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Briefly Noted

IRAs Primarily Funded by 401(k) Rollovers and Higher Income Households

Individual retirement accounts (IRAs) were originally created in 1974 to provide those without workplace retirement plans a tax-deferred method of saving for retirement. Since then IRAs have become predominantly a depository for savings accumulated in 401(k) and similar defined-contribution workplace retirement plans.

Using data from the Internal Revenue Service, researchers at the Center for Retirement Research at Boston College found rollovers accounted for the overwhelming majority of the inflows into IRAs. There are several reasons why this is the case. The maximum deductible contribution to IRAs is lower than it is for defined-contribution plans. The 2017 limits for traditional and Roth IRAs are $5,500 (plus a $1,000 catch-up for those ages 50 or older.) The 2017 limits for 401(k) and similar plans are $18,000 (plus a $6,000 catch-up.) Some workers find it easier to rollover their workplace savings to an IRA when switching jobs than switching it to a new workplace retirement plan. Others prefer the control and greater choice of investments that an IRA provides. There are also income restrictions on who can make contributions to IRAs.

This isn't to say people aren't contributing directly to IRAs. Quite the contrary: 14% of U.S. households made contributions in 2014. Their contributions accounted for just 13% of all new money flowing into IRAs, however. Direct contributions were closely split between traditional and Roth IRAs (35% and 36% of total contributions, respectively.) Employer-sponsored IRAs accounted for 10% of contributions with the remainder going into "more than one type." The study's authors note that when employer-sponsored programs are excluded, Roth IRAs tend to be more popular. They attribute the popularity of Roth IRAs to the higher income caps on who can contribute.

Overall, and not surprisingly, higher income earners are more likely to contribute to IRAs. The average household earnings of contributors in 2011 (the most recent such data available) was $110,000 versus $70,000 for non-contributors. IRA contributions tended to be better educated and more likely to contribute to a 401(k) plan as well. Married individuals in two-earner couples also tended to be more likely to contribute, though there is also a group of one-earner "frugal breadwinner" households that contribute.

Source: "Who Contributes to Individual Retirement Accounts?," Anqi Chen and Alicia Munnell, Center for Retirement Research at Boston College, April 2017, Number 17-8.

Long-Term Care Insurance: Less Benefit for the Premium

Purchasers of long-term care insurance have faced a combination of rising premiums and changes in both the types and dollar value of the benefits offered. On the positive side, policies have become more standardized. On the negative size, the duration of policies has declined and the growth in daily benefit coverage for nursing home care has lagged premium growth. These observations are based on an analysis of nearly 8,800 policies by LifePlans Inc.

Between 1990 and 2015, average annual premiums for purchased policies rose from $1,071 to $2,727. This equates to an annualized 3.8% increase. More recently, premiums rose at a 3.6% rate between 2010 ($2,283) and 2015 ($2,727).

The daily benefit amount for nursing home care has risen at a 3.3% annualized rate, from $72 in 1990 to $161 in 2015. Daily home health care benefits have risen at a faster 6.0% annualized rate, but the increases are based on a much smaller starting number: $36 in 1990. The daily benefit for home health care in 2015 was $155.

The increases in benefits do not tell the full story. The average duration for which nursing home benefits are paid has shrunk from 5.6 years in 1990 to 4.0 years in 2015. At the same time, the nursing home policy elimination period (the number of days a person must be in a nursing home before benefits are paid) has widened to 49 days in 2015 from 20 days in 1990. A more comprehensive number, however, is the integrated policy elimination period (the number of days care must be provided before benefits are paid.) This period has nearly doubled from 46 days in 1995 to 91 days in 2015.

LifePlans attributes the rise in premiums to more conservative assumptions used by actuaries in pricing policies. These assumptions include fewer purchasers letting their policies lapse and interest rates. LifePlans blamed the post-financial crisis interest rate environment for leading to "significant premium increases." Consumers have responded by opting for shorter benefit durations (60% of policies bought in 2015 provided three or fewer years of nursing home care) and somewhat less inflation protection. LifePlans does think premiums could be more stable going forward, given the changes in how policies were priced over the past several years.

Source: "Who Buys Long-Term Care Insurance? Twenty-Five Years of Study of Buyers and Non-Buyers in 2015–2016;" LifePlans, January 2017.

