The savings crisis of working Americans: The retirement industry call to action

America, we have yet another problem… one that has been building for years.

Where, exactly, are working Americans going to get enough income to replace 80% to possibly 100% of their career-end compensation so they can retire, remain self-sufficient and contribute to the costs of health care — and do so without falling into financial ruin or, at the very least, significantly changing their lifestyle?

From traditional pension plans? What pension plans?

A study by Towers Watson found that only 17 Fortune 100 companies continue to offer a traditional defined benefit pension plan to new hires, down from 20 in 2009 and 24 at the end of 2008.[1] To say nothing of the vast number of smaller firms that typically never offered a pension to begin with.

Are working Americans expecting help from Social Security? Given this year's report from the Social Security Board of Trustees, one can only hope not: "Social Security expenditures exceeded the program's non-interest income in 2010 for the first time since 1983. The $49 billion deficit last year… and $46 billion projected deficit in 2011 are in large part due to the weakened economy and to downward income adjustments." The report goes on to note: "After 2014, cash deficits are expected to grow rapidly as the number of beneficiaries continues to grow at a substantially faster rate than the number of covered workers… After 2022, trust fund assets will be redeemed in amounts that exceed interest earnings until trust fund reserves are exhausted in 2036, one year earlier than was projected last year. Thereafter, tax income would be sufficient to pay only about three-quarters of scheduled benefits through 2085."[2]

Perhaps the American worker plans to generate retirement income by taking the equity out of their home? What equity?

According to Zillow.com: "Home values have fallen 29.5 percent since they peaked in June 2006." What's worse, Zillow.com reported: "Negative equity reached a new high mark with 28.4 percent of single-family homeowners with mortgages underwater at the end of the first quarter (of 2011), up from 27 percent in the fourth quarter of 2010."[3]

And just how long will American workers need to make their retirement assets last? Chances are, a very long time. More specifically, according to data released this year from the Center for Disease Control, someone who was 50 years old in 2009 can expect to live beyond 80 on average; someone 65 in 2009 can expect to live beyond 83 years of age, and if 75 in 2009, they could live more than 11 years to surpass 86 years old.[4]

Living longer is good news. The problem is affording it. America faces a challenging, uncertain economic future, and it is difficult to predict whether working Americans will have enough income to survive in retirement, much less enjoy it.

What we do know, with complete certainty, is that if our society does not acknowledge and address the coming retirement savings shortfall, the American dream of retirement will most certainly become a nightmare.

Employees must take better advantage of opportunities to save at work

There's simply no getting around it: Americans must save more for their retirement. As members of the retirement industry, we strive to provide tools that give working Americans an opportunity to take full advantage of favorable federal tax incentives to save at work.

Since its introduction, one of the most powerful and popular tools to encourage saving at work has been the defined contribution plan in its various forms: 401(k), 403(b) and 457 plans for commercial, not-for-profit and government employees.

Today's defined contribution plans have become a critical employee benefit. According to the Investment Company Institute, "Americans held $4.7 trillion in all employer-based DC retirement plans on June 30, 2011, of which $3.2 trillion was held in 401(k) plans."[5]

---

[1] Towers Watson, More Fortune 100 Companies Offering Account-Based Retirement Plans to New Salaried Employees, Towers Watson Analysis Finds, May 26, 2010

[2] Social Security and Medicare Boards of Trustees, Status of the Social Security and Medicare Program – A Summary of the 2011 Annual Reports, May 5, 2011

[3] Zillow.com, Q1 2011 Zillow Real Estate Market Reports, May. 9, 2011

[4] National Vital Statistics Reports, Vol. 59, No. 4, March 16, 2011

[5] Investment Company Institute, The U.S. Retirement Market: Second Quarter 2011, Sept. 30, 2011.

The good news about DC plans

The good news is simple: defined contribution plans work; and they work particularly well when plan participants make consistent, maximum contributions and take a long-term view about investing without overreacting to market volatility.

