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Friday, Oct. 09, 2009

Why It's Time to Retire the 401(k)

By Stephen Gandel

Retiree Robert Shively spends his days on the golf course. For many, that would be a dream come true, but not quite in the way Shively does it. The 68-year-old is the cart mechanic at the Niagara Falls Country Club.

Two and a half decades ago, his then employer, Occidental Petroleum Corp., cut its traditional defined pension plan in favor of a 401(k)-type system. So instead of getting a guaranteed pension check of \$1,308 a month for his 36 years as a full-time, salaried employee, the former chemical-factory worker receives \$225 a month from his 13 years as an hourly employee, plus \$180.16 a month from a profit-sharing plan Oxy had for salaried employees until 1994. He also has \$70,000 left of the money he saved from his tax-deferred 401(k). On the days he works, Shively rises at 5 a.m. to get to the golf course. He mostly enjoys the job. But on tournament mornings, he has to be at the course at 4 a.m. A few years ago the country club switched from gas to electric carts, some of which have four 84-lb. batteries each. Every year, Shively and another worker have to lift out all the batteries and store them for winter. "Your body aches all over," he says. ([See 10 perfect jobs for the recession — an after.](#))

This isn't how retirement was supposed to be.

If you have even peeked at your account statements in the past year, it's painfully obvious that something is wrong with the way we save. The tax-deferred 401(k) plan, and others like it, such as the 403(b) and the IRA, have become our nation's go-to retirement piggy bank. Invented nearly 30 years ago as an executive perk — one more way to dodge Uncle Sam — the 401(k) was never meant to

replace the employer-guaranteed pension fund, supplemented by Social Security, as the cornerstone of our nation's retirement system. But propelled by a combination of companies looking to cut costs and consumers who wanted control of their retirement destiny, that's exactly what happened.

The ugly truth, though, is that the 401(k) is a lousy idea, a financial flop, a rotten repository for our retirement reserves. In the past two years, that has become all too clear. From the end of 2007 to the end of March 2009, the average 401(k) balance fell 31%, according to Fidelity. The accounts have rebounded, along with the rest of the market, but that's little help for those who retired — or were forced to — during the recession. In a system in which one year's gains build on the next, the disaster of 2008 will dent retirement savings long after the recession ends.

In what must seem like a cruel joke to many, the accounts proved the most dangerous for those closest to retirement. During the market downturn, the 401(k)s of 55-to-65-year-olds lost a quarter more than those of their 35-to-45-year-old colleagues. That's because in your early years, your 401(k)'s growth is driven mostly by contributions. You control your own destiny. But the longer you hold a 401(k), the more market-exposed it becomes. It's a twist that breaks the most basic rule of financial planning. ([See 10 ways Twitter will change American business.](#))

The Society of Professional Asset-Managers and Record Keepers says nearly 73 million Americans, or just under 50% of our working population, now have a 401(k). And collectively we pour more than \$200 billion into these accounts each year. But retire rich? Don't bet on it. The average 401(k) has a balance of \$45,519. That's not retirement. That's two years of college. Even worse, 46% of all 401(k) accounts have less than \$10,000. Today, just 21% of all U.S. workers are covered by traditional pensions, and the number shrinks every year. "The time may have come to consider returning 401(k) plans to their original position as a third tier of retirement planning, behind pensions and Social Security," says Alicia Munnell, who heads the Center for Retirement Research at Boston College. "They should not be the thing we rely on for retirement security." And the government seems to agree. This summer, the Government Accountability Office concluded, "If no action is taken, a considerable number of Americans face the prospect of a reduced standard of living in retirement." That's what is known as an understatement.

The 401(k)'s defenders say bad markets don't make the accounts a bad idea — and that it's still too soon to tell whether they work. Many companies adopted them less than 20 years ago. Even then,

most firms (including mine) still provided pension plans to their workers. So boomers retiring now were never focused on piling money into 401(k)s. In order for the plans to succeed, workers have to stash savings regularly for about 30 years. Most accounts haven't been around that long.

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One exception is Occidental Petroleum. In 1983 the energy and chemicals giant, then No. 14 on the *Fortune* 500, became the first large company to toss its pension and switch to a defined-contribution 401(k)-type system. That was at least a decade before most other large companies made a similar switch, which makes the experience of Oxy Pete and its employees an ideal window on the 401(k).

We talked to nearly two dozen former Occidental employees. All of them are alumni of the company's chemicals division and worked in a Niagara Falls plant. Not all are 401(k) disaster stories, and most had good things to say about Oxy Pete. Some said they were very happy with their 401(k). Jim Maul, 70, has two cars and a boat and travels regularly. (See 10 big recession surprises.)

But all the people who shared their financials with us would have been better off in a pension. And nearly all of them, save possibly Maul, do not have the resources they need to live another 20 years in financial comfort. "It's the biggest scam ever put over on the American people," says Dennis O'Neil, a former human-resources executive who worked for Occidental for 29 years.

