Case study 2

MAKING PROJECTION STATEMENTS MEANINGFUL

Providing projection statements is non-negotiable. Not, perhaps, in the eyes of the regulators. Even PF130 makes no mention of this requirement. But if we are going to give members a sense that they are on a journey, that there is most decidedly a specific goal, and that from time to time we may overshoot that goal or undershoot it, then we had better give considerable thought to how we are going to present that information. If we can get members to engage in the progress they make on that journey and act when they need to to keep them on course, then we can gain significantly greater certainty that:

- They won't abandon that journey. (because they don't understand where they are)
- They won't be surprised by the outcome.

So, we have a choice. We can treat communications as part of our fiduciary duties and consider our duty done when we comprehensively tell employees how we invest their retirement savings. Or we can think of retirement funding as an ongoing, interactive process that uses communication to keep the member an active participant in the conversation. This is not the same discussion as our discussion on choice[18]. Here we are addressing the reality that individuals tend to have problems determining how best to tackle a problem that has many moving parts with huge consequences on outcomes that only materialise decades in the future.

We know that when members are confronted by the complexities of retirement planning, most do nothing. Inertia tends to be the dominant emotion. But we also have serious doubts about whether the 'set-it-and-forget-it' approach to retirement investing necessarily works anymore. Can we actually afford to be horribly wrong with members' outcomes?

The dynamic we believe is worth exploring is more closely aligned to the thinking around 'smart defaults' in **Part 2, Chapter 3**. Individual preferences are not likely to be stable over time. The decision maker will have different preferences over the same future plan at different points in time[19]. We need to be able to accommodate this. This is covered in more detail in **Part 2, Chapter 10.**

As Create Research's report *A 360 Degree Approach to Preparing for Retirement* highlights: ***"key decisions are not single events like buying a house. New decisions are often forced by changes in job, family, health or market situations[20]."***
So, how do we help members to engage in the journey and respond when it's clear that they need to respond? Members need to understand:

- What does their future potentially look like?
- Are they on track for getting the income they need in retirement?
- How much uncertainty is in these projections?
- What can they do if they are off track?

This means that while members most definitely need to see current basic information that the regulators require such as asset allocation, contributions, investment performance, fees and any new developments in the fund, they also need forward-looking information.

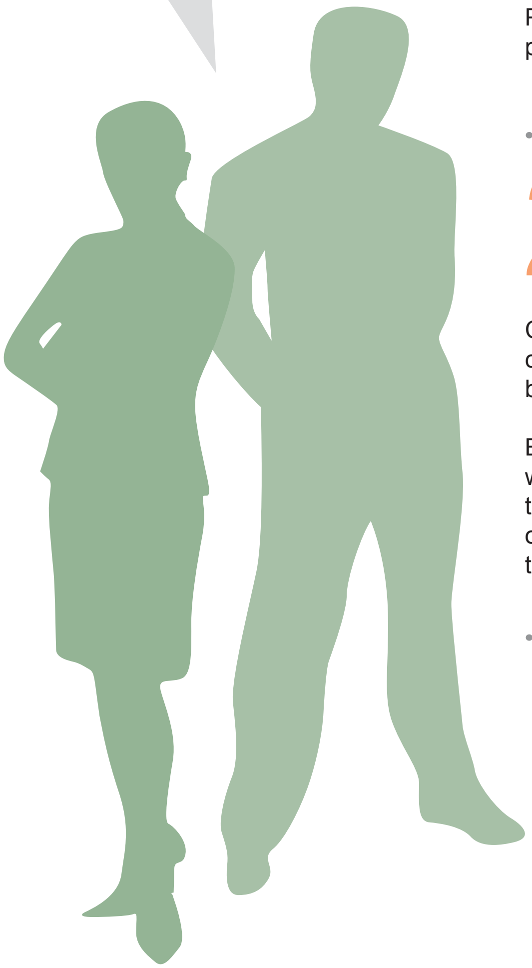
A projection statement combines both what the member has already achieved and an expectation of what they could achieve in the future.

