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The New Retirement Strategy

By Reshma Kapadia Jan. 5, 2019 8:00 a.m. ET

Illustration by Robert A. Di Ieso, Jr.

The tripling of the S&P 500 index over the past decade has helped retirement assets balloon, but saving for the golden years could get harder, requiring a shift in strategy.

Interest rates are beginning to rise, but still sit near historic lows. And Morningstar warns that, over the next 10 years, a balanced U.S. stock and bond portfolio could generate, after inflation, roughly a half-percentage point before fees and taxes.

A paper co-authored by Olivia Mitchell, a professor at the Wharton School of the University of Pennsylvania, examines the effects of persistently low returns on retirement. "Retirement advisors generally use historical returns when helping clients design retirement planning forecasts," says Mitchell, who is also executive director of the Pension Research Council. "But they should be taking a closer look at the assumed expected returns they're building into their retirement planning models going forward, ratcheting up simulated saving needs. Additionally, people will not be able to spend as much throughout their lifetimes if real returns remain low."

Low returns also would change the way people invest and save. For example, Mitchell says, tax-qualified accounts like 401(k)s might not be the preferred way to save for retirement because the advantage of having pre-tax investment earnings isn't as appealing when the portfolio isn't returning all that much. Roth accounts, as well as other accounts funded with after-tax money, could be more appealing, she maintains.

If stocks are more volatile than in the past, Mitchell says, payout or income annuities could play a greater role in retirement by helping to stabilize income. The wisdom of delaying Social Security benefits also will ring truer, since it will be even harder to find investments that can match the 8% annual increase a retiree gets by deferring payments each year beyond full retirement eligibility until age 70.

Low returns will make it tougher to earn more than the rate of increases expected for medical care. Though few people buy long-term care insurance, Mitchell argues that it remains a good, albeit expensive, option for middle-income households. Another option, not widely used: a reverse mortgage.

Alternative investments, such as private equity or real estate, are often offered as a possible antidote for low returns. While they are well- represented in defined-benefit pension funds, they have yet to crack the $8 trillion in assets in defined-contribution plans.

But illiquidity doesn't work so well in a defined-contribution plan that must provide daily liquidity, says David Blanchett, Morningstar's head of retirement research. After adjusting these investments to work within a 401(k) plan and factoring in costs, Blanchett figures, an investor may be just as well served by investing in liquid options, such as micro-cap funds.

But, he adds, alternatives such as private equity could work within a target-date fund or separately managed account in retirement plans incorporating illiquid options. Indeed, target-date funds—a default option in many 401(k) plans—are overly exposed to equity risk, according to a recent paper by Angela Antonelli, executive director of the Georgetown University Center for Retirement Initiatives. Including private equity could boost median retirement income by 6% or more for someone retiring with $100,000 in pre-retirement annual wages, while offering a cushion in downturns, she contends.

Bill Muysken, global chief investment officer of alternatives at Mercer, notes that Australia has been using alternative investments in retirement plans for years, with 10% to 30% typically held in illiquid assets, including private equity, hedge funds, and infrastructure. Their often high costs can be blunted through co-investing or investing directly, rather than using a middleman.

However, Blanchett cautions, instead of trying to squeeze more out of investments, it might be better to simply work longer—feasible with the unemployment rate now below 3% for people over 55. Another option: Save more now and plan to spend less when you do retire.

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