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Retirement Portfolios

Theory, Construction, and Managemen

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Preface

Life in 2009 and Beyond

"What was I paying you for?"

Whether asked in a civil or angry tone, that is the question that many advisers hear explicitly or implicitly from their clients. It's a valid question. The business model of retail financial services has been based around creating high expectations but devoid of defined milestones or goals; in the jargon of the MBA, the business model has been built around selling hope without offering the client any explicit deliverables.

For nearly 25 years, beginning in 1981, selling based on expectations and hopes was enough to build a business. As the affluent classes expanded, portfolios were created and markets boomed. Retail advisers could sell expectations and the market generally delivered the outcomes for accumulators and retirees alike. The few storm clouds and squalls that did appear could all be managed—and the manageability of those small storms seemed to justify a business model with expected performance as its linchpin. As in any business model an arms race inevitably develops around the selling linchpin. In financial markets expectations of performance begat expectations of outperformance. Built around raised expectations of performance rather than delivery of outcomes, this business model left clients—and the model itself—vulnerable to the financial hurricane.

The first dark clouds appeared with an unexpected mortgage write-down by HSBC Holdings in early 2007. The clouds were followed in June with the lightning bolt forced liquidation of two Bear Stearns hedge funds. Credit markets soon began to blow apart leaving corporate borrowers unable to roll debts, particularly those funded with short-term paper. Asset-backed commercial paper, auction rate securities, variable rate debt obligations, and the entire repo market foundered. The Fed cut rates and injected liquidity, yet Bear Stearns and AIG still failed. Lehman failed, Merrill almost failed. Morgan Stanley looked to be in a death spiral.

The events of 2007–2009 were a double blow. The softening of the housing market was impacting the balance sheets of clients and putting a drag on the economy, but the failures within the financial system nearly sent the economy over a cliff. Not only did the markets for all asset classes deflate with suddenness and violence as if it were a case of financial "Ebola," many of the mainstay firms that proffered advice to retail clients were destroyed. They were largely responsible for the debacle, inept at handling the crisis, and unconcerned about the damage wrought. It is hard to sell your advice as wise when your firm is blowing itself to kingdom come and the CEO is mismanaging nearly every utterance, including public testimony before Congress. For clients, it meant that plans, built on thrift and deferred consumption were destroyed. For advisers, the impact has been, and is being, felt at both the personal and career levels.

In the aftermath of the panic, with its damage to both client portfolios and client relationships, some have been quick to declare the retail model dead. Selling based on expectations and fair-weather investing may not be dead, but it will certainly be tempered for a while, perhaps even for a generation. Clients are reevaluating their strategies and tactics for building portfolios, which means that the business model will, if nothing else, evolve.

Selling expectation-based portfolios based on concepts promising risk-free enhancement of yield such as alpha[1] are great for raising client's expectations of higher return per unit of risk. Unfortunately, what was often sold as alpha was really either just a liquidity premium or a premium for non-linear risk; in normal markets these premiums accrued to the holder. In markets such as the one of 2008, however, illiquidity acted as a lead weight on a struggling swimmer and events that previously seemed like remote possibilities came to pass. For the most part, alpha-promising products are great for selling on aspiration but poor for resiliency in meeting future needs. Advisers need to have a business model that allows them to sell based on expectations that meet both client's aspirations and future needs.

In spite of all that has happened, the news is mostly good. Portfolios can be constructed to withstand market turmoil, and they can be constructed out of familiar components. The "sleeves" might feel a little different, but the feel is familiar. For many people, this means keeping the type of portfolio that they know and are comfortable holding. For the adviser, the change in business model is substantial, but the change in day-to-day operations will feel natural. To be sure, there are some things to think about and do differently. For most people there's no need to take a "sledgehammer" approach. Saving for retirement doesn't become any easier, but you can build portfolios that are sensible, robust enough against market cycles to protect lifestyle and still provide opportunities for aspiration to a better lifestyle.

Clients defer consumption and save their money for a reason. A portfolio is not a flower garden designed for purely aesthetic value, but a means to prepare for future needs. While willing to take risk, clients maintain an expectation that *enough* of the money will be there when it is required to meet future needs. For the adviser, it means that creating outcomes is important. It doesn't mean, or have to mean, risk avoidance. But it will mean that alert risk monitoring will be required for some and risk compartmentalization for others.

