Anecdotal Evidence

By Kerry Pechter *Thu, Sep 22, 2016*

In this week's opinion piece: The possibility that the DOL rule will extend to taxable accounts; Vanguard's formula for calculating a safe withdrawal rate; thoughts on recent news coverage of Wells Fargo and BlackRock.

Expect the DOL rule to apply to taxable accounts

At the Financial Planning Association's annual conference in Baltimore last week, *RIJ* asked ERISA attorney Marcia Wagner, who is a kind of defensive coordinator for firms wishing to ward off potential class action lawsuits under the DOL fiduciary rule, if she thought the ethical standard established by the rule would eventually apply to taxable accounts as well as IRAs and 401(k) plans.

Yes, she said, she believes it will, regardless of what the SEC does or doesn't do. Others have noted that it will be difficult or impractical for advisors to apply a suitability standard to the taxable part of a client's portfolio and the fiduciary standard to the tax-deferred part. That may be true. But multiple standards will continue to exist. The protections that apply to hedge fund customers, for instance will presumably continue to be different from the protections for less wealthy investors.

If the DOL rule applies to all advisors and all types of accounts, we can expect to see an even faster and more extreme shift among advisors to AUM compensation models and to the use of robo-advice for younger investors and smaller accounts.

Put guardrails around your four percent withdrawal: Vanguard

For planners and advisors who like to tell their clients to spend about four percent of their assets in retirement—as opposed to those who prefer "bucketing" or partial annuitization as their income-generation tools—Vanguard has created a new formula for calculating a safe rate of withdrawal from savings.

In a **white paper** published this month, "From assets to income: A goals-based approach to retirement spending," a Vanguard team recommends a compromise between two versions of the 4% rule: one ("A") that calls for spending an inflation-adjusted 4% of the original balance and another ("B") that calls for spending 4% of the current real balance.

Each of those alternatives has a drawback. The first is too rigid, the second too flexible, in the face of market volatility to provide sufficiently predictable and sustainable income. Splitting the difference, Vanguard's decumulation experts call for using the second alternative but putting upper and lower limits on annual spending.

Supposed, to use the classic example, that a new retiree has $1 million in savings and, conveniently, a need to spend $40,000 in the first year of retirement. He takes Vanguard's advice and, in the following years, promises not to give himself a raise of more 5% or to tighten his belt by more than 2.5%.

Here's how the hypothetical numbers play out. At the start of the second year, after earning a 10% return and spending $40,000, the retiree has $1.06 million. Under version B of the 4% rule he could spend $42,400 (.04 x $10.6 million). But since his upper limit is $42,000, that's all he spends. Conversely, if the market gone down that year, he would have spent no less than $39,000 ($40,000 – ($40,000 x .025)).

Since retirees often disregard their recommended spending limits, this might seem like a labor-intensive exercise in false precision. It gets even more complicated when you factor in variables like asset allocation and portfolio choices, and even more so when you try to obey the rules of tax-efficient decumulation.

Still, Vanguard's method adds nuance to the 4% rule. Advisors can also point to research like this to show that they did their homework before recommending a withdrawal rate.

Bad day at Wells Fargo, good day at BlackRock

One of America's great financial services brands was sullied this week when Wells Fargo's over-zealous sales practices, which reportedly included the creation of false accounts by more than 5,000 employees who hoped to reach or were compelled to reach big, hairy aggressive sales goals, became front page news.

"A brand is a promise kept over and over and over," a consultant once told me. That's a variation on the truism that it takes a long time to achieve trust but a short time to lose it. Wells Fargo may yet emerge whole from this episode. Consumers have short memories. And, just as many voters hate Congress but admire their own district's representative, the ubiquitous bank's retail relationships will probably survive.

But the incident indicates the pressure at publicly held companies to stoke earnings and please shareholders—even if it means throwing customers under the bus. That may sound harsh, but this fundamental conflict of interest tinges every public company's product design, compensation, sales practices and even the wording of its advertising and communications. In the extreme, it results in incidents like those at Wells Fargo.

By contrast, BlackRock and its CEO, Laurence D. Fink, received almost unalloyed praise from the *New York Times* last weekend. BlackRock, formerly Blackstone, has grown dramatically through acquisition (absorbing Merrill Lynch's funds in 2006 and Barclays Global Investors in 2009) and its share price has soared.

In the retirement income market, its primary product entry seems to be CoRI target-date bond funds. These are long-term bond funds that track the proprietary CoRI Index, which reflects the fluctuating price of $1 of lifetime income on your retirement date, as determined by prevailing immediate annuity prices, which also follow long-term bond returns.

The concept relies on asset-liability matching. The CoRI Index and the value of CoRI funds, like immediate annuity prices, move in the opposite direction of long-term interest rates. As rates rise, your fund will lose value, but immediate annuity prices will fall too, so that your CoRI fund will always buy the same income (in proportion, of course, to your investment in the fund).

But if you never intend to buy an annuity, the long maturities of the CoRI funds entail a lot of interest rate risk. And the funds aren't cheap. According to page 3 of the CoRI 2017 **prospectus**, there's a front-end Investor A share load of 4% for purchases under $1 million, and an annual fund expense ratio of 83 basis points (58 basis points for institutional shares requiring an investment of $1 million or more).

The cost could potentially be much higher. The prospectus explains that the annual operating cost is 2.06%, of which BlackRock has waived 1.23%. A footnote adds, "the Fund may have to repay some of these waivers and/or reimbursements to BlackRock in the following two years." Such ambiguity makes the value of the CoRI funds proposition hard to assess.