RETIREONE® REPORT

Protecting Clients in The Fragile Decade

Mitigating Sequence of Returns Risk and Longevity Risk with Next-Gen, Low-Cost Guaranteed Lifetime Withdrawal Benefits

One of the most difficult tasks that Registered Investment Advisors (RIAs) face is advising their clients who are in the period five years before retirement through the first five years of retirement. This ten-year period forms a "fragile decade" where a poor sequence of returns can have a debilitating impact on a client's retirement portfolio. Suffering a significant loss of assets during this period makes it nearly impossible to recover because of the relatively short investment horizon that remains.

For example, a client who suffers a 33 percent decline in portfolio value would need to achieve a 50 percent gain to recoup those losses. Such a loss at age 30 leaves the client with decades to recover. The same loss between the ages of 60-70, however, would not only leave a much smaller window of opportunity to recover from the portfolio loss, but would also happen when the client is making withdrawals—decumulating the asset. This is what makes that ten-year period so fragile.

Historically, advisors have sought to protect their clients during the fragile decade by recommending that they allocate retirement assets more heavily toward bonds, trading the higher yield potential of equities for the greater relative stability of bonds. As the thinking goes, once clients enter retirement, advisors could help establish a withdrawal regime that maintains the asset for the entire retirement period—best exemplified by the "4 percent rule" first proposed by William Bengen in 1994.[1]

However, in recent years, advisors have seen their clients face an unprecedented array of historical, economic, and even biological factors that have undermined their clients' ability to have enough money to last their entire retirement. Simulations predict that, after adjusting for inflation, 6 percent of portfolios using a 4 percent withdrawal will fail in less than 30 years. Projected failure rates can jump as high as 57 percent when calibrating for current bond returns.[2] These failure potentials are concerning, especially considering that these particular models do not factor an advisor's fee, which effectively turns the strategy to a 5% withdrawal and results in compounded predicted failure rates. Even if these failures remain on the lower side of the predictive models, then that is still an unacceptable number of clients who could potentially run out of income during their retirements.

What can advisors do to combat these predictions of failure and secure a safe withdrawal strategy of lifetime income for their clients? This report will discuss the challenges facing RIAs and their clients, why traditional strategies for protecting client retirement assets may become increasingly insufficient, and how methods of guaranteeing retirement income for clients have evolved—from costly and opaque proprietary annuity products to low-cost, no-load annuities offering transparency, no commissions, and better underlying investment options. Topics in this report include:

» How the change from defined benefit to defined contribution retirement plans completely shifted the risk paradigm for retirement from the provider to the retiree. This shift is the prime reason why the five years before and after retirement have become so tenuous for Americans.

» An exploration of how market volatility and poor bond returns have made it increasingly difficult for advisors to develop retirement allocations that sufficiently manage risk while still providing returns that can sustain the portfolio for the length of retirement.

» How traditional withdrawal strategies like the 4 percent rule have grown less reliable and cannot guarantee retirees will outlive their assets. The economics of this strategy may be negatively impacted when factoring in the asset-based fee charged by RIAs.

» How greater longevity has also increased the possibility of portfolio exhaustion, and human longevity will continue to increase in the foreseeable future.[3]

» And how retirement income guarantees have evolved from expensive and restrictive to flexible and less expensive riders that provide sufficient lifetime guarantees without shackling participants with excessive requirements. There are also more products coming to market for the fee-only advisor who can't refer a commissionable insurance product.

CLIENT RISK 1: The Erosion Of Guaranteed Retirement Income

For more than a century, the concept of retirement income hinged on defined benefits, guarantees of fixed income manifested in the form of pension plans and Social Security. The American Express Company introduced the first private pension plan in 1889. Pension popularity grew in the subsequent decades and then exploded in the post-World War II era.[4] By 1979, 90 years after that first pension plan, 87 percent of private sector workers were covered by a private pension plan.[5]

During the same period, in 1935, the Social Security Act was passed. Intended primarily to bring relief and mercy to massive suffering and deprivation, "Old-age insurance" was established along with two other components of the Act. Commonly referred to by the shorthand "Social Security," this provision formed the bedrock of that legislation.

