

# Two Simple Recommendations to Ensure Successful Reforms in CT

Dr. Arun Muralidhar

Presentation to CT Retirement  
Security Board

October 16<sup>th</sup>, 2015

# Dr. Arun Muralidhar - Bio

- ❑ Pension Investments: Founded M<sup>cube</sup> and AEGIS
  - ✓ Won numerous awards; clients won innovation awards
  - ✓ Added significant value to client portfolios from beta management (especially in 2008 and 2011)
  - ✓ Used to manage World Bank Pension Fund
- ❑ Author: *Innovations in Pension Fund Management*, and *SMART Approach to Portfolio Management*
- ❑ Reform: Developed innovative solutions for reforms
  - ✓ Co-author *Rethinking Pension Reform* (with late Prof. Franco Modigliani, Nobel Prize Winner)
    - ✓ *Offered unique solution to solve Social Security crisis*
  - ✓ Advisor to Overture (Consultant to CA Secure Choice IB)
  - ✓ Advisory Member, Council of Scholars - Georgetown CRI
- ❑ Academic: Adjunct Prof. of Finance, GWU

*Disclaimer: All views expressed are solely personal and do not represent the views of any of the organizations I am associated with.*

# Overview – Two Simple Messages For CT

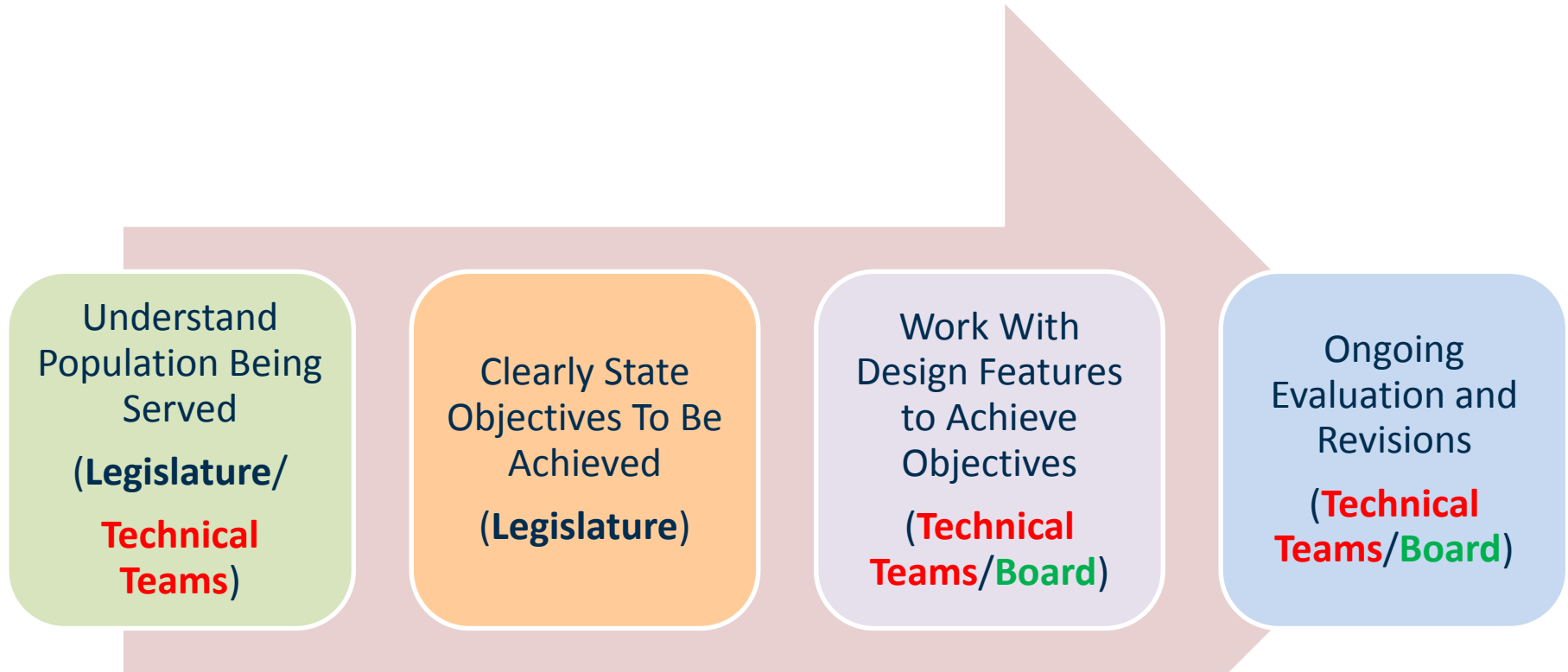
## 1) Successful Reforms: Effective Decision Process

