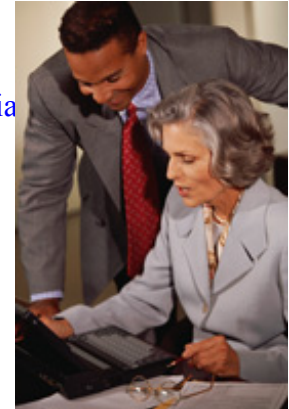




## Longer Lives and the 'Lump-Sum Illusion' Are Just Two of the Challenges Retiring Baby-Boomers Face

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In the United States alone, an unprecedented 77 million baby-boomers will be living the next 20 to 30 years in retirement. With long lives ahead of them -- and without adequate planning -- what are the risks they are facing? According to [Olivia Mitchell](#), Wharton professor of insurance and risk management, and Christopher "Kip" Condron, president and CEO of AXA Financial, the world's largest financial services firm, the rising tide of boomers in the U.S. and around the world needs to meet challenges that previous generations never faced, including changes to key retirement institutions, as well as medical-care cost inflation and the "lump-sum illusion" -- the tendency to view retirement savings as a lump sum, as opposed to a prospective income stream. Knowledge@Wharton spoke with Mitchell and Condron about how the financial services industry is working to meet the needs of this next wave of retirees.



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### Podcast Transcript: Longer Lives and the 'Lump-Sum Illusion' Are Just Two of the Challenges Retiring Baby-Boomers Face

**Knowledge@Wharton:** Olivia, can you give us a brief understanding of what the baby-boomer market is facing today, particularly in the financial space of both retirement and wealth management?

**Mitchell:** The situation facing the baby-boomers is very different from that facing their parents. The risks are much greater and the uncertainties are terrific. For example, Social Security and Medicare face tremendous insolvency problems. The capital markets are much more globally integrated and more volatile. And therefore, baby boomers really have a very great challenge facing them, one quite distinct from what their precursor generations confronted.

**Knowledge@Wharton:** Kip, although your business is a global company, what services do you provide in the United States [alone] for the baby-boomer market?

**Condron:** Basically, our business is the business of providing guarantees. We provide guaranteed income for people at retirement and we provide guaranteed death benefits. You would typically think that what we do [as an insurance company] is life insurance and annuities. But what we really do is take the risk off an individual's personal balance sheet, put it on ours, pool it with others and find ways to hedge it in the marketplace so that we can provide some comfort to these baby-boomers as they are approaching

retirement.

**Knowledge@Wharton:** And how have your services changed and evolved with the baby-boomers getting older? Are you finding it requires a different sales process now to reach them and to market to them and also to service them?

**Condron:** Absolutely, and I think that there's a realization that when you think about baby-boomers today, you say, what's their biggest fear? Their biggest fear is that they are going to run out of money. So what we do is provide guarantees that they'll have a stream of income for life, regardless of how long they live.

**Knowledge@Wharton:** Boomers generally do have a lot of money. Is that correct?

**Condron:** Well, some do and some don't.

**Knowledge@Wharton:** On average, would you say that it's a wealthy population?

**Condron:** I think it is tiered and Olivia probably would have some comments on this. But I think that there are people at one end of the spectrum who plan for retirement and worry about running out [of money], but they have done some good planning. At the other end of the spectrum, you have people who have done very little planning and have accumulated very little and don't know what they are going to do.

**Mitchell:** The research shows that boomers, on average, are about at the same position financially as their previous generations; however, they face much greater uncertainty. For example, my parents' generation had Social Security to look forward to. What we know today is that Social Security is running short of financing. My parents' generation benefited from a huge run-up in the value of their houses. What we don't know looking forward is: How secure is that housing asset?

Healthcare is much more uncertain going forward. The good news is we are going to live much longer. The bad news is it's going to be that more much expensive to take care of our healthcare needs. So I identify, along a number of spectrums, new risks or graver risks that boomers are facing. And that's where I think the work that Kip is doing is so important -- to talk about protecting against those risks.

**Knowledge@Wharton:** What are the psychological barriers to penetrating the market? Is there a 'fear factor' there that's underlying the population? Do they need to be educated more than with other sales processes'?

**Condron:** Well, I think they surely need to be educated more, and that's the one thing that we found out about this particular population. They're smart and they're better educated than their parents were about financial issues. But they want to be smart and make smart personal decisions. They don't want to be told what to do, but they want to be educated so that they can make smart decisions.

The big problem is that the conventional wisdom is wrong. The conventional wisdom is that as you get older, you should become more conservative in your investment portfolio. So, as I go into my 50's and I'm approaching 60 -- let's say 65 is the magic age -- the conventional wisdom is I should start making my investment portfolio more and more conservative. Yet a couple at age 60 today has a 62% probability that one of them will be alive past age 90. So we're not planning for 15 years, we're planning for 30 years or more.

If you go back 30 years ago to 1976, you had an inflationary environment that was very different. If you go through the last 30 years, you couldn't possibly have major investments and fixed income securities

and have hedged yourself against inflation.