"While Social Security and pension plans were not intended to be the sole sources of retirement assets, they provided a guaranteed income for retired Americans."

While Social Security and pension plans may not have been intended to be the sole sources of retirement assets, they provided a measure of protection for retired Americans by sheltering them from risk, as employers and the government managed the funds. Regardless of any additional retirement assets Americans amassed through savings or investments, they could rely on receiving at least *some* guaranteed income throughout the entirety of their lives in retirement.

At the very height of the popularity of pensions, however, that began to change. 401(k) plans were created under the aegis of the Revenue Act of 1978. Originally intended to supplement existing retirement assets—including pensions—401(k) plans quickly overtook pensions as the main retirement asset vehicle.

By 2017, only 13 percent of private workers had pensions,[6] and 401(k) assets accounted for nearly $2 trillion more than defined benefit programs ($5 trillion to $3 trillion).[7] This gap grew from $1 trillion in 2012 and marks a shift from defined benefit to defined contribution plans. Participating employers would offer plans and in some cases matching contributions, but the investment allocations and risk were the responsibility of the plan participants. For most Americans in the private sector, this removed any guarantee of retirement income from their employers.

In addition, Social Security faces funding challenges that could render it unable to provide full benefits to retirees. Current estimates by the government-appointed Board of Trustees predict that the program will not be able to meet 100 percent of its benefit obligations by 2035.[8]

The reduction in pension plans and precarious state of Social Security leave advisors with little choice for guaranteed retirement income solutions. They have traditionally advised clients to build suitable retirement portfolios by investing more heavily in equities early and gradually shifting to bonds as clients approach the fragile decade. However, monetary policy and economic changes in the last two decades have compromised this strategy.

CLIENT RISK 2: The Increase of Portfolio Failure Due to Reduced Interest Rates and Volatility

In 1994, while 401(k) accounts were accelerating in popularity as the primary retirement savings vehicle for many Americans, financial analyst William Bengen proposed his 4 percent rule. Bengen devised the strategy by looking at financial data from the previous 75 years and using it to calculate the effect of interest rates and inflation on a retirement portfolio over a 30-year period. His model suggested that retirees who drew no more than 4.2 percent of their portfolio every year would have a high likelihood of their assets outliving them.[9] This rule became a common strategy for advisors, and it fit with recommending that clients shift more of their portfolios from high risk equities to safer bonds as they approached retirement. At the time of Bengen's research, the bond market, while safer, still provided competitive interest rates that could provide some additional return even as retirees began drawing down their nest eggs.

That is not the case in today's current bond market. Low interest rates have driven down bond yields to historic lows, to the point where returns can be minimal or even negative when factoring for inflation. This combination of low yields and inflation can dramatically eat away at retirement portfolio value. For example, an inflation rate of 3 percent can reduce the buying power of a retiree by 45 percent over a 20-year period. Entering the fragile decade with a bond-heavy portfolio could send a client's retirement assets on a downward spiral to exhaustion before the end of the client's life.

In fact, recent simulations suggest that, after adjusting for inflation, 6 percent of portfolios using the 4 percent drawdown strategy will fail in less than 30 years. When the models calibrate for current bond rates rather than relying on historical averages, the simulations have 30-year failure rates as high as 57 percent.[10] Note that these simulations did not include adding an RIA's asset-based fee, which would push the annual withdrawal rate to 5 percent and further compound the chance of failure.

Advisors also cannot count on current rates increasing simply because rates have historically gone up again after down periods, as historic bond performance is not necessarily an indicator of future bond performance. Therefore, relying on current, lower bond rates as a gauge of future bond performance is a safer and likely more accurate method for basing investment strategies. (Bengen arrived at his 4.2 percent figure using a similar conservative approach, basing it on the worst 30-year investment period in his historical analysis.)