The idea that we could ever save enough to pay for 30 years of leisure is a relatively recent invention. An entire profession, financial planning, is dedicated to telling people they can, and must, pay for their own retirement. A 401(k) is usually a central part of those plans. Even for people who don't have enough money to send their kids to college or buy a home, building their 401(k), they are told, is their first priority. It's not terrible advice. The accounts grow tax-free, though you have to pay Uncle Sam's levy when you cash out. Unlike health coverage, you don't lose your 401(k) when you lose your job. And once you set the account up — a minor task at most companies — it's automatic, making it an easy, thought-free way to save. Indeed, Americans have more saved specifically for retirement than ever before. But the past year has shown that even with our added savings, we are at much greater risk today of our bank accounts running empty than when employer-guaranteed pensions were the norm. By Munnell's calculations, 44% of all Americans are in danger of going broke in their postwork

years.

A Brief History of the 401(k)

Congress was trying to close a loophole on executive bonuses when it created the 401(k). Most companies intended 401(k)s — which were originally called salary-reduction plans but then renamed for the portion of the tax code that makes them possible — to be a perk for highly paid executives, not a pension replacement. That's because lower-paid employees probably could not afford to defer a portion of their paychecks. So companies held on to their pension systems even as they added 401(k)s, which by law they had to make available to all employees. When the market took off in the 1980s, the rank and file clamored to get in. ([Read why older workers are happier.](#))

With a 401(k), contributions came out of your pay but were not taxed, and you had control of them. Contributions could be added or suspended. Best of all, when you left your company, your 401(k) traveled with you, removing a penalty for switching jobs that had been built into the pension system. On the corporate end, a change in accounting rules made the growing cost of pensions more apparent to shareholders. Cutting the pension was a guaranteed way to improve the bottom line. The rise of the 401(k) began.

Around the same time, Occidental was having problems. In the late 1960s the company bought Hooker Chemical Co. in an effort to diversify. But in the 1970s, allegations surfaced that toxic waste that Hooker dumped into the ground during the 1940s and early '50s was causing severe health problems in Niagara's Love Canal neighborhood. Oxy Pete needed cash to shore up this and other problems, and its CEO, Armand Hammer — flamboyant, powerful and ultimately corrupt — came up with a solution: raid the retirement kitty. Amazingly, this was legal at the time, and Hammer wasn't alone in doing it.

High interest rates in the inflationary 1970s produced solid returns for Oxy's bond-heavy pension fund — so much so that Oxy's accountants figured the plan was overfunded by \$600 million. For Oxy to get at that cash, pension laws required it to close its fund and start again. It did so with a far cheaper option: the employee-funded 401(k). The company made it clear that with the high interest rates at the time, Oxy employees could see their 401(k) account balances soar with little risk. Few doubted it — Oxy, like most other big companies of that era, had always taken care of its own.

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At first, Occidental's union workers were not allowed into the plan. So when Ernie Lucantonio was offered a supervisor job in the fire-retardant division at Occidental, part of the reason he took it was to get into the 401(k). "The 401(k) forced you to save money, because you couldn't touch it," says Lucantonio. "I was making good money, but I wasn't saving anything. I had three kids going to college. So the 401(k) forced me to save, which I needed." (See pictures of the college dorm's evolution.)

After 34 years, he left Oxy in 2005. Lucantonio, 61, is proud of what he has been able to afford in retirement. He and his wife bought a cabin in New York's hilly Southern Tier. "It's even got ceramic tile in the kitchen," he says. He would like to spend more time there, but like many other former Occidental employees we talked to, he's had to unretire into a new job. He is a real estate agent.

If Occidental had stuck with its pension plan, Lucantonio might not have to work. When he retired, he had a salary of nearly \$80,000. That means he would have received a pension check of about \$3,100 a month. It would be nice if 401(k)s could produce a guaranteed check as pensions do. But most 401(k)s don't generate enough income, and Lucantonio's is no different. He retired from Occidental with \$350,000 in his 401(k). That's a hefty sum, but he can withdraw just 4% of it annually, or about \$1,200 a month, to limit the chances of outliving his money. That's 60% less than what the traditional pension would have paid him.

Dennis O'Neil plays the part of a former HR executive well. You can find O'Neil, who left Oxy on disability a few years ago, on a golf course, clad in picture-perfect golden-years attire: a black Izod shirt with white shorts, faux-alligator-skin cleats, Ray-Bans, a gold shamrock hanging from a gold chain on his neck and a black baseball cap. But O'Neil's retirement outlook is growing darker every day. He once made a six-figure salary, but the 63-year-old is fairly certain that his savings won't be able to sustain him for very much longer. He has some \$500,000 left in his 401(k) and spends about \$75,000 a year. At this rate, he worries he will tap out his retirement savings within the next decade. (See 10 things to buy during the recession.)

