

The *Ambachtsheer* Letter

Research and Commentary on Pension Governance, Finance and Investments

Letter # 232

May 2005

DB PLANS AND BAD SCIENCE

“Science has made little progress dealing with whole systems. It tends to become arrested in the stage of singling out isolated bits, with little grasp of how these interact with other bits of integrated systems...”

Jane Jacobs

from “Dark Age Ahead”

Science and the Design of Pension Contracts

In her new book “Dark Age Ahead”, Jane Jacobs reminds us that bad science leads to bad outcomes. Specifically, the legendary chronicler of the life and death of North American cities shows how bad research in the fields of traffic engineering, public health practices, and the economics of urban development has led to bad policy and design decisions in each of these fields.

What about policy and design decisions in the pensions field? Are they based on good science-based research? Or are they based on bad science too? And if they are, what are the consequences? As it pursues the answers to these questions, this *Letter* ends up concluding that DB-based pension contracts contain a serious, potentially fatal, design flaw. This design flaw poses a serious, potentially fatal, threat to the sustainability of DB plans. Can the flaw be fixed? We invite you to reach your own conclusion after you study the logic presented below.

The *EPPAM* Contract

Our prior two *Letters* developed the *Efficient Personal Pension Accumulation Model (EPPAM)* from first principles. Its design is based on sound theory and sound research. It starts with the premise that rational individuals

wish to devise life-time consumption plans that maximize life-time utility or satisfaction. Two types of barriers stand in the way of achieving this goal. First, devising such a plan is a highly complex undertaking, leading most people left to their own devices to either make highly sub-optimal decisions or simply ignore the problem all together. Second, getting expert help with pensions-related planning, investing, and administration brings its own set of agency-related problems, leading to the prospect that people will end up ‘paying too much for too little’.

The *EPPAM* arrangement addresses both types of barriers. The knowledge/behavioral problems are addressed by an ‘auto-pilot’ savings, investment, and annuitization protocol. This protocol aligns income replacement targets with target savings rates and optimal investment/annuitization policies. The agency problems are addressed through the establishment of single purpose pension ‘co-ops’ of sufficient scale to be able to operate these ‘auto-pilot’ savings/investment protocols at low unit costs.