EFAMA

Investing in Equity Markets Bring Better Retirement Income

Key Findings of a recent OECD Study

OECD Pensions Outlook 2024 | OECD

Improving Asset-backed Pensions for Better Retirement Outcomes and More Resilient Pension Systems

The *OECD Pensions Outlook* aims to enhance retirement outcomes by providing insights and recommendations for improving the design of asset-backed pensions

EFAMA

Background (1/3)

- Chapter 4 of the OECD report assesses whether investing in equity markets leads to better retirement income outcomes for members of DC pension plans. It presents three complementary analyses that provide a comprehensive assessment of the impact of equity investment on retirement income outcomes by looking at different indicators, including a stochastic analysis.

- This presentation summarizes the main findings of the second analysis, which used historical returns on selected asset classes since 1900 in 19 OECD countries to calculate the level of assets that successive cohorts of individuals (groups of people of the same age) would have accumulated at retirement had a DC pension plan existed in those countries. It compares various illustrative investment strategies with different levels and profiles of exposure to equities.

Background (2/3)

- The calculations assume that each cohort is represented by a typical individual. That individual joins the labour market at age 25 and receives wages that grow in line with historical inflation and a fixed productivity rate of 1.25%. Under the baseline assumptions, contributions are paid continuously over 40 years based on a constant contribution rate of 5%. The individual pays an annual 1% asset-based fee and retires at age 65. The assets accumulated at retirement are expressed as a multiple of the sum of contributions paid.

- The analysis uses historical data on returns and inflation between 1900 and 2021 for 19 OECD countries. Assuming a career of 40 years (from age 25 to 65), this means that the level of assets accumulated at retirement is calculated for 83 successive cohorts retiring between 1939 and 2021 for each country.

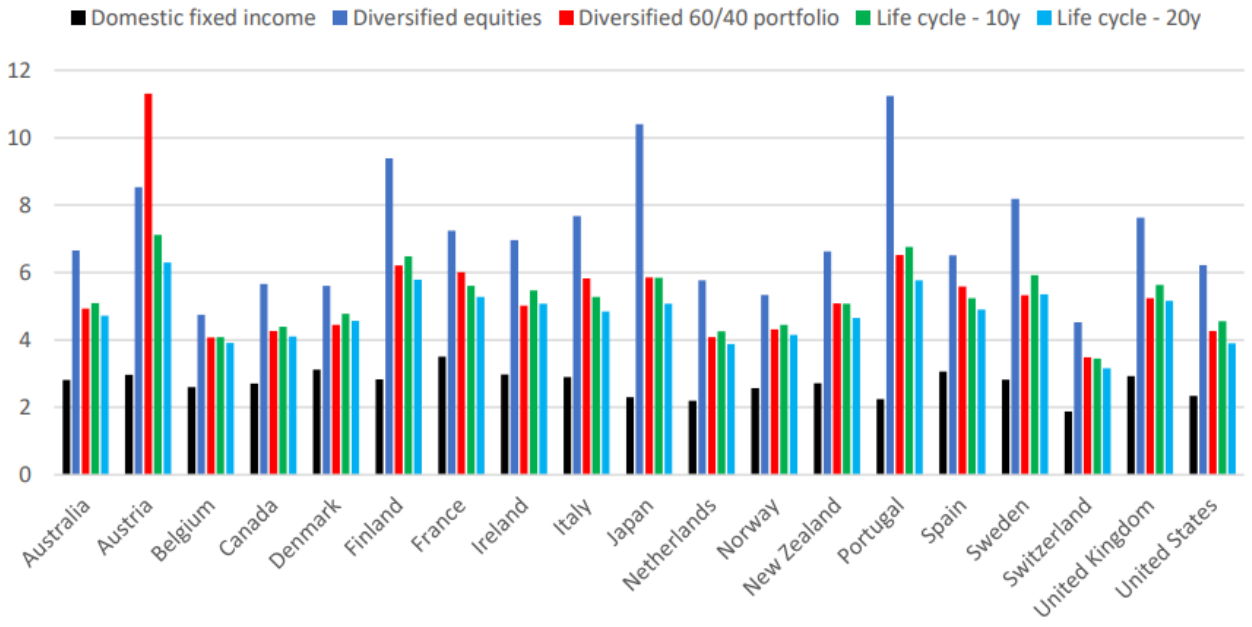
Background (3/3)

