Too poor to retire

Why younger generations will have to work more, save more or spend less

Rathbones
Look forward

Live long and prosper?

Stagnating pay, higher housing costs, decreasing home ownership, rising student debts, unfunded government pensions and lower investment returns mean younger generations are less likely to retire at the same age as their parents. Meanwhile, the responsibility for a financially secure retirement has shifted to the individual and the state is not in a position to be much help.

Younger generations simply aren't saving enough. In this summary of our full research report, we highlight some uncomfortable truths. Notably, the large savings gap younger generations need to bridge in order to retire. That's disconcerting because we believe there are many reasons why they may need to save even more just to enjoy the same level of comfort as their parents.

Don't bet the house on a comfortable retirement. Can we unlock cash from property to support us in retirement? This is unlikely to be an option for many millennials, and helping children or grandchildren to get a foot on the housing ladder may not be the best way to support them financially.

There are options. Without a jump in pension contributions, a comfortable retirement is likely to be unaffordable for many, and an entire lifetime spent working could become the reality. But by planning ahead, it is possible to meet your retirement objectives. The main choices are work for longer, save more today or spend less in retirement.

Big pensions gap = big investment implications. As investors we need to consider whether people will be able to maintain the consumption levels of previous generations. How would lower growth and consumption impact retailers, consumer goods and services companies? Could the financial services sector benefit from increasing savings?

Let's talk retirement. We want everyone to ask if they or their families are saving enough for retirement. We hope this report encourages helpful conversations between different generations about investing for the future.

Edward Smith
Head of asset allocation research

How much should I save?

Economists and public policymakers around the world use different ways to work out how much money people will need to enjoy a comfortable retirement. A popular figure is 70% of pre-retirement income, which they describe as the replacement rate. Regardless of the method, the results come to the same conclusion – most people aren't setting aside enough money.

The International Longevity Centre (ILC), a UK think tank, calculated the annual savings the average person entering the workforce today needs to make to generate a pension equal to the replacement rate.

Its results show that, across the developed world, current savings habits will result in a 5% shortfall – otherwise known as the savings gap. In other words, workers need to save an extra $2,015 (£1,570) a year. The news is a bit better for UK workers, who need to save an additional 4% of their earnings to make up the shortfall.

The average person starting work today in America, Canada, Germany and the UK needs to save 10% to 20% of their income to meet the 70% replacement rate and 15% to 25% to match the retirement incomes of previous generations.

A lost generation

This problem is not limited to the youngest generations. Generation X is also way off target. In the UK, this generation is likely to be financially worse off than millennials because many have missed out on the defined benefit pensions enjoyed by their parents, but started work before automatic enrolment in defined contribution company schemes.

Meanwhile, a report from the World Economic Forum explored the saving habits of workers in eight major economies. The results reveal wide generational differences.

These results suggest people have three choices:

– save more today by increasing pension fund contributions;

– work for longer and delay retiring until they've built up enough savings; or

– spend less in retirement and adjust to a more frugal way of life.

Research suggests that to enjoy a decent income* in retirement, younger generations around the world need to *increase* their pension contributions by:

5%
of earnings for the average worker

£1,570
per year for the average worker

*The benchmark is 70% of pre-retirement income. Source: International Longevity Centre, Berenberg and Rathbones.

Generation spend

It's easy to think that younger generations spend too much money enjoying the finer things life has to offer. Yet the research doesn't support this stereotype.

After adjusting for inflation and excluding housing costs, those aged 25 to 34 in the UK spend less relative to 55- to 64-year-olds than at any time since the 1960s. The trend reverses the increasing consumption patterns established by younger adults in the 1960s, 1970s and 1980s.

The reality is that millennials face additional financial pressures from high property prices, pay packets that have only just risen in line with inflation and less secure jobs.

Can my home provide a pension?

One way to boost your pension pot is to unlock cash from your home by selling up and buying a cheaper property or moving into rented accommodation. Equity release is another option. However, research shows that few retirees are drawing on property wealth today, while home ownership rates are falling.

This approach is likely to be increasingly unavailable to younger generations. That's because they're finding it more difficult to buy property following the rapid rise in prices between 1996 and 2006 (figure 1). By the time they were 30, almost 60% of baby boomers owned their own homes. The rate is just 30% for millennials of the same age.

The transfer of wealth through inheritance is unlikely to help. On average, millennials will have to wait until they're 61 to inherit the family silver. If they're still renting by then, they'll have missed out on many of the financial benefits that come with buying a property early in life. That includes the freedom to live rent free once you've paid off the mortgage.