**Knowledge@Wharton:** Today, many people are as active as can be at age 65 -- entrepreneurially, education wise; some of them are going back to school.

**Condron:** Well, the [idea about retirement at age] 65 came about from Benjamin Disraeli, I think, [over] 100 years ago, because 65 was the life expectancy at that point and time.

**Mitchell:** In the U.S., we've already started to push on that retirement age frontier along a number of fronts. For example, the Social Security Administration has moved the normal retirement age for getting full benefits to 67. So boomers cannot count on the old fashioned retirement plan anymore at 65 or younger. It will probably have to be pushed up even further.

If we go back to when Social Security was created, age 65 was selected as the life expectancy. Now we would have to talk about age 80 as the possible retirement age. I'm not saying that everybody should or could do that. But I do believe -- and this is what we've been pushing -- that we have to encourage people to work longer, because just another two, three, four or five years of work can really alleviate some of the shortfalls later on in this climate.

**Knowledge@Wharton:** Some of the institutions you've mentioned -- such as Social Security and Medicare -- are changing, and I imagine will impact boomers.

**Mitchell:** The boomers are very much influencing the solvency of Medicare and Social Security -- there's no question about that. And indeed those systems will be running short of money in the near term. It's not something that's 50 years away; it's going to be starting in about 10 years. So we do have to focus on greater risk management and risk prevention and mitigation. If we can just work a few more years now, save a little more, invest a little more wisely and protect against some of the bigger risks, we're going to be a whole lot happier when we're 85 or 90.

**Condron:** I think that 'retirement' means different things to different people today. If we think of our parents' generation, they retired from whatever they did and they didn't work anymore. Today people retire usually or often *to* something, and they'll have a second career or a second interest in life. So people may not continue to work in the same places they've worked for most of their career, or even in the same areas of interest. But they will go do something to make up the short-fall financially. Also, they're healthier and they're living longer and they want to keep active. So keeping a sort of 'finger in the pie' is something a lot of people care about.

**Knowledge@Wharton:** As an international company, do you see a difference between United States baby-boomers versus those in Europe? Is it a different mind set? Is it a different process there?

**Condron:** There are a lot of similarities and there are a lot of differences. The similarities are that there are boomers everywhere, all around the world -- post World War II baby-boomers. And the need for retirement planning is universal. However, when you look at the make-up country by country, we probably have in the U.S. the most sophisticated retirement systems of almost anywhere in the world.

**Knowledge@Wharton:** From a protection standpoint?

**Condron:** Yes, because of our corporate structure with corporate pension plans, 401K plans, 403B plans and so forth. Our population has more private sector money put away for their retirement, whereas in a lot of other countries there is a lot of public sector money supporting people for retirement. But, they haven't put the kinds of incentives and systems in place that we have. So the challenges, country by country, are

rather different as to how you solve the needs that individuals have as they are approaching retirement.

Because we are a global company, we are taking this initiative we call "At Retirement," which is a model for advising people about making smart decisions at retirement. We are taking this model and rolling it out across the world, but we are adapting it country by country, because every country's needs are different and every country's demographics and social make-up is different. It's a fascinating challenge, actually, because we've never done this inside our company before, and I'm not sure if anyone has ever done it at all. So, trying to figure out how to take a universal problem, like satisfying peoples' financial needs at retirement and looking at it from a global perspective, rather than just a domestic perspective, takes on a whole lot of other issues that you have to deal with.

**Mitchell:** If I could just add to that -- one of the things that we've realized, looking around the world, is that different countries have different institutional structures. Sometimes they facilitate retirement planning, retirement protection, and sometimes they don't. As an instance of that, in Japan we see that most older people, like in many countries, have a house. They have a lot of money invested in their dwelling, but they don't have many other assets, so they're not very diversified. So, one of the questions might be how to develop financial markets and new financial products to help people tap into those assets. An example in the Japanese case would be to try to develop a reverse-mortgage market. You can live in the house and get the services from the house, but by the same token have some protection from running out of money.

**Knowledge@Wharton:** How does real estate factor into the retirement situation in the United States?

**Mitchell:** Most older Americans do own a house. It's a very key part of their retirement portfolio. Past experience has suggested that people tend to hang onto their house until the bitter end -- until there is a death in the family or they have to move into a nursing home. So, one of the challenges in the U.S. is, again, how to develop means to let people access that equity, to finance their retirement while not forcing them to move until they absolutely have to.

**Condron:** There are a lot of challenges around that because the concept of reverse mortgages is wonderful. If I have a million-dollar house and I borrow \$500,000, I can create income for myself and settle up the debt at the time of my death, and so forth. But the problems with it are that on the front end, it tends to be expensive for the client because there are a lot of mouths at the trough. There are the mortgage people, there are the investment people -- there are a lot of fees, and that's the challenge.