- The analysis compares the level of assets accumulated at retirement that the following illustrative investment strategies would have produced:
  - **Domestic fixed income**: a fixed portfolio invested 100% in fixed income
  - **Diversified equities**: a fixed portfolio invested 70% in domestic equities and 30% in international equities
  - **Diversified 60/40 portfolio**: a fixed portfolio invested 60% in equities and 40% in fixed income, with an equal mix of domestic and international securities for equities and government bonds
  - **Life cycle 10y**: life-cycle investment strategy with a proportion invested in equities (70% domestic and 30% international) starting at 80% and declining linearly during the last 10 years before retirement to 20%, and with equities substituted by domestic fixed income
  - **Life cycle 20y**: a life-cycle investment strategy with a proportion invested in equities (70% domestic and 30% international) starting at 80% and declining linearly during the last 20 years before retirement to 20%, and with equities substituted by domestic fixed income

Findings (1/6)

Investing in equities leads to better retirement income outcomes for members of DC pension schemes, i.e., a higher average performance, more assets accumulated at retirement and higher replacement rates than only investing in fixed income.

Average level of assets accumulated at retirement across cohorts, by investment strategy and country, as a multiple of total contributions paid

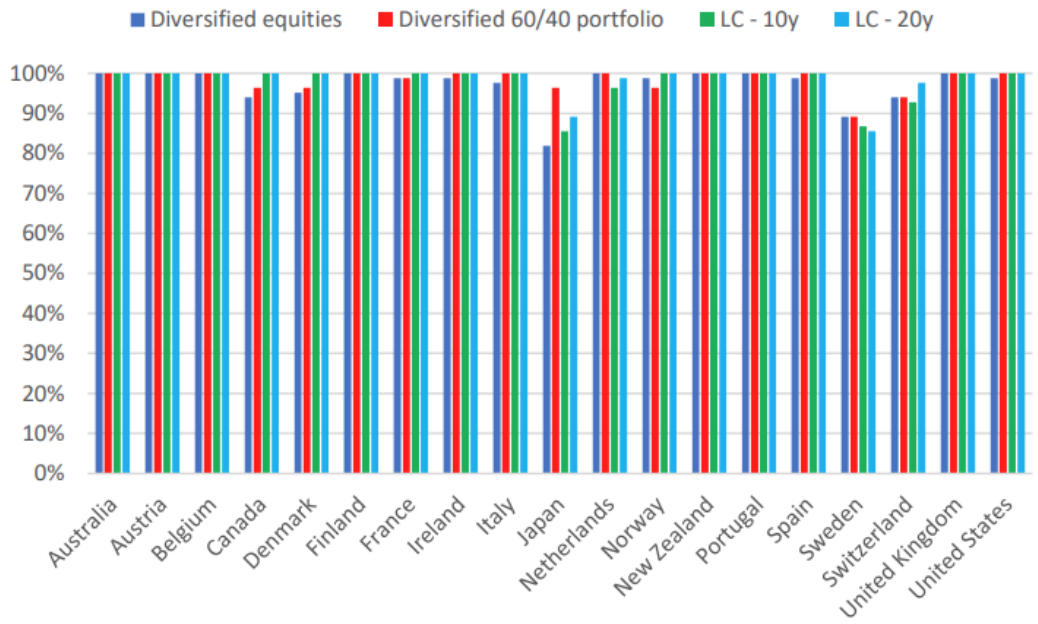


Source: OECD calculations.

Findings (2/6)

In all countries, at least 80% of the 83 analyzed cohorts would have been better off investing in equity markets. In 7 countries, this proportion reaches 100% for the four portfolios with equity exposure.

Proportion of cohorts better off investing in equities rather than in domestic fixed income only, by investment strategy and country



Source: OECD calculations.

Findings (3/6)

- Assets accumulated at retirement would have been significantly higher when investing in equities rather than only in domestic fixed income. Depending on the chosen investment strategy, the average difference in accumulated assets varies between 2.8 and 3.7 times the sum of contributions.