This is a good time to reflect on what advisers can do that is both viable in a business sense and valued by their shell-shocked clients. Advisers offer more than market knowledge, product knowledge, transactions, and advice. Advisers have a comparative advantage as service providers for clients. This book focuses on helping advisers—and individual clients—utilize that advantage and ensure value-additive portfolio creation and proper management.

In the traditional model, advisers combine product and market knowledge with sales acumen to create a book of business. Here we show how to extend beyond the simple lens of risk-return to create a scalable business model that allows for most of what you are used to doing but simultaneously meets the customized needs of clients. We also cover other ways an adviser adds value, particularly as a *delegate:* Someone who can take action without the conflicted passions of trying to manage one's own emotions and portfolio simultaneously. Whether the relationship allows for discretion or not, the adviser's monitoring of markets means that the adviser can act faster and without waffling when conditions are met (nondiscretionary) or deemed warranted (discretionary).

Retirement is the most opaque, costly, and angst ridden part of financial planning that most people face. The good news is that it doesn't have to be that way. The bad news is that, as of 2008, only a small percentage of financial advisers describe themselves as competent when it comes to creating portfolios designed to meet retirement needs. Clients can't look to 401(k) administrators for solutions; they'll probably receive a nice pamphlet with lots of bromides for the "average" retiree, but it will be next to useless for your client. For the most part, they are neither properly registered to be allowed to offer investment advice nor, as plan administrators, able to provide tailored advice; asking for information about something not on the menu would be a complete waste of time. For some, the last two sentences are a problem, for you and for me they're an opportunity.

When properly explained, understanding how to structure portfolios for retirement income is an easier problem than most advisers realize. Saving for retirement may be difficult, but, with the proper understanding, you can analyze the circumstances of your clients and from there show them what to do without feeling lost yourself. By knowing where they are, and where they want to be, you will better understand how you can take actions to improve outcomes.

Much of what advisers and clients need to know is straightforward and intuitive—its stuff that makes sense. Most of the material is geared for the financial professional; if you're an individual whose goals are simply to understand what needs to be done and be able to converse intelligently with your adviser you may want to skim the more technical sections. Each chapter is designed to (1) enhance understanding, (2) enhance competence, and (3) enhance expertise. At the very least, you should finish this book with a better understanding of what needs to be done, even if you skip the sections on how to do it or how to do it really well.

Most parts of the book are not technical but expository. However, some parts will require—and reward—those with patience and concentration. There is a workbook accompanying this book for those who want to implement the portfolios discussed here. I make no apologies for the segments on allocations and active risk management being technical in nature. On balance, I've attempted to minimize the abstract and maximize concrete examples. Most of the mathematical concepts are found in the accompanying workbook or moved to the appendix of this one. There are a few background areas where I get into the assumptions and theory underlying the methods used, but I keep those for exposition that will be of most use to those who want to implement some of the ideas discussed in the book for a varied client base.

In reading this book, you will spend most of your time learning how to reframe your existing practice to provide more value to clients. Much will focus on what to ask and how to act to protect your client's retirement *and* aspirations. You'll also be given a menu of alternatives that you can undertake in concert with your clients. All of the alternatives presented here conform to best practices. Your job will be to understand your client's preferences and pick which alternative works best for him or her. For an individual, you can choose between going it alone or conveying what you want your financial adviser to do on your behalf.

In writing this book I have received no funding or payment from any firm. It is not my intention to sell anything but rather educate so that you can do the selling. For that reason, this book is aimed at helping professionals understand how to manage a portfolio of assets to protect a lifestyle without changing the desirable features of current practice and bridging them to the emerging thought on best practices. Some intrepid individuals may find this book useful, but it is not meant as a simple guide for average readers. For professionals, I have sought to provide a framework of solutions that can be scaled across their client base. These professionals can be:

- Transaction-oriented salespeople
- Asset gatherers
- Portfolio managers
- Insurance planners
- Financial planners

PART ONE: FRAMING THE PROBLEM

Part One (Chapters 1–5) provides the setup, the thematic underpinning for viewing retirement income needs. These first chapters are designed to focus your attention on framing the retirement portfolio problem in a way that can be solved. If you think back to your days of doing word problems, Part One is designed to help you understand the important aspects of the portfolio problem and set up the problem to be solved in Parts Two through Four.

