PLANNING FOR RETIREMENT:
PROTECTING RETIREMENT INCOME AGAINST KEY RISKS

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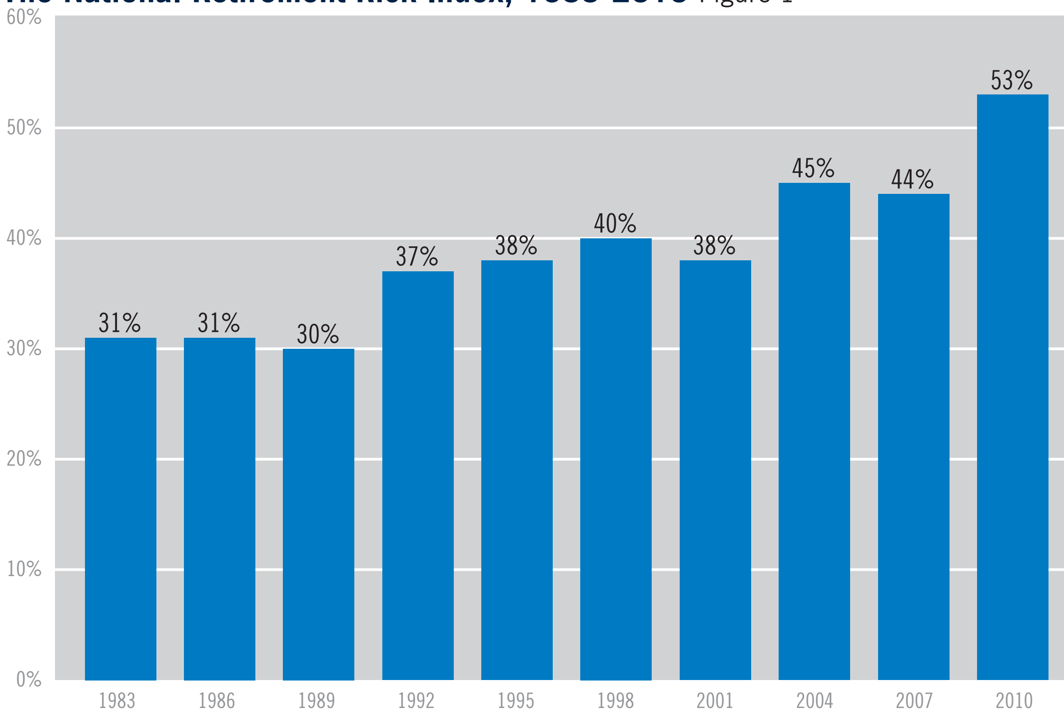
Every three years, the Center for Retirement Research (CRR) conducts an official update of its National Retirement Risk Index (NRRI), which measures Americans' retirement preparedness. The NRRI is constructed using data from the Federal Reserve's Survey of Consumer Finances. The Index results from comparing households' projected replacement rates—retirement income as a percentage of pre-retirement income—with target rates that would allow them to maintain their living standard.

Findings

The latest update indicates that the percentage of households at risk of being unable to maintain their pre-retirement standard of living in retirement has soared by 9 percentage points, from 44 percent to 53 percent. (See Figure 1.) The new results are based on the Federal Reserve's 2010 *Survey of Consumer Finances* and reflect changes from the 2007 survey.

The National Retirement Risk Index, 1983-2010 Figure 1



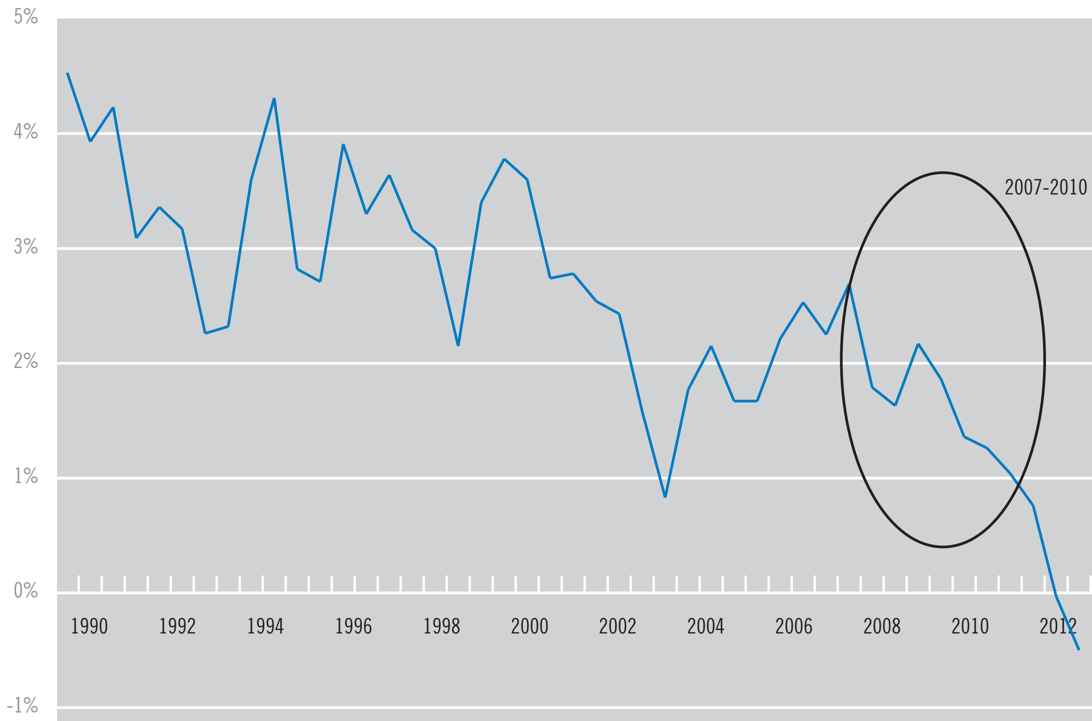
The CRR attributes the dramatic increase in the percentage of those at risk to four key factors:

- A sharp decline in equity values
- A decrease in housing wealth
- A sharp decline in interest rates
- The scheduled increase in Social Security's Full Retirement Age from 65 to 67

Further, over the full 1983-2010 period, increased longevity has been a significant contributor to the increasing percentage of households at risk.

Obviously, the financial crisis had a significant impact on some of these factors. In addition, American economic policy in recent years has focused on keeping interest rates very low in an attempt to spur economic growth. (See Figure 2.)

Real Ten-Year Interest Rate, 1990-2010* Figure 2



*CRR Note: Real interest rates equal the ten-year Treasury bond interest rate minus anticipated ten-year inflation for 1990-2004 and, thereafter, the ten-year rate for Treasury Inflation Protected Securities (TIPS). Sources: CRR's calculations based on U.S. Board of Governors of the Federal Reserve System (2012); and Federal Reserve Bank of Philadelphia (2012).

The impact of the financial crisis on retirement preparedness was felt far more acutely by older households. Figure 3, which identifies the change in percentage of households at risk for different age groups, indicates those age 50-59 saw the percentage at risk rise from 32% to 44%.

Percentage of Households 'At Risk' at Age 65 by Age Group, 2007 and 2010 Figure 3

Age Group	2007	2010
All	44%	53%
30-39	53%	62%
40-49	47%	55%
50-59	32%	44%

Source: Center for Retirement Research calculations.

More information regarding the latest NRRI results can be found in the Issue Brief "The National Retirement Risk Index: An Update" by Alicia H. Munnell, Anthony Webb, and Francesca Golub-Sass.

Prudential's Perspective

The NRRI is based on data that projects households' ability to maintain their living standard in retirement. The dramatic rise in households at risk in just three years, especially for households in their 50s, points to an increased need to protect retirement income from market downturns, low interest rates, and increased longevity. With fewer workers in the private sector retiring with traditional defined benefit pension plan income, individuals are increasingly vulnerable to these risks.

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Although the possibility of stock market losses has traditionally garnered greater attention, low interest rates over an extended period of time can also be very damaging to the retirement security prospects of those saving for retirement, as well as those drawing income in retirement. For savers, low interest rates result in lower investment returns in deposit account products such as bank certificates of deposit (CDs) and money market funds, and therefore lower amounts of retirement savings. Less retirement savings translates into lower income from those savings in retirement.

An upcoming paper developed by Prudential, using research provided by Ernst & Young Insurance and Actuarial Advisory Services practice, found that a 65-year-old female retiring with a $300,000 portfolio and planning to withdraw a flat amount of $15,000 per year faced tremendous risk when market volatility, an extended period of low interest rates, and the risk of outliving her savings (longevity risk) were modeled in a simulation environment. In fact, when all three risks were considered via 2,000 Monte Carlo simulations, the failure rate—defined as the retiree running out of assets—was 54%.[1]

As savers and retirees increasingly shoulder greater investment risk, interest rate risk, and longevity risk, they should look for ways to protect their retirement income against these risks. Guaranteed lifetime income products may help protect retirement income from market downturns, as well as an extended period of low interest rates, while guaranteeing that income can be generated for life.

Importantly, the latest NRRI results also reinforce the value of Social Security income. Social Security represents a stable source of retirement income that is not impacted by investment and longevity risks. A forthcoming Prudential white paper, "Innovative Strategies to Help Maximize Social Security Benefits," offers strategies to help individuals optimize Social Security-claiming decisions to help attain greater retirement security.

While the key measurement in the NRRI formula is retirement income, the NRRI brief finds that the median retirement savings in 401(k)s/IRAs for households approaching retirement is $120,000. The income that can be generated from this savings will not be sufficient for the vast majority of retirees, even with Social Security income. Therefore, it is imperative that individuals save more in their workplace retirement plans and personal investment accounts, while measuring their progress in terms of an income goal, not a savings goal.

Prudential is the exclusive sponsor of the National Retirement Risk Index.

[1] The research, provided by Ernst & Young Insurance and Actuarial Advisory Services practice, utilized a Monte Carlo analysis to solve for the probability of success given a defined amount of starting assets and a specified income amount for the life of a hypothetical retiree. The portfolio was assumed to be invested 60% in equities and 40% in bonds. The equity class was modeled as a large-cap U.S. equity fund and calibrated using historical S&P 500 total returns. The assumed risk premium was 5% with a standard deviation of returns of 15.91%. The bond returns assumed that interest rates remain at their December 31, 2011 levels for the life of the retiree. The mortality table utilized in the analysis was the Annuity 2000 mortality table with Scale G2 mortality improvements.

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