

Research Roundup

By Kerry Pechter Thu, Sep 30, 2021

This month we bring you scholarly articles on the Social Security 'tax torpedo,' the likelihood of needing long-term care, the best decumulation strategies from DC plans, the people most likely to 'freak out' when the markets crash, and what advisers must do to avoid trouble when recommending rollovers.



This month's edition of the *RIJ* Research Roundup covers a lot of ground. From Australia, recent research offers direction on optimal distribution of defined contribution savings in retirement. In another paper, investment experts at MIT explain who "freaks out" and sells during big market crashes. The answer may surprise you.

We cite two papers for advisers from the *Journal of Financial Planning*. One tells advisers how to help clients avoid the Social Security "tax torpedo," which can cause a spike in taxes on benefits. The other article offers up-to-date legal advice from a top ERISA law firm on recommending rollovers without violating any subtleties of the latest iteration of regulators' "best interest" rule.

Finally, a new *Issue Brief* from the Center of Retirement Research at Boston College offers statistical insight into your likelihood of needing several years of long-term care in your old age—and into your likelihood of being able to afford it if you do need it. (Practically every family has stories about its struggles to provide and pay for late-life care for a parent.)

"Personalized drawdown strategies and partial annuitisation to mitigate longevity risk." Wen Chen, Aaron Minney, Peter Toscas, Bonsoo Koo, Zili Zhu, Athanasios A. Pantelous. *Finance Research Letters*, No. 39. March 2021.

The US has a voluntary defined contribution (DC) system. Australia has a mandatory DC system, to which both employer and employee contribute. But neither country has yet broken the "decumulation" code. Neither system shows DC participants how to convert their plan balances to retirement income.

A group of retirement researchers at [Challenger](#), Australia's largest annuity issuer, and at Australia's [Commonwealth Scientific and Industrial Research Organization](#) (CSIRO), explored the task. In a recent [paper](#), they provide "a do-it-yourself drawdown design for members of superannuation funds along with comparison studies on a range of retirement

income strategies under an array of realistic scenarios. A stochastic economic scenario generator is used to simulate the uncertain outcomes of different drawdown strategies during retirement.”

They hypothesize a single, 67-year-old man with A\$50,000 (Australian dollars) in personal savings and either A\$300,000 or A\$500,000 (both balances were studied) in his “Super” fund. (That’s short for “superannuation fund” as Australian savings plans are called. His fund was divided between growth-oriented assets (equities and real estate) and safe assets (bonds and cash). It was also assumed that he might live for an additional 37 years—to age 104.

Several decumulation strategies were tested with 10,000 Monte Carlo simulations of possible future conditions, including the famous 4% inflation-adjusted method, annuitization of 30% of Super savings, and use of deferred income annuities that provide supplemental income at age 87. It also tested “layering,” the common-sense practice of buying a monthly annuity income stream that, when paired with the basic Australian “Age Pension” (a means-tested entitlement of up to \$882 for one person and \$1,330 for a couple) covers essential expenses throughout retirement.

Each method was found to have strengths and weaknesses. (It’s dealing with tough tradeoffs that bedevils income planning.) The annuitization of 30% of Super savings, not surprisingly, was the method of “drawdown” most likely to sustain adequate income through to age 104—a degree of longevity risk that would require a substantial amount of personal savings to mitigate *without* an annuity. Drawdown in Australia is a bit complicated by the fact that strategies can be used to create eligibility for the Age Pension. On the other hand, it entails fewer tax issues than the US system does. Workplace contributions to Supers are taxed (at a concessional rate) as income but withdrawals in retirement are not.

“When Do Investors Freak Out? Machine Learning Predictions of Panic Selling.”

Daniel Elkind, Kathryn Kaminski, Andrew W. Lo, Kien Wei Siah and Chi Heem Wong. MIT Sloan School of Management. August 2021

You might be surprised to hear that, according to new research, the investors most likely to “freak out” (as these authors describe it) and sell in a panic during market turmoil are middle-aged men with families.

