**401(k): Failed Experiment**

by [Jack Marrion](http://annuityoutlookmagazine.com/author/jmarrion/)

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**The belief that most workers in the ‘70s and early ‘80s retired with a company pension has almost become an urban legend. Even then, fewer than half of all workers were covered by any type of employer retirement plan. It’s no surprise that workers in the private sector today are even less likely to get a company pension. Of workers in their fifties, 21 percent will get a pension at retirement. If they’re in their forties, the covered percentage drops to 15 percent and only 12 percent of thirty-somethings are in line to get a pension. Each of these categories is down 20 percent or more when compared with pension-eligible workers in 1989.1**

If a private sector employer offers a retirement plan, it is almost certain to be a defined contribution plan wherein the employee saves – possibly matched to some extent by the employer. The original idea was that 401(k) plans would give workers greater flexibility in their retirement with a “portable plan” that they could use to create their own pension. The worker would somehow have the knowledge to make good investment decisions, even though there was no provision for educating workers. Indeed, the way the law was written, the sponsors of the 401(k) plans could be held responsible if they provided any education beyond the most basic and generic investment advice. The end result was analogous to giving someone a box full of car parts without instructions, showing them a picture of an automobile, and telling them to build it. So, how did that work out?

**On Paper It All Works**

 Pat retired at the end of last year at age 66, and in that final year of employment, she earned $75,000. Let’s assume that Pat received a three percent raise every year and contributed six percent (with employer match for a total 12% investment) of that annual salary since 1979. Let’s also assume Pat invested 100 percent in some S&P 500 index fund with zero expenses. Over that 35-year period, those annual contributions would have grown at a rate of 9.7 percent and resulted in a 401(k) balance today of $592,265.

Conventional wisdom says we’ll need 80 percent of our pre-retirement income, so Pat will need $60,000 in retirement. The calculator on the Social Security website says Pat’s annual Social Security Benefit is $20,352. Wall Street suggests four percent is the most that can be prudently withdrawn and four percent of $592,265 is $23,691. There is no pension, so between Social Security and the four percent rule, it says Pat has a retirement income of $44,043 – or $16,000 short of what is needed in retirement.

Pat could use some or all of the 401(k) balance to buy an immediate annuity. Say she got a quote of $40,152 for a life income immediate annuity based on a $592,254 premium. If we convert the 401(k) balance to an annuity and add that to Social Security, Pat gets $60,504 – meeting the initial goal (the immediate annuity income does not increase).



**Reality Often Upsets Paper Plans**

Pat is in a far better position than most, because we’re assuming Pat was never unemployed and thus kept contributing year after year. Pat never had family financial demands requiring money to be withdrawn from the plan. She contributed a percent more than the average worker to the 401(k), received steady raises, and, most importantly, this assumes that Pat never futzed with the allocation and kept it always invested in the index fund. Here’s what futzing can do:

The stock market was down in 1981 and 1990. As an example of futzing, say that these down years caused Pat to move the money to the money market account for 1982 and 1991 – just for the following year – and then Pat returned to investing in the index in 1983 and 1992. By going to the money market for only two years, Pat’s balance drops by a hundred thousand dollars down to $491,000.

What if Pat was a might spooked when the 401(k) balance dropped to $323,000 at the end of 2008, and she moved the money to the money market fund for the next five years? Instead of having $592,265 in 2012, Pat now has $350,000. If we use the four percent rule for withdrawals, we generate $14,000 in income, and when added to Social Security, this totals $34,352. Even turning the $350,000 into an immediate annuity income only produces $23,725 and combined with Social Security totals $43,627. Better, but it’s still a long way from the $60,000 needed.

**Annuities for When Reality Gets In the Way**

The problem with the concept of 401(k) plans as a replacement for pensions is that real life investors do not act how computer models say they should, which is why the DALBAR studies consistently show long-term investor returns are roughly a third of what the actual market generates.  Put simply, in real life, people buy high and sell low because decision-making biases get in the way and they get scared or overly optimistic or follow the crowd when they shouldn’t. When they finally reach retirement, retirees are left with a pot of 401(k) money and advice coming from more computer models guessing how much they can take out each year, but never guaranteeing they won’t run out of money if they guess wrong.

Washington is tacitly admitting they screwed up by originally ignoring longevity risk by beginning to encourage 401(k) providers to offer life income annuities as a retirement plan option, but it could go much further.  Teaching workers about the benefits of contributing to fixed deferred annuities offering guaranteed lifetime withdrawal benefits will result in a surer path to having sufficient retirement income. Carriers and industry groups should be reaching out to employers and offering annuity educational resources for their employees.

Unlike a pension, annuity income is not an obligation of the employer, but of the insurance company. Unlike investments, annuity income is based on guarantees and not dreams and hopes. Consider an annuity. After all, we can’t all be as lucky as Pat.

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Jack Marrion is president of Advantage Compendium Ltd providing research and consulting services to select financial companies. He has twice been asked to address the National Association of Insurance Commissioners on annuity issues, his insights on the annuity and retirement income world have appeared in hundreds of publications including Business Week, Kiplinger and The Wall Street Journal, and his research is frequently referenced by regulators.