- ❑ Ideally: Separate Design from Objectives (Sec 185)
  - ❑ Population: Less Educated; Want Liquidity/Annuity
  - ❑ “Goals”: No Liability, Low-Cost, Guarantees, Annuities

## 2) Success for CT: Requires Innovation in Markets

- ❑ Challenge: Need A Simple, Low Cost, Liquid Default Option for Investments and Annuity

# Successful Reform Needs An Effective Sequencing Process



***Sec 185 Includes Design Features  
Can Pose A Problem or Force Innovation***

## Population Served: Low Financial Acumen; Need Simple, Low-Cost Default Options

- ❑ GAO: Participants likely to be lower-income, less educated and working for smaller firms
- ❑ CA Median Annual Wage  $\approx$  \$25,000-30,000
  - ❑ High fees dramatically lowers replacement rate
- ❑ CA: 81% want retirement income for life
  - ❑ Is simple, low cost, and liquid Sec 185.8 feasible?

## Population Served: Strong Need for Liquidity

☐ Potential Issue: What If Folks Are Borrowing?

☒ Forcing Contributions = Further Indebted

☐ CA: 56% Credit Card debt (>3 months); 43% Car Loans; 29% Mortgage; 23% Student Loans

☐ 30% Wanted to Access Funds Before Retirement (Health Issues, Loss of Job, Death)

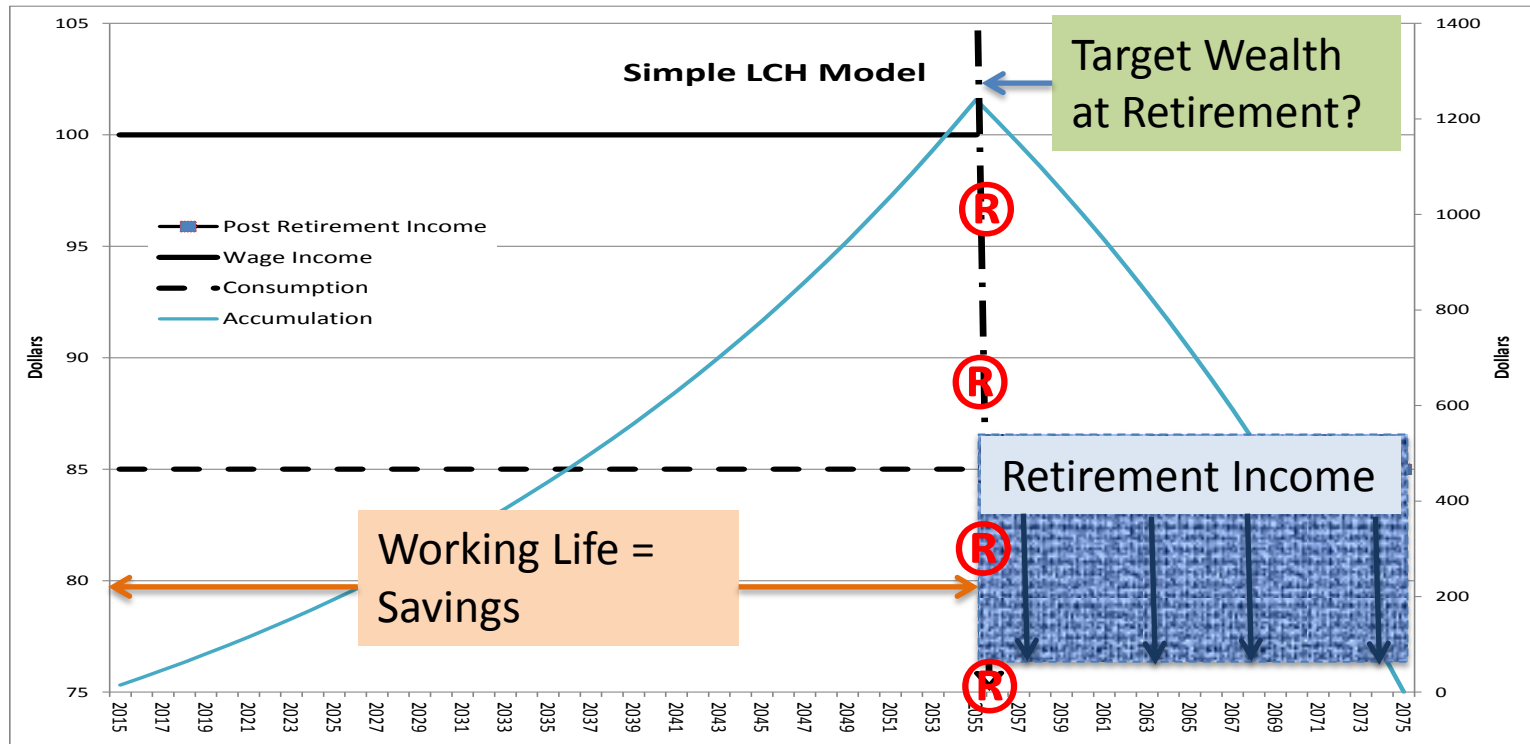
***2014: 30 mn Tapped Retirement Funds for Emergency!!***

