Increased savings can help decrease concern about retirement

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Maria Bruno

In a 2011 survey conducted for the American Institute of Certified Public Accountants (AICPA), almost 40% of working Americans said they will never afford retirement. Not only was it the second consecutive year that retirement affordability ranked as the nation's most important financial concern, but the AICPA survey also revealed that more than half of working Americans (55%) had no idea how much to save for retirement. In fact, those who thought they knew how much to save were way below the actual amount needed.

Survey results such as these are why Vanguard emphasizes making retirement savings a priority earlier in one's career. But this naturally leads to the question, "How much is enough?" While Vanguard has long recommended a savings rate of 9% to 12% of pay per year (which, in a retirement plan, could be a combination of employer and employee contributions), we recognize that the savings goal should be set higher to 12% to 15% as a best practice in meeting retirement goals.

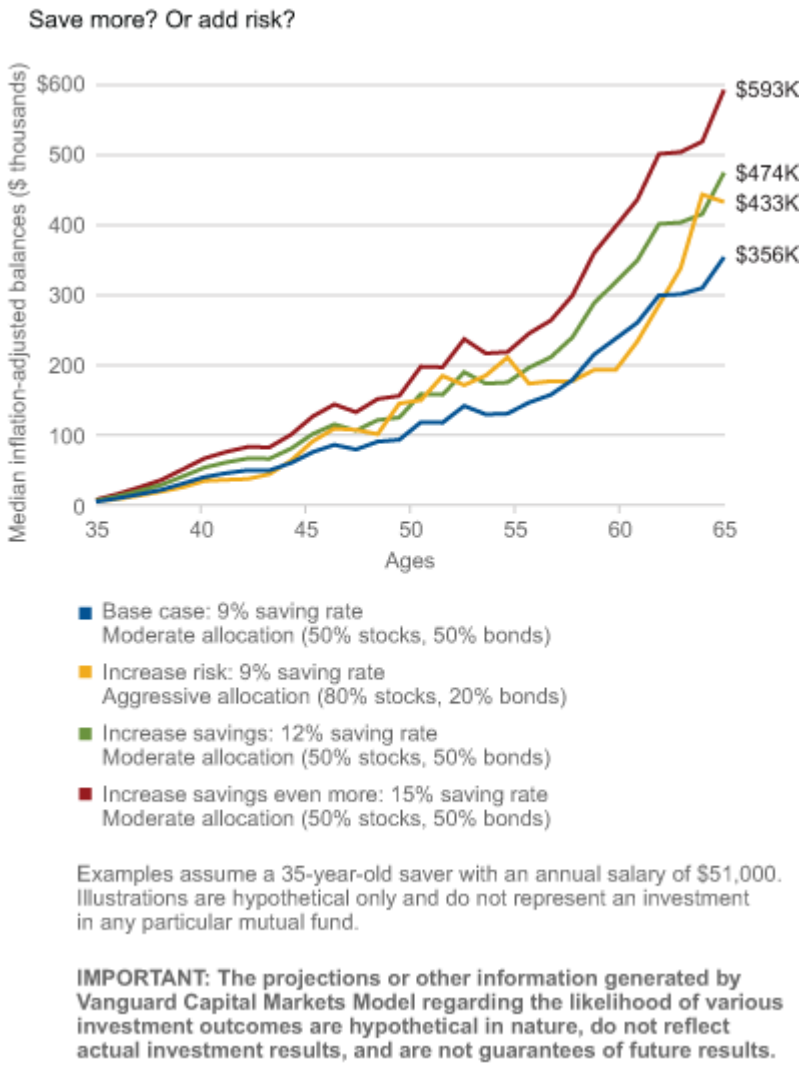
Several long-term trends show the need for higher individual savings, including the financial shortfalls facing public benefit programs such as Social Security and Medicare, low returns in equities over the past decade, increase in lump-sum retirement benefits, and overall longer life expectancies.

How sponsors can help

Maria Bruno, a senior analyst with Vanguard Investment Counseling & Research (IC&R), noted that several factors can be very important to participants in their retirement investing—such as keeping costs low, maintaining a long-term perspective, and being balanced and diversified. But the fundamental aspects of disciplined saving and starting early are critical, she said.

In a forthcoming research note, Ms. Bruno and her colleague, Yan Zilbering, examined the trade-offs of

saving more versus investing more aggressively, through simulations that included different levers of start ages, savings rates, and asset allocations. The chart below shows that increasing the savings rate to 15%—even with a moderate asset allocation—resulted in the highest amount being accumulated.