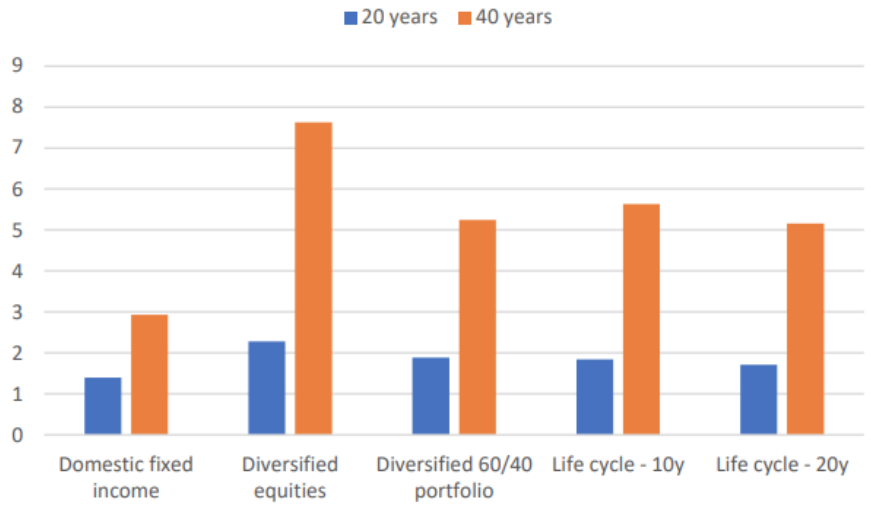
- By contrast, for the few cohorts better off with the portfolio with domestic fixed income, the additional accumulated assets at retirement would have been modest compared to what would have been accumulated with the other investment strategies.

"Most people are likely to be worse-off with portfolios only invested in fixed income and to forego significant pension benefits. Additionally, even when a fixed-income portfolio may be the best option, the difference with other investment strategies may only be moderate, as portfolios with equity exposure may only produce slightly lower accumulated assets and replacement rates in case of negative events."

Findings (4/6)

Investing in equity markets produces better results when people save for retirement for long periods as compound interest accumulates over time.

Average level of assets accumulated at retirement across cohorts in the United Kingdom, by length of the contribution period and investment strategy

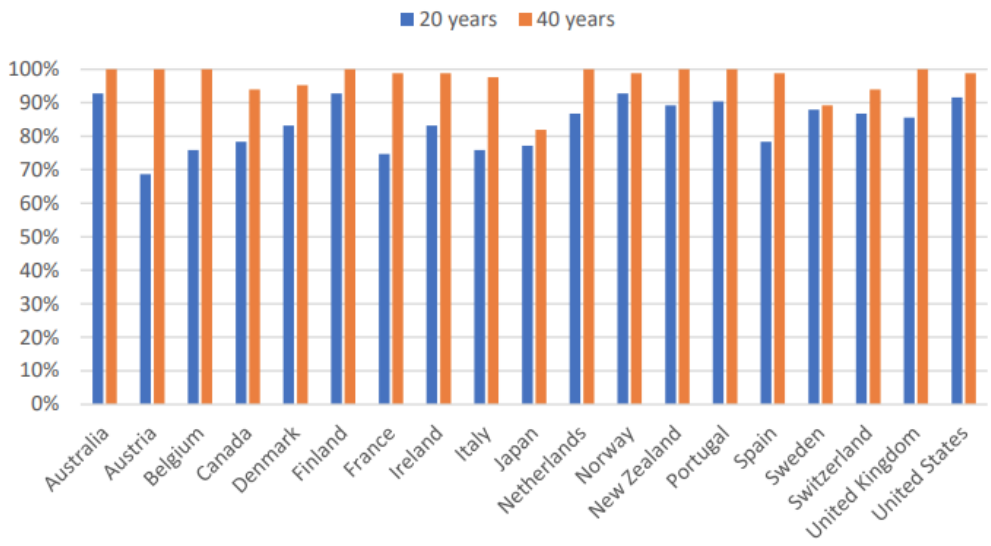


Source: OECD calculations.

Findings (5/6)

Most cohorts would have remained better off even with 20 years of contributions, confirming that investing in equities would still have been worthwhile for most people.

Proportion of cohorts better off investing in diversified equities rather than in domestic fixed income only, by length of the contribution period and country



Source: OECD calculations.

Findings (6/6)

Life-cycling investment strategies can mitigate the risk that equity investing makes pension benefits sensitive to equity market downturns occurring when people are close to retirement

"By keeping a high exposure to equities during the first part of the accumulation phase and reducing it gradually as the retirement date approaches, life-cycle strategies use the compounded return effect to grow savings and reduce the risk of large losses when accumulated assets are at their peak.

The analysis from the stochastic model shows that, while the equity portfolio outperforms life-cycle strategies in terms of replacement rates in more than 75% of the cases, the life-cycle strategies produce higher replacement rates than the equity portfolio with a probability between 40% and 50% when there is a fall in equity markets the year just before retirement."

The end