

What Works in Retirement Planning

A fast-growing field of research is starting to uncover why some retirement savers succeed and others fail

By Penelope Wang

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(MONEY Magazine) – HOW DO YOU GET PEOPLE WHO NEVER have money left over at the end of the month to contribute 5% of salary to a 401(k)? How do you improve the investment returns of a worker who knows little about stocks and bonds and has no time to learn? As the nation's retirement system demands that ordinary citizens bear more and more responsibility for funding their future, economists and policymakers have been asking questions like these with growing urgency. The answers, based on survey and pilot programs, are beginning to trickle in, and what's emerging is an outline of principles that really have led people to make smart decisions about their future. So far only professionals have paid much attention. But maybe you should too.

The most useful insights, it turns out, come from the field of behavioral finance, the study of the emotional and sometimes counterproductive ways we make decisions about money. The key difference between retirement success and failure, researchers have found, is not how much CNBC you watch or even how much you earn. (Amazingly, one small study found that the median income of a group on track for retirement was 17% below that of those falling behind.) What matters instead is how you handle the all-too-human inclination to undersave and procrastinate. "Much of investing success has to do with overcoming our own worst tendencies," says Richard Thaler, a pioneer in behavioral finance from the University of Chicago.

As you will see from the examples of successful retirement savers in the following pages, you don't have to be an economist to grasp what works. Much of the latest research just reinforces classic money-management practices. But that's not bad. Indeed, it's just one more reason to be confident that if you do the right thing as you go along, it will pay off.

FINDING NO. 1 Planners Prosper

The simple act of planning--calculating a retirement target, say, or estimating how much you should save--has a surprisingly large impact on your odds of success. Consider the results of a study by Annamaria Lusardi, a professor of economics at Dartmouth College, and Olivia Mitchell, a professor of insurance and risk management at the University of Pennsylvania and executive director of the Pension Research Council. Analyzing data from a 2004 national survey on the first wave of baby boomers, Lusardi and Mitchell found that those who did "a lot" of retirement preparation had a median net worth of \$200,000, compared with \$84,000 for those who did the least. "Even a small amount of planning can make a huge difference," says Lusardi. Those who did "a little" were also ahead, with a median net worth of \$172,000.

Planning pays off because it's a crucial psychological trigger. Studies show that writing a plan down--or even simply thinking about it--greatly increases the likelihood that you will follow through. "Planning helps us overcome the internal blocks that lead us to procrastinate or worry," says Dr. Richard Peterson, a psychiatrist and author of the upcoming book *Inside the Investor's Brain*. And any facts you pick up along the way may motivate you or scare you into action.

Thinking about the future was enough to make Rob and Sucheta Shah, now 36 and 35, serious about retirement from an early age. "I figure Social Security won't be there for me when I'm 65," says Rob. "So we have to take charge of our destiny." The Scottsdale couple became self-taught investors--he's a

manager at a consumer products company, and she's a former wedding planner who now stays home with two-year-old daughter Simran. Using online calculators, Rob figured they would be on track if he regularly stashed away 4% of his income in his 401(k), where he receives a 4% match, and saved another 11% in a taxable account. Rob recently raised his 401(k) contribution to 10%. Fourteen years into their plan, the Shahs have \$150,000 saved.

- What to do now: If you don't already have a plan, a good first step is to come up with a savings goal. Your 401(k) website should have a savings calculator, and most major fund companies offer similar tools online. If you want advice, you can buy a personalized retirement plan from a fund company such as T. Rowe Price (800-638-5660) or Vanguard (800-851-4999), typically for \$250 to \$500.

THE POWER OF PREPPING

Thinking ahead to your retirement and taking steps to save money pay off in greater wealth.

SOURCE: "Baby Boomers and Retirement Security," by Annamaria Lusardi and Olivia Mitchell.

FINDING NO. 2 Know-How Equals Net Worth

In a study analyzing the impact of financial literacy, Lusardi and Mitchell quizzed people on simple calculations, such as compound interest or percentages, and then compared their knowledge with their net worth. The findings: More right answers matched up with greater wealth. Those who grasped compound interest, for example, had a median net worth of \$309,000 vs. \$116,000 for those who missed the question.

In another study, Lusardi found that those who had attended retirement seminars had a 20% increase in net worth. Those with the least money and education got the most from the events, but even the wealthier profited. "People who attend financial seminars tend to be the most motivated," says Lusardi. "But the results suggest that education has a positive impact on building wealth."

Jason Jacobsohn credits his retirement head start to an early dose of financial education. In a college business class, he heard an example of compounding that every retirement planner knows by heart. It goes like this: If you start saving \$2,000 a year at age 20 and keep it up for 10 years, you'll have about \$34,000 by age 30, assuming a 10% annualized return. If you never save another dime, you'll have \$677,000 at 60. However, if you wait until age 30 to begin, you'll have to put away \$3,600 a year for 30 years to end up with the same amount at age 60. In other words, you have to save almost twice as much each year for three times as long to make up for a late start.