Unless, as O'Neil's thinking goes, he can make something happen in the stock market. So he spends much of his day watching CNBC. "Right now, I want to know which area of the economy is going to recover first. Will it be retail? Commodities? Energy?" says O'Neil. Playing the market is probably the wrong thing to do, but he got divorced eight years ago, depleting a good portion of his savings, and

his medical bills are likely to go up soon. O'Neil is going blind from histoplasmosis. These days he has to golf with a friend. He would like to buy a house in Florida before he loses his eyesight completely, but he just can't afford it.

Under Occidental's old pension plan, he would have gotten a monthly check of about \$2,200. More important, he wouldn't have to spend much of his remaining eyesight squinting at CNBC, wondering how he will afford the rest of his life. The pension check would have been guaranteed until he died. "I'm a pretty optimistic guy, but I'm still worried," says O'Neil. "Ten years from now, where am I going to be after I burn through the cash?"

Where 401(k)s Go Wrong

In theory, 401(k)s should provide much more of a retirement cushion than they do. A 2007 study from the National Bureau of Economic Research (NBER) estimated that, on the basis of historical returns, by 2040 the average 401(k) of a near retiree would grow to an inflation-adjusted \$451,944. That money, spread over 30 years, could replace at least 50% of the average retiree's income. Add Social Security and even highly paid workers will probably earn more than 80% of their preretirement income. "The only reason these accounts haven't lived up to their potential is that they haven't gotten enough time," says James Poterba, president of the NBER, who co-authored the study ([See 25 people to blame for the financial crisis.](#))

In practice, 401(k)s haven't been nearly so rewarding. When Boston College's Munnell looked at the returns 401(k)s have actually produced compared with the projections, the difference was sobering. The average 55-to-64-year-old should have a 401(k) balance of \$320,000. In fact, at the end of 2007 the average 401(k) of a near retiree held just \$78,000 — and that was before the market meltdown.

Why don't these accounts amount to much? Munnell found a number of reasons. Some people don't contribute as much as they should — essentially ignoring free money from company matches and tax relief. And, as the original engineers of the 401(k) suspected, the less you earn, the less you are likely or able to contribute. For most employees, the maximum contribution to a 401(k) is \$16,000 annually. She found that just 5% of people earning \$80,000 to \$100,000 maxed out, compared with 30% of those making \$100,000 or more.

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Additionally, to get the hypothetical higher returns over time and avoid investing disasters, you have to hold a diversified portfolio of stocks and bonds. Many of us don't. Munnell found that 14% of workers held no stocks at all, leading to weaker-than-average returns. On the opposite end, more than a quarter of all 401(k)s were 100% stocks, exposing those accounts to big losses when the market dropped.

Earlier this year, mutual-fund company T. Rowe Price tried to determine the optimum retiree portfolio — the mix of stocks and bonds that would produce the highest returns without the risk of the nest egg running out. To do this, the analysts ran something called a Monte Carlo simulation, which mimics the real-life ups and downs of the market. Most of the time, the market goes up slightly. But some years — *ka-pow!* — stocks and bonds do spectacularly poorly. What T. Rowe Price found should frustrate anyone who has spent time wondering if 25% of a portfolio should be in international bonds or small-cap stocks. No portfolio is 100% safe from disaster. (See pictures of the stock market crash of 1929.)

Trying to boost returns by adding stocks can make matters worse. Even if you withdraw a mere 4% a year from your 401(k) and have an ultraconservative portfolio of 80% bonds and 20% stocks, you still have a chance of outliving your retirement account. Swap the bonds for stocks, and the chance of outliving your money actually rises. In reality, most of us don't have nearly enough in our 401(k) to live off just 4%. At a 6% withdrawal rate, hypothetical retirees in more than a third of the Monte Carlo simulations crapped out.

Saving more, another common prescription for fixing the 401(k), has its downside too. That's because of another unpleasant quirk of the 401(k), which was mentioned earlier: the older you are, the riskier a 401(k) gets. That's because contributions make up a very big part of the account's growth in the early years. Later on, once the account has grown, it is much more sensitive to market drops.

Imagine a worker who earns \$100,000 a year for 30 years. Each year she puts 5% of her income into her 401(k). Through most of her working life, the market does pretty well, boosting her diversified portfolio 5% a year on average. When she retires, our worker will have \$332,194 in her account. Now imagine a second, thriftier worker contributing 7.5% of his salary, or \$2,500 more a year, to his 401(k). But in this scenario, the market does a 2008 in the last year before he retires, and his account drops 30%. Result? Even after saving 50% more a year for 30 years, worker No. 2 ends up with a

balance of \$327,194 — \$5,000 less than the first worker.