You might find it surprising that MIT academics consider panic-selling to be a potentially smart, portfolio-protecting move on their part—much smarter than, say, excessive trading.

But you would probably not be surprised to learn that those with the smallest portfolios panic-sell the most.

In their analysis of more than 653,000 individual brokerage accounts belonging to almost 300,000 US households, the authors of this [paper](#) “document the frequency, timing, and duration of panic sales, which we define as a decline of 90% of a household account’s equity assets over the course of one month, of which 50% or more is due to the results of personal trades rather than market performance.

“We find that a disproportionate number of households make panic sales when there are sharp market downturns, a phenomenon we call ‘freaking out’... Panic selling and freakouts are predictable and fundamentally different from other well-known behavioral patterns.

“Investors who are male, or above the age of 45, or married, or have more dependents, or who self-identify as having excellent investment experience or knowledge, tend to freak out with greater frequency,” they found. More than 40% of the freakouts, however, occurred among those with accounts of \$20,000 or less—people with presumably little capacity for loss.

“Panic selling and freak-outs often have negative connotations,” the authors write. “We show that this negativity may not always be warranted. While panic selling in normal market conditions is indeed harmful to the median retail investor, freaking out in environments of sustained market decline prevents further losses and protects one’s capital. Panic sales are not random events. Specific types of investors, such as those with less than \$20,000 in portfolio value, tend to liquidate more frequently than others.”

“What Resources Do Retirees Have for Long-Term Services and Supports?” Anek Belbase, Anqi Chen, and Alicia H. Munnell. Center for Retirement Research at Boston College Issue Brief, September 2021, 21-16.

There’s no silver lining to the long-term care (LTC) story. LTC insurance is expensive, nobody wants to die in a nursing home, and few people want to see their legacies consumed by nursing home expenses, which can run to well over \$100,000 a year.

Medicaid covers LTC cost for many indigent Americans, of course. But people don’t typically hope or plan to be both poor and disabled in their old age. Such an outcome is not uncommon. But it isn’t, to cop a phrase from *Hamlet*, a consummation we wish for.

How many of us will need LTC before we die? According to a new [Issue Brief](#) from the Center for Retirement Research at Boston College, “about 20% of retirees will escape the

need for LTSS [Long-Term Support Services] and 80% will need at least a year of part-time support—with around a quarter requiring full-time support for several years... At age 65, only about one-fifth of retirees have the family and financial resources to cover high intensity care for at least three years and about one-third do not have any resources at all. The remaining half of older adults lie somewhere in between.”

The analysis considers informal care from family members as well as paid care that can be bought using income and financial assets and categorizes older adults by their ability to afford minimal, moderate, and severe care needs. The results show that about one-third of retirees do not have the resources for even minimal care and only one-fifth can afford severe care. The pattern varies even more across sociodemographic groups. Married individuals, those with college or more, and whites have more resources for LTSS care needs.

The big question is whether the people who will need help are the same ones who have the resources. To answer that question, the next brief will compare people’s likely care needs with their available resources for LTSS. This process will identify the individuals and groups who may end up with unmet needs and discuss how Medicaid plays a role.

Retirement Account Rollovers: How to Comply with the DOL’s New Fiduciary

“Rule.” Fred Reish, Bruce Ashton, and Stephen Pennartz. *Journal of Financial Planning*, September 2021.

Many hairs have been split with respect to the regulation of so-called “rollover recommendations.” Under ERISA (Employee Retirement Income Security Act of 1974), a financial adviser may only advise a retirement plan participant to move (“roll over”) his or her plan savings to an IRA at the adviser’s firm if doing so is in the client’s “best interest.”

In a new [article](#) in the *Journal of Financial Planning*, ERISA attorneys at the firm of Faegre Drinker show advisers and their firms how to comply with the latest version of the Department of Labor’s rules governing rollovers, which seem to change in subtle but important ways when administrations change in Washington.

