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Floor-and-Upside: A New Strategy for a New Era

By David Macchia *Mon, Jul 30, 2012*

When constructing retirement income investing strategies, advisors should try to plan for even impossible outcomes, writes David Macchia, president of Wealth2k, the retirement income marketing and modeling program.

"Anything is possible." Over the course of my career, this is perhaps the most important lesson I've learned. It holds a special relevance when I speak to financial advisors about the business strategies they should use to maximize their own success.

When it comes to generating retirement income, savvy advisors will move beyond old dogmas and open their minds to new investing strategies. Advisors should also try to position investors for a wider range of outcomes, including some that may be considered extremely unlikely.

Let me offer you a true story that helps frame my advice.

In 1989, one of my consulting clients, PaineWebber, sent me on a twelve-city speaking tour. I delivered the same seminar presentation in each venue: *Tax-Advantaged Retirement Planning for Affluent Investors*. The seminars took place in nice hotels in major cities. In the morning I'd train the PaineWebber stockbrokers in the local branch office, and in the evening I'd present a seminar to the brokers' clients and prospects on the utility of including insurance products in investment portfolios as a way of generating tax-favored retirement income.

The impossible became possible

My seminars included a rather emotional discussion about Japan. Looking back, I see a striking parallel to the concerns of Americans today. In 1989, many American worried that the Japanese would surpass us in economic power.

This was quite understandable given the facts: In 1989, eight of the world's ten largest banks were Japanese. In the 1980s the market value of Japanese real estate had skyrocketed to stratospheric levels. The world's most expensive retail space was located not in London, New York or Beverly Hills, but in the Ginza section of Tokyo. From 1980 to1989 the Nikkei 225 stock index rose from about 5,000 points to more than 39,000 points. The index reached its all-time high in December 1989.

Japanese citizens possessed the world's highest rate of personal savings—more than 14% a year. Japanese manufactures dominated in consumer electronics. The world's most admired company was Sony. News reports in the U.S. about the acquisition of high profile American properties such Rockefeller Center and the Pebble Beach Golf Club by Japanese investors only added to the anxiety that caused Americans to feel that their country had become a declining economic power. Japan appeared to Americans much as China appears to us today: a seemingly unstoppable economic juggernaut destined to inevitably become the world's largest economy.

Like most people in 1989, I would have told you with great conviction that what was soon to take place in Japan was impossible. Twenty-three years later, we can see that the impossible has actually occurred.

Japan has been mired in an economic decline for more than two decades. To stimulate its economy the Japanese government lowered interest rates to unprecedented low levels. As Japanese savers fled to safe assets, interest rates on 90-day Japanese government paper at times paid a negative rate of interest. Many Japanese savers viewed a small guaranteed loss as their safest option.

From 1989 to 2004, the value of Prime "A" commercial real estate in Tokyo fell 99%. By 2007 the once vaunted Japanese personal savings rate had declined to 1.7%. And by July of this year, the Nikkei 225 index had fallen by more than 30,000 points, to 9,104. Stock prices in Japan are at the same general price level that they were in 1984. In July the share price of Sony, originator of the Walkman and Trinitron TV fell to ¥990, its lowest level since 1980 and a fraction of its high of ¥16,900 in 2000.

Japan's experience shows that our tendency to project past results into the future can be dangerous and even reckless. We've entered a new era where our frameworks for measuring risk are outdated or irrelevant. Regarding the range of possible economic outcomes, something fundamental has changed in our world. As result, our assumptions should be reconsidered.

I suggest that financial advisors consider this when they design investment strategies for their retirement income clients. When dealing with retirees, some of whom may have zero tolerance for economic failure, advisors can't afford to rely upon models of thinking that may simply provide a false sense of security.

The anti-"floor" dogma

Many academics who have studied retirement income planning suggest that establishing a "floor" of lifetime income be the foundation of an investor's retirement strategy. It's hard to argue with this recommendation. If an investor can't tolerate the risk of being unable to meet essential living expenses, an advisor should include a layer of lifetime guarantee income in the strategy.

The non-profit Retirement Income Industry Association (RIIA) has championed the importance of the income floor—an income source, generally payable for life, which is quite certain or guaranteed and which enables the investor to meet the most important living expenses. But the "floor" is just one component of the investing strategy. The companion component is the search for "upside" through exposure to risky assets such as equities.

RIIA has also created a *Client Segmentation Matrix* that advisors can use to identify which investors need a "floor" as part of their retirement income investing strategies. RIIA categorizes investors not by AUM but rather by the ratio of their expected annual spending in retirement to the amount of their investible assets. Dividing the investor's annual spending by his/her investible assets will place each investor in one of three segments:

- Overfunded (<3.5%)
- Constrained (3.5% to 7%)

- Underfunded (>7%)

Clients in the *overfunded* category are safe. They can choose almost any retirement income investing strategy, including a systematic withdrawal Plan (SWP), and be confident that they will be financially secure. By definition, they have more than enough assets to generate their required level of annual income in retirement.

Underfunded investors, by contrast, have too little money relative to their income needs. There's not much that the financial advisors can do for them except try to align their income expectations with economic reality.

Constrained investors have the most to gain from a retirement income plan. In my experience, these investors tend to have between $250,000 and $1.5 million in investible assets. Typically, they have little or no margin for error once they start distributing their assets in retirement. Their choice of investing strategy is a truly high stakes proposition. They need an income floor.

(If you wish to specialize in retirement income distribution planning, I recommend that you consider the Retirement Management Analyst (RMA) professional designation offered by the RIIA. Both Boston University and Texas Tech University offer preparatory classes to prepare candidates for the RMA exam. The courses offer income-planning concepts that can help you produce better results for your clients. They can also help you gain a competitive advantage over advisors who still follow the logic of asset accumulation.)

Embrace the "Floor" Your Way

For a variety of reasons, many financial advisors neglect one obvious way to create a floor—guaranteed income annuities. If so, they do a disservice to their constrained clients. In my view, advisors who reject annuities out of hand and have no other way to introduce predictable income won't have a bright future in retirement income distribution planning and may even find it difficult to keep clients.

Some advisors don't like the fact that when clients buy annuities, assets escape their management. But that's short-sighted. Investors tend to consolidate retirement assets with advisors who are experts in retirement income distribution planning, and consolidation may actually increase the total retirement assets advisors manage, even after the purchase of the annuity. Counter-intuitively, advisors who don't consider annuities may be costing themselves a lot of income.

Moreover, new types of annuity structures make it possible to introduce lifetime guaranteed income within an advisory account. Stand-alone living benefit (SALB) products accomplish exactly this. One registered investment advisory firm (RIA), The Institute for Wealth in Colorado, has introduced the SALB solution in its investment program. San Francisco-based ARIA Retirement Solutions offers a program that makes SALBs available to other RIAs.

Some advisors overlook the fact that even high-net-worth investors can fall into the constrained investors segment and need a floor of guaranteed income. Investors may have $10 million in investible assets, but if they spend $1 million annually on living expenses, they are clearly underfunded.

I have found that financial advisors who wish to find new clients and retain the loyalty of their existing clients will be more successful if they leave old dogmas about "impossible" outcomes behind. "Floor plus upside" is a valuable planning strategy for advisors and retirees who are about to navigate a very different future—a future where nothing's impossible.

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