# Implications From Population Analysis

- ❑ Not Sure “Auto Enrollment” Is Right Policy
- ❑ Keep Costs Low (Sec 185.7) – Even 1% Hurts
- ❑ Have to Keep Plan Liquid – Clearly A Need
- ❑ Low Sophistication (Sec 185.3) = Effective, Simple, Default Option (for both Investments and Annuity)

# Biggest Challenges in All Retirement Systems

***Main Qs: How Much to Save? What Portfolio To Invest In?  
What Target Wealth Ensures Desired Retirement Income?***



***We Know: Investments in Stocks + Bonds = Risky  
Annuities Are Complex, Expensive and Illiquid***



# Challenge: Private Guarantee of Return (Sec 185.9)

☐ Objective: Safety of Outcome (DB Outcome)

☐ Issue: CT Wants No Liability = DC (Sec 185.1)

☒ Private Guarantees Will Be Very Expensive

☒ Financial Solutions: Complex/ Enrich Wall St.

***A Guarantee Is Going To Be Impossible To Achieve or  
So Low as To Be Worthless (Bank Deposit)***

# Potential Implications From Financial Analysis

- ❑ Traditional DB/Guarantees Are Not Feasible
- ❑ Focusing on Retirement Income Desirable
- ❑ Typical Approaches Complex, Costly & Risky
- ❑ Annuity Markets Complex and Costly

***Is There Scope for Innovation to Achieve Desired Outcome?***

# Example of a Model The Combines Best Features of Two Extremes

Typical DB

Flex MM  
Model

Typical DC

- **Guaranteed Outcome**
- **Retirement Income**
- **Inter/ra Generational Risk Sharing (Hedge Longevity Risk)**
- **Minimal Engagement**
- **Lower Cost**
- **Accumulation/Decumulation with Same Entity**
- **Dynamic Risk Mngmt**

- **Soft “Guarantee”**
- **Retirement Income**
- **Close Link Between Contribution/Benefits**
- **Minimal Engagement OK but Also Facilitate Active Engagement**
- **Accum/Decumulation with Same Entity**
- **Innovation: “FSB”**
- **Dynamic Risk Mngmt**

- **Close Link Between Contribution/Benefits**
- **Permits Life Cycle Smoothing**
- **Can Leave Bequests**
- **Wealth Focused**
- **“Choice”**
- **Allow for Varying Replacement Rates**
- **Private – Fosters Innovation**

# Background To The Innovation

- ❑ We All Want Some Target Retirement Income
- ❑ Young People: Income Needed 30-40 Yrs Out!
- ☒ Stocks, Bonds, TDFs or Annuities = Expensive  
+ Leave Risk for Individuals to Bear
- ☒ Requires Complex/Dynamic Asset Allocation

