

Four Ways to Improve the Probability of a Good Retirement

By Robert C. Merton, PhD, Nobel Laureate and Resident Scientist at Dimensional

Around the world, individuals are being asked to take on greater responsibility for their own retirement. In the US, for example, a combination of limited Social Security funding and a reduction in the number of defined benefit (DB) employer plans—historically, the primary retirement savings vehicle for many—is causing investors to make decisions they have never had to face about how to save for retirement.

Many workers are disengaged from retirement planning during the early parts of their work life. They know they should be saving for retirement, but they have less clarity on what that really means. Often, they don't know how to set a realistic goal or how to get there.

Over the past two decades, the shift toward defined contribution (DC) plans as the primary vehicle for retirement savings has compounded this challenge. While DB plans and Social Security benefits are typically communicated in terms of expected income during retirement—language participants can easily comprehend—DC plans often look at

account accumulation, an overall number that means little to the average person trying to understand how much he or she needs to save for retirement.

So, what represents a good retirement income? No matter who is asking, I always give the same response: “An inflation-protected income that allows you to sustain the standard of living you enjoyed in the latter part of your working life throughout the rest of your life.” That is what you should be striving for with a retirement plan.

Of course, every plan needs a reality check; a good design also must be feasible. If your goal seems out of reach, keep in mind these four ways to truly improve the probability of a good retirement:

1. Save more

Ultimately, this means lowering your lifetime spending level, and likely, your standard of living. While it's relatively simple in theory, it may be more complicated in practice.

Four Ways to Improve the Probability of a Good Retirement

2. Work longer

Opting to work longer can help in two ways. First, you may have the opportunity to save more. Second, you will have a shorter retirement period to support.

3. Take more risks

With less infringement on your current lifestyle, taking on more investment risk may seem like the way to go. But it's important to have a backup plan. Don't count on higher returns being a sure thing. Risk is real, and if taking risks is part of a solution, then one must be prepared for what to do if the risk is realized by, say, a big decline in stocks during retirement.

4. Make the most out of assets available at retirement

While the above strategies are driven by creating more assets, this fourth is about getting the most benefit from the assets you have at retirement time. By making an investment in an annuity instead of a bond, for example, you can "purchase" a larger set income for the rest of your life in return for giving up that income when you no longer need it.

Despite the fundamental shift over the past two decades in how people save for retirement, research shows that one of the best ways you can support an expected standard of living in retirement remains the same: Save early in your career, save more as your annual income increases, and build a framework to monitor your progress.

Robert C. Merton is Distinguished Professor of Finance at MIT's Sloan School of Management and University Professor Emeritus at Harvard University. He received the Nobel Prize in Economic Sciences in 1997 for developing a new method to determine the value of derivatives. He is Resident Scientist at Dimensional Holdings Inc.