Retirement Income
JOURNAL

Russell Up Some Income

By Kerry Pechter *Sun, Nov 4, 2012*

Two weeks ago we wrote about "Someday Rich," the new book from Russell Investments. This week's topic is Russell's Retirement Lifestyle Solution, a decumulation strategy that combines systematic withdrawal, dynamic asset allocation, and (as a last resort) an income annuity.

As an advisor, you know that it’s sometimes hard to dissuade wealthy retirees from over-spending. A client might insist on burning through 10% a year, even after your Monte Carlo projections demonstrate that he’s flirting with long-term disaster by doing so.

“The four percent rule?” one advisor recently moaned. “I have trouble enforcing the 14% rule.” As for introducing the concept of “annuity” into the plan to reduce longevity risk… Well, that’s a conversation that few fee-based advisors, or their clients, want to have.

So, given the sensitivity around this topic, there’s obviously room in the marketplace for new ways to rivet your clients’ attention on safe spending rates, annuities and mortality without confusing them or scaring them half to death.

That is essentially what the Seattle-based asset manager Russell Investments is trying to do with a program that it rolled out about a month ago to advisors at Lincoln Investment Planning, based in Wyncote, Pa., and Cambridge Investment Research in Fairfield, Iowa.

It’s called the Russell Retirement Lifestyle Solution. An advisor feeds his clients’ data—age, assets, and income needs, etc.—into a web-based, interactive income planner. The tool spits out a “funded ratio” that, like the funded ratio of a pension plan, tells the advisor and the client whether the portfolio is on track to provide income for life.

Here’s where annuities enter the picture: If the funded ratio drops to 100%, it signals to the clients that they will have just enough money left in 10 years to buy an income annuity that can protect them from a late-life diet of Friskies and Fancy Feast. In a sense,, it uses clients’ own dread of annuitization to discourage them from over-spending.

Phill Rogerson (right), Russell’s managing director for consulting and product, calls it “a quick, direct way for advisors to calculate a client’s funded ratio in the context of a fairly sophisticated strategy.”

The catch is that client and advisor have to be willing to commit all or most of their investable assets to the program and to a Russell fund-of-funds that uses Russell's "Adaptive Investing" technique—aka dynamic asset allocation, or reverse asset-rebalancing—to buffer downside risk. Since dynamic asset allocation is inherently conservative, and since the program employs mortality pooling only as a last resort, this approach might appeal more to clients whose legacy motive is greater than either their desire for growth or their need for current income.

Calculating the 'funded ratio'

Russell's Rod Greenshields (below, left), a consulting director for Russell's advisor-sold products, recently led RIJ through a demonstration of the Lifestyle Solution's online planner. Like other web-based income planners, it has data entry boxes, dynamic sliders, colorful bar charts and handy comparison tools.

What's different is that, instead of using Monte Carlo projections to calculate the success rate of a certain annual withdrawal percentage from a certain level of assets over a certain number of years, the tool measures success by whether the client's funded ratio is above or below 100%.

Funded ratios over 100% mean three things. First, that clients can meet their spending goals with systematic withdrawals for 10 years. (It's a rolling 10-year period, and the funded ratio is recalculated every six to 12 months.) Second, that they'll have enough money at the end of 10 years to fund a life annuity that will cover their expenses for the rest of their lives. (Russell regularly re-calculates the cost of the annuity.) Three, that they can afford to invest in equities.

A funded ratio under 100% means that it's time for a course correction. Clients can make it positive again either by retiring later, spending less in retirement, or eventually buying a life annuity, which, at the expense of liquidity, allows them to take advantage of the so-called "survivor's credit" that comes from mortality pooling.

Meanwhile, inside the planning tool, Russell's "Adaptive Investing" re-allocates assets in a Russell fund-of-funds in response to changing market conditions. A kind of financial gyroscope, it protects the funded ratio by moving money from bonds to stocks when the funded ratio rises and from stocks to bonds when the funded ratio falls.

That's not especially new. Russell first developed the strategy in the 1990s for a Japanese pension fund. The technique itself is a cousin of Constant Proportion Portfolio Insurance, or CPPI. Prudential Financial uses a modified version of CPPI to mitigate the risks of its Highest Daily variable annuity living benefit.

