Vanguard

Filling the retirement income gap caused by the pandemic

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A forthcoming Vanguard research paper highlights the fact that almost double the projected number of Americans retired during the pandemic. Some may be forced to reenter the workforce as they have not accumulated enough assets to last through retirement. The authors discuss their ongoing research to find viable solutions to address the retirement income gap, which may only get wider.

"During the pandemic, some 1.6 million older workers left the labor force earlier than expected," said Andrew S. Clarke, principal of Vanguard Investment Strategy Group's retirement team and one of three authors of The Great Retirement? Or the Great Sabbatical?

"For those in the top deciles in wealth, early retirement is manageable. For those with less assets, it's not. Although the latter represent a small portion of the population, their pandemic behavior raises provocative questions about American workers' prospects of financing life after labor."

How can those who retired earlier than expected address asset shortfalls during retirement?

This question takes on greater urgency in the current environment, said Fu Tan, investment research analyst and coauthor of the paper. "Our research drew on data through 2021. Obviously, the drop in market value of retirement assets and spiking inflation since then will make it more pressing for some earlier-than-expected retirees to return to work. Our analysis demonstrates that a few extra years of employment can greatly enhance retirement security."

But what about those who can't return to work or may still not have enough income?

There are several additional options to consider.

Modifying the replacement ratio

One of the most common rules of thumb regarding retirement income is the replacement ratio—the amount of preretirement income that needs to be replaced in retirement.

Vanguard's forthcoming research assumes a target replacement ratio of 79%, consistent with assumptions in many research models. But retirees have some flexibility in how much of their preretirement income to replace.

"Model stress tests and empirical research suggest a wide range of replacement ratios," Tan said. "If an expected replacement ratio of 80% includes significant discretionary spending, those whose assets look a little lean might be able to finance retirement with a lower replacement ratio."

Another guideline that can be reevaluated, particularly in this market environment, is the 4% withdrawal rate. Vanguard's research suggests a rate of about 3% is a more realistic figure given current inflation and muted expected returns for both stocks and bonds, Clarke said.

"It's important to keep in mind that, ultimately, these are all just rules of thumb," Clarke said. "There are too many variables with market conditions and each individual's circumstances to reduce a solution to one number for everyone."

These rules also ignore another potential source of income for retirees—the four walls that surround them.

Untapped equity: The home

About 80% of Americans 65 and older are homeowners, and housing wealth accounts for 40% of their net worth. Preliminary Vanguard research spotlights one strategy these retirees have used to extract equity from their homes.

"We find that many homeowners 60 and older tap into housing wealth by moving to a cheaper place," Clarke said. "They bolster their retirement security with such moves in two ways. First, by moving to a new location with a lower house price, they seamlessly liquidate some of their housing wealth. Second, they also benefit from settling in a new location with a lower cost of living."

More guidance needed

The onus should not be just on the individual to figure this out.

“What’s clear is that the picture has gotten more complex for all, whether individual investors, advisors, consultants, or plan sponsors,” Clarke said. “There’s no consensus even among experts on next best steps, so we shouldn’t expect the average person to judge their best route to a secure retirement.

“Advisors may want to check in with their clients to see if their goals and circumstances have changed and provide counsel. Plan sponsors might want to reevaluate their participant education and support programs to ensure their employees remain on track to meet retirement goals. Plan providers and researchers must take into account how the shifting dynamics in the financial and labor markets affect the assumptions used in their models. At Vanguard, we’re doing research and modeling that can set the most appropriate goalposts in our ever-changing environment.”

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