Retirement Income
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Where’s The Alpha?

By Editor Test *Tue, Feb 16, 2010*

"Academics continue to create analytical solutions that rarely apply in the human world," says this Denver advisor.

More than twenty-five years have passed since I completed my CFP curriculum and what strikes me today is the “disconnect” between reality and what I learned in the classroom. What concerns me (and amuses me at times) is that an academic/reality gap persists.

In my youth I noticed a generation gap between my parents and me. It narrowed as time went on. But on the financial frontier, academics continue to create analytical solutions that rarely apply in the human world.

With my CFP I was armed with the tools to create financial plans that spanned my clients’ entire adult lives. I learned about managing debt, funding college educations and ultimately creating enough wealth for a comfortable retirement. And all with tax strategies and insurance safety nets built in.

As a new CFP, I decided to specialize in retirement income planning and have remained in that specialty ever since. With my newly acquired academic credential I was equipped to create elaborate spread sheets that illustrated a variety of monthly expenses and carefully adjusted them for inflation and taxes.

 I could create tailor-made portfolios consistent with the risk tolerances of my clients. I could analyze any money manager’s results and seek out funds that delivered positive “alpha”—without realizing that investment alpha was virtually impossible if I were compensated along the way. (If 80% of money managers don’t beat their index, then adding another point or so for me pretty much eliminates any “investment” alpha.)

When markets are dropping and portfolios are losing money, very few people are comforted by “alpha.” When the cashflow spreadsheet, so painstakingly detailed, is interrupted by a son who needs $25,000 because he lost his job, my Excel talents are of little use.

Of course we set aside an “emergency fund.” But we never thought we would need one for unexpected unemployment. We planned for our children’s weddings, but not for their divorces. We planned for our children to move out some day, but not to move back in.

Who would have imagined that Bruce’s ex-employer would stop paying for retiree health insurance? Under what circumstances could we have anticipated a pension plan going broke and benefits being reduced to the PBGC limits? Why didn’t I anticipate Sally’s premature death and Hal’s re-marriage to someone 20 years younger? How about Dan and Sarah’s weekend getaway that resulted in the purchase of an illiquid timeshare, or Jim’s aunt who died and left him her royalty income of $50,000 a year.

I find myself saying, or thinking:

This can’t be… It’s not what my spreadsheet projected… We weren’t supposed to need that mutual fund for another 10 years… Whoever thought interest rates would be so low… Your expenses don’t seem to be tracking the national inflation rate… You can’t pull your money out of the market; your risk tolerance answers said you could tolerate this kind of drop… I thought you understood that “guarantees” limit your upside potential… This product would have worked well if the market hadn’t gone up (or down)… Gee, the Monte Carlo analysis said this ROR had a 90% probability of success…

And on and on and on.

Yet every day I read another academic or analytical article on how “best” to provide enduring retirement income, on how to achieve that “exact” allocation of asset classes and “optimal” combination of income riders and model portfolios.

I just laugh to myself and ask, “What really is alpha?” Investopedia defines alpha as “the value that a portfolio manager adds to or subtracts from a fund’s return.” Unfortunately, Investopedia doesn’t add a footnote stating that this “alpha” was achieved in a parallel universe where human conditions do not exist.

Bottom line: There are no one-size-fits-all solutions. No product mix is best for everyone. There is no spreadsheet that can anticipate or project with perfect foresight. The most precise analysis becomes invalid the minute it leaves your office.

I don’t recommend that you stop reading and learning-the academics offer great comic relief. But the question, “Where is the alpha?” can be answered in two words: Review and Adapt. Every strategy you implement must be flexible and changeable. Most single-product strategies are neither.

Wake up, fellow advisors! The elusive “alpha” is you and your relationship with your client. It is your ability to problem-solve, to explain potential consequences and to advise on “life” decisions. R-squares, standard deviations, betas, and Monte Carlos make for fascinating debate, but they are relatively insignificant in the overall success of a retiree’s income strategy.