Improving on the Magic Formula

Joel Greenblatt's Magic Formula attempts to identify winning stocks by using a dual ranking system: one based on value and one based on profitability. The strategy was described in his best-selling book, "The Little Book That Beats the Market" (John Wiley & Sons, 2005). A new study claims to improve on Greenblatt's formula by using a different measure of profitability.

The Magic Formula uses earnings before interest and taxes (EBIT) to determine profitability. EBIT can simply be calculated by taking pretax income and adding back interest expense. (Both can be found on a company's income statement.) Two professors at Fordham University, citing work by Rochester University professor Robert Novy-Marx, replaced EBIT with gross profits. Since gross profits appear higher on the income statement, they are less effected by management decisions over expenses and accounting.

Douglas Blackburn and Nusret Cakici call their strategy the Improved Magic Formula. The formula consists of two parts. The profitability component is gross profits divided by tangible capital. (Tangible capital is the sum of net working capital and fixed assets.) The value component is gross profit divided by enterprise value. (Enterprise value is common and preferred shareholder equity plus interest-bearing debt.) Stocks are ranked separately on the profitability and the value components with the two ranks combined to create a composite score.

The Improved Magic Formula bested the Magic Formula in all four geographic regions tested. In North America (the U.S. and Canada), an equal-weighted portfolio composed of the top 20% of stocks as ranked by their composite scores realized average monthly returns of 1.97% for the period of 1991–2016. In comparison, the comparable group for Greenblatt's strategy realized an average monthly return of 1.50%. More notably, the monthly return differential between the best and worst scoring stocks for the new strategy was positive (0.79%), whereas it was negative for the older strategy (–0.36%).

A few caveats should be noted. Greenblatt's strategy called for buying the 30 stocks with the best composite score each month and holding them for a full year. The Fordham professors grouped stocks into quintiles, with each group containing 700 stocks. Furthermore, they rebalanced the portfolios monthly instead of annually. The Fordham professors acknowledge that this more frequent rebalancing may not have not given the value stocks identified by Greenblatt's strategy enough time to realize higher returns.

Source: "The Magic Formula: Value, Profitability, and the Cross Section of Global Stock Returns," Douglas Blackburn and Nusret Cakici, SSRN, May 2017.

Workers Lack Information When Making Lump-Sum Decisions

A MetLife study found workers are not being presented with enough useful information when offered the chance to take either a lump sum or an annuity at retirement. Even when online tools are offered, many workers don't use them. This results in a situation where many workers are making an important decision without fully understanding the potential consequences.

Fewer than half of all surveyed defined-benefit (DB) plan participants recall seeing information comparing the lump-sum amount to the total value of annuity payments. (A pension is a defined-benefit plan.) Only 39% of defined-contribution (DC) plan recall receiving information about how much income their savings will provide in retirement. (Examples of defined-contribution plans are 401(k) and 403(b) plans.) Smaller percentages of respondents recall being cautioned about the risks of outliving the lump-sum amount or spending it too quickly. Only slightly more than one in four say they were given tips about coordinating their pension or workplace savings with Social Security and other sources of retirement income.

Rather, retirees say the factors influencing their decisions included their then-current financial circumstances (58%) and the tax treatment of the payment options (42%). Just 20% said they took their family's history of longevity into account. Attitudes about risk played a significant role, with nearly half (46%) of DB and DC plan participants who took a lump sum describing themselves as "risk-takers." Conversely, nearly two-thirds (64%) of those who opted for the annuity described themselves being "risk-adverse."

Of those who took a lump sum, approximately one of five (21%) spent all of their lump sum within 5½ years, on average. Additionally, 35% of those who hadn't spent their entire lump sum are concerned about outliving the remaining amount.

There are some caveats to be considered before drawing conclusions from the last paragraph. The average retirement ages of those surveyed were 58 for defined-benefit plans and 61 for defined-contribution plans. The average lump sums were $192,357 for defined-benefit plan participants and $239,792 for defined-contribution plan participants. Thus, many retired early and without enough identified wealth to fund the early retirement. Potentially compounding matters was the fact that nearly two-thirds of lump-sum takers reported "major spending" within the first year of retirement.

Source: "Paycheck or Pot of Gold Study: Making Workplace Savings Last," MetLife, April 2017.