Improving retirement affordability

5 value drivers that can drastically reduce your cost of retirement

HOOPP
Healthcare of Ontario Pension Plan

Introduction

Canadians are diverse in many ways, including their choices of employment, the distances they're willing to commute for work, or even their favourite coffee chain. But one thing most of us have in common is that, at some point, we want to retire and be able to enjoy life after work. While it is a positive goal, retirement is one of life's biggest expenses and saving for it isn't easy. Most Canadians simply are not saving enough or preparing as well as they could be, and many don't have access to workplace pensions or savings plans that can help. That puts their retirement security at risk.

While there is no magic formula that can guarantee a comfortable retirement, saving early and often is critical. Yet saving for retirement isn't as simple as setting aside money in a bank account. It involves:

- **being consistent in your approach to saving,**
- **making solid investment decisions,**
- **understanding and minimizing related fees and costs,**
- **staying calm and rational during the market's many ups and downs, and,**
- **managing long-term risk.**

With family budgets strained across the country, finding the best ways to make saving for retirement more affordable can create significant benefits for individuals, businesses and governments. Without enough retirement savings, we run the risk of facing financial pressures in retirement and are more likely to depend on taxpayer-funded support.

The different approaches

When thinking about the ways Canadians save for retirement, our research shows that we typically take one of five investment approaches that offer a range of efficiency. The approaches range from a completely individual, do-it-yourself approach, to collective savings arrangements, such as small employer group RRSPs or Canada-model plans.

Although the individual approach is generally considered the least efficient, and thereby the most expensive, of the five approaches, for about half of Canadians, it's the only option: they do not have access to collective or workplace plans. The full responsibility of saving, managing risk and making investment decisions are made by the individual, with or without any expert advice.

Small and larger employer plans have the advantage of pooling the assets of their members, increasing economies of scale and reducing fees and costs; but in most scenarios, the employees (or members) are still left with the decision of how to invest their money.

Large-scale pooled plans and Canada-model pension plans also combine their members savings but have the benefit of being large enough that they can spread their costs across a greater number of members; this lessens the cost impact on each member. Many workplace pension plans fall into this category. While Canada-model pension plans may be the most efficient of the approaches and the best equipped to manage the risks of saving for retirement, they are not available to all Canadians.

The five value drivers of retirement savings

In our recent study *The Value of a Good Pension*, we took a very close look at the efficiency and affordability of retirement in Canada. The report highlighted that the average worker saving for retirement individually will need to save $1.2 million during their working years to replace 70 per cent of their income in retirement. That's a daunting task on its own even before you factor in the daily living expenses that compete for limited available dollars. That's why it's even more important to find ways to lower the cost of providing you with a comfortable future, while allowing you to keep more money in your pocket today.

As part of the study, we identified five value drivers that can help shift your retirement savings from 'park' to 'drive' by making your money do more and go further. These value drivers can be found to varying degrees in each of the five investment approaches discussed earlier. The drivers are:

- **Saving**
- **Fees and costs**
- **Investment discipline**
- **Fiduciary governance**
- **Risk pooling**

Combining as many of these drivers as possible into your investment approach can drastically reduce your cost of retirement. In fact, our research shows that when used together, the five value drivers can reduce the cost of retirement by almost $900,000 – a significant amount by any means.

Let's take a closer look at the individual drivers, and how each one can help on the path to a more affordable retirement.

The five value drivers

Saving

Be a disciplined saver.

"Saving," in the context of this conversation, is our ability to put money away for retirement. On the surface, that seems like the first step in a relatively straightforward process: put money away, grow that money and then use the money for a comfortable retirement. However, there are many factors that impact our ability to effectively save. Wage changes, life events, spending habits, focusing on current needs and a lack of financial knowledge can influence our ability to build our savings in a consistent way.

Finding a way to save early, save consistently and protect those savings can significantly reduce the overall cost of your retirement and enhance your ability to retire comfortably.

Those factors, and many others, influence those attempting to save on their own. The results: individuals often save later, save less consistently, and withdraw from their retirement savings far too often. That means they are saving much less than is required during their working years and allowing less time for their money to benefit from the power of compounding returns. Unfortunately, that can compromise their ability to retire as planned.

