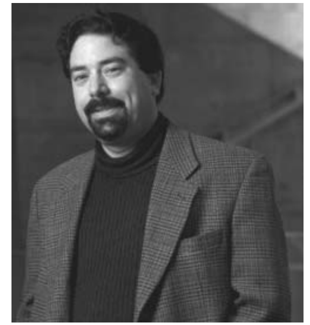
News Article

Pay For Life

Advisors need to shift from wealth accumulation to income distribution



"The industry has become so convinced that all you need is a diversified portfolio."
Moshe Milevsky

INTERVIEW BY MARK BROWN

ADVISOR Q&A

As investors move from accumulation to spending in retirement, Moshe Milevsky, a finance professor at York University and executive director of the Individual Finance and Insurance Decisions Centre tells Mark Brown that advisors need to go beyond portfolio diversification. Retirees need longevity insurance, downside protection and inflation hedges.

Q What is your basic message?

A As people transition from accumulating wealth to distributing income and creating an income stream, they are going to have to think more broadly about their investment. Although their asset allocation will not have to change, their product allocation will have to change.

What do I mean by product allocation? Investing in things like annuities, investing in things that have lifetime income, investing in things with downside protection, investing in things that keep up with inflation – product allocation as opposed to asset allocation.

Q How has that message changed?

A I think that for many years the industry has become so convinced that all you need is a diversified portfolio. They've almost gone too far in the belief that that's all you need throughout your entire life cycle. I think it is important to distinguish between someone who is 30 or 40 or 50 years old, where really a diversified portfolio is all they have to think about, as opposed to once they start transitioning into income. The message is different in the sense that asset allocation is not enough anymore.

Q So you believe a diversified portfolio doesn't provide enough downside protection.

A It doesn't provide downside protection. It doesn't provide longevity insurance. It's not going to provide you with inflation-protected income on a regular basis. You have to start thinking about your defined benefit pension. You have to start thinking of tax efficiency of retirement income. That's a very big issue.

When you are accumulating wealth, it's not that big a deal, but when you are withdrawing money and you have all of these different silos, you have to figure out which silo to tap into first and that's a message that is different from what advisors have been hearing till now. They never had to tap into money; it was about saving money.

Q What are the disadvantages with the products that are currently out there?

A I would say that there is an entire generation of products that are coming out to try to meet this need, whether we are talking about principal-protected notes, index-linked GICs, retail put options, long-term options or seg fund solutions. They are all trying to do the same things, which is to slice off some of the volatility and create downside protection.

Q How do you see the product market evolving?

A Competition creates better innovation and this is what we are going to see. Whereas 20 years ago we had about 500 mutual funds, we now have reached the explosive level of 5,000 mutual funds. That's not going to continue anymore. It's not going to be about more asset classes, it's going to be about more product classes where those same investments will still be around, but you will be able to slice and dice the downside protection in a different way. So in 10 or 15 years from now we will be bewildered by all of these different ways to create income.

Q Is the market incomplete?

A Definitely incomplete. That's a key word there. Economists use it very often to describe the current state of markets. Markets are heavily incomplete. There are all of these different securities that we would love to have, but don't have yet and part of innovation is to complete the markets.

Reprinted with permission from

Advisor's Edge Report

November 2006

Compliments of

CI Investments

Q Can you provide some examples?

A One of the areas in which you are going to see innovation is in real estate, where you are going to be able to buy insurance against the value of your house declining by the time you have to sell it, whether it is to move into a nursing home or a long-term-care facility. Right now you have no way to insure this, which is a huge risk. If my house burns down I can buy insurance from Co-operators, if my house is flooded I can get insurance from AIG. Why can't I get insurance if I sell my house and I don't get as much as I anticipated? I pay a small premium for the next few years so that if I have move out during a bear housing market.

Q A lot of the innovations you are describing seem to be coming from the insurance side. Is that a fair characterization?

A They are. I'm bullish on insurance.

If I had to bet banks or insurance I like to joke I would go long insurance companies and short banks.

Q Why is that?

A Because I think they have the ability to bear risks in way the banks can't because of the fact that they can pool mortality and longevity risk. By pooling risk you can diversify a large part of risk. You think of long-term-care insurance or disability or critical illness or longevity insurance: You need a large pool to make that work. Insurance companies by their nature can do that; banks can't. They are both types of intermediaries, they both manage risk, but I would say the risks that insurance companies can manage are somewhat larger than the risks that financial institutions like banks and trust companies can offer. That said, banks have much better experience and much more efficient hedging strategies than insurance companies do, but it is a matter of time and they will be catching up.

Q What types of products limit the risk of ruin?

A First and foremost, before we get anything complicated, it is a life annuity, a payout annuity that pays you income for the rest of your life. That is what a defined benefit pension provides. You've got to have some of that, whether it is through your pension at work or whether it is your CPP or whether you voluntarily purchase some immediate annuities.

For the next layer, you need something that keeps up with inflation. There are some bare basics that you don't have to worry about, but you need cost of living so you need to have some sort equity exposure or some sort of exposure to an asset that grows over time.

Then you want to think about downside protection. So whether it is going be index-linked GICs, or put options or principal protected notes, you need some downside protection. I like to think of it as a pyramid that you grow and you start with a very solid foundation and you move up depending on your risk preferences.

> "I'm bullish on insurance. . . I would go long insurance companies and short banks."

Q Manulife has introduced a product with a twenty-year market-linked payout. How does that fit?

