A Break in the Conventional Wisdom on Pension Saving?

When should you start saving for retirement, and how much should you save?

The conventional answers to these questions are ‘as soon as possible’, and ‘as much as you can afford’.

For years, these have been my standard answers. Simple arithmetic and plain common sense both confirm it! However, the conventional answers may be wrong.

This is according to new research by the Institute for Fiscal Studies (IFS), an independent economic research institute based in London, covering subjects from tax and benefits to education policy. It produces both academic and policy-related findings.

What is certainly true from the conventional wisdom on pensions saving is that the laws of compound interest mean that money invested at an early age will work for longer…

And deliver you a decent retirement income.

In real life, saving for a pension doesn't happen in a vacuum, and the IFS's modelling argues that once you take into account your financial circumstances, along with your time of life, rather than just thinking about pensions in isolation, saving for retirement so early in your working life often doesn't make economic sense. Indeed, they conclude that it would be much more rational to do the lion's share of your retirement saving later in life.

These findings contradict the long-standing rule that people should start saving at a young age, and gradually increase the amount as their incomes grow.

Whether it is correct or not, it is good news for those thinking that they have not yet saved enough for retirement, in relation to their age.

Here's what the IFS concluded.

In your 20s and 30s, it is likely your income will be lower than later in life, as your career progresses. It is also likely that your outgoings will be higher in your 20's and 30's.

You may be repaying university debt or covering the cost of a mortgage. You may have children. You may still be accumulating the possessions it takes time to acquire, furniture, for example.

Later, by contrast, these pressures tend to ease. Hopefully, you are earning more, and as your children leave home and debt is repaid, disposable income should rise further.

Therefore, the IFS argues that spreading your pension savings equally across these two very different periods of your life is irrational. To make pension contributions early in your working life may require sacrifices and compromises that outweigh the benefits of saving.

Equally, when your financial position improves, you may well be able to comfortably afford much larger pension contributions.

On this basis, the IFS's analysis suggests a typical 45 year old who has 2 children should do at least two-thirds of their pensions saving after this age.

There is, of course, no such thing as a typical 45 year old. Everyone's circumstances will vary.

But for all of you that are beating yourselves up for failing to maximise your pension savings in your early working years, which is what the pension experts tell you to do, this analysis probably makes comforting reading. You are still able to achieve your desired retirement income.

IFS associate director Rowena Crawford said "There are good reasons why individuals should not want to save a constant share of their earnings for retirement over their entire working life. How an individual wants to allocate their income between repaying a mortgage or saving for retirement depends on the financial return on their pension saving compared with the mortgage and loan interest rates and how risk averse the individual is."

But

Steven Cameron, pensions director at Aegon, warned that leaving pension saving until later on in life risked leaving individuals short at retirement, particularly if earnings don't rise and expenses don't fall with age.

Cameron said the wrong message must not be given to young savers.

"We must avoid sending out any message suggesting it's OK for younger workers to delay thinking about pensions until later in life. While retirement may seem far off for this group, it's the contributions paid at younger ages which have longest to benefit from compound investment growth. It's also risky to assume that earnings will necessarily rise or financial pressures disappear later on in life."

Of course, whilst sound in advice, Pensions Director Mr. Cameron has a certain amount of self-interest in persuading people to start pension contributions early!

From the Strategic Expat's perspective, there are a couple of important things to bear in mind.

Why? Because it is a balancing act and you could be walking a tightrope.

Firstly, I want to make it very clear that at whatever age, if you have the option of joining a pension scheme at work, doing so will normally qualify you for additional pension contributions from your employer.

You really don’t want to miss out on these, so it makes sense to join the scheme and pay the minimum contribution required to get your employer’s contribution.

Doing most of your pension saving later in life does not mean doing no saving at all earlier on.

Remember that retirement planning does not demand buying a ‘pension’. It is perfectly logical to invest for retirement using other, more flexible investment vehicles.

The other key point to remember is that to leave pension saving until later does carry a number of risks.

Apart from the risks highlighted by Steven Cameron at Aegon, if you fall ill or lose your job in your 50s, you may find yourself unable to make up for the saving you opted out of earlier on. For this reason alone, where you do have the ability to make affordable pension contributions earlier in your working life, it is a good idea to do so, because you can never be sure how things will work out.

Then there is the previously mentioned compound interest factor, a powerful concept that can supercharge the value of savings made early.

However, if you are in your 40’s or 50’s and feel that you haven’t saved enough yet, it’s never too late to make more significant contributions. The IFS research suggests now could be the perfect time to do it.