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Retirement Income Planning, Part 9*: Are New Products a Solution or a Stopgap?

The likely answer to this question is: some of both. While it is heartening to see creativity being applied, especially by insurance and securities firms, recent product introductions offer more sizzle than real substance. And even at their best, products can be only part of the solution in this market. Some companies realize this already, but many are acting as if they don't.

Some of the news is good

In the 1980s and 1990s, development of new products for retirees advanced in some areas, but faltered in others. The insurance industry made the biggest strides, offering long-term care insurance on a large scale, introducing annuities with variable payouts, and adding riders to life and annuity contracts that provide accelerated death benefits or help with long-term care costs. In the banking world, we saw the rise of reverse mortgages. The securities industry was mostly silent.

In the last five years or so, however, change has accelerated in this market. Insurers have offered new products that offer stronger guarantees to annuitants, and/or that provide access to capital even after annuitization. Mutual fund companies are offering life-cycle funds that target specific age groups and grow more conservative over time. Banks are looking at ways to make funds more accessible to retirees who have assets rather than income to back them up.

These developments are to be applauded, because each provides new options that will be suitable to certain retirees. But they also carry a risk.

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* Part 1 of this series discussed in general form the urgent and wide-ranging planning needs of people facing retirement. In Part 2 we further explored the follow-up question: can a comprehensive financial planning approach really work for retirees and, if so, how? Part 3 examined investment risks and strategies, and argued that most retirees should be investing conservatively rather than for asset growth. Part 4 identified serious problems with the use of Monte Carlo models in retirement income planning, and suggested an alternative approach. Part 5 discussed the optimal time to annuitize. Part 6 dealt with the question of what retirees need from the planning process, suggesting inadequacies in current approaches. Part 7 outlined what "holistic" planning should mean for retirees. Part 8 set as its goal to define what Income Planning will look like in 2010.

When the Good is the enemy of the Best

Many financial executives seem to view the whole retirement income / distribution arena as a minefield – too dangerous to nagivate boldly. Rather than do nothing, though, they are opting for a middle way: avoiding innovation in areas that are speculative and new, but focusing on one field that is ripe for progress and where expertise already exists: new product development.

Companies opting for a middle strategy that focuses mainly on product development will not be the big winners in the Retirement Income Sweepstakes.

Companies choosing this middle strategy, however, will not be the big winners in the Retirement Income Sweepstakes, because: (1) the kinds of product developments being offered are mostly marginal in their value to retirees, even when at first blush they appear to be revolutionary; and (2) product competition will always be a sideline event, while the real winners and losers are determined on a wider playing field.

Financial companies should, by all means, be pushing hard on product development. But where product development is substituting for, rather than supplementing, broader solutions to the retirement income / distribution conundrum, it is actually hurting the companies who pursue it. It would be insulting and unfair to compare it to re-arranging deck chairs on the Titanic. But it might be accurate to compare it to mid-century airplane manufacturers who thought the future lay in improving propeller aircraft, while competitors were designing jets. Prop planes are good, and they still have a market – and so will the new financial products for retirees. But the main opportunity lies elsewhere.

Why the new annuities are not so valuable as they appear

Let's imagine the ultimate annuity: a product that would pay for life, no matter how long that was, no matter how many lives were covered, and regardless of whether or not medical research extended human lifespans by decades or even centuries. Furthermore, the annuitant would have full access to the original principal at any time, so there was no loss of control over the funds. If desired, annuitants could choose a lower starting return and have payments increase over time, or returns could float with the market. What would we call such a fabulous product?

We may not have a simple name for it, but we already have the product, and it's not an annuity at all: we can call it "investing conservatively and living off the interest." By leaving principal untouched, a retiree can make a fund last virtually forever. An increasing income can be generated by withdrawing an amount less than that earned every year (e.g., if the account earns 6% a year and only 4% is withdrawn, the withdrawals can inflate 2% a year, forever). Variable increases can be obtained by investing some or all of the fund less conservatively.

Living off the interest does not generate as much income as an old-fashioned SPIA. But neither do the fancy new annuities with impressive guarantees.

Naturally, such a product does not generate as much monthly income as a pure, traditional, single-premium immediate annuity.

But *neither do the other new annuity products* that provide guaranteed withdrawals or other special benefits.

It is an exaggeration, but not a huge one, to say that most of the new annuity products are merely a compromise between traditional SPIAs and ordinary savings and investment portfolios (in some cases, perhaps, with a small life insurance benefit or investment hedge thrown in). To the extent that this is true, these products are merely replacements for a simpler compromise: putting part of one's money into an old-fashioned SPIA, and putting the remainder into old-fashioned savings and living off the interest.

Of course, such an old-fashioned compromise would not *exactly* replicate the advantages (or disadvantages) of the new annuity products. But it would come reasonably close in most cases. And this is why we say that the new products are not as revolutionary as they appear: very similar effects can be achieved with old products. Furthermore, the cost of the guarantees being offered is significant. The closer the annuity products get to pure conservation of principal, the lower their monthly income payments become. We have seen income numbers from some such annuities that are actually lower than what we would expect a moderately conservative savings and investment portfolio to generate.