A It's certainly the middle layer. It is not the bottom layer; it is not the foundation. Once you've built some sort of foundation you move up to the next step. It's not just me that is saying this. I am taking a cue from the enormous industry in the U.S. People don't realize this that this is not something that was invented in Canada or invented by Manulife, this has been a product that has been in the U.S. for about five or six years now, maybe even longer, and it is now a $150-billion-a-year industry a year.

If anything, I would say this is just the first generation of this. For example, one of the recent innovations is a [guaranteed minimum withdrawal benefit], like what Manulife launched, but it pays out for life just like a payout annuity, which combines the wonderful assets of payout annuities, longevity insurance with downside protection. Now that's an innovation I'm hoping we are going to see here soon.

Other companies are saying, "Why do I have to have managed money with this downside protection? I don't want to bay 250 basis points for a seg fund from some mutual fund manager, I want to protect ETFs. I want to protect my index funds. Will you do that?"Yes. Two or three companies are now launching downside protection products on your choice of ETFs. Want to invest in S&P SPDRS and mid-caps and EAFE, fine. You pay 20 basis points for your money management and layer of insurance over that, which is another incredible innovation where you can disentangle the protection from the money management.

People ask: "Why would I just want to protect myself ? We're a couple. Can we protect a couple now? Can we have income that lasts for the life of a couple?" That's another level of innovation. Another incredible area of innovation is combining these products with long-term-care insurance, nursing-home insurance and other types of insurance so that if you have liquidity need – you have a sudden shock, you need money – you can pull it out and you are insured against that as well. So it's cross-product innovations.

Q Do you see any problems with variable immediate annuities?

A In Canada, about two or three years ago, Clarica and Standard Life launched them. They are not very popular and they don't sell a lot, but they are on the shelf of those two companies. It doesn't have downside protection and that's probably one of the reasons why it has not been as well received. I think that on the flip side you get mortality credits, lifetime payouts and as long as you invest in assets that are slightly more conservative or if you put some sort of downside protection on top of it, it would be an ideal candidate for a product. I like variable immediate annuities; I think they complement fixed immediate annuities. It's just a question of how do you deal with the downside risk.

Q At what point do you plan your retirement income?

A I don't know if there is a point at which you plan your retirement income. But as this horizon gets closer, and as the fog starts to lift on what the next 10 or 15 years are going to look like, you start to think more carefully about it. It becomes clearer and clearer as you get closer and I say three years before retirement you better be crystal clear on what that

date is going to look like.

The last thing you want to do is attend a seminar six months before you retire and start thinking about it. And that's what unfortunately many of these employers do.

> "If you say, `I don't do insurance, go somewhere else,' people will take their wealth elsewhere as well."

Q In terms of calculating withdrawal rates, how do these factors fit in?

A Risk tolerance is a big one. How tolerant are you for risk. Can you sleep at night knowing that there is a risk that you will run out of money with that withdrawal rate. There is no universally optimal withdrawal rate. Anyone who gets up there and declares, "Thou shalt withdraw 4.7% a year" – no. Just like when you are saving money, there is no universal asset mix; when you are withdrawing money there is no universal rate at all. It's somewhere between 4.7% and 7.5% a year, depending on your tolerance for risk, depending on your need for inflation protection, depending on your asset allocation.

Q Is there any way to mitigate the risk of failure of a financial institution?

A When I contemplate a payout annuity or an income annuity the big thing that worries me is, will this company be around 30 or 40 years from now. It's a tough one and there are a number of things you can do about it. First of all, don't do business with anyone unless they have a AA or AAA rating. Second, diversify across companies. Never, ever – and this is to financial advisors – write one large ticket with one company. I would always split it up, even if it means incurring some transaction costs. "Oh, but I'm going to have to pay an application fee here and there if I split the ticket."You know what, it might be worth it to mitigate some of the credit risk.

Another thing I would strongly recommend is the due diligence process. Part of what you have to do as an advisor when you are selling these instruments is not just figure out how it works and what the tax treatment is or what your compensation is going to be, but find out how they are going to manage that risk over 20 or 30 years.

Q Given the complexity of retirement planning, what type of expertise do advisors need?

A When you are building a business – as much as I like to say that technical skills are important – the truth is the sales skills and people skills and practice skills are more important. Who is the successful advisor? The one that can network, the one that can exude confidence, the one that can convince the client they are doing the right thing.

Technical skills aren't at the top of the list and many, many advisors will say that. But once you transition into retirement income planning, I think the technical skills are going to become just as important, if not more, because these really are technical issues. We are going to see more of an emphasis on what I like to call the calculus of retirement income as opposed to the relationship management of retirement income.

Q What will this mean for licensing?

A You must have an insurance license. Whether you are in an MFDA shop or an IDA shop or whether you are in one of the big investment houses or whether you are opening up shop by yourself, you must be knowledgeable about insurance, whether you want to specialize in it or not? If you say, "I don't do insurance, go somewhere else," people will take their wealth elsewhere as well.

Q How can advisors become better risk managers?

A From a biased prospective, I would think a little more about the probabilities and the statistics of events. I think thinking holistically; thinking about all of the moving parts. Right now we tend to focus on these pieces of our wealth – what should I do with this RRSP or What should I do with this investment account? "How does everything move together?" And quite honestly, this is an excuse for advisors to tell clients: "I need to know more. I need to know what else you have, not because I want to insert myself in your business or because I want to control more of it. I need to help you manage risk and I need to know more than just what's going on in this little account."

Excerpt from
Advisor's Edge Report

November 2006

Compliments of