# Nobel prize winner to pension funds: Simplify!

Prof Robert Merton calls for reforms to support fund members.

*Patrick Cairns | 24 July 2015 00:41*

CAPE TOWN – There is a huge challenge in the retirement funding industry. The change to models in which members are responsible for their own pension savings has created a gap between expectations and reality.

The majority of pension fund members are retiring with incomes far below those that they enjoyed while they were working. And funds are under pressure to find ways to address this.

Speaking at the launch of the Alexander Forbes Benefits Barometer 2015, Nobel laureate and distinguished professor at the MIT Sloan School of Management Prof Robert Merton said that this is a global concern, but it isn’t one without solutions. He sketched a clear picture of how he believes retirement funds can tackle the problem, essentially by simplifying what members are presented with.

“The objective is that we want to create a good retirement for people,” Prof Merton said.”What is a good retirement? My definition is that it’s when you can sustain the standard of living you enjoyed in the latter part of your work life. But we all know that you don’t necessarily get there, and you certainly don’t get there by magic.”

**Show members the right measure**

His first concern is that, universally, pension funds provide statements that show how much capital members have accumulated. However people aren’t concerned primarily with how big their pot of money is. They want to know what income they will be able to get from it.

“It’s pretty serious if you are trying to manage people to get to an objective, but you are using the wrong measure,” he said. “We have to start measuring risk, measuring objectives, measuring goals, determining how we invest and regulating what we can and can’t do based on a measure that matters, and that is income in retirement.”

This is critical, because a certain amount of money does not guarantee a certain level of income. Changes in interest rates can have significant impacts on the size of a guaranteed pension that can be bought even between one year and the next.

“We have to get to the idea that we measure risk not in terms of how the pot has changed, but in terms of how much the income we can buy at a future date has changed,” he argued. “If funds show members a statement that says this is your pot and this is what has happened to it over time, they are teaching them that what is important is the value of the pot and that what is risky is how much the pot fluctuates in value. If we show them the value of future income instead, we would be training them to look at the right thing and they would be getting the right measure of what’s risky and what’s not.”

Prof Merton added that showing retirement savings in terms of future income may have the added benefit of reducing the number of people who cash out when they resign or change jobs.

“If we show people future income, it reminds them that this is not a savings account, it’s a retirement plan,” he said. “If you show them future income, you bring home to them how much they are going to need, and what happens if they cash it out. Then I think they will be less likely to withdraw.”

**Have a clear goal**

The second critical change that Prof Merton argued for was that retirement savings plans needed to show a goal. Members have to be aware of the level of income they are trying to achieve.

“Having a goal also gives members a sense of control,” he said. “They know where they are going and how close they are to getting there. They may be behind, but if there is a feasible path to improving that situation, then they understand it.”

Critically, this information has to be provided on an individualised basis. It is not good enough to consider an average.

“Any system that treats people the same is not sufficient,” Prof Merton said. “We need individualisation. It can be done. And it can be done at low cost on a reliable basis.”

**Whatever members are told must be meaningful**

Pension funds should also only present members with what is really relevant to them.

“Don’t give them any information other than meaningful information and give them no choices except meaningful choices,” Prof Merton said. “And important is not the same as meaningful. Some important information is meaningless to the consumer.”

He used the example of the technical specifications of motor vehicles. Some may be extremely important to how the car performs, but something like the engine’s compression ratio is meaningless to most people.

The same principle applies to retirement funding.

“Questions like asset allocation are very important to the process, but are totally meaningless to the member,” Prof Merton said. “The reality is that they shouldn’t be looking at it at all, not because it’s not important, but because they are not in a position to use that information for anything good. The thing is to cut out the clutter, not because they are not smart and well educated, but because they are not experts in the area.”

Funds should think along the same lines when it comes to the choices members are given for improving their positions.

“There are only three choices,” Prof Merton said. “You can save more, work longer, or you can take more risk. Those are the only meaningful choices they need to think about. And if they are doing the most they can, or are unwilling to make any of those choices, then maybe it’s time for a touch of realism and they need to lower their goal.”

Prof Merton argued that, overall, these steps may not address all the issues with retirement funding, but they would be a move towards creating something far more effective and efficient than the current system.

“When there is a need, you can get things done,” he said. “We certainly have a need, and this is the time to step back and revisit the issue of how we design and provide these benefits.

“And I believe this is not a science problem, it’s an engineering problem. We do know how to address these things. Everything can be framed as common sense. Simplify the member’s life.”