“We borrowed a couple of things from the pension world that have relevance for individuals,” Greenshields told RIJ. “First, we adopted the concept of using a funded ratio to communicate the health of the plan. Second, we recognized that pension plans focus on the capacity to bear risk. In the retail market, advisors tend to focus on assessing risk in terms of willingness to tolerate market volatility. But that doesn’t map to the real risk in retirement.

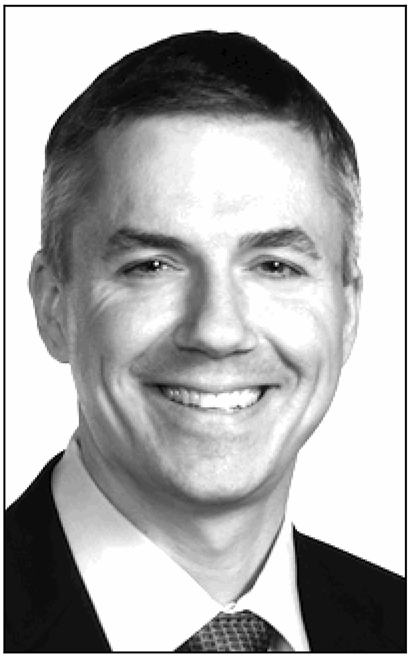
“In pension plans, they focus on the capacity to bear risk. That works for the individual too,” he added. “By saying that the investor with a surplus [above the 100% funded ratio] can bear more market risk, you’re shifting the focus from risk tolerance to risk capacity. The funded ratio is a great proxy for that. The higher their funded ratios, the more they can expose themselves to market risk.”

“We like the funded ratio because it captures a lot of information, and it shows investors where they stand,” Rogerson told RIJ in. “The tool is direct and straightforward and produces a personal funded ratio and proposal in 10 minutes.”

The funded ratio is really just a different way of expressing a retirement spending limit. The numbers that are used to generate the funded ratio could be used to generate a safe spending rate. Greenshields told RIJ that Russell’s calculations translate into a safe spending range that varies roughly from about 3% at age 55 or 60 to 8% at age 80.

At its heart, the Retirement Lifestyle Solution is a systematic withdrawal plan with a chip inside. More importantly for advisors, it provides a narrative that can help re-frame the difficult running-out-of-money conversation to make it simpler and less scary.

“We believe that if we provide the advisor with information about the ‘point of no return,’ then they can change the conversation,” Greenshields told RIJ. “As clients get closer to that line, they may have to lower their spending, at least temporarily.”



Though Lifestyle Solution isn't meant to be pro-annuity—Russell is a $152 billion fund company, albeit one owned by Northwestern Mutual—it puts the life annuity option on the table. By introducing annuitization as a kind of remedy for over-spending, it also demonstrates, perhaps unintentionally, that life annuities enable retirees to spend more.

Third-party thoughts

One advisor told RIJ that he welcomed the Russell program because it facilitates a frank conversation that many clients would prefer to avoid. "The conversation needs to be had," said Tom Forst of Lincoln Investment Planning. "We thought this was a unique way of starting the conversation. It provides clarity. It's a unique way of framing the situation."

"It's a unique discipline for retirement planning. The current tools are: Manage it yourself; Use variable annuities with living benefits; or Self-insure. This provides a discipline that allows the client to invest in a managed portfolio, but gives them an 'airbag' that allows them to reallocate their portfolio if the market turns against them. In this case, the airbag is all about taking a breath and re-looking at the process."

Denver-area advisor Phil Lubinski noted that he already uses a similar technique when discussing retirement income. But he suggested that Russell might be providing an important service for advisors who don't have the time or inclination to do all the necessary calculations on their own.

"On every review I do a 'stress test' that involves telling the client what their current withdrawal rate is," said Lubinski, who originated the time method behind Wealth2k's Income for Life Model (IFLM). "If it goes over 6%, then I tell them that there is more stress on the portfolio than I am comfortable with—particularly if they hope to leave a legacy. Obviously, if the client is 88 years old, then the 6% isn't as critical."

