

# A New Six-Step Retirement-Advice Process

By Mark Chamberlain

*Editor's Note: The author developed this article in collaboration with The Open Architecture 2020 Group.*

The conservative best practices of pension plans don't translate well for individuals despite the considerable efforts of many academic and institutional thought leaders. In the real world where retirement advice is sold, multiple self-interested advisor business silos have ignored implementation of these ideas—the way inside agendas have thwarted attempts to persuade public plan trustees to adopt the more conservative funding rules of corporate defined benefit plans. As a result, progress for individual retirement-advice standards may continue to stagnate—with or without Department of Labor (DOL) intervention—unless the business realities that have created industry inertia are overcome. This is true for the commission world and the fee-only segment as well.

The advice industry needs to evolve toward a new process that is unbiased and scalable, one that translates academic thinking into actionable steps. Without a pragmatic template, different silos will continue to market opposing points of view to a confused public. One side will promote the discretionary asset manager's model of prudence that targets high-net-worth clients (supported by fees for assets under management) and the other will stick to its definition of a pragmatic approach for the average American (supported by a transactional business model). Given the immense profitability of the status quo—and the corresponding weight of resistance to change—the only solution may be to disrupt inertia at its source by inspiring a voluntary movement toward a new professional-grade retirement-advice process that is led by advisors themselves.

Our original team of financial industry veterans accepted a pro bono call for leadership in 2013 from Don Trone (currently the founder and CEO of 3ethos; previously the principal founder and CEO of fi360 and president of the Foundation for Fiduciary Studies), who challenged us to design a retirement-advice process for individuals. We focused on new ideas for Americans entering the decumulation phase of their lives, and our task grew to include the other two financial lifetime stages as well, accumulation and near-retirement. We quickly embraced the following three core values in our work:

1. Avoid limitations on the truth by accepting no sponsors, advertisers, membership dues, or financial backers of any kind.
2. Create ideas that aren't limited in practice to just the wealthy.
3. Accept that the exclusion of academically supported prudent ideas because they are outside the realm of the registered investment advisor's fiduciary standard can reduce the objectivity of retirement advice as defined by an Employee Retirement Security Act of 1974 (ERISA) fiduciary standard. This paradox is pervasive, and overcoming it will require leadership that embraces a new process based on open architecture; we hope to reach a tipping point by the year 2020.

One challenge we've tackled is how to apply best practices in the institutional retirement arena, historically the source of evolution in retail advice, to individuals regardless of net worth. Many of our concepts are informed by liability-driven investing (LDI), which developed in pension plans to address longevity risk but is not yet widely used for retail clients. This is a major disconnect given that many individuals rank

the risk of running out of money in retirement as their number-one issue (with fluctuations in stock and bond prices causing more stress after retirement than before) and many corporate chief executive officers say the top priority for their company pension plans is protecting the funded status from volatility in stocks and interest rates.

## Our Framework

Our six steps can be thought of as an open source-code for anyone who wishes to build out a professional-grade retirement-advice process. The process works on the premise of funding an individual's retirement as if it were a defined benefit pension plan with a finite future. Everyone needs to meet expenses such as food, shelter, and health care, but overcoming investment losses becomes a greater factor for some people. Solutions may include a probability approach using asset allocation theory, or an immunization approach using LDI (which we call "the prevention approach"); we propose that individuals should be able to consider both. We also integrate the institutional idea of asset-liability matching by proposing a core funding ratio.

Longevity risk is the central consideration, emphasizing the importance of matching expected variability in lifetime income with expected variability of lifetime expenses. Investment risk versus return is a secondary decision, with standards for using a probability approach addressed in existing rules under the 1995 Uniform Prudent Investor Act (UPIA). For the prevention approach, there is strong support for lifetime income annuities; examples include the 2016 General Accounting Office's Congressional Report 16-433 on retirement income options, the 2006 Pension Protection Act (PPA), and the 2013

Employee Benefits Security Administration (EBSA) recommendations for lifetime income illustrations on 401(k) participant statements. We further recommend that products with cost-of-living adjustments (COLAs) be used to offset inflation, and that diversification across multiple issuers be considered. Other products often used as immunization in pension plans are not specifically referenced in either the PPA or the EBSA 401(k) statement safe harbor recommendations, and they are neither addressed nor excluded by us.