So, how do we do this?

18 *Benefits Barometer 2013*, pages 80-88
19 Laibson, (1997)
20 Rajan (2013)

To make projection statements meaningful, consider the following:

1. Don’t show members their total fund credit at the top of the page.
2. Avoid performance graphs that have little connection to member realities.
3. Help members understand uncertainty.
4. Give them options on what to do to improve outcomes.



1 DON’T SHOW MEMBERS THEIR TOTAL FUND CREDIT AT THE TOP OF THE PAGE

Take a few minutes to think about this. If I told you that you have a fund credit of R1.6 million, how would you feel? Excited? Sounds like a lot of money? Feel like you’re, well, a millionaire?

And yet in *Benefits Barometer 2013* we pointed out that you will need R1.6 million to cover just your post-retirement comprehensive medical care requirements - only that!

People don’t understand large numbers, particularly when those numbers need to be allocated across another 20 to 25 years for your living costs.

How do we make this ‘conversation’ with the member more meaningful? The answer is to convert that fund credit into a post-retirement monthly income (in today’s terms). People understand what they need to live off monthly. And by comparing their current expenditures to what they’ll need to pay for post-retirement, they can get an immediate sense of whether they’re in trouble.

2 AVOID PERFORMANCE GRAPHS THAT HAVE LITTLE CONNECTION TO MEMBER REALITIES

Cumulative performance graphs are the common currency of performance report-backs to members.

But what exactly could a member do with that information? Are they winning the war on retirement income? Does this outperformance have anything to do with their ability to retire? The most important information that’s missing here is exactly what kind of an income they can buy given whatever gains they received. Is that not the most important information a member needs to act on? Outperforming benchmarks is a meaningless consideration if that benchmark has no bearing on where members need to get to.

3 HELP MEMBERS UNDERSTAND UNCERTAINTY

Much of the concern about projection statements is driven by the number of risky, uncertain variables that will likely influence outcomes. If projection statements are deterministic, and the majority of them are, then the projection could become confused in the member's mind as holding out some future promise. A number of providers integrate scenario stress tests into their projections to try and convey the magnitude of this uncertainty.

In theory, the more robust way of conveying projection information is to use stochastic modelling. Here, members would be given a range of probabilities for each of the outcomes. While this modelling is more likely to capture a real-world outcome, probabilities are notoriously difficult concepts for members to properly respond to.

When Pablo Antolin and Olga Fuentes developed the pension risk simulator for the Chilean market, they found that participants had difficulty understanding what confidence intervals and probability distributions were exactly[21].

That said, understanding that there is a substantial amount of uncertainty in these projections is perhaps the most important message that we can convey to the member.

Here is where visual representation of concepts can be critical. It is far easier to convey a message of variability of outcomes or probability of events with simple graphic representations than it is to have someone correctly internalise that 'two out of seven times your fund may lose as much as 20% of its assets'.

4 GIVE THEM OPTIONS

If the annual report to a member is not a happy message, what then? "Contact your financial planner" is not particularly helpful. In truth, it's a commercial. So should we get the board of trustees to hire new fund managers? Even if they do, that's unlikely to improve the news.

Poor replacement ratio outcomes are typically driven by lack of preservation, inadequate contribution levels, low pensionable pay or retiring too early. What members need is feedback on how any changes in those parameters would improve their situation.

If we want members to improve their contribution rates, we need to show them the impact of doing so. What happens if they increase their pensionable pay or contribution rate? What happens if they delay their retirement by a few years? What happens if they preserve their savings between jobs?

Research[22] shows that even simple projection statements that highlight when a member is off track and how to get back on track, can help improve decision making. So, getting projection statements right can make a difference!

21 Antolin & Fuentes (2012)
22 Goda, Manchester & Sojourner (2012)