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## **Bright Ideas from the SOA Investment Meeting**

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By Kerry Pechter     Thu, Mar 24, 2016

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*Last week, the Society of Actuaries held its investment conference in New York. We weren't far from the brass statue of the Wall Street bull, but the sell-side's unquenchable optimism about the future was missing. Practical new ideas flourished nonetheless.*

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What are the implications of negative short-term interest rates for insurance companies? What do current market valuations tell us about tomorrow's asset prices? How can near-retirees protect their savings from a bear market?

Every spring, the Society of Actuaries holds a conference for actuaries who help their companies manage assets. At this year's meeting, held in New York last week, there was a lot of discussion around questions like the ones above, along with cautious predictions about the future and reminders about a few inconvenient tradeoffs that, collectively, we probably can't avoid.

Last week's meeting featured descriptions of several new product ideas from entrepreneurial actuaries, including a structured equity product for qualified plan participants, a psychological assessment tool that tells advisors how to communicate better with each client, and a mobile app that encourages 401(k) participants to rebalance their accounts every day just before the market closes.

### **De-risking 401(k)s with options**

A risk protection product for the 401(k) market was suggested by Dan Cassidy, an actuary and financial analyst at [P-Solve](#), a unit of River and Mercantile Group. P-Solve provides hedging advice and services, and Cassidy was promoting a structured equity product that near-retirement participants could use to de-risk their portfolios in the year or two before their retirement date.

The product establishes an options collar around the returns of an appreciated retirement account. It appears to provide protection similar to that provided by the structured variable annuities that MetLife, AXA, Allianz Life and Thrivent have created for individual investors since the financial crisis. Cassidy told *RIJ* that he was not familiar with those products.

For participants of jumbo plans whose money is in designated target-risk separate accounts and who are near retirement, P-Solve can provide the managers of those separate account with an options overlay that can establish a floor under losses and a cap on the gains,

Cassidy said.

The options portfolio is actively managed, with P-Solve trading puts and calls behind the scenes with counterparties that have less downside tolerance or more upside appetite than the separate account manager. (In a sense, it operates like an all-season heat pump.) The downside and upside limits, and the triggers for trading the options, are customized for each plan sponsor client.

The money that P-Solve makes by trading options is designed to pay for the overlay. This risk protection service is costless for the plan sponsor. The separate account gets billed an asset-based fee of 10 to 20 basis points a year, depending on the size of the account. Large defined contribution plans with long-tenured participants who have large, highly appreciated investment portfolios are P-Solve's target clients.

### **Client psychology**

Behavioral finance is an increasingly important topic in the investment world, and two of the conference presenters addressed it. Many advisors are required to assess their clients' risk-tolerance levels prior to designing an investment plan, but Hugh Massie, president of [DNABehavior](#), takes the assessment process much farther.

An accountant and former advisor originally from Australia, Massie has partnered with psychologists since 2001 to create and refine a battery of [personality tests](#) that give advisors a multi-dimensional understanding of their clients.

The results can be used to help advisors communicate with clients, understand their reactions to market events, and set goals for their retirement years. He offers the products to individual advisors for as little as \$650 a year; enterprise-level licenses can cost much more. "Our sweet spot would be an advisory firm with about \$50 million in assets under management" that have mastered the basics of running their business and want to take their game to a more polished level, he told *RIJ*.

[Massie administered an online 45-question test to *RIJ*'s editor and provided instant results. The test categorized me as an "Initiator" with is "creative" with a "take charge" but "reserved" nature.

"Initiators like to take bold, aggressive actions and create the rules. They will prefer to lead decision-making, setting the agenda for others to follow and monitoring the timely completion of tasks. They are goal-driven people who like their expectations managed and

not to get caught up in unnecessary details. Their decision-making will typically be fast-paced and rational. They will not be afraid to take on challenging assignments or to accept a lot of risks to realize their ambition.”

The dnabehavior test put me in the third highest risk category (“Accumulation,” or medium to high risk). It also suggested the type of advisor that would be most compatible with me (“influencer,” “initiator,” strategist”).]

### **Daily rebalancing?**

Rick Schmitt, an actuary who teaches retirement planning at Golden Gate University, gave a presentation plugging his “Rebalance app.” It’s designed to allow 401(k) participants to boost their long-term returns by rebalancing their retirement accounts every day, in response to a signal on their smartphones shortly before the closing of the equity markets and the daily valuation of mutual funds.

The system requires at least two 401(k)s, one containing a money market mutual fund and the other an S&P500 Index mutual fund. Each day, the participant rebalances by buying or selling an amount of the Index equal to one one-thousandth of his aggregate balance times the point change in the S&P500. Someone with \$50,000 in stocks and \$50,000 in cash would move \$500 if the S&P500 moved by five points.

Schmitt calls this “modified daily rebalancing.” It works best in choppy markets and worst in steadily rising markets, Schmitt said. According to his calculations, a 50/50 S&P500/cash fund with modified daily rebalancing would have beaten the pure S&P500 Index by 15 percentage points (about one percentage point per year) between January 1, 2000 and December 31, 2015.

An audience member pointed out that such an inherently contrarian strategy could not be practiced by everyone and still maintain its effect. Another observed that Schmitt’s hypothetical participant seemed to be trying to profit by acting as a market maker, supplying liquidity or inventory as the market demanded. “I’m just trying to start a conversation,” Schmitt said.

### **The macro view**

Regarding the overall economy, the outlook from big-picture authors and consultants at the meeting was decidedly sober. Although the SOA held its meeting in a Marriott only two subway stops from the tourist-magnet of the big brass Wall Street bull, none of the sell-

side's irrepressible optimism was evident here.

If anything, investors are on the horns of a dilemma, consultants said. "We need to accept low interest rates or accept defaults," said David Ryan O'Meare of Willis Tower in describing the bond market. An increase in rates would make it harder for debtors to service the debt they roll over as well as reducing the value of existing bonds. "We can either write down assets today or write down future returns."

The outlook for equities was equally gloomy. O'Meare and colleague William Rearden said that, historically, when the cyclically-adjusted price-to-earnings ratio—Robert Shiller's CAPE ratio—is over 20, the S&P 500 is overvalued. Last June, the CAPE ratio was 27. (In 2000, it was 44.2.)

Investors can expect a real growth for equities of only 1.5% a year over the next decade, the consultants said. They projected the average PE ratio at 8.23 in 2025 and at 9.14 in 2030. Pensions fund managers who assume a 7% asset growth rate will be disappointed. They don't have enough time to wait for a recovery, because a big chunk of their liabilities come due in the next 10 years.

Demographically, we appear to be victims of our own success. As common sense suggests, middle-aged people tend to buy stocks as they accumulate for retirement and older people tend to decumulate in retirement. Between 1954 and 2010, there was a strong correlation between the middle-to-older-age ratio and the PE ratio. But the ratio of middle-aged to older people peaked in the mid-2000s in the so-called G-7 wealthy countries.

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