Russell's "parachute" decumulation strategy

By Kerry Pechter *Tue, Apr 10, 2012*

The strategy recognizes that most people don't want to relinquish a big chunk of their liquidity at age 65 and that the SPIA "mortality credit" isn't attractive until the client reaches age 75 or so.

For five years or more, financial analysts at Russell Investments have been publishing papers and articles on what you might call the "parachute" approach to lifetime income planning.

Just as skydivers eventually fall to an altitude where they have to pull the parachute ripcord to land safely, Russell recommends a systematic withdrawal program for the first 10 years of retirement (the freefall period), to be followed at age 75, if necessary, by the decision to purchase of a SPIA (pulling the ripcord).

The big difference is that a skydiver has to pull the ripcord at some point but the investor doesn't have to buy an annuity. With the Russell strategy, clients can choose to buy the SPIA or not. It depends on whether they've spent their portfolios down to the point where only a SPIA can guarantee an adequate income for the rest of their lives.

The strategy is built on two major assumptions: that a) most people don't want to relinquish a big chunk of their liquidity by buying a SPIA at age 65 and b) that the "mortality credit" from risk pooling isn't big enough to justify the purchase of a SPIA until the client reaches age 75 or so.

Russell's patent-pending methodology, officially called "Adaptive Investing," is much more sophisticated than the skydiving metaphor suggests. The details of this dynamic "multi-period portfolio optimization approach" are described in a new research paper, *Adaptive Investing: A responsive approach to managing retirement assets*.

"Planning for your client to live 10 years and then have enough wealth to buy an annuity at the end of those 10 years is a useful way to address longevity concerns without significantly overstating the spending liability," says the paper.

The paper's authors, Sam Pittman, Ph.D. and Rod Greenshields, CFA, write that the main financial risk for pre-retirees is performance volatility. After retirement, the main risk becomes income shortfall, and retirement portfolios should be—but often isn't—managed with that in mind.

"Advisors should look beyond investment strategies based on mean variance optimization because it solves a different problem than what most retirees have. The real risk retirees are trying to manage is running out of money, not volatility which is central to mean variance optimization," they write.

"Retirees want consistent income from their portfolios and to avoid running out of money before they die," said Pittman, a senior research analyst at Russell, in a release. "They also want to maintain control of their assets for as long as possible. In fact, many would like to be able to bequeath any remaining assets to heirs or charitable organizations.

“The Russell Adaptive Investing framework supports these aspirations by simultaneously helping investors retain control of their assets for as long as possible, while working to address the real risk of outliving assets by preserving the option to annuitize if it is needed.”

The framework starts with a calculation of the client’s “funding ratio,” which is the ratio of assets (investments and future savings) to liabilities (debt and future spending needs). The investor’s wealth, spending needs and anticipated lifespan determines the asset allocation.

“Many planning approaches try to mitigate longevity risk by planning to a fixed age that is either at or beyond the life expectancy, but using a pre-determined ending age can lead to an overly restrictive spending plan if the age is set too high and an overly risky plan if the age is set too low,” said Greenshields in the release. “Under this framework, investors can preserve flexibility and keep their options open.”