Data compiled by the Urban Institute supports this assessment. By the end of the first quarter of 2009, when the stock market bottomed out, retirement accounts (defined contribution plans and IRAs) had lost $2.7 trillion, or 31% of their peak value. "By the first quarter of 2011, retirement account balances had surpassed their peak 2007 value in nominal terms."[6]

Importantly, employer-sponsored plans such as 401(k)s also help employees at the lower end of the wage scale to save. Data prepared for The American Society of Pension Professionals & Actuaries (ASPPA) by the Employee Benefit Research Institute (EBRI) suggests that without the benefit of an employer-sponsored plan, only 5% of employees save for retirement on their own. By contrast, 70% of moderate to low-income workers earning between $30,000 and $50,000 participate in employer-sponsored retirement plans when they are offered.[7]

Working together to drive greater savings

If we are to confront the coming retirement crisis, five key stakeholders must work together to drive a higher savings rate for working Americans.

1. The retirement industry

The retirement industry is made up of three basic types of firms:

- Companies that provide defined contribution platforms and services
- Asset managers that create investment solutions and invest employee contributions and employer matches
- Financial advisors and consultants that serve plan sponsors and/or plan participants

Some firms provide multiple services.

As an industry, we need to be innovative. Some new concepts gaining traction or under consideration to enhance defined contribution plans include:

- Automatic enrollment and auto contribution increases
- In-plan annuity options and guarantees
- In-plan personal advice options
- Professionally managed asset allocation services including target date funds

The retirement industry must also look at the bigger picture and apply lessons learned from defined contribution plan design into the IRA space, to help make it more attractive for employees to contribute to personal retirement accounts when they do not have access to a defined contribution plan.

---

[6] Urban Institute, Fact Sheet on Retirement Policy, Retirement Account Balances, October 2011

[7] Employee Benefit Research Institute data prepared for The American Society of Pension Professionals & Actuaries (ASPPA), Asppa Urges Congress To Protect Retirement Incentives, November 10, 2010

2. Employers/plan sponsors

Plan sponsors are becoming aware of the looming retiree savings shortfall problem and some are beginning to take action because, according to employee benefit consultant Aon Hewitt, "companies have little confidence that workers are taking the actions necessary to meet their retirement savings needs."[8]

If a company already offers a defined contribution plan, it should commit to the following:

- Show that it cares about its employees' long-term retirement security and champion the need to save more through focused communications and campaigns
- Consider providing a matching contribution and an attractive plan as incentive to encourage a higher saving rate
- Offer high-quality, ongoing education to plan participants that focuses on increasing their saving rate
- Provide access to professional guidance tailored to help employees make informed decisions and understand the need to save more during their wealth accumulation phase, and how to plan for income in their retirement phase

If a company does not offer a plan, it will become less attractive to employee candidates that embrace the need for ambitious retirement savings. Smaller companies that do not have a plan should consider taking advantage of retirement plan solutions that have been developed for smaller employers by payroll service providers and other retirement plan industry participants.

3. The financial advisor/consultant

As plans become increasingly complex, expectations of those in a fiduciary capacity grow and the need for a higher savings rate becomes increasingly urgent. The role of the financial advisor/consultant has never been more important.

In order for financial advisors/consultants to work with plan sponsors and plan participants, they must commit to the following:

- Promote transparency
- Champion the message that working Americans need to save much more, and show them how
- Be accountable to the plan sponsor and plan participant
- Over-communicate. There can never be enough reinforcement of key retirement themes
- Never stop teaching, never stop elevating the knowledge and abilities of plan sponsors and plan participants; for participants, the focus needs to be on retirement income planning from Day One

4. The federal government

We encourage the federal government to embrace the private sector and work in partnership to create solutions that incentivize more employers — large and small — to provide the ability for their workers to save at work.

While it is important for government watchdogs to prevent potential abuses in the system – something that we in the retirement industry wholly support — it is also important that the government recognizes the changing needs and complexities facing plan sponsors, and the fact that plan sponsors and participants alike need advice now, more than ever.

---

[8] Aon Hewitt, Aon Hewitt Survey Shows Employers Offering Workers More Help to Meet Retirement Goals, January 26, 2011

5. Working Americans

Battered by a painful economy and financial uncertainty, working Americans are certainly resilient, but increasingly worried about their retirement. Those working at companies that offer defined contribution plans should do all they can to fully understand the plan benefits and maximize their contributions.