We emphasize the importance of modeling the tangible impact of inflation over time, particularly for core expenses such as food, shelter, and health insurance. We recommend using tangible, itemized, inflation-adjusted calculations over long periods instead of relying on less-tangible probability calculations.

Our process abandons philosophical fiduciary opposition to commission-based products, similar to the DOL Best Interest Contract and fixed annuity exemptions, with such revenues allowed to offset advice costs. We do not take sides in the compensation debate. Open architecture is redefined to mean access to all available solutions in the marketplace, subject to safeguards that emphasize transparency and prioritize the client's best interest.

We incorporate academic thought leadership in behavioral finance with best practices taken from both the institutional pension arena and government regulators. The latter includes the revised definitions for prudence outlined in the 2016 DOL Best Interest Contract, the 2006 PPA, DOL's 2011 Final Regulation for Investment Advice, the 2013 EBSA recommendations for lifetime income illustrations on 401(k) statements, and the 1995 UPIA.

### Step 1: Define the Preferred Approach

Explain the Expected Time Horizon

- Address current gender-based life expectancy estimates as statistical distributions with standard deviations, emphasizing that a meaningful percentage of the

population lives significantly longer than average and faces additional retirement funding risk. Explain the reduction in a couple's combined Social Security income that may occur upon the death of a spouse, including gender and/or health factors that may affect outcomes. Explain physical and cognitive age-related changes that affect decision-making and risk tolerance over time.

- Discuss how stress due to the fear of running out of money increases after retirement (e.g., the fear of whether you can ever get back into a moving boat as it sails away becomes truly real only after you've gone overboard). Acknowledge the realities that prevent many people from continuing to perform either blue- or white-collar work as they age, calling into question the reliability of this plan as a fallback strategy in retirement.

- Probability means uncertainty; retirees may outlive their savings due to long life-spans, exposure to unusually large negative returns, and/or unusually high asset class correlations. To paraphrase Nobel economist Paul Samuelson's idea about the possible decline of end period wealth invested in random return markets, risk does not go away with time—it accumulates.
- Behavioral and age-related issues may impact a retiree's ability as they age to tolerate extreme volatility in the markets, making Monte Carlo stress tests unreliable for some people.

#### *For the prevention approach*

For the prevention approach, which utilizes lifetime income annuities, clients should understand the following:

“Open architecture is redefined to mean access to all available solutions in the marketplace, subject to safeguards that emphasize transparency and prioritize the client's best interest.”

Determine Client's Preferred Approach to Retirement Income Risk  
Retirement income risk is also known as longevity risk, and the advisor needs to ensure that the client understands the tradeoffs between risk and return using each of the two following best practices:

- The probability approach, using asset allocation theory, which includes consideration of computer-driven portfolios that utilize risk-based asset classes.
- The prevention approach using LDI, which includes consideration of guaranteed lifetime income annuities.

Explain Advantages/Disadvantages of Each Approach

#### *For the probability approach*

For the probability approach, which utilizes a portfolio of risk-based asset classes, clients should understand the following:

- Income for life should adjust to address inflation; the long-term benefits of different COLA or consumer price index options available in the marketplace should be compared to products with higher initial cash flows but no inflation adjustments.
- Diversification across multiple issuers may be prudent, and it is easily done given low minimum purchase requirements. Explain insurer credit ratings, state guaranty fund parameters, and the differences in reserve requirements for fixed versus variable annuities.
- Loss of control (liquidity) occurs at inception; explain how some insurance companies offer liquidity for specified periods of time and others offer none at all; also illustrate the tradeoffs between guaranteed minimum distribution periods and installment refund options versus higher monthly cash flows with fewer guarantees.

### Specify All Required Advisors

Specify all advisors that are required, whether affiliated, unaffiliated, or networked, for their expertise and/or licenses. Explain potential obstacles to objectivity, including whether any implementation solutions will be excluded due to business model constraints, lack of certain licenses, etc.

### Disclose the Method(s) of Compensation

Disclose to the client the method(s) of compensation for all advisors, including whether retirement-advice services will be offset by investment advisory fees, commissions, hourly, and/or project-based rates. This disclosure should be easy to read, understandable to the lay person, and include all indirect forms of compensation.

