companies would be able to hide fewer costs and risks in the contract.

Is this the sort of benefit that employers could offer?

I would also like to see employers offer it as part of a benefits package, so long as they are doing the due diligence and are responsible for the choice of the insurance company. You start to get professional-quality selection that way.

Annuities, long-term care insurance, and other financial products for seniors have been criticized for their lack of transparency and difficulties in collecting what is owed. How can buyers safeguard against this?

There should be sensible regulation. Also, it makes sense to buy from Vanguard or TIAA-CREF or another provider with a long track record of doing business honestly and constantly, and at a low cost.

What happens to your money if your insurance company goes out of business?

There are several things you can do. One is to buy longevity annuity contracts from more than one company to diversify your risk. And don’t buy the cheapest contract; the one with the highest payout likely will be reaching to pay those claims by making risky investments. Secondly, and most people don’t know this, every state has an annuity guarantee pool. If the amount you have annuitized isn’t too large, and if the insurance company
goes bankrupt, you are still protected up to a certain amount. You need to know how much your state will guarantee, and treat only that portion as guaranteed.

*We’ve spent a long time discussing how to invest 15% of retirement assets in a deferred annuity. What should you do with the other 85%?*

You should invest it in a diversified index that is consistent with the amount of risk you are comfortable taking. I generally agree with the dimensional wisdom, that retired people shouldn’t take a lot of risk, and that fixed income should be dominant in the asset mix. But at today’s astonishingly low fixed-income yields, it is hard to invest that way. It is hard to convince anyone to take 2% or 3% nominal returns with the possibility that interest rates are going to rise. You would be locking in capital losses, so you put a little more in equities. The current fashion seems to be for even retired people to have 60%, 70%, 80% of assets invested in stocks, and that is way too much.

*What is the optimal percentage?*

It is 30% to 60%. I would favor the lower end of that range unless you have some special ability to cut spending if the stock market folds in half. The risk tolerance is really your ability to cut spending. If you are spending $150,000 a year and all of a sudden that becomes $75,000, are you going to get a job at Wal-Mart, rob a bank, or be OK? Maybe you’ll just drive a Toyota instead of a Lexus.

*Fair enough. Thank you.*

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