Chapter 1, Portfolio Focus and Stage of Life, shows you how tools and techniques used in the accumulation phase of your client's life don't work well or are inappropriate for both planning for and living in retirement.

Chapter 2, The Top-Down View: A Short Primer on Economic Models of Retirement Income, provides a capsule summary of the last 40 years of economists' work in the areas of consumption planning and lifetime portfolio selection relating to retirement. This provides a useful way of framing the issues and splitting up the problem into two parts: meeting your client's lifestyle needs and meeting your client's need to aspire. Our focus for the remainder of Part One is on the lifestyle needs and we defer the aspirational needs to Parts Two through Four, where we discuss allocations, portfolios, and risk management for retirement.

Chapter 3, The Importance of Lifestyle Flooring, is all about understanding lifestyle (flooring) needs and the classifications of product types that help to safeguard lifestyle during retirement. We delve a little deeper to see how what is considered a need will be funded. By matching needs against resources, and the options available for securing lifestyle needs.

Chapter 4, Monetizing Mortality: Annuities and Longevity Insurance, looks at risk pooling, how longevity-based products work, and an individual's ability to monetize one's own mortality. Roughly 15 percent of all retirement assets are held in insurance-related retirement products such as annuities. For many, it is the only retirement product that they own. There are many classes of these insurance-related products and most individual products seem difficult to understand. The goal of Chapter 4 is to simplify the understanding of insurance products and, when coupled with Chapter 3, help your clients decide if insurance products are right for them.

Chapter 5, Flooring with Capital Markets Products, is a brief look at using capital markets products to help secure a floor under a lifestyle. It is not meant as a comprehensive guide, but in tandem with Chapter 4, meant to provide a perspective on the possibilities for creating lifestyle security with standard products such as stocks and bonds that can be used to construct a retirement income portfolio. When coupled with Chapter 3, Chapter 5 helps to crystallize the notions of a protected floor.

PART TWO: ADAPTING PORTFOLIOS FOR RETIREMENT INCOME

Part Two is designed to move you from understanding to action. The theme is to start with the subtle changes that make big differences. This part is dedicated to taking your ingredients and combining them in a recipe to meet outcome-oriented goals. In Part Two, we start with some simple retirement income constructs that dovetail with traditional accumulation portfolios. The objectives are twofold. Our first objective is to show advisers and individuals that there are straightforward ways to prepare for the act of retirement, naturally transitioning from an accumulation to a retirement income focus. Our second objective is to show that the changes to portfolios are not drastic; conceptually, they make sense to clients and they are as scalable as traditional constructs.

Chapter 6, Building Retirement Income Portfolios, walks through the basic portfolio construction for retirement income. For those still working or in the preretirement accumulation phase, this chapter offers simple construction types for building retirement income portfolios. The portfolio constructs offered are straightforward for individuals and scalable for professionals to offer to multiple clients. The last section of Chapter 6 offers a list of 11 common pitfalls regarding the use of taxable versus tax-advantaged accounts for assets. To paraphrase Nigel Tufnel, most books only offer 10 pitfalls, but this book has *11*.

Chapter 7, Creating Allocations for Constructing Practical Portfolios by Age and Lifestyle Needs, provides some information and examples of functional asset allocation useful for conceiving complete retirement income portfolios. This chapter provides guidance on allocations to lifestyle security, longevity risk, precautionary needs, and risky assets. We also discuss the impact of having lifestyle security on an individual's risk tolerance. Chapter 7 helps to clarify the line between those who are more natural candidates for insurance products versus standard capital-markets products like bonds.

PART THREE: MANAGING PORTFOLIOS FOR RETIREMENT INCOME

All portfolios need to be monitored and occasionally they need attention. This is as true of a passive portfolio as an actively managed one. For passively managed portfolios, the goal is to keep the portfolio on a predetermined track. For actively risk-managed portfolios, the goal is to seek the higher returns that come with higher risk without letting the risk threaten to endanger lifestyle.