The 401(k) Alternative

So what can be done to fix our retirement-savings mess? Most of the proposed fixes to our retirement plans have to do with getting people to save more or invest better. The most popular solution is the so-called automatic 401(k). Under that plan, all workers would be enrolled in 401(k)s when they're eligible. Companies would establish default settings to boost returns and make the portfolios safer as workers near retirement. People who worked for companies that didn't offer 401(k)s would be automatically enrolled in savings accounts. In other words, make inertia work for employees, not against them. However, a number of economists and policy experts think that while those changes would help, upgrading the 401(k) alone won't save the nation's retirement-savings problem. ([See pictures of the recession of 1958.](#))

Here's why: Remember, the biggest factor in whether the 401(k) works as designed has to do with *when* you retire. If the market rises that year, you're fine. If you retired last year, you're toast. And the chances of your becoming a victim of this huge flaw in the 401(k) plan are pretty high. The market fell in four of the nine years since the beginning of the decade. That means anyone retiring this decade had a nearly 50% chance of leaving work in a down market. In fact, your chances of retiring into a down market are even greater than that: forced retirements spike in recessions just as the stock market is tanking.

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The solution: a new type of insurance. Retirement savings, it turns out, are exactly the type of asset we need insurance for. We need insurance to protect against risks we can't predict (when the market collapses) and can't afford to recover from on our own. "People tend to meld savings and insurance in their mind, but they are not substitutes," says Nancy Altman, a former Harvard professor and the author of *The Battle for Social Security*. "It's fine to have a savings plan as a supplement but not as the main retirement protection for everyone." She says the best way to guarantee a replacement for people's wages in retirement is by pooling risk, and the way to do that is through insurance.

Altman is not alone. Teresa Ghilarducci, an economics professor at the New School, has proposed a

plan in which the government would divert 5% of everyone's wages. In return, you would be guaranteed in retirement a check for 26% of your final salary every year until you died. Altman would also like to expand Social Security to pay an additional 20% of workers' final pay. It's unlikely Congress would go for that at the moment.

But guaranteed accounts don't have to be run by the government. The ERISA Industry Committee (ERIC), a group that represents the nation's largest employers, has proposed a system of exchanges that would allow individuals the ability to buy a guaranteed retirement account on their own. Some government regulation would be needed, but it would be a private plan.

What the ERIC plan and others like it are essentially proposing is a form of retirement insurance. So instead of putting 6% of your salary into a 401(k) or some other investment account, each pay period you would send 6% of your check to a retirement-insurance provider. The policy would work similar to a traditional pension in that it would provide a guaranteed monthly check equal to about a quarter of your final pay, from when you quit working until you die. Some employers might even be willing to pay the annual premium as a perk. If not, employees would pay for it much as they currently fund their own 401(k)s. But the policy would be portable. Contribute for 30 years and you would be guaranteed income in retirement, no matter how many employers you worked for. Combine your retirement-insurance check with the money you get from Social Security, which can equal as much as 50% of final pay, and presto: you have something approaching retirement security. ([See the best business deals of 2008.](#))

Would it be feasible, politically or otherwise, to get people to dispense with their 401(k)s? Corporations, for one, are not the least bit interested in taking on pensions again — the cost would be enormous, and the expense makes them less competitive globally. "There are people in the Obama Administration who are supportive of some kind of guaranteed system," says Dean Baker of the Center for Economic and Policy Research. "People should not have to shoulder the risk of a bad turn in the market."

Nonetheless, a government-run system is not in the cards. "I think there is broad political support for the government administering some sort of retirement plan," says Christian Weller, a senior fellow at the liberal-leaning Center for American Progress. "But even if health-care reform is passed, the debate over the public option has made a similar solution for retirement less likely."

But many policy experts say some type of change to our retirement-savings system is coming. First o

all, given the market carnage, there is some backing for the idea — not to mention anger and disappointment among retirees who can't really retire. Recent opinion polls show that people would be willing to give up the flexibility of a 401(k) for a guaranteed return. What's more, the fact that ERIC supports a guaranteed plan is encouraging. "Whether the 401(k) is a perfect plan or even the right plan is something that is being questioned in Congress," says Democratic Representative Georg Miller of California, chairman of the House Education and Labor Committee. "When you have seen the market's ability to create bubbles, you've got to ask whether the people trying to save for retirement should have to ride that risk." ([See pictures of the top 10 scared stock traders.](#))

Back at the golf course, Shively is not the only former Occidental employee toiling away in his retirement. There are three other former Oxy Pete workers among the staff. All would be better off today — and probably playing the course as opposed to working it — had Occidental stuck to its pension system. Still, Shively says he is not mad at his former employer. And so far, he hasn't found working in retirement to be too bad. Let's hope we all think the same.

— *With reporting by Christopher Maag / Niagara Falls*

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