Jacobsohn promptly stashed \$1,000 from a summer job in an IRA, and he's been a diligent saver ever since. Today the 33-year-old business adviser and his wife Hillary, 33, a recruiter, have a \$70,000 retirement portfolio. Even with money a bit tight lately--daughter Hailey was born 18 months ago--they still save enough in their 401(k)s to earn the full company match. "I want to have financial independence," he says. "I'm taking care of our future."

- What to do now: If you're simply trying to master the basics, read a beginner's personal finance book such as *The Bogleheads' Guide to Investing*. Or go to the Money 101 section of our website, CNNMoney.com. If you still feel overwhelmed, consider consulting with a financial adviser who charges by the visit (rather than by commission on the products you're sold). For help picking one, see Question of the Month on page 45.

FINDING NO. 3 Inertia Can Work for You

The question of why people don't save more money is a hot topic in academic circles. A third of eligible 401(k) participants never sign up, and those who do typically don't put away enough. "We may have every intention of saving," says Brigitte Madrian, professor of public policy at Harvard University. "But most of us can't follow through."

That follow-through is what academics have been shedding light on lately, and the solution they've found is to do, well, nothing: If you make 401(k) enrollment automatic--new hires must opt out, not in--those who do nothing still save. In a recent analysis of companies that have adopted automatic enrollment, professors at Harvard and the University of Pennsylvania found that participation levels skyrocketed to as high as 96%. "With autopilot 401(k)s, inertia works for you instead of against you," says Harvard economics professor David Laibson, who co-authored the study. "Since people aren't inclined to take action, very few of those who are signed up automatically will choose to drop out." The results have been so strong that Congress took notice: The recently enacted pension bill will make it easier for companies to enroll you in a 401(k) the day you start work.

Letting your company automatically increase how much you put in your plan can cure low savings levels too. In a landmark experiment at one midwestern company, Thaler and UCLA accounting professor Shlomo Benartzi found that automatic contribution hikes raised average savings rates from 3.5% to 11.6%.

The lesson from all these programs is that if you're forced to save, you probably will. Still, a healthy portion of families manage to save enough money on their own. How? These motivated planners develop a savings habit and, once accustomed to it, tend to keep it up. Frank Maldonado certainly has. When he was just 26, Maldonado began saving 30% of the income from his dental practice. "I grew up with four brothers in an apartment in Brooklyn, and my father was a bus driver," says Maldonado, 46. "I wanted better financial security for my family." Over the years he kept putting away that 30%. Today he and wife Gina, 40, are raising four children in Short Hills, N.J., and their portfolio is well over seven figures. Maldonado, who never converted to online banking, still writes his monthly check to his savings plan. "It just became a habit," he says. "When I haven't written the check, I start to feel bad."

- What to do now: If you have access to a 401(k), sign up immediately and save at least enough to qualify for the company match. No 401(k)? You can set up an automatic investing program at nearly any fund company or brokerage. Then sit back and let inertia do the work for you.

FINDING NO. 4 Good Advice Gets Good Results

When it comes to 401(k) plans, what doesn't work is pretty evident: Retirement investors tend to be lousy at picking the right mix of stock and bond funds. Many opt for either supersafe, low-returning choices, such as stable-value funds, or the most risky investment of all, company stock. Those findings have spurred 401(k) providers to offer workers more help with investing, in one of two ways: target funds, which give you a premixed portfolio that becomes more conservative as you near retirement, or accounts managed by professional advisers.

Early data suggest that these new options are having a powerful impact on retirement wealth. Consider the results at Financial Engines, an advisory firm founded by Nobel-prizewinning economist William Sharpe that runs managed accounts for 401(k) plans. An analysis of returns at 65 companies found that the switch to managed accounts boosted returns by as much as 3% annually after expenses. The key: more money in stock funds. "With a better asset mix, you have more potential for building wealth," says Financial Engines chief investment officer Christopher Jones.

Evidence is emerging that target funds are also delivering strong results. Analyzing returns at two 401(k)s, Hewitt Associates found that in each of the three years from 2001 through 2003, investors in funds with preset portfolio mixes, including target funds, had higher returns than those who chose their

own portfolios. Those investors also kept more of their money in stocks--65% vs. 54%--than those who invested on their own.

Does this mean you have to let someone else do the driving? No, but it does illustrate the power of picking a suitable stock and bond allocation and sticking with it. Putting together an effective mix helped Brad Hall save enough to retire early. During a 29-year career as a financial executive at Koch Industries, Hall held an aggressive 90% of his 401(k) in stocks. "When the market goes down, I don't mind. I know it will go back up," says Hall, 56, who lives with wife Cathy, 55, in Wichita. Still, he was careful to stay well-diversified, holding large- and small-cap funds as well as foreign funds.

Two years ago, tired of the frequent international travel his job required, Hall decided to quit. His retirement savings had grown to seven figures, so he was free to launch Hall Motors, which deals in high-end classic cars. "It's something I've always loved," he says. His portfolio, which he rolled over into an IRA, remains aggressive. "I'm still investing 80% in stocks," says Hall. "But I have fixed-income and alternative assets too."