Fees and costs

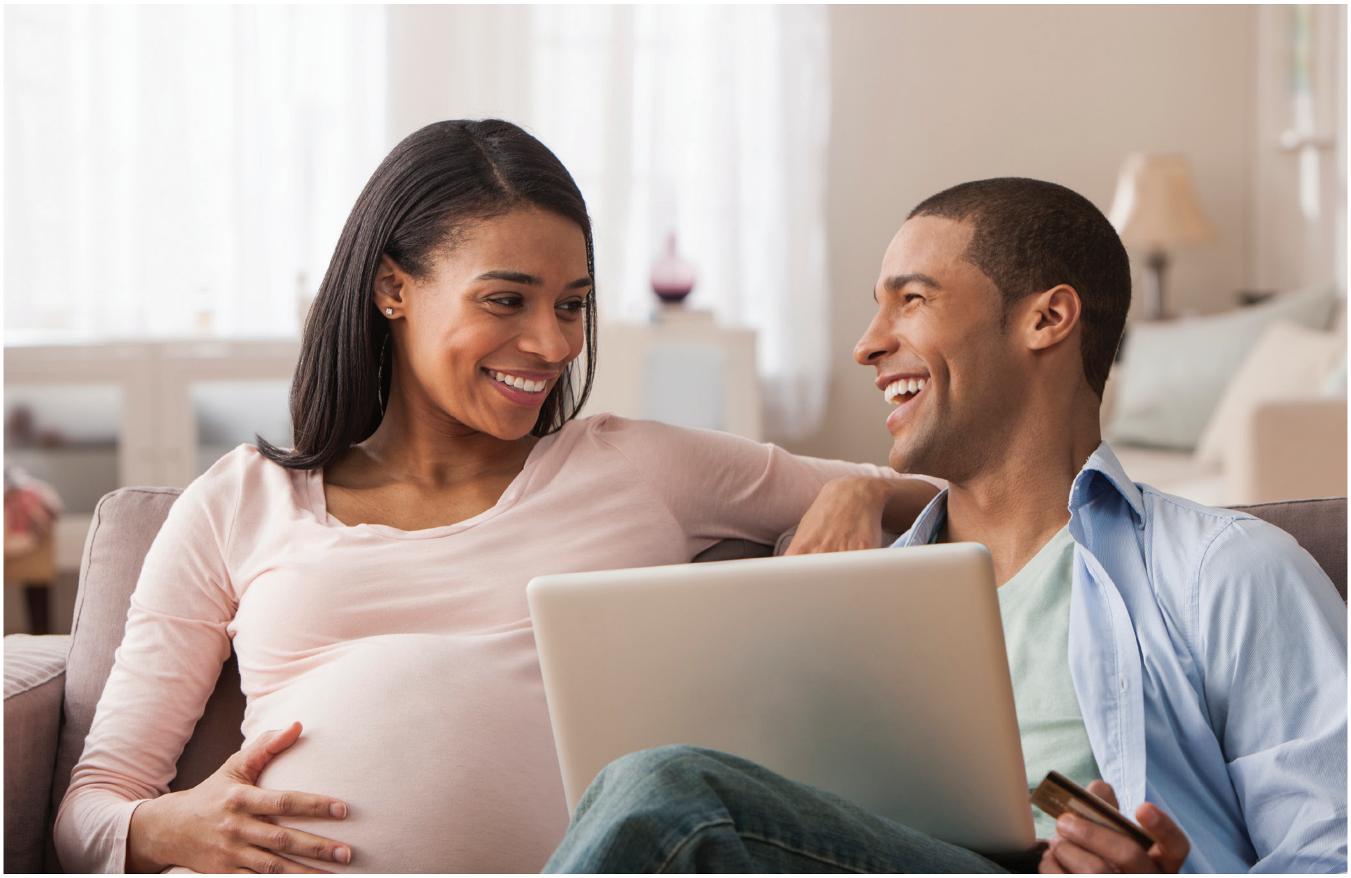
Keep more money in your pocket.

As retirement savings start to accumulate, individuals need to decide how that money will be invested. In many cases, these savers are directed into mutual funds and other products which often carry high fees. In fact, Canada has among the highest mutual fund fees in the world. Over a lifetime, these fees can significantly reduce your overall returns.

To put this in perspective, our research shows that investment fees and costs can reduce an average worker's retirement savings by as much as $275,000 during their working years when compared to a Canada-model pension plan.

You've no doubt heard the expression, "Watch the pennies and the dollars will take care of themselves." The same can be said about fees and costs. Lower your fees and costs and keep more of your money working for you.

Although trying to get the most value for the fees you pay is important, not seeking professional investment advice simply to avoid paying a fee can be riskier and costlier to you in the long run. The goal should be to reduce expenses responsibly, not eliminate them completely.



Investment discipline

Avoid bad behaviour.

Studies show that when it comes to investing, individual investors "have a striking ability to do the wrong thing."[1] Managing a retirement fund over a working career requires a level of investment discipline to avoid many of the psychological traps that frequently plague investors.

By exercising these or any other bad behaviours, individual investors can compromise their returns over the long run. Our research shows that over a lifetime, this can cost the average Canadian $116,000 in lost performance.

Having professional money management is a great way to stay disciplined. When the experts do the heavy lifting, you have more time to focus on saving, and enjoying life.