What options does this leave today's advisors? With fixed-income investments returning insufficient yields, advisors may eye the higher yields of equities as worth the risk, even as clients near retirement. However, consider that the stock market lost $1.4 trillion in the 2001-2003 period and $3.7 trillion in the 2008 crash.[11] A client encountering such a serious downturn during their fragile decade would find it difficult to recover from such a negative sequence of returns.

This may leave RIAs in a bind while balancing risk and yield, especially when compounded by another issue: increased client longevity.

CLIENT RISK 3: Increased Longevity Means Retirement Assets Have To Last Longer Than Ever

In 1940, just a few years after Social Security was enacted, men who lived to 65 had an average remaining life expectancy of 13 years; the figure was 15 years for women.[12] Retirement savings only had to last a decade and a half for many Americans who lived to retirement age, and many of those who worked also received employer-sponsored pensions.

Today, there's a greater than 50% probability that men and women who reach age 65 will go on to live to age 85, and a better than 35% chance that they live into their nineties.[13]

Increasing longevity creates strategic challenges for RIAs as they try to help their clients plan for retirement. They must find ways for their clients to accumulate enough money to last longer than ever at a time when low bond rates reduce the sustainability of retirement portfolios; an erratic market could make a poor sequence of returns even more devastating if clients are invested too heavily in equities around the commencement of retirement; and the only guaranteed retirement income most will have to rely on are their increasingly tenuous Social Security benefits.

Initial Attempts To Insure Retirement Portfolios Against Total Loss

For decades, consumers have purchased insurance for assets such as homes and automobiles. Likewise they have purchased health insurance as a hedge against expensive future medical expenses. As retirement savings vehicles shifted to defined contribution plans with no guarantee of income, insurers began offering retirement income insurance as a way to protect retirement balances from depletion.

Longevity: Probability of a 65-Year-Old in Average Health Living to Age 95[13]

These guaranteed living benefit riders allow participants to insure a minimum level of income regardless of portfolio performance, without being forced to annuitize as with traditional annuities like single premium immediate annuities (SPIAs).

SPIAs, too, offer a way to insure an income stream. They allow participants to pay a lump sum in exchange for a guaranteed withdrawal benefit—for a set amount of income, a set time period, or for the life of the participant.

They also appeal to investors who want to guard against uncertain markets and the possibility of outliving their assets. But they are very restrictive.

Though more flexible, early guaranteed living benefit riders were not always designed for optimal client value.[14] They were complex and somewhat restrictive. Once the participant paid into the insurance plan, their money was no longer accessible without paying surrender penalties, and participants could not opt out if they changed their minds.

"To meet this demand, insurers developed low-cost, next-gen, commission-free annuities with Guaranteed Lifetime Withdrawal Benefits ."

The plans determined how participants could allocate their investments to avoid being over-invested in equities, how much the participants could receive of their payouts, and often had no adjustment for inflation or market performance. And in the case of SPIAs and/or annuitization, there were little or no death benefit options for those participants with a bequest motive.

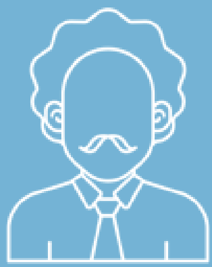
Even with the potential for guaranteed income in the event of asset depletion, the inflexibility and loss of control inherent with these products was unappealing.

Toward A More Flexible, Beneficial Retirement Insurance Model

Unfortunately, the challenges of unsure markets, rising healthcare costs, and longevity risk appear to be growing. Fiduciaries and their clients have made it clear they may seek the benefits of guaranteed retirement income streams only if the products are flexible, transparent, and offer better control over the underlying assets.

To meet this demand, insurers developed low-cost, next-gen, commission-free annuities with Guaranteed Lifetime Withdrawal Benefits (GLWB)—a powerrful evolution in insured retirement solutions.

Lack of flexibility and transparancy are the greatest issues with traditional annuities. Clients are required to make long-term commitments with SPIAs and similar guaranteed income benefits. There are also restrictions on investment allocation that force participants to remain in bond-heavy portfolios that (as mentioned above) have a greater chance of failure. GLWBs address these two key issues by allowing clients to build their portfolios with higher equity allocations and back out of or postpone participation.