- What to do now: To have an expert determine the right combo of stocks and bonds for your age and risk tolerance, the simplest solution is to switch your 401(k) holdings into the appropriate target fund. (For information on the T. Rowe Price and Vanguard target funds on our MONEY 65 list of top funds, see page 90). If such funds aren't available, use these broad guidelines: Early in your career, keep at least 75% to 80% in stocks for growth. Reduce that stake to 60% to 70% in your forties and early fifties to cut risk. To create a more detailed allocation, go to cnnmoney.com/tools.

FINDING NO.5 Your Worst Enemy: Overspending

As a senior investment analyst at Vanguard, John Ameriks has a close-up view of how well shareholders save for retirement. And he's come to a conclusion: How much money you make matters a whole lot less than how much you spend. Looking at the assets of Vanguard 401(k) plan participants, Ameriks found that those who were saving enough to retire comfortably had a median income of \$69,000 and median assets of \$200,000. The group falling behind, with assets of just \$38,000, earned more--a median of \$83,000. "Clearly this group is spending relatively more of its income," he says.

That brings us to Ameriks' second point: Everyone needs a budget. Studies by Ameriks and others suggest that those who fail to pay attention to spending tend to consume more. Using TIAA-CREF plan data, Ameriks looked at the relationship between monitoring a budget and net worth. His finding? "Budgeting, like planning, is closely linked to greater wealth," he says. "After all, it's the best way to put a rein on spending."

The right kind of budget--or spending plan, to use a friendlier term--depends on you. Some households, particularly those in debt, may need to keep a close watch on expenditures, while for others a more flexible approach is just fine.

What works for William and Michelle Hartmann, both 37, is setting a goal of living on just 70% of their \$100,000 combined salaries. So before spending any of their income, the couple make sure savings are taken care of. Michelle funnels the maximum 14% into her 401(k), and William invests another 10% or so into his IRAs. On top of that, the Hartmanns try to get the best deals possible. The \$425,000 they spent to build a three-bedroom home was far less than the \$650,000 a comparable home in their Dallas neighborhood would have cost. With that careful attitude, they have amassed more than \$400,000.

- What to do now: For an idea of your spending, add up a couple of months' worth of bills. Chances are, you'll find a lot of trivial expenditures. You can find an easy budgeting tool in the Personal Finance section of CNMONEY.com. Another tip: Use online banking, which will do much of the budgeting research for you by showing you where your money goes. At that point, though, it's up to you to create a plan and stick to it.

THE HOUSING TRAP

Why one popular financial move could actually leave you in worse shape

All that stuff you've heard is important for retirement? It works, according to the latest academic research. So two thumbs up for saving, diversifying, buying a house...wait, scratch that last one. Today economists are warning that too many investors have a dangerously large amount of their wealth in real estate. The typical older boomer household has nearly 50% of its \$110,000 net worth in home equity, according to an analysis of 2004 data by Annamaria Lusardi of Dartmouth College and Olivia Mitchell of the University of Pennsylvania. Says Lusardi: "The heavy reliance on home equity to finance retirement is risky." Why?

- No free cash

It's hard to live off your house. You can tap home equity, of course. But to do so you must take out a reverse mortgage or sell your house and downsize. Most boomers say they intend to stay in their home at retirement, surveys find; 70% believe there is less than a 10% chance they'll have to sell their home to pay living expenses.

- Price risk

In their study, Lusardi and Mitchell considered what might happen if housing prices simply returned to 2002 levels. That relatively mild drop would cause the median older boomer household to lose 13% of its net worth.

- The lessons

Don't skimp on retirement savings just because you have a lot of equity in your house. And don't overextend to buy more house than you can really afford. The traditional guidelines hold: Your mortgage debt shouldn't exceed 28% of your income. Your ratio of total debt to income should be 36% or less.

PLEASE JUST MAKE ME SAVE

In a study of four large companies that made 401(k) enrollment automatic, researchers found that few employees resisted saving for retirement.

Percentage of employees saving in 401(k) plan six months after being hired

Up to 96% After AUTOMATIC ENROLLMENT

Up to 43% Before

SOURCE: "Saving for Retirement on the Path of Least Resistance," by James Choi, David Laibson, Brigitte Madrian and Andrew Metrick.

WHY YOUR MIX MATTERS

Investors who opted for a target-date or other fund with a preset allocation in their 401(k) have done better than those who picked their own funds.

% MEDIAN ANNUAL RETURN

2002

INVESTORS IN PREMIXED FUNDS -3.8

SELF-DIRECTED INVESTORS -5.1

2003

INVESTORS IN PREMIXED FUNDS 15.7

SELF-DIRECTED INVESTORS 14.7

2004

INVESTORS IN PREMIXED FUNDS 11.6

SELF-DIRECTED INVESTORS 9.6

NOTE: Premixed funds include target-date funds and risk-based portfolios.

SOURCE: Hewitt Associates, January 2006.

47% net worth in real estate

EARLY BOOMERS (AGES 51 TO 56)

SOURCE: Lusardi and Mitchell.

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