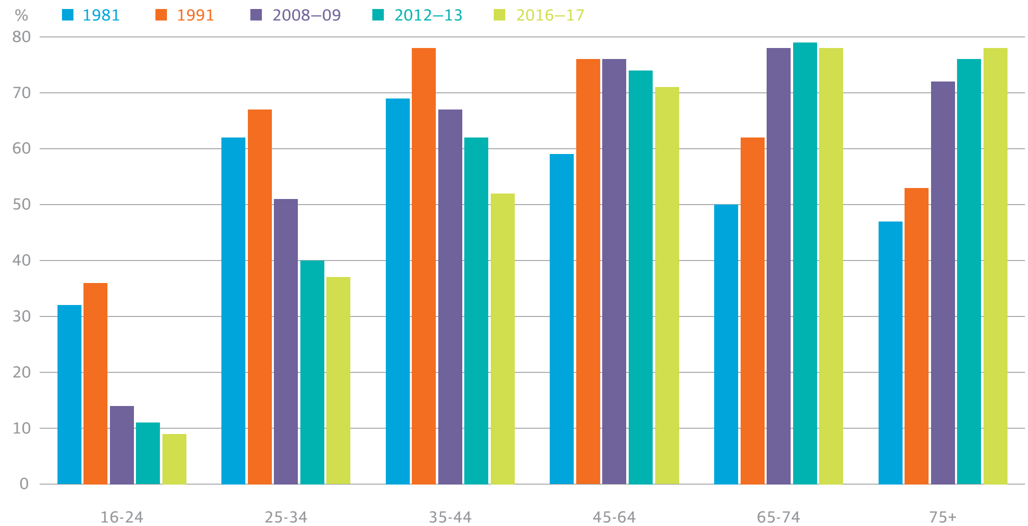
Another consequence of high property prices is that millennials are spending more of their incomes on accommodation than previous generations. By the age of 30, almost a quarter of their after-tax income pays the rent or mortgage, compared with 15% for baby boomers. This trend puts additional pressures on their ability to put away money for later life.

If millennials are less likely to approach retirement with any property at all, and those that do are much more likely to have outstanding mortgage debt, they will require even more pension income just to live as comfortable a retirement as previous generations.

Even though UK property prices are unlikely to enjoy another rapid rise any time soon, people continue to believe that investing in property can deliver the best returns. We're concerned that too many young households are using past performance as a guide to future returns and ignoring other ways to save and invest for their years in retirement.

Although home ownership rates have plummeted for younger generations, expectations haven't caught up with this reality. According to the Pensions & Lifetime Savings Association, one third of 35- to 44-year-olds feel they will have no choice but to use their property to finance retirement. Yet almost a quarter of people in this age group don't yet own a home.

Figure 1: A home to call your own
Percentage of each age group that were owner occupiers.



Source: English Housing Survey, full household sample.

How many people owned their homes by the time they reached the age of 30?

60%
of baby boomers

30%
of millennials

Why are we not saving enough?

We've uncovered various issues to explain why younger generations aren't saving enough for retirement. They include:

– stagnant earnings and rising housing costs;

– rising life expectancy;

– the burden of risk shifting to the individual;

– lower investment returns and annuity rates;

– rising personal debt; and

– unfunded government pension liabilities.

One of the most concerning issues is a lack of basic financial knowledge at a time when the government is asking people to take control of their financial futures. In one survey, fewer than one in three demonstrated an understanding of compound interest, the impact of inflation and why it's important to spread risk.

Great expectations

In addition, there's a wide gap between reality and expectations. For example, in 2015, market research firm Ipsos Mori asked people in the UK to estimate how much they would need to accumulate in a private pension fund to generate an annual income of around £25,000 after they retire. The most optimistic calculation at the time was a pension pot of £315,000 when supplemented by the state pension. However, the median guess was way below this level, at £124,000. Notably, the average guess for millennials was even further out, at just £90,000.

Another issue for younger generations is that expected investment returns have fallen owing to various economic factors. They include a slump in productivity growth across the developed world as well as demographic trends. That means saving more in order to generate the same returns that a smaller pot would have produced in the past.

At the same time, annuity rates have plummeted to reflect longer life expectancies and falling interest rates. In 2000, a 65-year-old man could purchase an annuity with a rate of 8.5% compared with just 5% today. Back then a £225,000 pension fund would deliver an annual income of £20,000, while you would need at least £350,000 to generate the same amount now.

