The Secret to a Plan’s Success

Earle Allen, CEBS
Partner, Cammack Retirement Group

Every new day brings publications with articles that describe how people are not saving enough for retirement, and how many will outlive their savings. Meanwhile, plan sponsors, who have worked hard trying to foster a culture of employee saving, inevitably begin to wonder if their plan is providing adequate retirement benefits.

Plan sponsors often encounter the problem of how to measure the success of their plan in meeting the future needs of their employees. As part of offering a retirement plan, they also need a gauge of results.

PLAN STATISTICS

Many different statistics can be used to give a plan sponsor some guidance. The most popular of these is probably participation rate. That statistic is calculated by dividing the number of employees making payroll deduction contributions to the plan by the number of employees eligible to contribute. If, for example, an employer has 100 eligible employees, and 70 of them are making contributions to the plan from their paychecks, the plan’s participation rate is 70%.

Another popular statistic is average deferral rate. From among the participants who are making deferrals to the plan from their paychecks, this statistic quantifies the average percentage of compensation that each person contributes. Yet another measure tries to gauge how well plan participants diversify their investment allocation. By tracking the percentage of participants that are using more than three funds, or a balanced allocation fund (such as a lifestyle or target date fund), the statistic measures how well-diversified the plan participants are as a group.

All these measurements provide some indication of how the plan is performing. In each case, the higher the percentage, the more advantageous it is for the plan and the underlying participants. A greater percentage of employees contributing at higher deferral rates, and being well-diversified among the investment offerings over the long term, should yield higher account balances at lower risk levels. In general, this should lead to better retirement outcomes.

However, none of these statistics capture what most plan sponsors are ultimately trying to determine – what percentage of the employee population is on target to meet their retirement needs. This is a much more difficult number to assess, which is probably why more plans focus on the other statistics, which are more easily attained.

REPLACEMENT RATIO

There are a number of challenges in determining the percentage of participants who are on track for meeting their retirement savings goals. For instance, the savings goal for one person can be very different from the goal of another. Clearly, the savings needed for a person who intends to retire early and travel the world, are very different from those of the person who does not intend to ever fully retire.

Nevertheless, the statistic used to help determine if a person is on track for adequate retirement savings is the replacement ratio. Most retirement experts counsel their clients that a person needs to have income in retirement that replaces between 70% and 80% of their final year’s salary. This amount represents the necessary income to maintain the same standard of living in retirement that they enjoyed while they were working. While it may not be true for all employees, it is assumed that a person will require less income in retirement than during employment. Daily commuting costs and other work-related expenses may be reduced, along with reduced taxes and housing expenses.
Replacement income comes from all sources, including Social Security, the current retirement plan, retirement plans from previous employers, other savings, etc. For the purpose of determining the percentage of employees who are on track with their retirement savings, targeting 75% of the person’s projected final year’s compensation as the replacement ratio is reasonable.

No plan sponsor, however, is able to capture all of the potential replacement income sources for all of its employee participants in the plan. For the purpose of measuring plan success in meeting participants’ targeted replacement ratio, the calculations focus on the accumulations from both employer and employee contributions to the retirement plans offered by the plan sponsor, as well as assumed Social Security amounts to be received.

**HOW ARE THE CALCULATIONS PERFORMED?**

The calculation of a participant’s replacement ratio requires some indicative census data (date of birth, annual compensation), some current plan data (account balance, deferral percentage, asset allocation) and some assumptions for the future (age at retirement, future increases to compensation, inflation rates, future returns on investments). In most cases, these calculations can be provided by the plan recordkeeper. Many recordkeepers have systems in place to perform this computation and already hold the current plan data. In addition, depending on the agreement with the plan sponsor, the recordkeeper may also be receiving the necessary census information with each plan remittance. If not, the plan sponsor must produce a file with the census information, in order for the recordkeeper to provide the projections.

Using this data, along with an agreement on the assumptions to be used, the recordkeeper should be able to project a future account balance based on historic rates of return for the investments being used by each participant. Because of the unpredictability of financial markets, a recordkeeper with a more robust system will run multiple iterations of these projections. Different investment return scenarios (i.e., Monte Carlo simulations) provide a range of potential outcomes for each participant.

Having performed these simulations, the recordkeeper will compute the percentage likelihood for each participant to meet his/her replacement ratio. Translating that into a rate of participants on target for meeting their retirement savings needs, the recordkeeper will typically indicate what portion of the population has a 100% chance of reaching the 75% replacement income target. Although it is not used as standard industry term, we can call this the plan’s “success ratio.”

With this information as a baseline, the plan sponsor can set in motion steps to improve this statistic. The plan sponsor might undertake an initiative to increase the participation rate, or the average deferral percentage. Working with the recordkeeper, the plan advisor or both, to design a campaign targeting specific groups of individuals who might not be participating, or who might be contributing very small amounts, the plan sponsor may be able to enhance these statistics. An improvement in these numbers, is also likely to improve that the plan’s success ratio.

There is one further consideration for plan sponsors who are considering an analysis of their plan’s success ratio. They must take into account which members of the employee population most critically need to meet the retirement needs. While ideally all employees will accomplish their retirement savings goals, plan sponsors may choose to focus more attention on the longest-tenured employees, or the ones who will be longest-standing, assuming they remain with the employer until retirement age. These will be the most loyal to the organization, and are also the most likely to achieve their savings needs.

It is more challenging to design a retirement program for an employee who will be employed by the organization for fewer than ten years to meet his or her savings goals. These employees are likely to have savings in retirement plans from previous employers, which will add to their overall replacement income. As you review your plan success statistics, it is important to keep this concept in mind.
NEXT STEPS
Ask whether your plan recordkeeper can provide you with these plan statistics, particularly a calculation of the percentage of participants who are on track to meet their replacement ratio. While most have the capability to project an individual participant’s replacement ratio, they may not have the capability to aggregate the numbers on a plan-wide basis. But it is still a worthwhile question to ask. Armed with this information, you can be more aware of how well your plan is meeting the future needs of your participants. You will have concrete information that can drive communication initiatives to improve your plan’s numbers, and you will be much more informed about your overall plan success.

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