Philadelphia Story

By George A. (Sandy) Mackenzie *Wed, May 16, 2012*

Mackenzie, author of two books on pensions and annuities, attended the Pension Research Council's conference on "The Market for Retirement Financial Advice" two weeks ago at the Wharton School and wrote this summary.

This conference, the latest in a long series of conferences organized by Wharton's Pension Research Council and devoted to important aspects of retirement security, examined the vital issue of financial security from the legal, economic and social points of view.

In particular, it dealt with:

- The lack of a uniform fiduciary standard for broker/dealers and investment advisers;
- The reasons for the limited take-up of financial advice;
- The effects of financial advice on clients;
- The quality of advice.

Speakers included economists, lawyers, pollsters and industry professionals. What follows draws from the more interesting presentations and papers:

The legal basis for the regulation of financial advice is not coherent. New Deal legislation established one standard—that of suitability—for broker-dealers, and a more exacting fiduciary standard for investment advisors. As Arthur Laby explained in a thorough and well-written paper, that distinction worked tolerably well until the 1970s-1980s, when discount brokers emerged and the distinction between broker-dealer and investment adviser became harder to draw.

Recent efforts by SEC to establish a more watertight distinction have not been successful. Passage of new regulations is now complicated by the fact that it is expected that it be preceded by a cost-benefit analysis of the new rules. Meanwhile, the average investor does not understand the difference between the suitability rule that is to apply to broker–dealers (or to the act of brokering) and the fiduciary standard. Gerri Walsh of FINRA remarked that 401(k) plan members did not see themselves as investors!

Financial advice, despite its universal importance, remains the province of the affluent. Kent Smetters thought that most planners will eschew households with less than $500,000 in financial assets. The demand for advice is discouraged by the upfront fee, which is typically upwards of $3,000 per plan. Financial planners emphasize the skilled-labor intensive character of the work, a trait that has resisted the effects of technological advances in financial software. Online advice reduces its cost, but speakers argued that it could not yet compete with the human touch. The implication is that short of a subsidy or technological breakthrough, the average American will remain without this valuable service.

A paternalistic approach, where everyone gets advice regardless of their interest in it, may not be cost effective. A paper by Angela Hung and Joanne Yoong of Rand reported on a statistical analysis of a sample of older Americans and described the findings of an experiment aimed at determining what led people to seek financial advice. The statistical analysis was not very revealing—there was no significant relationship between either wealth or the level of financial literacy and the propensity to seek advice. Similarly, there was no obvious impact on investment decisions.

Those seeking advice were more likely to continue making their plan contributions, however, although they were also more likely to reduce them. The experiment divided participants into three lots: one that received no advice; a second, that received advice whether they wanted it or not; and a third that was offered a choice.

Those (in group 3) choosing advice were more likely to lack financial literacy than those who did not, suggesting that advice is a substitute for a do-it-yourself approach. The Rand researchers draw the conclusion that a paternalistic approach, where everyone gets advice regardless of their interest in it, may not be cost effective.

A definite relationship between taking advice and net worth, even when controlling for income, education and cognitive ability, was among the findings of an empirical study by Michael Finke of Texas Tech. Moreover, investors taking advice were less likely to cash out in a severe bear market. A survey carried out by the ICI and presented by Sarah Holden found that a major life event was often a trigger for an initial consultation, and that advice was sought more often when young than when old. The survey also found a significant relationship between education and wealth and the tendency to seek advice. Fear of loss of control often explained a refusal to seek advice.

One interesting paper by two well-known financial advisors, Paula Hogan and Rick Miller tried to integrate the insights of behavioral economics into a life-cycle approach. The life cycle approach is an advance over the traditional approach, because, among other reasons it recognizes the importance of the timing of the decisions to retire and claim Social Security as well as the importance of human and not just financial capital.

However, life cycle economics makes unreasonable demands on people’s understanding of their finances and their ability to foresee their needs many years into the future. The authors noted that their clients were often quite ignorant of their financial situation. Asking a 30-year-old about his retirement is pointless, because he or she will not know what his needs will then be.

Regarding Social Security, Matt Greenwald reported on a survey of financial advisors and the advice they gave on claiming Social Security and related decisions. Sound advice is critically important, especially given the outsized role the program plays in retirement finances. Matt found that many advisors did not have a good idea of how spousal benefits worked, and that they could give bad advice on the timing of retirement. Clients were often preoccupied with the issue of OASDI solvency, which reduced the amount of time available for other topics.

One particularly interesting finding related to the framing of advice on the claiming decision. This decision can be tilted away from delaying a claim by downplaying the insurance aspect of annuitization. Financial advisors favored the first approach. They also favored the break-even approach, as in “if you delay claiming

Social Security for two years you can expect to break even in 14 years.” Remarkably, and as Olivia Mitchell noted, it appears that SSA agents have an incentive to encourage prospective claimants to claim early.

Anna Rappaport and Kelli Heuler addressed the important issue of encouraging annuitization, and in particular the role of advice. They contrasted what they called structured advice with active guidance. The former might take the form of a special website on the site of the plan sponsor, where employees could seek information on terms and premiums, and put questions to on-line advisors. Personal advice, as the name suggests, includes a personal touch. In the authors’ view, the second was far superior to the first, at least in encouraging annuitization. This paper noted that it was not uncommon for plan members to purchase more than one annuity, perhaps because state insurance schemes create an incentive to spread purchases out over more than one state. Zvi Bodie, drawing on his experience as a trustee at Boston University, argued that advisors remained biased against annuities.

Summary. The conference was certainly stimulating. One participant argued that its rather agnostic results argued for a default approach (as with the auto-IRA), there being no magic bullet to broaden the coverage of financial advice, improve its quality and make it more affordable. Another argued that target date funds (TDFs), given the way they worked, could be seen as a gateway to advice. For my part, I was left without a strong sense of how the coverage and quality of financial advice might be enhanced.

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