

The *Ambachtsheer* Letter

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BUILDING PENSION PLANS FOR THE REAL WORLD: *THE EFFICIENT PERSONAL PENSION ACCUMULATION MODEL*

“Model: a simplified description of a system or process to enhance understanding”

The Oxford Dictionary

Human Foibles and Agency Dysfunction

The previous *Letter* set out two compelling reasons why most people should not be left to their own devices to build a post-retirement income stream:

1. Human Foibles: Most people are perfectly rational in their decision-making as long as the decision context is familiar. Unfortunately, retirement planning issues such as income replacement target, required savings rate, investment choices, time horizon, expected return, and risk appetite are decidedly unfamiliar territory for most people. So now, many exhibit a lack of firm preferences, inertia and procrastination, a lack of self-control, and an irrational aversion to realizing losses. The results are dysfunctional (non?)-decision processes from the perspective of building adequate post-retirement income streams in the future.
2. Agency Issues: Just as it is not reasonable for people to build their own cars, it is also not reasonable for them to build their own pension vehicles. In the case of cars, a small number of global corporations compete for market share by offering ‘bundles’ of quality, choice, price, and convenience. The car market is highly competitive and efficient because most buyers are knowledgeable enough to choose the optimal qual-

ity/choice/price/convenience transportation bundle for them. What about the market for pension vehicles? Is it also highly competitive and efficient? No, it is not. Why? For two reasons. First, there is the ‘human foibles’ problem. In other words, people are in unfamiliar territory when making pension-related decisions. The second reason is that pension vehicle suppliers know this to be the case, providing them the opportunity to charge more for their products and services than they are really worth. When the pension vehicle supplier is a ‘for profit’ organization, this informational asymmetry problem easily translates into a wealth-transfer process from the retirement savings principals to the intermediary agents.

So what can be done to counteract these two fundamental impediments to the generation of adequate post-retirement income streams for most people? Our answer is the *Efficient Personal Pension Accumulation Model (EPPAM)*. The goal of this *Letter* is to unveil it. We do so by identifying three ‘auto-pilot’ strategies to help keep people on rational decision tracks, and three organizational strategies to help minimize agency costs. The *Letter* ends with a discussion of the implications of our proposed *EPPAM* blueprint for the employer community, for public policy, and for the future of defined benefit (DB) plans.