The Fragile Decade™

Providing A Sustainable Withdrawal Strategy For Retirement Planning In An Era Of Economic And Demographic Challenges

Read this paper to better understand the difficulties RIAs face as their clients approach retirement, including:

- Factors that are increasing retirement portfolio failure
- Why traditional withdrawal strategies cannot adequately solve tomorrow's retirement funding challenges
- Advances in providing guaranteed income for clients during retirement

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. If a client suffers a significant loss of assets during this period, it is almost impossible to recoup those losses due to the shorter time horizon for the portfolio. 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 still 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. This is what makes that decade so fragile.

Historically, advisors have sought to protect their clients during the Fragile Decade by recommending shifting retirement assets more heavily toward bonds, trading the higher yield potential of equities for the greater stability of bonds. Once clients entered retirement, RIAs could help them establish a withdrawal amount that would maintain the assets 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 have predicted 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 should alarm RIAs, especially considering that the models do not factor an advisor's fee, which effectively turn 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 RIAs do to combat these predictions of failure and secure a safe withdrawal strategy of lifetime income for their clients? This paper 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. Topics will include:

- 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 clients of RIAs.

- 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.
- Traditional withdrawal strategies such as the 4 percent rule have become less reliable and unable to guarantee retirees will outlive their assets; this strategy also effective becomes a 5 percent rule for fee-based advisors
- Greater longevity has also increased the possibility of portfolio exhaustion, and human longevity will continue to increase in the foreseeable future.[3]
- Strategies for guaranteeing retirement income for retirees have evolved from more restrictive insurance riders to flexible retirement wrappers that provide sufficient lifetime guarantees without shackling participants with excessive requirements. There are also more products being made available for the fee-only advisor who cannot 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, the Social Security Act was passed in 1935. Although initially intended primarily to provide direct financial assistance to elderly Americans, the secondary provision of the act, the old age insurance provision, became the bedrock of the current Social Security program.

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. They also sheltered retirees from risk, as employers and the government managed the funds. Regardless of any additional retirement savings most Americans added to pensions and Social Security, they could rely on receiving at least some guaranteed income throughout their retirements.

At the very height of the popularity of pensions, however, that began to change. In 1978, 401(k) plans were created through changes in the U.S. tax code. Originally intended to supplement existing retirement assets—including pensions—401(k) plans quickly overtook pensions as the main retirement asset vehicle. By 2012, only 17 percent of private workers had pensions,[6] and 401(k) assets accounted for nearly $1 trillion more than defined benefit programs ($3.5 trillion to $2.6 trillion).[7] This marked 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 leave it unable to pay its 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 2033.[8]

The eradication of pensions and precarious state of Social Security leave retirement advisors with little chance to help their clients find adequate levels of guaranteed retirement income. Instead, RIAs have 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, economic changes in the last decade have greatly undermined this strategy.

CLIENT RISK 2:
The Increase Of Portfolio Failure Due To Greatly Reduced Interest Rates And Increasingly Volatile Equities

In 1994, as 401(k) accounts were accelerating in popularity as the primary retirement savings vehicle for many Americans, financial analyst William Bengen proposed his 4 percent drawdown 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 strategy, the bond market, while safer, still provided competitive interest rates that could provide some additional return even as retirees began drawing from 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 they can be a zero sum or even a negative return 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 start a client's retirement assets on a downward spiral toward total 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. Even more alarming, 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 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 if not impossible to recover from such a negative sequence of returns. This leaves RIAs in a serious bind when balancing risk and yield, especially when those issues are 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 pensions from their employers.

Today, not only do more than half of men and women who reach age 65 go on to live to age 85, many also live into their nineties. Consider these longevity statistics:

- Men age 65 have a 13 percent chance of living until age 92.
- Women who reach age 65 have a 20 percent change of living to 92.
- For a couple who both live to age 65, there is a 25 percent chance at least one will reach age 97.[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 have 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 much in equities around the commencement of retirement; and the only guaranteed retirement income most will have are 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.

These guaranteed living benefit riders allow participants to insure a minimum level of income that could be received regardless of portfolio performance. Products such as single premium immediate annuities (SPIAs) allow participants to pay a lump sum and then receive a guaranteed withdrawal benefit—for a set amount of income, a set time period, or for the life of the participant. They had appeal for many people who wanted to have some safeguards against uncertain markets and the possibility of outliving their assets.

As some have pointed out, early attempts at these products were not always on terms favorable to the participant.14 They were inflexible and irreversible, and once the participant paid into the insurance plan, their money was no longer available without big penalties. They could not opt out if they changed their minds (for instance, if their portfolios experienced an upswing), or had to pay significant penalties if they did. The plans had restrictions on benefits—how participants could allocate their investments to avoid being over-invested in equities, how much the participants could receive their payouts—and often had no adjustment for inflation or market performance. If participants died during annuitization, the insurer also kept the money.

As such, these early retirement insurance offerings were not appealing to advisors. Even with the potential for guaranteed income in the event of portfolio depletion, the inflexibility and loss of control for clients were unappealing.

Moving Toward A More Flexible, Beneficial Retirement Insurance Model

Unfortunately for RIAs and their clients, the challenges of unsure markets and increased potential to outlive assets appear to be growing. Clients may be seeking the benefits of a guaranteed retirement income stream as long as they are not overly restricted by the conditions imposed by the insurer. And fiduciaries will only be comfortable recommending a guaranteed retirement income solution if they can have greater control over how the underlying assets are invested. To meet these market needs, insurers developed new Guaranteed Lifetime Withdrawal Benefits (GLWB), an evolution in retirement insurance strategies.

The lack of flexibility was the greatest issue with previous retirement annuity products. A client had to make a long-term commitment with SPIAs and similar guaranteed income benefits. There were also usually restrictions on investment allocation that would force participants to remain in bond-heavy portfolios that (as mentioned above) are having greater chance of failure. GLWBs address these two key issues by allowing clients to back out or postpone participation and choose their portfolio allocations.

Two examples illustrate how the GLWB allows greater flexibility than previous annuity products:

Scenario 1: A client nearing retirement wants to increase the yield potential of his portfolio by maintaining a 70/30 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 a GLWB as a wrapper on their portfolio to insure their portfolio. Earlier annuity products would have restricted such a mix, likely pushing clients toward a 50/50 portfolio split.

Scenario 2: A client enters her Fragile Decade during a volatile market period. She wants to protect her retirement income should markets turn downward, but not commit to decades of retirement insurance if she doesn't need it. She purchases a GLWB at the start of retirement. The market eventually stabilizes, growing her portfolio, and she decides to cancel the GLWB after five years. She does so with no penalty, something not possible with earlier iterations of retirement insurance products.

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

CONCLUSION:
In Today's Retirement Environment, Fee-based RIAs Need More Tools To Protect Clients Of Retirement Age Against Adversity And Insolvency

Contingent Deferred Annuities 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. In light of the sagging bond market, GLWBs may 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 penalty also allows them to maintain control over their portfolio and not have to commit to an insurance product they may not need.

In short, GLWBs offer another way to serve their clients in an environment where longevity, yield, volatility, and lack of guaranteed retirement income have dramatically raised the risk of outliving retirement assets.

Questions About This White Paper?
Contact Aria Retirement Solutions at 877-575-2742.

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[10] Finke, Pfau, and Blanchett, ibid.

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