The article addresses, for instance, the question of whether a rollover recommendation constitutes regulated (impartial or “fiduciary”) advice if the adviser and the participant don’t yet have a professional relationship. That issue is now settled, according to the article.

“The DOL previously took the position that a rollover recommendation did not satisfy this part of the test unless the investment professional was already a fiduciary to the plan,” the

authors write. “In the preamble to PTE 2020-02, the DOL reverses this position and then further expands on its view in a series of Frequently Asked Questions (FAQs) issued after PTE 2020-02 went into effect.”

Quoting from a DOL statement, the authors write, “when the investment advice provider has not previously provided advice but expects to regularly make investment recommendations regarding the IRA as part of an ongoing relationship, the advice to roll assets out of an employee benefit plan into an IRA would be the start of an advice relationship that satisfies the regular basis requirement. The 1975 test extends to the entire advice relationship and does not exclude the first instance of advice, such as a recommendation to roll plan assets to an IRA, in an ongoing advice relationship.”

The regulators, however, allow advisers to make rollover recommendations or solicitations that benefit themselves if they follow the procedures and meet the requirements of Prohibited Transaction Exemption (PTE) 2020-02, which the authors of the paper go on to describe in detail.

“Financial institutions must document the reasons that a rollover recommendation is in the best interest of the retirement investor and provide that documentation to the retirement investor,” the article concludes. “In addition, the PTE’s conditions require that financial institutions adopt policies and procedures that are prudently designed to ensure compliance with the Impartial Conduct Standards and that mitigate permitted conflicts of interest; and conduct and document an annual retrospective review of compliance.”

“Minimizing the Damage of the Tax Torpedo.” William Reichenstein, *Journal of Financial Planning*, September 2021.

Torpedos come in all sorts of shapes and size. There are torpedos that submarine commanders fire at enemy vessels. There are torpedos in black shirts and white ties who get rough with slow-payers of gambling debts. There are even “torpedo” cigars.

Then there are the “tax torpedos” that strike certain unwary Social Security recipients.

The tax torpedo refers to the “income range where an extra dollar of earned income causes another \$0.50 or \$0.85 of a Social Security recipient’s benefits to be taxable,” [writes](#) William Reichenstein in the current issue of the *Journal of Financial Planning*. “Thus, taxable income increases by \$1.50 or \$1.85. So, the marginal tax rate (MTR) is 150% or 185% of the tax bracket, where MTR denotes the additional taxes paid on the next dollar of income.”

In his article, Reichenstein “illustrates how a planner can add substantial value to a mass-affluent client with \$1 million of savings by helping them minimize the adverse effects of the ‘tax torpedo,’” mainly by converting tax-deferred accounts to Roth IRAs early in retirement.

Reichenstein’s hypothetical client “makes Roth conversions in his early retirement years before his SS benefits begin, when his MTRs on the converted funds are generally the same as his tax brackets. These Roth balances provide the ammunition that allows him to avoid making additional [tax-deferred account] withdrawals in later retirement years that would be taxed at MTRs of 185% of the tax bracket, due to the taxation of SS benefits.

“These Roth balances allowed [a hypothetical client] to avoid making TDA [tax-deferred account] withdrawals during most of his retirement years that would have been taxed at MTRs of 46.25%,” the article says. If his method is used, Reichenstein estimates the reduction in lifetime taxes for a retiree with an initial portfolio balance of \$1 million at \$118,053.

Reichenstein, an emeritus professor of investments at Baylor University and head of research at Social Security Solutions, Inc., offers his strategy as an alternative to the “conventional wisdom” strategy, which calls for retirees to spend down their after-tax accounts first, then to exhaust their tax-deferred accounts and, finally, to take tax-free withdrawals from their Roth IRA accounts. “The key lesson in this case is to focus on your clients’ marginal tax rate,” he writes. “Too many advisers solely focus on tax brackets and do not consider their clients’ MTRs.”

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