



# Why Target Practice Equals Financial Malpractice

by

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Whether we want to admit it or not, most of us are financially sick. We overspend, underinsure, invest on hot tips, gamble, max out our credit cards, get hooked on Starbucks and spend as little time as possible thinking about the future. Most of us end up in old age living off Social Security.

Or we do the opposite. We pinch every penny, oversave, overinsure, take no risks and avoid debt like the plague — only to wind up in a retirement home with far more money than we can spend. We squander our youth instead of our money.

As pathological as our financial behavior may be, it makes sense.

Figuring out how to manage our finances is incredibly complex and scary. There is a plethora of interconnected factors to consider, including household demographics, earnings, federal and state taxes, housing plans, economies of shared living, the relative costs of children, medical expenses, retirement accounts, mortgages, special expenditures, pensions, Social Security benefits and estate plans.

Listing these factors is one thing. Knowing how to integrate them to achieve financial health is another. Among economists, the prescription for sound financial health involves a concept called consumption smoothing, which means achieving and maintaining a stable living standard per household member through both work and retirement years.

Consumption smoothing underlies everything economists have to say about the appropriate level of saving, insuring and investing. But determining precisely how much households need to spend, save, insure and diversify in order to smooth their living standards over time is incredibly complicated. It requires highly sophisticated mathematics and computer programming.

Contrast this economics approach to financial planning, which calculates targets, with the approach common in the financial services industry, which asks households or their advisers to target on their own.

Specifically, conventional planning programs ask households and advisers to set their own retirement income targets. If not, software establishes targets based on an industry standard 75% to 85% replacement rate.

Unfortunately, this target practice rarely hits the bull's-eye of consumption smoothing.

Even very small targeting mistakes, on the order of 15%, can lead to huge disruptions in pre- and post-retirement living standards and financial health upon the death of a spouse or partner — largely because targeting mistakes are being made for each and every year of retirement as well as survivorship. And all these mistakes add up.

The replacement rate method of retirement income calculation is a horrible offender in this regard. It generates overtargeting mistakes on the order of 50%.

As a result, it leads to saving and insurance recommendations that easily can be five times too high.

Why is the replacement rate method so far off the mark? Take the calculation made by researchers at Georgia State University in Atlanta that was financed by AON Corp. of Chicago.

It assumes that a household's spending after retirement will be precisely the same as its spending before retirement, aside from work-related expenses.

This assumption is mind boggling, considering that pre-retirement spending typically includes mortgage payments, tuition payments and special vacations, none of which continue forever.

You might think that "responsible" companies such as TIAA-CREF of New York and Fidelity Investments of Boston would adjust for the brain-dead nature of the replacement rate formula by taking these limited-time expenditures into account. Not the case.

Fidelity's My Plan asks just five questions before using an 80% replacement rate; TIAA-CREF's Retirement Goal Evaluator asks just six. No one asks when you will pay off your mortgage, the ages of your kids, the age of your spouse or a number of other critically important questions.

The second problem with the replacement rate is that it presumes that the household's demographic composition will remain constant throughout retirement. That is not necessarily so.

I'm close to retirement age, my wife is nine years younger and we have young children. My household's retirement spending needs will be high at first and then decline dramatically over time as the kids move through college and then out on their own.

The third problem is the ridiculous contention that not one single penny of the principal of retirees' assets will be used to finance their retirement spending. Instead, retirees are assumed to be able to spend only the income earned on the assets.

The fourth and the most damning problem is the replacement rate's implicit assumption that a household's current saving behavior is consistent with

consumption smoothing — that is, the savings rate somehow will produce enough income to maintain the household's underlying living standard per person through time.

There is no reason to believe this is the case.

Ironically, if households already are saving the appropriate consumption smoothing amounts, they have no need for replacement rate targeting. But if they are not, the replacement rate methodology will produce the wrong replacement rate, because it will use actual saving (which is "incorrect") in calculating the rate.

The impossibly high saving targets emanating from the replacement rate methodology lead to "advice" whose provision can be characterized only as financial malpractice.

First, calculations for the probability of a household meeting its spending targets assume, incredibly, that the spending target is fixed and will never change, regardless of how poorly or well assets perform.

Based on targets that are far too high and assuming no adjustment in spending over time invariably results in a very low probability of a household meeting its target. (The target, of course, is more the software's goal than the household's.)

Then, in response to what I call replacement baiting, households are urged to hold riskier assets with higher average returns to raise the probability of meeting "their" targets.

This focus on the probability of meeting an artificial target is completely inappropriate. Advisers need to show households the average level and variability of their living standard, not the probability of meeting an inappropriate and inflexible target.

In particular, advisers need to show households the potential major reduction in their living standards associated with their investing in riskier securities.

In brazenly accusing the financial industry of systematic malpractice, I don't mean to indict all financial planners. I know that most understand the limitations of conventional methodology and attempt to correct for them. Most, of course, use software that provides better targets than web-based calculators.

But the industry's ubiquitous practice of engaging in target practice, which promotes consumption disruption and risk taking, appears to be doing as much harm as good when it comes to providing financial advice and is, quite frankly, light years behind the current state of economic science.

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