

2006 in review ▼

On the Forefront of Retirement Planning

What's the Question?

by Francois Gadenne

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By now, most would agree that the future health of our nation's retirement security will be impacted by a variety of factors, including investor ability and desire to work beyond age 65, the public affordability of retirement security programs, and the investment results on private savings. The quality and value of these factors will depart from past experience given the quantitative impact of 76 million Baby Boomers entering retirement. This unprecedented and demographic phenomenon will affect the qualitative and quantitative aspects of retirement long into the future. This phenomenon also raises a number of strategically important questions that we believe will drive product development, processes, tools, research and education on the topic of retirement income distribution.

Perhaps the most important question today is what does the retiree really want from the retirement income industry? Encapsulating investor concerns heard during several industry "free-lunch/free-dinner" events for pre-retirees, a blue-collar pre-retiree asked the following question of independent brokers, advisors and mutual fund representatives: "Do not ask me how much annual income I want in retirement. Yes, \$50,000 a year in retirement sounds nice. However, we all have to live with budgets. I will tell you everything I own. I will even tell you when I die. All I want you to tell me is:

What is my allowance?" This question is gaining increasing urgency as McKinsey & Co. (2006) reports that more than half of all investable U.S. financial assets are controlled by heads of household older than 55 years of age. These households are expected to control two-third of investable assets over the next 10 to 20 years.

Based on this insight from real people and current research, a key issue now facing the retirement income industry is: can we answer the retiree's question with traditional Hopeful Accumulation strategies which can best be described as: "Let's build a mountain of cash. Of course, your returns may vary.?" Investors realize they need to save and invest with the goal of accumulating wealth for retirement. Yet most of them are uncertain as to how big a mountain of cash they really need to build, or if the mountain they are currently building will give them the sustainable income they need to fund all their years in retirement.

Or, will traditional Reliable (Guarantee) Income strategies meet the need? These strategies may be expressed as: "To get my guarantee, I must cede control." Generally and subject to exceptions, the terms of financial product contracts that offer the guarantees which investors find attractive require that investors give up control over their wealth. As an example, the purchase of a single premium immediate annuity from an insurance company will guarantee payments for a defined number of years, and/or the investor's lifetime. However, the guarantee comes at the significant cost of lost liquidity and control over the assets.

MANAGING THE TRANSITION PHASE

While it is now routine to contrast the accumulation phase of retirement planning to the income generation phase, continuing discussions among RIIA members suggest that the real life picture may not be so binary. We need to look beyond hopeful accumulation and reliable (guaranteed)

income distribution to add a new phase: transition management. This is key for advisors to understand in order to best help their clients plan for today and into the future.

RIIA's identification of the transition management phase arises from two observations. First, in the late accumulation/pre-retirement phase, the investor is completing an accumulation career that may have spanned 30 or 40 years. Due to the compounding nature of accumulation, half of the investor's dollar accumulation is achieved in the last eight to 10 years of the typical career. What's risky here is that if investment returns on retirement assets fall below expectations during this the final years of this phase, it could be devastating to the retirement nest egg because so much of the total retirement dollar accumulation is at stake. It also puts a spotlight on the importance of advisors' focusing on downside protection as well as growth during the last eight to 10 year period of the accumulation phase.

Additionally, investors may be experiencing the psychological impact of transition management when they begin to feel a "dislocation of expectations" as they try to make retirement expectations (in dollar terms) converge with illustrations of the odds of success and probable investment returns (in percentage terms). The investor's changing metric for risk may be shifting from focusing on the odds that "returns may vary" to the actual dollar amount of the "mountain of cash" and the sustainable dollar income it may provide. Such a change may move investors from being somewhat risk-averse to becoming more clearly loss-averse. The loss-averse investor will increasingly expect the advisor to have a downside protection story as well as a growth story.

A second observation leading to the identification of the transition phase is that in early retirement, researchers (Milevsky, 2006) are showing that the first decade in retirement is particularly important in terms of the potential risk of "portfolio ruin." Portfolio ruin is the possibility of living longer than the portfolio's income generation capacity. As a conditional probability statement, the experience of zero returns on the retirement portfolio (let alone negative returns) in the first decade may be 70 to 80 percent correlated with portfolio ruin. This risk exhibits exponential decay over the entire retirement period. Accordingly, the risk of portfolio ruin drops in the second and third decade in retirement, but does not disappear entirely. Given this perspective, downside protections become critically important during retirement in general and during the first decade in retirement in particular. Recent retirees will also expect the advisor to have a downside protection strategy.

As investors and advisors start to realize the importance of transition management, they may begin to change their mindset about how to plan for portfolio growth and against portfolio ruin. Such a change may force both the investment and the insurance industries to move beyond incremental adaptations of their existing business models to the consideration of new business models that will more effectively address the rapidly evolving needs and wants of consumers, especially during the transition phase. It may also require the active cooperation

and teamwork among individuals with specific skills who are mostly confined to existing industry silos, including investment management, actuarial science, and financial engineering. Finally, this change in outlook may help explain why many RIIA members are researching and reporting the early rumbles of a tectonic shift in the market, a shift that pushes them to consider going beyond incremental improvements and solutions to known problems in favor of innovations that address a new questions. Conceivably, we are at the threshold of a new retirement income story in ways that extend beyond business as usual.

KNOWLEDGE IS POWER

Information, training, and education are especially vital for financial advisors who are the backbone of advising, helping, and strategizing with clients to prepare for retirement and within retirement to ensure retirement security over the long-term. To properly understand and deliver on the unique retirement income needs of the Baby Boom generation, a new set of expertise and acumen may be required of the financial advisor. Those advisors who master these specialty skills and communicate their knowledge and capabilities to clients effectively will experience greater success as they transition Baby Boomer clients into their retirement paycheck years.▲