As the economy improves, those looking for work should seek employment with a company that provides a defined contribution plan that includes an employer matching contribution. If the opportunity for work is with a small company, at the very least ask if the company provides access to a Simple IRA.

First & 10

In the end, there is no avoiding the fundamental reality we face in the United States: working Americans must save more to retire successfully. But given the economic pressures so many of us face on a daily basis, the biggest challenge is figuring out how much more to save.

The Legg Mason Retirement Advisory Council proposes that working Americans consider, as a starting point, following a simple rule characterized by the football term **First & 10.**

First — start saving. Enroll in your 401(k) or defined contribution plan at work; open an IRA; do whatever you can to start saving. And then **try to save at least** 10% of your income.

In other words: **First & 10.**

Why at least 10%? Because the current national average savings rate of 5.4%, as measured by the U.S. Department of Commerce in June 2011, is not nearly enough for many workers who want to replace 80% to 100% of their last year of income each year in retirement.

It's important to note that retirement savings accumulations depend on various factors in addition to savings rate, including the length of time over which saving and investment takes place and the investment rate of return earned during said period. Even a 10% savings rate might not result in adequate retirement savings for certain workers. But, 10% is a significant improvement over the current national average savings rate, and would be a good start.

More specifically, the long-term benefits of saving more — especially saving more in a defined contribution plan — become vividly clear when you consider the following scenario:

A 25-year-old worker today with zero retirement savings is earning a $30,000 annual salary. He hopes to receive annual salary increases that average to 3%.[9]

This would make his anticipated last year of income about $100,000 by age 67.

[9] 2.9% is the average salary increase of the employers projecting to grant base pay increases in 2011 according to Mercer, 2010/2011 US Compensation Planning Survey, August 2010.

Here's what it looks like if this 25-year-old saves 5% and 10% of his salary annually in a taxable brokerage account until retirement at age 67 while earning a hypothetical annual 5% after-tax rate of return until retirement. Also included are the estimated number of years those assets are projected to provide 80% of income replacement for this worker ($80,000), assuming that the account earns a hypothetical annual 3% after-tax rate of return following retirement.

Based on the assumptions in this example, saving 10% instead of 5% provides twice the total amount of assets upon retirement and more than doubles how long those assets are projected to last — from three years to seven.

Reason enough to save more. But what happens if our 25-year-old has access to a defined contribution plan, like a 401(k), at work that includes an employer matching contribution of 50% of his contribution, up to 6% of his salary? The amount he saves could truly be life changing.

If this same 25-year-old contributes 10% of his annual salary to his defined contribution plan while earning a hypothetical 6.6% annual rate of return (the pre-tax equivalent of a 5% after-tax rate of return based on an assumed blended federal tax rate of 25%),[10] it is projected that he would have accumulated $1,254,952 upon retirement at age 67, thanks in good part to his employer's matching contribution and the power of tax-deferred compounding.

Saving in a Traditional Brokerage Account…

25-year-old's annual saving rate through age 67	5%	10%
Total accumulation in taxable brokerage account earning hypothetical annual 5% after-tax rate of return	$302,407	$604,813
Age assets are projected to run out at 80% income replacement	70	74

Source: Diversified

…and in a Defined Contribution Plan

25-year-old's annual saving rate through age 67	5%	10%	10% saved in DC Plan
Total accumulation in taxable brokerage account earning hypothetical annual 5% after-tax rate of return and in DC plan earning hypothetical 6.6% pre-tax rate of return[10]	$302,407	$604,813	$1,254,952

Source: Diversified

[10] For purposes of the above comparison, it has been assumed the taxable account will generate a combination of long-term capital gains and qualified dividends taxable at a maximum rate of 15% under current federal income tax law, and short term capital gains and interest taxable as ordinary income, resulting in an annual blended federal tax rate of 25%. Changes in tax rates and tax treatment of investment earnings may impact the comparative results shown. The comparison assumes that no distributions are made from the tax-deferred account during or at the end of the 42-year period, and that taxes applicable to the taxable account are paid out of such account each year. Withdrawals from a tax-deferred account are taxable as ordinary income in the year made, and early withdrawals prior to age 59 ½ generally are subject to a 10% additional federal tax. The impact of taxes on tax-deferred withdrawals is not reflected in the comparison. If reflected, such impact would make the accumulation of assets in the tax-deferred account relative to the accumulation of assets in the taxable account look less favorable. The rate of return used in the comparison is not intended to be representative of any investment product. An actual investment may include fee, charges and other expenses that would affect the investment's return.