The Russell method "has great psychological value and creates a floor in the mind of the client," he added. "I just can't imagine having to go through all these elaborate calculations that Russell is doing."

Wade Pfau, Ph.D., who writes extensively about decumulation, blogged about the Russell program and raised a question about the merits of dynamic asset allocation. "I haven't seen the math behind this part, but I do wonder about the implications that one is buying high and selling low when overfunded," he told RIJ. "I wonder if the asset return assumptions guiding this part of the analysis account for mean reversion or whether they are independent and identically distributed. Mean reversion would work the other way, suggesting to reduce the stock allocation as the overfunding level grows."

Commenting on Pfau's blog, Crowley, Texas-based advisor Jason Hull found two potential weaknesses in the Russell approach. First, that dynamic asset allocation may not do a perfect job of market timing during a crisis, and second, that the client might be better off actually buying an income annuity instead of merely keeping the annuity option open.

"It just seems a little risky to think that you can catch the timing if your asset base is shrinking to know when to buy the annuity," Hull wrote. "Remember, we hate to sell losers because of the endowment effect. Better, to me, to remove that temptation altogether."

Greenshields defended dynamic asset allocation. He believes that, while asset-rebalancing suits the accumulation phase, reverse asset-rebalancing better suits the decumulation phase. as well as asset-rebalancing suits the accumulation phase. He also pointed out that it works well in slowly declining equity markets, similar to what occurred in 2007 and 2008.

"In investors' memories, the financial crisis seems to have happened in a matter of weeks or days," he said. "It seemed like everything was going off a cliff at once. But it didn't happen all at once. There were seven quarters in a row that the equity markets registered a loss." Buying-the-dips can make sense during a rising equities market, he noted, but buying into a market that's falling is a losing game. That's especially true for retirees, he said, who should be more concerned about minimizing losses than maximizing gains.

"Our strategy says, if you're in equities and equities get punished, back off the equity exposure. Over those seven quarters [in 2008-2009], our strategy would have been to go to fixed income and cushion the fall. You give up the quick snap back, but there's no free lunch. That's a reasonable trade-off during retirement. If we knew that the market was going to snap back in the next quarter, our strategy wouldn't make sense."

Back to the future

Retirement Lifestyle Solution isn't entirely new for Russell. It represents the evolution of Russell's LifePoint Retirement Distribution Funds, which were launched about five years ago. Those were funds-of-funds that paid out a predictable but not guaranteed income over a 10-year period and used dynamic asset allocation to keep the account value from straying off course.

LifePoint Funds, like other payout funds launched, fell victim to a number of adverse factors. They faced bad timing (the financial crisis), a fairly narrow focus (they were purely product-based solutions) and they lacked transparency (their risk management method was a bit of a "black box").

But the LifePoint Funds live on as the investment vehicle for Russell Retirement Lifestyle Solution, which takes the earlier product, puts it inside a planning tool and adds a dashboard indicator—the funded ratio. All of which makes the funds more transparent, easier to explain and, presumably, easier to market.

“It’s very similar under the hood to what we did with LifePoint,” Greenshields told RIJ.

“We developed software for it, but that never went anywhere. The underlying mathematical algorithms are similar in principle, in terms of doing optimization process.”

The new strategy is being put to the test right now, as Lincoln Investment Planning and Cambridge Investment Research roll it out to their advisors. Cambridge is the ninth largest independent broker-dealer in the U.S., with about 2,000 advisors and annual revenue of almost $400 million. Lincoln’s 850 advisors manage $19 billion for about 250,000 customers nationwide.

“It’s up to our reps to embrace it, and they haven’t had time yet,” Forst told RIJ. “We just started training on October 1, and we don’t expect to see significant sales or movement of assets until next year.”

Russell already has commitments from three other broker-dealers to use the Retirement Lifestyle Solution, Rogerson said, and the firm has plans to use it in defined contribution space, where it would compete against programs such as Financial Engines’ Income+ and Dimensional Fund Advisors’ recently-launched Managed DC. Said Greenshields, “We are actively pitching this to DC clients.”