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HOW DO WE ADDRESS THE MOBILITY PROBLEM?

Job mobility makes the replacement ratio convention particularly problematic. Most members are unlikely to retire with 40 years of service from one employer, so it becomes even more difficult to assess if their financial position at retirement is attributable to the retirement goal that any particular fund used along the way. It is arguable that a goal designed to be met over 40 years is of little practical use in a world where the average service period of an employee at any particular company is three years[15].

One way to address the impact of high employee turnover is to have a standard target that all funds will aim to achieve for their members. This is not a new concept since many South African funds now target a replacement ratio of 75%. However, complications arise when we consider the fact that pensionable salary definitions vary across funds. This means that if we consider the target as a percentage of an individual's pensionable salary, the true amount that funds are targeting can end up being quite different from one fund to the next. Setting an arbitrary target of 75% of pre-retirement earnings also ignores the consumption and expenditure pattern of fund members.

We therefore propose that rather than standardise the number that all funds should target, we should standardise the approach to calculating the target. A consumption smoothing model can be used to solve simultaneously for the contribution rate and the target that the fund will aim to achieve. The advantage of a consumption smoothing model is that it looks at the spending patterns of members and aims to give them a post-retirement income that will continue to support that spending.

The added value of the consumption smoothing model is that it also solves for the required contribution rate.

Rather than using replacement ratios as our measure for the target, we propose the use of a wealth-earnings ratio. Targets like this are easily communicated and easily aggregated across different funds. And if all funds use the same approach to setting the target, the investment strategy and fund design used to achieve that target should not vary too much between funds.

The consumption smoothing model will require information about fund salaries, salary increases over time and the normal retirement age. And when we consider the different income requirements of individuals we find that the wealth-earnings ratio that they require can vary from person to person. For instance, a person with higher housing values may have a higher target[16]. As such, the model may have to be run for distinct categories of workers, making the target even more specific.

However, this specific approach looks solely at the outcome the retirement fund must deliver and does not aim to optimise the allocation of contributions towards protection and saving at each point in a person's life cycle. For this we will need a more holistic measure of a person's needs.

So in summary, a consumption smoothing model helps us to establish a target. That target can be in terms of a replacement ratio or a wealth-earnings ratio. But because wealth-earnings ratios are easily communicated to ordinary fund members, we suggest the use of this measure when calculating targets.

15 Member Watch™ 2012 data set
16 Butler (2013)