And secondly, you have the power of compound interest working against you, and that's a problem. This debt that keeps growing, if you want to think of it in those terms, is a real significant issue. There is a lot of work being done on reverse mortgages. There are some in the marketplace today. It's not yet, at least in the United States, something that's hit the mainstream very well because I think the product structure is still a little bit flawed. It's one thing that we're doing a lot of analytical work on right now to see if there is a design that can be beneficial to the client, not create an environment where the heirs are going to feel like someone took advantage of their parents, which is always an issue here. So there are a lot of challenges around it. It's sort of like the Holy Grail -- if you can figure out how a retired couple could continue to live in their house and create liquidity and have enough income, maybe you would get the prize for figuring out retirement. So we are working on it.

**Knowledge@Wharton:** On the psychological side again, there's got to be a group that's very stubborn, that wants to just defer the whole thought of retirement. What do you say to those people? And how do you educate them to start planning and emphasize that the more you push it off, the more pain you're going to feel later on in life?

**Condron:** I think that you have to remind them that they are going to live for a long time. And, I think that is the one piece [of information] that people are shocked at. For example, people tend to think, "If I'm

65, I've got a 15-year life expectancy" -- because life expectancies for children born today are somewhere around 80 years. But the fact is, if you [make it] to age 65, your life expectancy is a lot longer. And then you get into the probabilities because what we found is -- going back to the point I made earlier -- if you're a couple that is age 65, there is a 62% probability that one of you is going to live past age 90. That's the year 2000 data, the most current data we have. In the 1970 data, you had a 40% probability that one of you was going to live past age 90.

**Knowledge@Wharton:** That's quite a shift.

**Condron:** People are living longer. One of the things that we have to worry about is managing [something] that people never talked about before: "longevity risk." We have to manage the risk of guaranteeing income for people who are going to live longer than we anticipated. And so those kinds of risk management challenges for companies like ours are very robust.

**Knowledge@Wharton:** Do you see a big difference in the post-boomers, in the next generation that is coming up? Is there a different attitude there with money and retirement?

**Mitchell:** I think that it's starting to emerge. I think that the next generation is seeing their boomer parents take care of the kids, plus the elderly in the sandwich group that they're in. And so there is some evidence that they're beginning to pay more attention. I know as a teacher and as a parent I certainly try to educate everyone under the age of 30 about all these problems. But I think that there is a lot of education needed; in particular, younger people tend to think they are immortal, that nothing will ever befall them.

Once you start getting into your 40s, maybe 50s, you realize health problems become an issue. You start to hopefully take some responsibility for retirement planning. But there is a tremendous amount of illusion around it still. I call it "lump-sum illusion." People think they have \$100,000 in their 401k Plan and feel rich. And they don't realize that there's a reasonable chance that they are going to live 30 years with that sum of money, and it's not going to boil down to very much.

I think a lot of the online retirement calculators contribute to that because they ask you your age and your sex. Then they spit out a number -- "you're going to live for 14 more years" -- never incorporating the possibility, the very high probability, that you may live to be 100, or if you're a woman, 110. And so these are the areas where we really do have to educate the populace.

**Condron:** I want to pick up on the "lump-sum illusion," because it's a problem in the way that the financial industry has taught people to think. You know we've developed retirement plans and defined contribution plans which pay off in a lump sum. We sell life insurance to people in a lump sum. People aren't equipped to really make the calculation and the conversion from a lump sum to income -- because it's all about income.

One of the things that we've been doing in our industry is putting income floors under lump sum calculations. For example, one of the products that our industry delivers to the market place is called "Withdrawal Benefit for Life." A 65 year-old could put \$100,000 into one of these products and have a guarantee to be able to withdraw 5% of the principal for life and never run out of money. They have a balanced investment portfolio, but a significant percentage of equities which will allow for some growth. Once a year, if their portfolio goes up in value, they can reset at a higher amount the value upon which that 5% is calculated. So if their portfolio went up in the second year to \$110,000, they set it at 5% of \$110,000. It will never go lower, and it can readjust itself, assuming that the price goes up.

Basically, one of the big problems we have here is: How do I create an inflationary hedge for myself during retirement? And if I take a fixed-income solution, I'm blocked at whatever that amount is. And that's the problem of inflation. The beauty of these products that we in our industry have worked hard to design is that they create an environment where people have an ability to transfer their lump sum into an

income stream -- not lock it into a fixed rate, but rather get an opportunity to get a higher rate if markets change.

**Mitchell:** I was just going to pick up on the inflation theme briefly. For one thing, many people don't understand inflation. They discount the impact it will have on their well being, 20, 30, maybe 40 years into retirement. The second factor people don't understand is the extra hit of medical care cost inflation and the toll it will take on their well being. So, once again we should think about the downstream consequences of needing long-term care, nursing home care, the downstream costs of pharmaceutical drugs and so forth. All these are concepts that today's boomers just aren't focusing on enough. And so part of the educational mission is again to get people to begin to estimate what it will take to maintain their lifestyle in retirement, even though prices are going up.

**Condron:** [That's] a very good point, because if you look at, say, a 3% inflationary environment and you're going off into retirement, your inclination is to plan for 3% inflation. But, if medical expenses are going up 10%, that's a bigger share of your wallet than it is of the 35 year-old's wallet. So you're not planning for a 3% inflation rate, you're probably planning for a 6% or 7% inflation rate. And that's a whole different planning process that people have to be cognizant of.

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