[1] Andrea Frazzini and Owen Lamont, "Dumb Money: Mutual Fund Flows and the Cross-Section of Stock Returns" (2008)

Here are four of the most common 'bad' investor behaviours:

Buy high. Sell low. The temptation to invest more when the markets are doing great, and to pull money out when markets are doing poorly, can be costly over the long term. Most investors don't have the courage or discipline to sell when markets are high and buy when markets are low.

Overconfidence. People are known to overestimate their investment abilities. Investors can sometimes feel that having more control can lead to better results. In fact, overconfidence can lead to riskier trading behaviours such as trading too much or trying to time the market.

Loss aversion. The reluctance to face a financial loss, at its extreme, can negatively impact a person's ability to reach their financial goals. For example, an investor may have a stock that just fell 30 per cent due to bad news; although the best decision may be to sell and take a loss, a loss-averse investor may continue to hold the stock indefinitely in the hopes that the price will bounce back.

Market timing. We are not capable of seeing the future, yet there are many investors who believe in their ability to forecast the future of an investment or the market in general. Trying to time the purchase or sale of an investment can be quite risky, and typically produces poor results.

Fiduciary governance

Putting investor interests first.

Trust is the basis of personal relationships, and it is just as important in financial relationships. Individuals managing their own money will try to do what's best for them financially, but when working with outside advisors, fiduciary governance lets savers know that their interests are legally required to be put first. Having your money managed by experts at a non-profit institution that has a fiduciary duty to member investors can generate better results than retail funds managed under a profit-driven model.

Funds that combine good governance, a non-profit structure and in-house professional investment management have been able to consistently outperform funds that lack such features.

Strong non-profit governance generates value for members by ensuring that investments serve the best interests of members, rather than shareholders (as with most retail fund governance structures). Our research shows that the benefit of strong governance can result in improved long-term performance.

Risk pooling

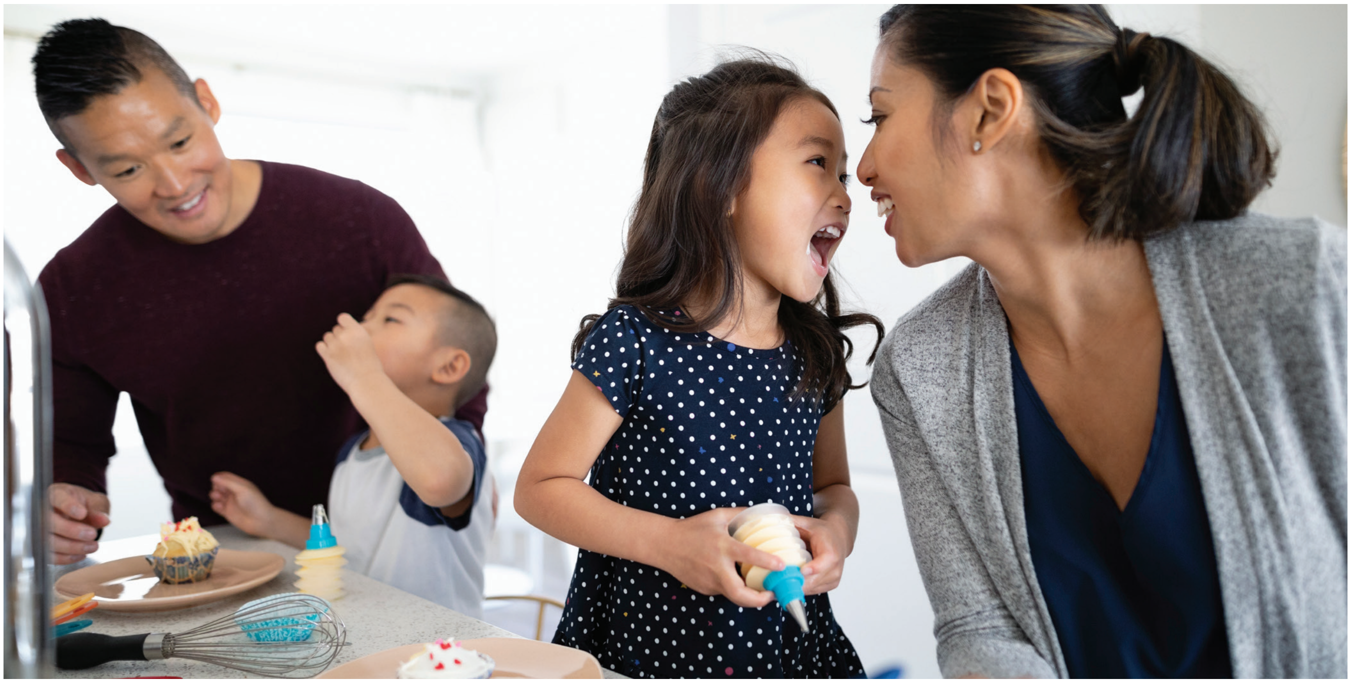
There's strength in numbers.