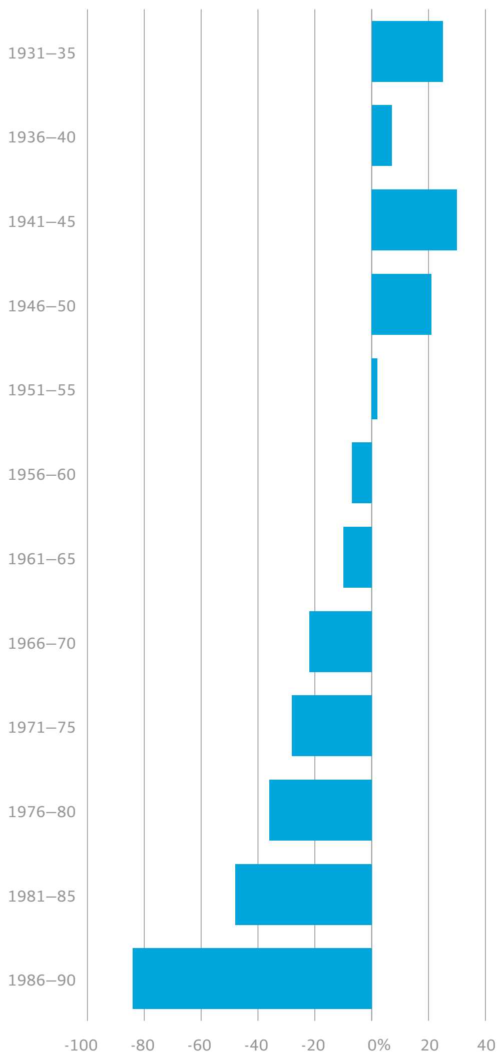
Make it last

What happens when you include money that's not in a pension fund? The news is rather gloomy. Across the UK, every five-year cohort since those born in the mid-1950s has accumulated less wealth than the preceding group had done at the same age (figure 2).

Student debts put additional financial pressures on the ability to save for retirement. Since the government removed the cap in 2010, most English universities now charge annual tuition fees of more than £9,000. Add in maintenance loans and interest payments, and a student who started a three-year course in 2017 is likely to graduate with £51,700 debt.

Meanwhile, we're all living longer, which means our pension pots will need to support everyday spending for many years – as well as potentially meet medical and care costs in later life for ourselves and our families. According to the Office for National Statistics, one in three people born since 2012 in the UK could live to 100.

Figure 2: Private wealth patterns are shifting
Every successive five-year cohort in the UK since those born in the mid-1950s has accumulated less wealth than their preceding group had done at the same age.



Source: Resolution Foundation.

Reality versus expectations

People have different ideas about how large their pension pots would need to be for a comfortable retirement.

£315,000
optimistic assumptions

£124,000
median guess

£90,000
millennials guessed

£51,700
the average student debt for someone who starts a three-year course at an English university in 2017

1 in 3
people born since 2012 in the UK could live to 100 years old

Can the state come to the rescue?

An ageing population presents financial challenges for the government. One of the main issues is a rising dependency ratio with fewer workers supporting an increasing number of people who are no longer employed. As income from taxation falls, the costs associated with paying pensions are rising as well as budgets for providing health care and social care.

According to the World Economic Forum, the governments of the world's largest economies are sitting on $53 trillion of unfunded pension commitments.

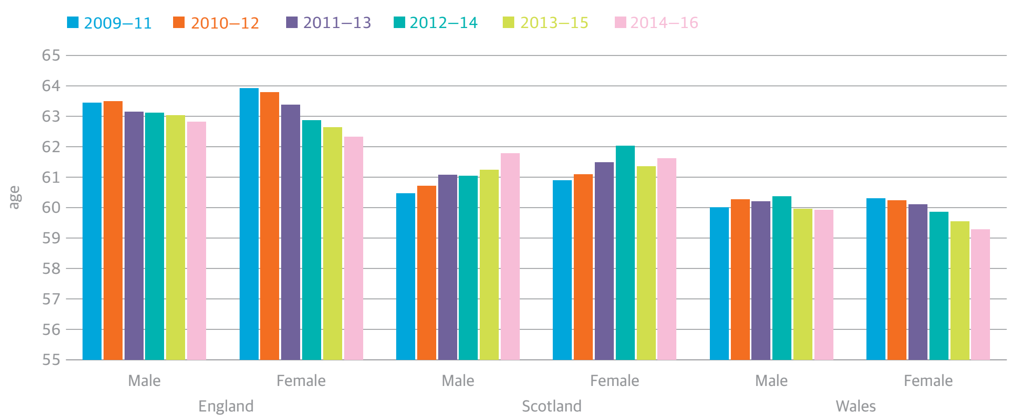
Politicians have three difficult choices – borrow more money, reduce welfare spending or increase taxes. All are likely to make it even harder for individuals to save enough for a comfortable retirement. They may not have the resolve to make potentially controversial and unpopular decisions. Cuts to healthcare could be political suicide, so the welfare spending axe would probably fall on pensions.