Examples assume a 35-year-old saver with an annual salary of $51,000. Illustrations are hypothetical only and do not represent an investment in any particular mutual fund.

IMPORTANT: The projections or other information generated by Vanguard Capital Markets Model regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results.

For plan sponsors, the key is to get their participants to save more—and to start now, Ms. Bruno said.

"The sooner you start investing, the less likely you'll have to play catch-up later," Ms. Bruno said. "We're encouraging participants to boost their contribution rate to 12% to 15%. With the median contribution rate in Vanguard-administered retirement plans currently about 9%, this could be a stretch. But plan sponsors can play a role when it comes to plan design—including automatic enrollment plans with higher initial contribution rates and autoincreases as a default option—that can help their participants reach that 12% to 15% level. And educating your employees on the importance of saving for retirement is vital to their

success in your plan."

Establishing a savings goal that's too high can lead to discouraged participants who feel unable to meet the target, which in turn could cause inertia. But if sponsors use plan-design tools that encourage an early start to saving and prudent asset allocation, participants may benefit down the road.

"As an investor, the earlier you start and the more you save, the more control you'll have in shaping your retirement decisions and the less you'll have to rely on factors outside of your control, like the markets," she said.

The outlook for investors

Because the global financial crisis has raised concerns about investors' willingness to enter—or stay in—the stock market, the impact on younger investors is also worrisome.

"There's a lot of hype right now that many younger investors seem scared off by the stock market," Ms. Bruno said, "and that's certainly a concern. If you invest too conservatively, especially early on, there's going to be a risk of not adequately growing your portfolio on a real-return basis. But through the use of target-date fund QDIAs, many younger investors have a sufficiently high equity allocation."

According to Vanguard data, automatic enrollment and qualified default investment alternatives (QDIAs)—such as target-date funds and balanced funds—have put younger investors in a much better position than their predecessors from an asset allocation standpoint. And while younger investors may be doing well from an asset allocation standpoint, that's only part of the picture. Combining that with a healthy savings rate of 12% to 15%, Ms. Bruno said, could give them a very good start on the road to retirement.

Indeed, plan sponsors and participants should take advantage of a defined contribution (DC) plan—especially since 2011 Employee Benefit Research Institute research showed that being in a DC plan at work is a key factor to affording basic expenses and uninsured medical care in retirement. That's good news in light of the AICPA survey results that represent the views of all Americans (not just plan participants).

"It's pretty dire that so many people believe they'll never afford retirement," Ms. Bruno said. "But there are things that plan sponsors and participants themselves can do to turn this around. For younger investors, autoenrollment with higher contribution rates, autoescalation to increase savings, and the diversification of being in a target-date fund can put them on a good track. For longer-tenured participants, reenrollment into a QDIA—as well as proactive education and communication—can help

reinforce the benefits of savings and asset allocation."

Both younger and longer-tenured participants could benefit from ratcheting up their savings rate, Ms. Bruno said, adding that they should make sure they're properly diversified and maintaining an appropriate asset allocation.

Notes:

Investments in target-date funds are subject to the risks of their underlying funds. The year in the fund name refers to the approximate year (the target date) when an investor in the fund would retire and leave the workforce. The fund will gradually shift its emphasis from more aggressive investments to more conservative ones based on its target date. An investment in a target-date fund is not guaranteed at any time, including on or after the target date.

All investing is subject to risk. Diversification does not ensure a profit or protect against a loss in a declining market.

The simulation results in the analysis are based on the Vanguard Capital Markets Model® (VCMM). We use various standard assumptions about asset allocations, inflation, and contributions. All results are in today's dollars. Starting salary for 25-year old is $30,000. Investor salary growth is modeled after the Social Security Administration's wage index. In our simulations, we also allow for 1.1% annual salary growth, on a real basis, in addition to the cross-sectional increase in the wage scale, which reflects the historical average productivity growth of the U.S. economy. Results may vary with each use and over time.

U.S. stocks are represented by the Wilshire 5000 Composite Index; U.S. bonds are represented by the Barclays Capital U.S. Aggregate Bond Index (a former Lehman Brothers index); international stocks are represented by the Morgan Stanley Capital International Europe, Australasia & Far East (MSCI EAFE) plus Emerging Markets Index. Inflation is calculated from the Consumer Price Index.

Moderate asset allocation is 50% stocks and 50% bonds, and aggressive asset allocation is 80% stocks and 20% bonds. For stock allocations, we assume a 70% allocation to U.S. stocks and 30% allocation to international stocks.