Chapter 8, Rebalancing Retirement Income Portfolios—even if you set up a passive portfolio for retirement income, it requires periodic rebalancing to raise what it provides for the client's lifestyle and to avoid increases in risk. There is a difference between rebalancing as used in the normal context of accumulation portfolios and portfolios that are set up to protect a lifestyle. In our case, rebalancing is a more delicate, but not more difficult, problem. There is a role for traditional rebalancing within the aspirational segment of the portfolio that is also discussed.

Chapter 9, Active Risk Management for Retirement Income Portfolios, shows how to actively risk manage around a lifestyle floor, without ever losing sight of the need to maintain the floor. We show how portfolios can be set up to take a little more risk, attempting to gain higher return, and be prudent at the same time. Remarkably, using historical returns we see that a little risk can go a long way in helping to raise lifestyles. Fortunately, historical returns also teach us that taking a lot of risk, even if coupled with diligent risk management, can pay off but is more likely to lead to no net gain in lifestyle.

PART FOUR: MAKING IT HAPPEN

By the time you get to Part Four, you should have a solid understanding about the important considerations for retirement portfolios, the methods for constructing retirement portfolios, and the techniques for managing the portfolios. What comes next? This part is about adapting a traditional business to encompass retirement portfolios. The emphasis here is on having a process that is backward compatible with your existing business model. To that end, we emphasize making the transition feel natural, working within current infrastructure, understanding the subtle changes in client segmentation, and how product sets fit into our framework. We cover a large number of examples that can be considered as outlines of portfolios targeted for the different segments. Information that speaks directly to clients is included in Chapter 14. The last chapter of the book is focused on final thoughts about myths and fallacies that are dangerous for portfolios and some helpful ways to rehabilitate the still viable portfolios that may have suffered a setback.

Chapter 10, The Transition Phase, moves from a focus on accumulation of assets to a focus on lifestyle protection. The goal of this chapter is to have the transition fit the natural evolution of a portfolio so that clients feel comfortable in the undertaking. This chapter shows the best time to begin the transition and constructs that make the transition natural.

Chapter 11, Putting Together the Proposal, combines the ideas of the book and focuses on putting it all together for a proposal to a (new) client.

Here we show how to take an ordinary accumulation portfolio and provide a makeover to create a retirement income portfolio—all in an intuitive and straightforward manner.

Chapter 12, Market Segmentation, synthesizes the material of earlier chapters regarding the segmentation of clients. As you will see, there are subtle but profound differences between traditional segmentation and effective segmentation for retirement income. The goal is to show how producers, marketers, and investment managers can create offerings targeting relevant market segments.

Chapter 13, Products and Example Portfolios, provides several case studies and sample portfolios that can be used for various client types. Though there are no specific product "endorsements," these portfolios are meant not as theoretical constructs but as prototypes.

Chapter 14, Preparing Your Client for a Retirement Income Portfolio, helps you provide something to the client and with the client in mind. It is designed as a tool to help you frame the issues to clients in a way that they can understand.

Chapter 15, Salvage Operations, Mistakes, and Fallacies, is meant to provide guidance for climbing out of the hole that has swallowed so many client portfolios. As a prelude, we first discuss common mistakes and fallacies in retirement income planning. We then move on to salvaging what is left in 2009 and the more general problem of helping clients who suffer a financial setback.

APPENDIXES

This book also includes two appendixes. Appendix A, History of Theoretical Developments in Life-Cycle Planning, features the more technical aspects of the material covered in Chapter 2. It is more technical and goes a little deeper into the material than the main text while still being accessible to nonacademics.

Appendix B, How Professionals Can Maximize the Usefulness of this Book, answers this question, whether your business model is transaction based or fee based, institutional or retail. This appendix explains the relevancy to maximizing the usefulness of retirement portfolios in your business.

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This book was written between September 2008 and July 2009. For most of that period, it was a good time to be focused on something other than the day-to-day spasms in financial markets. But out of the mix doesn't mean that I worked alone, in a vacuum, or without the generous help of others.

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