***That's more than twice* the amount he would have saved in a taxable brokerage account!**

How long those assets will last in retirement depends on a variety of factors, including the rate of return earned on the assets during retirement, his overall tax situation (including tax rate) during retirement and how he takes his 401(k) distributions. But it's fair to assume that these assets should provide 80% income replacement for a period significantly longer than 10% saved in a taxable account, even after taking into account the taxes that will apply to withdrawals from the defined contribution plan.

Furthermore, our 25-year-old's contributions to his defined contribution plan are made on a pre-tax basis — reducing his taxable income — while contributions away from a defined contribution plan are made from after-tax income. As mentioned, distributions from the defined contribution plan will be subject to tax as ordinary income.

It's important to note this scenario was created to demonstrate the power of a higher savings rate, especially within a tax-deferred retirement plan. **First & 10** is a starting point. Each investor's situation is unique. The Council strongly encourages plan participants to seek professional direction from financial advisors to determine how much more than 10% they might need to save to achieve their goals.

The views expressed are those of the Legg Mason Retirement Advisory Council as of September 23, 2011 and are subject to change. The Legg Mason Retirement Advisory Council is a group of retirement plan industry professionals, most of whom are associated with firms that are unaffiliated with Legg Mason, whose mission is to address high priority issues facing the retirement industry. The views of the Legg Mason Retirement Advisory Council may differ from the views of Legg Mason and its affiliates, and they are not intended to be a forecast of future events, a guarantee of future results or investment, or financial planning advice. Investors seeking financial advice regarding the appropriateness of savings or investing strategies should consult their financial professional.

The First & 10 concept is simply a strategy for increasing a worker's rate of savings. Retirement savings accumulations depend on various factors in addition to savings rate, including the length of time over which savings and investment takes place and the investment rate of return during such period. There is no guarantee or assurance that following the First & 10 concept will allow an investor to accumulate retirement savings sufficient to meet the investor's retirement income needs.

Scenario calculations are based on Diversified's Retirement Planning and Retirement Savings Calculators using the following criteria:

Total amount saved in taxable brokerage account
(Retirement Planning Calculator)

Single
Current Age: 25
Age at retirement: 67
Current income: $30,000
Current retirement savings: 0
Rate of return before retirement: 5%
Rate of return during retirement: 3%
Percent of income to contribute: 5% and 10%
Expected salary increase: 3%
Years of retirement income: 20
Percentage of income in retirement: 80%
Expected rate of inflation: 3.1%
To include Social Security: No

Total Amount Saved in DC plan
(Retirement Savings Calculator)
Percent to contribute: 10%
Annual salary: $30,000
Current age: 25
Age at retirement: 67
Current retirement savings plan balance: 0
Annual rate of return: 6.6%
Expected annual salary increase: 3%
Employer match: 50%
Employer maximum: 6%

Hypothetical results are inherently limited and should not be relied upon as indicators of the future performance of any Legg Mason product. Investors should not use this information as the sole basis for investment decisions and different hypothetical scenarios will provide different results.

Past performance is no guarantee of future results. All investments involve risk, including possible loss of principal. Asset allocation does not guarantee a profit or protect against a loss.

Diversified is not affiliated with Legg Mason, Inc.

Legg Mason, Inc., its affiliates and its employees are not in the business of providing tax or legal advice to taxpayers. These materials and any tax-related statements are not intended or written to be used, and cannot be used or relied upon, by any taxpayer for the purpose of avoiding tax penalties. Tax-related statements, if any, may have been written in connection with the “promotion or marketing” of the transaction(s) or matter(s) addressed by these materials, to the extent allowed by applicable law. Any taxpayer should seek advice based on the taxpayer’s particular circumstances from an independent tax advisor.

© 2011 Legg Mason Investor Services, LLC, member FINRA, SIPC. Legg Mason Investor Services, LLC is a subsidiary of Legg Mason, Inc.
406476 RETX014132 11/11 FN1111085