Americans Aren't Saving Enough for Retirement, but One Change Could Help

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Wall Street resistance thwarted one attempt by the Obama administration to impose fiduciary responsibility on I.R.A. advisers. CreditSam Hodgson for The New York Times


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Here is something every non-rich American family should know: The odds are that you will run out of money in retirement.

On average, a typical working family in the anteroom of retirement — headed by somebody 55 to 64 years old — has only about $104,000 in retirement savings, according to the Federal Reserve's Survey of Consumer Finances.

That's not nearly enough. And the situation will only grow worse.

The Center for Retirement Research at Boston College estimates that more than half of all American households will not have enough retirement income to maintain the living standards they were accustomed to before retirement, even if the members of the household work until 65, two years longer than the average retirement age today.

Using a different, more complex model, the Employment Benefit Research Institute calculates that 83 percent of baby boomers and Generation Xers in the bottom fourth of the income distribution will eventually run short of money. Higher up on the income scale, people also face challenges: More than a quarter of those with incomes between the middle of the income distribution and the 75th percentile will probably run short.

The standard prescription is that Americans should put more money aside in investments. The recommendation, however, glosses over a critical driver of unpreparedness: Wall Street is bleeding savers dry.

“Everybody’s big focus is that we have to save more,” said John C. Bogle, founder and former chief executive of Vanguard, the investment management colossus. “A greater part of the problem is the failure of investors to earn their fair share of market returns.”

His observation suggests a different policy prescription: shoring up Americans’ retirement requires, first of all, aligning the interests of investment advisers and their clients.

A research paper by Mr. Bogle published in Financial Analysts Journal makes the case. Actively managed mutual funds, in which many workers invest their retirement savings, are enormously costly.

First, there is the expense ratio — about 1.12 percent of assets for the average large capitalization blend fund. Then there are transaction costs and distribution costs. Active funds also pay a penalty for keeping a share of their assets in low-yielding cash. Altogether, costs add up to 2.27 percent per year, Mr. Bogle estimates.

By contrast, a passive index fund, like Vanguard’s Total Stock Market Index Fund, costs merely 0.06 percent a year in all.

Of course, Mr. Bogle has a horse in the race. He founded the Vanguard Group. He invented the first index fund for the public. His case is powerful, nonetheless.

Assuming an annual market return of 7 percent, he says, a 30-year-old worker who made $30,000 a year and received a 3 percent annual raise could retire at age 70 with $927,000 in the pot by saving 10 percent of her wages every year in a passive index fund. (Such a nest egg, at the standard withdrawal rate of 4 percent, would generate an inflation-adjusted $37,000 a year more or less indefinitely.) If she put it in a typical actively managed fund, she would end up with only $561,000.

We might have seen this building decades ago. As companies gradually did away with the defined-benefit pensions that once provided working families with their main supplement to Social Security, workers found they had to shoulder the responsibility and risk of saving and investing for retirement largely on their own.

In 1979, almost two in five private sector workers had a defined-benefit pension that would pay out a check until they died. Today only 14 percent do. Almost one in three, by contrast, must make do with a retirement savings account alone to supplement their Social Security check.

If there is an industry rived with conflicts of interest, it is the financial conglomerates that advise Americans on investing these savings. Yet nobody was paying attention to the safeguards that might be needed when corporate retirement funds managed by sophisticated professionals were replaced by individual 401(k)s and Individual Retirement Accounts.

“Wall Street makes no money on low-cost index funds,” said David F. Swensen, who runs the investment portfolio for Yale. “That is the problem.”

It’s not hard to find evidence of Wall Street’s rapaciousness.

Sendhil Mullainathan of Harvard and colleagues from M.I.T. and the University of Hamburg sent “mystery shoppers” to visit financial advisers. They found that advisers mostly recommended investment strategies that fit their own financial interests. They reinforced their clients’ misguided biases, encouraging them to chase returns and advising against low-cost options like low-fee index funds.

Another study, by Susan Christoffersen of the University of Toronto and colleagues from the University of Virginia and the University of Pennsylvania, found that investment advisers directed more of their clients' money to funds that shared the upfront fees with them. Returns of these funds were poor, compared with alternatives.

"It is superslimy," noted Kent Smetters, an expert on finance at the University of Pennsylvania's Wharton School.

President Obama has tried to take a crack at one corner of the problem: questionable advice provided by managers of I.R.A.s.

For all their flaws, 401(k) plans have a fiduciary responsibility to act in participants' best interest. Managers of I.R.A.s, by contrast, are not legally bound to put their clients' interests first. They must offer "suitable" products — a much squishier standard.

"They can't put your grandma in a heavy tech fund," Mr. Smetters said. "But they could put her in a more expensive bond fund that pays them a huge commission."

It should be no surprise which of these Wall Street prefers. In a 2011 report, the Government Accountability Office of Congress said it found advisers who were paid $6,000 to $9,000 if clients rolled over savings from 401(k) plans to I.R.A.s.

I.R.A.s are a huge source of profit for Wall Street. Workers roll some $300 billion worth of 401(k) balances into I.R.A.s when they leave their jobs every year.

The White House's Council of Economic Advisers argues that "conflicted advice" by advisers who get payments from the funds they recommendreduces the annual returns to investment by 1 percentage point, a more modest penalty than Mr. Bogle's analysis might suggest. Still, this could cost savers up to $33 billion a year out of $3.3 trillion invested by I.R.A.s subject to potentially conflicted advice.

In 2010, the Labor Department proposed imposing fiduciary responsibility on I.R.A. advisers. The resistance from Wall Street was so fierce that the Obama administration was forced to back down. Last month, the administration tried again. Perhaps it will have better luck this time.

Mr. Swensen, Mr. Bogle and Mr. Smetters applaud the Obama administration's shot at changing the rules. But they acknowledge that imposing tighter standards on I.R.A.s will not end suspect advice. And most investment assets are held outside tax-preferred retirement accounts and would not be subject to the rule change.

Unlike regulations in Canada and some Western European countries, which have essentially banned kickbacks from funds to investment advisers, the Obama administration's proposed rule does not directly attack conflicts of interest.

But the new rule could move American retirement saving one step closer to the goal: getting almost everybody to stop trying to beat the market, put their money in low-cost index funds and leave it there. Then Americans might reach retirement better prepared.

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