'Show Me the Income'

By Kerry Pechter *Thu, Jun 14, 2018*

The focus was on mutual funds and ETFs at Morningstar's 30th Investor Conference this week in Chicago, but retirement financing and the 'best interest' proposal were also discussed. (Photo: Nobel Prize-winner Daniel Kahneman and Morningstar's Sarah Newcomb talk behavioral finance.)

At the Morningstar Investor Conference in Chicago this week, Nobel laureate Daniel Kahneman was asked to define an investor's "best interest." It was a timely question, given the recent failures of two federal agencies to create a clear or workable definition for brokers and advisors to follow.

Kahneman, whose pioneering work (with Amos Tversky) on risk perception and financial decision-making led to the 2002 Nobel in economics and to the influential book, *Thinking Fast and Slow* (Farrar, Straus and Giroux, 2011), said that advisors can act in a client's best interest by guiding them to their own unique "regret proof" strategy, "the kind of policy that people can live with even when things go badly.

Inside McCormick Place

"This is not necessarily profit-maximizing," Kahneman told Morningstar's Sarah Newcomb during their on-stage interview. "And the optimal allocation will not be the same for people who are prone to regret as for people who aren't."

One way to execute a regret-proof strategy in retirement, he said, is to divide a retiree's money into a low-risk portfolio for essential needs and a higher risk portfolio for discretionary needs or just for the sake of upside potential. People tend to be satisfied if at least one of their buckets does well in any given market, he said.

During a Q&A session before more than 1,000 advisers and asset managers at Chicago's vast McCormick Place, Kahneman also endorsed behavioral finance expert Meir Statman's ideas about respecting a client's emotionally driven preferences, even when they don't seem fully rational to the adviser.

Taboo on spending principal

Retirement savings and distribution strategies didn't receive a lot of attention at the conference, where most of the energy is devoted to mutual funds and accumulation strategies. But a couple of sessions, including one called "Show Me the Income," touched on retirement-phase issues.

In that session, Wyatt Lee, co-portfolio manager of T. Rowe Price's target date funds, talked about the benefits of payout mutual funds that would provide retired participants with a stable income based on distributions of earnings and principal without arousing their inborn resistance to spending principal.

"If you can repackage a total return strategy that meets people's need for income, they will be drawn to it. Eating into principal isn't a terrible strategy," he said, adding that people already do it without knowing it. "People don't want to sell some of their stock, even though selling shares for income is exactly the same as getting a dividend and using it for income. If you offer a fund that acts and feels like an income security, people won't care if they're getting a dividend or a gain."

In a session called, "Evaluating the Government's Approach to Helping Investors," Morningstar's Aron Szapiro, a former Government Accountability Office staffer, said that last December's tax reform bill, by lowering to 21% the effective tax rate on business owner's income, could eliminate a major incentive for small company owners to start retirement plans.

"The 'pass-through provision effectively means that taxes will be higher not lower in retirement for business owners," Szapiro pointed out. Therefore it doesn't make much sense for them to save on a tax-deferred basis. In the past, the high deferral limit—currently $55,000 per year—has been a big selling point for advisers trying to sell 401(k) plans to small business owners.

Regarding regulations, Szapiro said that the SEC's new Regulation Best Interest proposal is unprecedented in requiring broker-dealers to act in their clients' best interests, and the requirement applies to rollover recommendations as well as sales.

But the SEC proposal doesn't define "best interest." "It's not clear what the broker-dealers' obligations will be," Szapiro said. "We know that broker-dealers wouldn't be operating under the same fiduciary standard as registered investment advisors [RIAs]. And there are no new rules for RIAs, just guidance. Where the DOL rule was product agnostic and specific to IRA accounts, the SEC proposal is account neutral but applies only to the products that the SEC regulates."

Daniel Kahneman

Kahneman's next book

During his interview with Morningstar's Sarah Newcomb, Kahneman revealed that he's currently working on a book with Cass Sunstein on the role of noise in decision-making.

(Sunstein, who co-authored *Nudge* (Yale, 2008) with Nobelist Richard Thaler, is founder and director of Harvard's Program on Behavioral Economics and Public Policy.)

"I've done a lot of work on biases and systematic errors. But there's something even more important: unsystematic error or 'noise' as a random factor in the making of decisions," Kahneman said. "We put a lot of weight on biases but not enough on the impact of noise."

Kahneman said he once convinced an insurance company client to study their underwriters' decisions. "We gave 50 underwriters the same case to work on, and we asked the executives, 'How much do you think they will vary in putting a dollar value on the case?' They predicted 10%.

"But when we took random pairs of those underwriters, and divided the differences between them by the average valuation, we got an average variation of 50%," he said. "That was a lot more variability and noise than anybody was aware of. We found the same thing with claims adjusters. When there's that much difference, even an unsophisticated algorithm might do better, because it's noise-free. Our book will tell that story."