Increasing the state pension age is another option but it's unlikely to solve the economic challenges associated with ageing. That's because for many people the ability to work falls dramatically after the age of 60 due to illness or long-term disability (figure 3). Public policy should focus on keeping the nation economically active in later life by promoting better health.

Governments do have a couple more options. They could encourage migration to offset rising dependency ratios, or consider radical ways to increase productivity and reduce future deficits through economic growth. However, mainstream political parties may be unwilling or unable to commit to these policies.

Figure 3: Taking care

Disability-free life expectancy has fallen for some groups over the past few years.



Source: Datastream and Rathbones. Dates represent years expectancy was measured.

A lifetime's work

Younger generations around the world are already accepting that they will probably retire later in life than their parents. In the most recent British Social Attitudes Survey, which has been carried out annually since 1983, more than one in three people aged 18 to 24 and one in five aged 25 to 34 expect to retire in their 70s. Yet just 10% of people in the UK aged between 70 and 74 work today.

Employers can help people work into later life by introducing less rigid working practices. In particular, more flexibility would help those who are responsible for caring for a partner, and would otherwise find it difficult to commit to a regular working routine.

The lump of labour fallacy

If people remain in work for longer, will there be fewer jobs for younger generations? The weight of evidence suggests everyone will benefit. Economists refer to the lump of labour fallacy, which reveals that there is not a finite number of jobs to go around. Employment tends to expand as more workers contribute to economic growth.

Studies suggest that increasing the participation rates of older workers expands the economy. According to the National Institute for Economic and Social Research, extending everyone's working life by one year could increase the UK's GDP by 1% a year – which is equivalent to £18 billion in 2015 when the study was carried out.

Any concerns about the economic benefits of people working for longer must be set against demographic projections. The UK's population of 20- to 29-year-olds is set to decrease by half a million people over the next 10 years. To create more jobs, the economy needs more workers.

Look forward with confidence

When they approach later life, today's younger generations are likely to be less financially secure than their parents owing to a combination of factors. They include high property prices, student debts and the absence of defined benefit pension schemes. Governments are unlikely to be able to help out as they feel the squeeze from spending commitments related to increasingly ageing populations and slower economic growth.

Yet will they be too poor to retire? We believe younger generations can still look forward to retiring with more confidence if they:

- start to think about the issues early in life and taking control of their retirement plans.
- gain an understanding of fundamental financial ideas, such as the benefits of long-term investing and compound interest.
- calculate how much money they would like to have in later life and set realistic expectations about the size of pension fund they will need to generate this level of income.
- consider that they may have to continue to work well into later life, and plan accordingly.

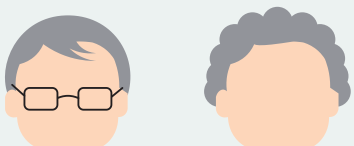
Some people may decide to save more today, while others may choose to cut back on their spending in later life. The implications are that investors need to lower their projections for growth in consumer goods and services sectors. Retailers are already challenged by technological disruption but concerns about the overall growth of household consumption are rarely heard.

The financial services industry has a responsibility to respond to these challenges by engaging with younger generations, and there are many opportunities. Firms that find innovative ways to motivate young savers are likely to do particularly well.

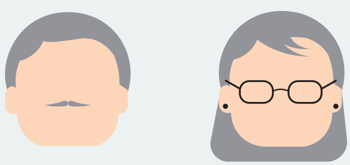
Which generation are you?

Although there's no standard definition for when one generation ends and another begins, at Rathbones we're guided by the following dates. People born in each range share the same major cultural, political and economic influences. This framework provides us with useful insights into the broad financial opportunities and challenges facing each generation.

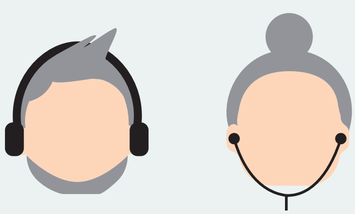
Baby boomers (1946–64)



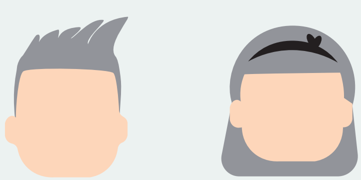
Generation X (1965–80)



Millennials (1981–96)



Generation Z (1997–)



Source: Pew Research Center.

This report is just one of a series of publications from Rathbones exploring a wide range of issues affecting today's younger generations relating to money, financial planning and investing.

They include *A brand new world*, which examines how companies are having to innovate and evolve in order to engage with our shifting attitudes and changing spending habits.

You can also read a more detailed analysis of the themes covered in this publication in our full *Too poor to retire* report.

Taking the next step

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