The final value driver also happens to be a core feature of the insurance industry: risk pooling. Although it sounds complicated, it amounts to combining money with other investors in a single pool, with the goal of reducing risks – specifically, longevity and investment risk.

Longevity risk is the risk of individuals outliving their retirement funds. Individual savers need to manage their retirement funds without knowing how long they'll live. As a result, many individuals need to plan for a longer-than-expected life for fear of outliving their retirement assets. On the other hand, Canada-model plans eliminate the tendency to oversave for retirement by pooling longevity risk and managing for the average life expectancy of all members.

Similarly, with *investment risk*, individuals saving for retirement need to prepare for their own individual outcomes by investing their money appropriately to reach their goals. For many, that means investing more conservatively as they age, for fear of being unable to recover from a big loss. But taking less investment risk also means sacrificing potential investment returns.

Risk pooling, of all five value drivers, has the largest impact on retirement savings and, according to our research, it can reduce the amount individuals need to save over their working life by almost $400,000. Managing risk is a challenge for teams of professionals let alone for individuals, but when pooling longevity and investment risk across a broad group of investors, it becomes more manageable.



Conclusion

➤ Alone we can do a little; together we can do so much more.

When used in combination, the five value drivers can significantly enhance the ability to save for retirement, with lower costs and more "bang for the buck." The value of the five drivers is in their ability to make each dollar of savings go further in retirement. In the most efficient arrangement, Canada-model pension plans, individuals need to set aside almost $900,000 less over their working years compared to the do-it-yourself approach.

To help individuals without employer plans save for retirement requires more support from all stakeholders, including businesses, governments and non-profit organizations. The benefits of implementing policies to encourage more affordable retirement saving solutions will positively impact Canadian workers and employers, as well as the overall economy.

Reducing the costs for government and taxpayers

The rising cost of retirement means fewer people will be able to fund their retirement on their own and will ultimately need the government's assistance. Government benefits for elderly Canadians are projected to grow from $51 billion in 2018 to $67 billion in 2023.

By doing more with less, a strong employer pension that leverages the five drivers is the most cost-effective way for individuals to generate retirement income. People with adequate retirement income are less likely to require any government assistance while in retirement. However, for those without a workplace retirement plan, there are still options.

What individuals can do

If you are part of the 50 per cent of Canadians who, for a variety of reasons, are saving on their own, implementing one or more of the five values drivers can help make each saved dollar go further.

For example, you could jumpstart your savings by setting up an automatic savings program through your bank. In that type of arrangement, a designated amount of your funds would be transferred into a savings account, on a schedule that works for you (e.g., each time you get paid). Starting to save regularly and consistently is half the battle.

Once you've created some discipline around saving, you can begin to focus on how to invest your nest egg. At this stage, you'll need to keep the second value driver in mind: managing fees and costs to get the most value for the fees you pay.

Combining the first two drivers will get you saving and investing, while the third driver aims to make investing unemotional and disciplined. Using the services of a professional advisor to help you plan for retirement, and manage your retirement funds, can help keep you on the right path. They can also help you maintain your investment discipline by presenting you with options and helping you avoid bad investor behaviours.

How we're helping

Knowing that half of Canadians are saving on their own without access to, and the benefits of, a collective savings arrangement, HOOPP is committed to helping those individuals through education and advocacy. Part of our efforts include providing all Canadians with the information they need to help them make smart retirement savings decisions.

Education about the five value drivers is meant to start the conversation, but it is only one facet of our approach to helping Canadians. We recognize that information and education alone are not enough to make retirement security attainable for the majority of Canadian workers. And, while having strong workplace retirement arrangements is a reliable way to deliver retirement security for the working population, these types of collective plans are not accessible to all Canadians. To help mitigate the lack of access to the value drivers of fiduciary governance and risk pooling, part of our strategy is to build working relationships with governments.

By engaging in a constructive dialogue with essential stakeholders, we can help create a consensus around the need for more accessible and affordable retirement savings options for all Canadians. We can also emphasize the need for policymakers and regulators to promote the value of good governance and fiduciary standards.

In addition, we are working hard to help governments understand the importance of scale and portability in retirement savings plans. Those factors play an important part in keeping plan costs down, which can lead to greater adoption by companies and more access for Canadians. We believe the current trend of single-employer pension plans merging with existing multi-employer plans is a clear recognition of the value and impact of scale, and we are confident that it is a positive development for Canadians.

Working together to find solutions

By working together, we can improve retirement affordability for everyone. Where individuals can start using the five value drivers to get more out of their savings, we can help by bringing all government, employers and employees together to the table. Through research, discussion and dialogue, we can help meaningfully improve the retirement security of all Canadians.