***Must Bridge Time Gap Between Savings & Retirement***

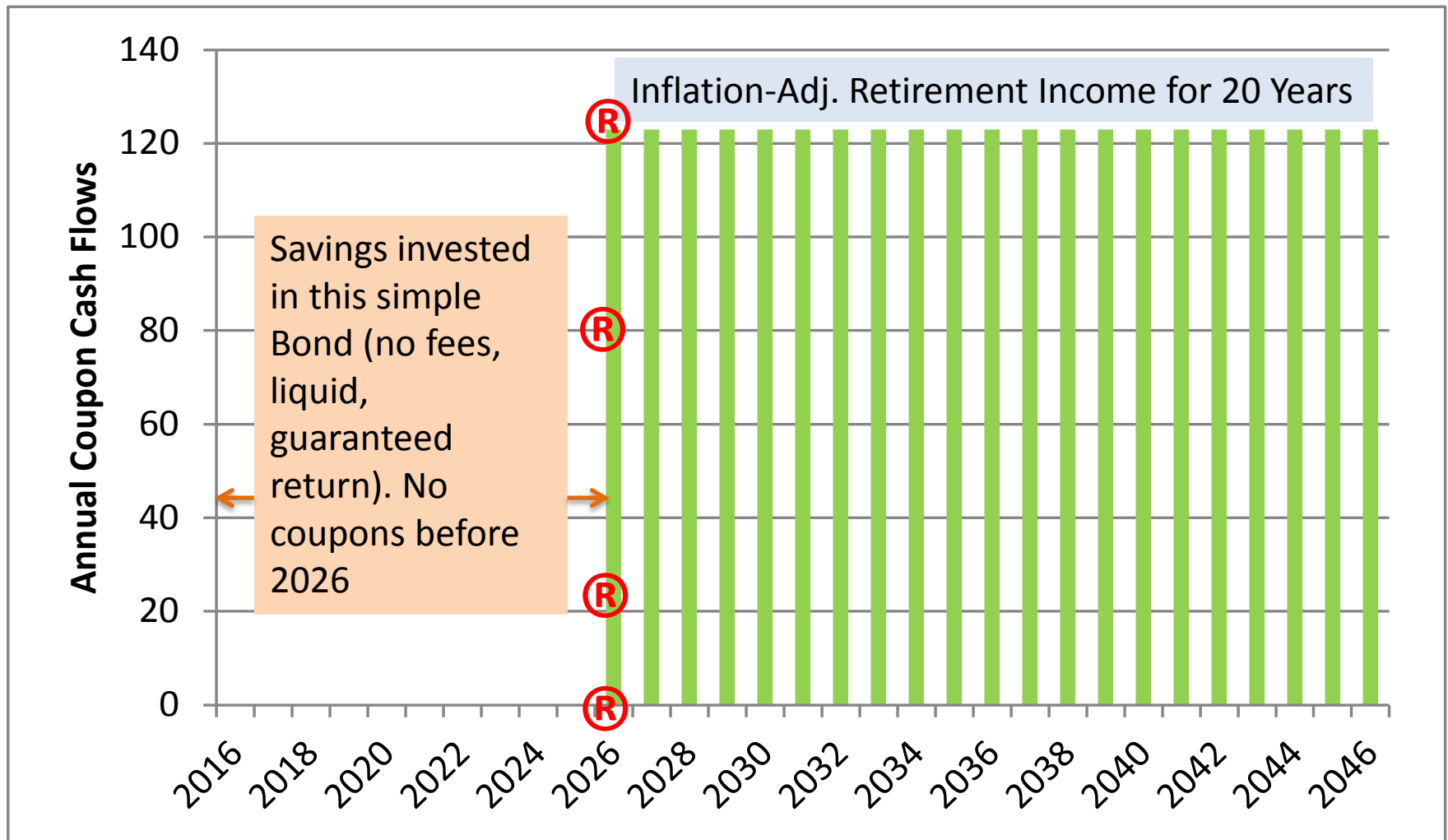
## FSB: One Possible Innovation To Help Reforms

- ✓ A Simple Bond Issued By Treasury (or Even State)
- ✓ Starts Paying Coupons At Retirement Date
  - ✓ Stagger this so some bonds start 2, 5, 10 Etc. Yrs Out
- ✓ Pays Coupon for 20 Years (linked to Life Expect.)
- ✓ Inflation-Protected

***Solves Challenges Posed by Sec 185: (3), (7), (8) and (9)***

# FSB: 10 Year Forward Bond for 20 Years

## No Need To Set Target Wealth/Buy Annuities



***“An Inflation-Linked IO Bond That Pays Me When I Need It”***

## Why This Bond is Attractive for CT Reforms?

- ✓ Mimics Annuity Payments, But is Liquid, Transparent, Cheap, Default-Free
- ✓ Individuals Create Own “DB-Like” Outcome
- ✓ Reduces Problem from How Much to Save and How to Invest to just How Much to Save
- ✓ Default Option Solves Problem of Sec 185.8
- ✓ Those Seeking More Income/Risk Can Add Equities or Save More etc.

***Simpler Than Non-Profit Annuity Provision?***

# Why This Model is Better Than Current Options

- ✓ Focuses on Retirement Income (and Understands the Volatility of Investment Choices)
- ✓ Soft Guarantee from Market Instrument
- ✓ Fully Funded (No Residual Risk)
- ✓ Not One Size Fits All:
  - ✓ Choice = Customization
  - ✓ Loans For This Population May Be Key Feature
- ✓ Flexible For Different Levels of Engagement
- ✓ Market-Based Approach



## Conclusions: Take-Aways for CT

- ❑ Understand Target Population Before Selecting Design Features
- ✓ **Focus on Ensuring Retirement Income**
- ❑ A New Bond To Create “Individual DBs”?
- ❑ Would Solve Challenge Posed by Sec 185 – (3), (7), (8) and (9)

Thank You