Client 1: Nearing retirement

He wants to increase the yield potential of his portfolio by maintaining a 80/20 equity/bond allocation. However, he is afraid of a poor sequence of returns should the equity market suffer a significant downturn so close to retirement. The client uses an annuity with a GLWB for a portion of their portfolio to insure their income stream by protecting against losses. Earlier annuity products would have restricted such a mix, likely pushing clients toward a 50/50 allocation.

Client 2: The Fragile Decade

She enters her fragile decade during a volatile market period. She wants to protect her retirement income should markets turn downward, but she doesn't commit to decades of retirement insurance if she doesn't need it. With her IRA she purchases an annuity with a GLWB at the start of retirement. The market eventually stabilizes, growing her portfolio, and she decides to cancel the rider after five years. She does so with no penalty since the money is qualified, something that would not have been possible if she annuitized her policy.

In both of the above client scenarios, a GLWB offers advisors a way to protect their clients' portfolios as well as their options when insuring their stream of retirement income.

Next-Gen GLWBs to Protect Clients in the Fragile Decade Against Adversity And Insolvency

Next-gen guaranteed lifetime withdrawal benefits can provide registered investment advisors with a way to secure the income streams of their clients without tying them down with long-term commitments or restrictive investment options. They are easier to explain and easier to understand.

In light of the sagging bond market, GLWBs may also provide an appealing way to reap the benefits of a retirement allocation that favors equities while sheltering clients from the risk of a poor sequence of returns.

The ability of clients to cancel a GLWB without penalties or tax consequences (in qualified accounts) also allows them to maintain control over their portfolio and not have to commit to an insurance product they may not always need.

In short, next-gen, no-load annuities with GLWBs offer another way to serve clients in an environment where rising healthcare costs, longevity, yield, volatility, and lack of guaranteed retirement income have raised the risk of outliving retirement assets.

1 Bengen, William, "Determining Withdrawal Rates Using Historical Data," Journal of Financial Planning (October 1994).

2 Finke, Michael S., Pfau, Wade D., and Blanchett, David, "The 4 Percent Rule is Not Safe in a Low-Yield World," (January 15, 2013). Available at SSRN: http://ssrn.com/abstract=2201323.

3 For an example of longevity predictions, see Garreau, Joel, "Drooling on Your Shoes or Living Long and Prospering: Four Visions of Our Future Lifespans," Slate (September 25, 2013). Available at http://www.slate.com/articles/technology/future_tense/2013/09/four_scenarios_for_our_future_lifespans.html.

4 Workplace Flexibility 2010, Georgetown University Law Center, "A Timeline of the Evolution of Retirement in the United States" (2010). Memos and Fact Sheets. Paper 50. Available at http://scholarship.law.georgetown.edu/legal/50.

5 "Social Security and Pensions," SmartMoney (October 2011).

6 U.S. Department of Labor, Bureau of Labor Statistics, "National Compensation Survey: Employee Benefits in the United States, March 2018," Private Industry Tables, Table 2. (https://www.bls.gov/ncs/ebs/benefits/2018/ownership/private/table02a.htm).

7 American Society of Pension Professionals & Actuaries citing resarch from Investment Company Institute, "U.S. Retirement Assets Reach $26 Trillion," (June 28, 2017). Available at: https://www.asppa.org/news-resources/browse-topics/us-retirement-assets-reach-26-trillion..

8 Social Security Administration, "A Summary of the 2019 Annual Reports," (April 25, 2019). Available at: https://www.ssa.gov/oact/TRSUM/index.html

9 Bengen, ibid.

10 Finke, Pfau, and Blanchett, ibid.

11 Loss figures based on S&P 500 data from Yahoo Finance, March 2012.

12 Social Security Administration, "Life Expectancy for Social Security," (no date). Available at: http://www.ssa.gov/history/lifeexpect.html.

13 Age data taken from the Society of Actuaries and American Academy of Actuaries (http://www.longevityillustrator.org/). Retrieved July 15, 2019.

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