The Ultimate Income Strategy

By Kerry Pechter *Thu, Jan 22, 2015*

"By making the final years of life (should they occur) the insurance company's problem, [a combination of risky assets and a deferred income annuity] makes retirement investing feel more manageable," write Laurence Siegel and Barton Waring in the Financial Analysts Journal.

With a title like, "The Only Spending Rule Article You Will Ever Need," a new piece in the latest issue of the *Financial Analysts Journal* sure sounds like required reading for advisors who specialize in retirement income planning. And, despite the obvious hyperbole of the headline, it probably should be.

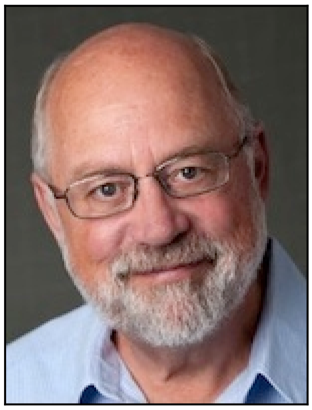
But here's a spoiler alert. The article starts out by proposing an annually-adjusted systematic withdrawal program from a diversified portfolio as the best possible retirement income generator for someone who holds risky assets. But about halfway through, the authors change direction and semi-endorse a strategy that combines risky assets and deferred income annuities.

Let's look at those two income strategies—which complement rather than contradict each other in this alternately wonkish and jocular article by former Barclays Global Investors strategist M. Barton Waring and Laurence B. Siegel of the CFA Institute Research Foundation—one at a time.

A new financial acronym

Waring (right) and Siegel primarily favor a drawdown principle that they call "periodic re-annuitization," which they've been fine-tuning for several years. It involves an algebraic, easily spreadsheetable formula for adjusting clients' spending levels each year in retirement to account for changes in interest rates, account levels and life expectancy.

"We call a portfolio managed according to this principle an *annually recalculated virtual annuity* (ARVA)—'virtual' because the investor does not have to buy an actual annuity to reap many of the benefits of annuity thinking, even if she continues to hold a portfolio of risky assets," they write.



They reject the classic inflation-adjusted "safe" spending rate of 4% because it uses the initial account value to calculate annual income and doesn't offer enough longevity risk protection. They also reject attempts at "smoothing"—using one year's surplus gains to offset another year's losses—as a way of keeping retirement income spending level from year to year, because they don't trust the principle of reversion to the mean. And they nix the idea of taking on more risk (and assuming a higher rate of return) in order to justify an unsustainably high drawdown rate.

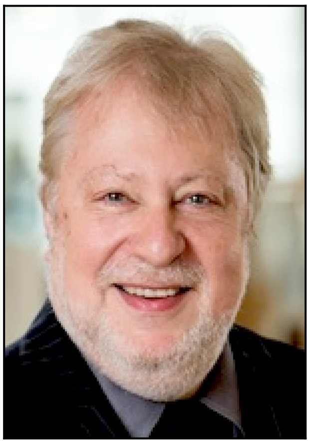
Instead, they insist that if you're going to invest in something riskier than Treasury Inflation Protected bonds (TIPS) in retirement, *and* you want to rule out the possibility of running out of money within a specific interval (in their example, 30 years), you have no choice but to accept a retirement income that fluctuates with the markets.

"Many would like to have their aggressive risky asset portfolio 'cake' and eat it smoothly too, as the old saying (almost) goes, holding lots of equities and other risky assets. But—this is a reality check—the 'tough love' lesson of this article is worth repeating: consumption volatility directly follows from investment and discount rate volatility and *is what risk is*."

A capstone of longevity insurance

Having said all that, Waring and Siegel concede that the ARVA method has a shortcoming: it relies on an assumed life expectancy (of 30 years, in their example) rather than the uncertain life expectancy that all of us face. So they take several pages to consider the benefits of using some kind of annuity as a source of or supplement to income from a portfolio of risky assets.

After considering various types of annuities—single premium immediate income (SPIA), deferred income (DIA), deferred variable (VA) and fixed index (FIA) with income riders, and ruin-contingent (RCLA)—they seem to settle on a hybrid strategy. That is, a combination of the ARVA method for the early and middle years of your retirement and a deferred income annuity for the years that you may not live to see and which are prohibitively expensive to save for.



“The appeal of the plan is that it is much less expensive than self-insurance to a very old age and enables the individual to focus on the earlier part of retirement, when he believes he is most likely to be alive and healthy enough to engage in discretionary consumption—instead of giving up when faced with the prospect of savings for a 45-year retirement. By making the final years of life (should they occur) the insurance company’s problem, the plan makes retirement investing feel more manageable.”

“I would give the TIPS-DIA strategy two and a half cheers and I am actually planning to invest that way,” Siegel (right) told *RIJ* in an email. “Barton would give it one-and-a-half cheers due to his concern about [insurance company] default risk. I think the gains from mortality risk pooling are much greater than the loss in expected utility from possible default. At any rate, I’ve only saved enough to last for 20 years so I need the strategy!”

An echo of a bestseller

Waring and Siegel have studied various retirement income strategies and published articles about them for several years. Waring is the former chief investment officer of Barclays Global Investors. Siegel is director of research at the CFA Institute Research Foundation. Siegel said that while the title of their article may echo the title of the 1978 bestseller, “The Only Investment Guide You’ll Ever Need,” by Andrew Tobias, which became a classic and has been reprinted many times, the resemblance was coincidental.