In fairness, one big exception to this somewhat jaundiced assessment lies in the important and truly innovative field of using 401(k) contributions to buy future guaranteed lifetime income – in essence, converting a defined contribution plan into a defined benefit plan. Of course, this laudable concept applies to the accumulation phase and will benefit retirees in the far future – but is of no benefit to retirees of today and of the near future.

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The biggest novelty in the new annuity products actually lies in who gains from them. If the retiree buys a mix of, say, an SPIA and some U.S. Treasury Bonds, the insurance company gets to manage only a portion of the assets. If the retiree buys a new-fangled annuity with nifty new riders on it and lets the insurer capture the entire nest-egg, then clearly the annuity sellers come out way ahead. The difference for the retiree, however, is not all that significant. The retiree may not lose, and may indeed benefit in some ways compared to what they could have done with more traditional products, but the insurance company is the main winner.

Why the new life-cycle funds are not so valuable as they appear

The life-cycle funds present a similar profile. They may create new asset retention possibilities for the firms that offer them, but they offer little new benefit to retirees.

This claim is counter-intuitive. Isn't it obvious that the retiree gains immensely by having a fund that will automatically be re-allocated as the retiree ages, reflecting a greater need for income and safety and liquidity over time? Obvious, yes, but probably not true.

The reason it is not true is that the changing allocation is right for the retiree only if the retiree happens to need those particular adjustments at the particular times they are being made. Yes, the *average* retiree needs increased income, safety, and liquidity over time.

But many retirees do not need those features, and most of those who do need them do not need them at the same time and to the same degree as everyone else.

Age is an important factor in portfolio construction, but it is neither the only factor nor the most important one. The vast majority of retirees would be better served by analysis of their *own* cash needs, present and future, and by having a qualified advisor construct a plan that reflects those needs, one that is reviewed and adjusted over time to account for the particular and often unexpected changes that occur in their lives. Otherwise, they are trading the convenience of never thinking about their portfolio again for the weakness of a portfolio that is not specifically suited to them, and that will probably become even less suited over time.

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Even if the life-cycle idea were beneficial to retirees, it could easily be emulated by using a combination of traditional mutual funds, adjusted by the retiree or by his or her advisor over time. So again, the change is marginal, not revolutionary.

Another recent development is the design of mutual funds with guaranteed withdrawal benefits. This is a little more creative, but again, the same effect could be achieved in an unbundled fashion with existing products. The convenience of getting this effect in a single product must be weighed against the additional fees, and it remains to be seen whether there is much if any net benefit to the consumer.

But either way, the real winner is the financial company. If you make your living from mutual funds, you hate to see your clients gradually shifting money into bank CDs or into bonds that are directly owned. By offering a life-cycle fund, you can probably keep more of the retiree's capital in your own house. By offering a guaranteed withdrawal product, perhaps you keep some of your assets from moving to annuity providers. And isn't that what you get paid for?

The real winners: those who help the retiree

We should perhaps reiterate and emphasize that we applaud the development of new financial products for retirees. This effort is important and necessary, and it should continue. Furthermore, actuaries and fund managers are obligated to come up with product ideas that will benefit their firms. There is nothing wrong with that.

We posit, however, that the financial companies who will be the big, long-term winners with retirees are the ones who best serve the needs of *retirees*, and who do so both passionately and compassionately. Offering new products contributes to this, but addresses only part of the need.

In the end, the retirees themselves will decide which of us are winners, and which are not. If we offer them what they want and need, they will respond. If we don't, they will go elsewhere. It really is that simple.

And what retirees cry out for, more than new products, is education, understanding, advice, *help*. Most retirees are not financial experts, and even the experts are often at a loss when retirement hits. Retirees are at the starting line of a race whose length and course they don't know, driving whatever vehicle they have cobbled together during the first six decades or so of their lives. A few are driving fast, sleek, luxurious vehicles with big gas tanks, and they will do fine, whether you help them or not. But most are struggling with jerry-built jalopies, and while they might need some new parts, they could benefit from the old stuff you have on the shelf just about as much as the new. What they really need is a road map, some advice on how to hold their vehicle together long enough to get them where they are going, and pointers on how to get the best mileage they can from it. If you give them the service they need, most will let you sell them the parts, too. If you don't, well, they can buy parts anywhere.

If you have little to offer other than product, retirees will abandon you, especially as they find competitors of yours who can offer *both* the products that retirees need *and* the other help that retirees positively crave. Within twelve months, maybe less, some of your competitors will be ready to offer that help. Will you be able to compete?

If retirees are at the start of an uncharted race, then so are we in the financial industry. There will be winners and losers in this race, too. Be careful not to spend all your gas money on buffing up the paint job. And don't wait too long to get to the starting line.

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