## Step 2: State Goals and Objectives

### Forecast Core Funding Needs

As a common practice, forecast client-specific core funding needs over time, using projections for expected food, shelter, and health insurance costs:

- Estimate growth for these three core expenses using expected inflation rates for each.
- Illustrate the funding need over multiple points in time, including at retirement, at 10 years post-retirement, and again at age 100.

### Forecast Discretionary Funding Needs

If requested, a more in-depth (and therefore more costly) forecast of client-specific discretionary funding needs over time may be included using additional projections for costs beyond core needs such as travel, entertainment, education, legacy, philanthropy, etc.

### Brief Decision-Makers

Inform all decision-makers and anyone else who may be involved in developing recommendations for this client process about objectives, standards, policies, and regulations. Note the requirements or restrictions specified in any existing legal documents (qualified domestic relations orders,

beneficiary designations, trusts, survivor benefit options, etc.).

## Step 3: Strategize

### Core Income

Calculate if core needs are fully funded over time by core income sources (i.e., sources that do not include savings accounts, investments, 401(k) plans, individual retirement accounts (IRAs), or home equity) by completing the following:

- Project Social Security and other guaranteed income sources (pensions).
- For the same periods modeled in Step 2 for expenses, adjust core income for expected COLAs in both the pre- and post-retirement years.
- Adjust core income for expected taxes.
- Show the impact of a delay in taking Social Security and discuss options for optimizing.

### Calculate Core Funding Ratio

Divide core income by the core expenses to calculate a core funding ratio for at retirement, at 10 years post-retirement, and at age 100.

### Income Replacement

Discuss the client's need for income replacement due to early death or disability, and estimate any expected insurance costs to be deducted from guaranteed income cash flows in retirement.

### Additional Funding Sources

Identify all additional sources of funding for core expenses as well as for discretionary retirement needs and goals; these additional sources may include savings accounts, 401(k)s, IRAs, home equity, etc.

- Using industry best practices for expected returns, project the value of assets at the point of retirement.
- Discuss the potential of using home equity to supplement income and/or liquidity for health care and other needs. Describe the benefits of setting up reverse mortgage home equity lines of credit at age 62 in order to have liquidity already in place when needed, and also to allow unused balances to grow over time.

- Based on the preferred approach chosen in Step 1, determine the additional amount of capital needed at retirement (if any) to fully fund core expenses over the projected time periods in Step 2.

### Additional Projections

If requested, model additional discretionary funding projections utilizing client-supplied data and industry best practices for financial planning, disclosing any incremental remuneration structure for providing more comprehensive services.

### Follow Prudent Practices

Follow prudent practices outlined in the UPIA for selecting and monitoring products, evaluating those available in both the insurance and securities marketplaces, including diversification and total costs.

### Compliance

Comply with governing authorities such as DOL, Securities and Exchange Commission, state agencies, etc.

## Step 4: Formalize

- Define a strategy that is consistent with current academic best practices, regulatory best practices, and industry best practices.
- Provide written recommendations to meet client goals, objectives, and constraints; and specify source of best practices in an easy-to-read and understandable format.
- Ensure the strategy is consistent with implementation and monitoring constraints.
- Articulate that open architecture is not limited by licenses, business models, custody needs, proprietary products, or advisor preferences.

Formalize the strategy in detail and communicate it with a written statement that includes the following information: the names of the client(s); the legal ownership structure of all accounts, including who has power of attorney if the client becomes incapacitated; the roles and responsibilities of all providers; the client's preferred approach to managing longevity risk; the client's assets, time horizons, and expected outcomes; the due-diligence criteria for the selection of

product(s); the monitoring criteria for the strategy, including the timing of reviews and meetings; the process for controlling and accounting for fees and expenses; real or potential obstacles to objectivity (conflicts of interest); and a signed client acknowledgment that the client understands and accepts the final strategy.

### Step 5: Implementation

- Define the process for selecting key personnel to implement the strategy.
- Determine the service providers necessary for implementation (for example, a tailored retirement process may include the services of a financial planner, investment advisor, insurance agent, attorney, or accountant, etc.).
- Define the process for selecting tools, methodologies, and budgets to implement the strategy.
- Specify solutions to be used for managing longevity risk based on either a probability approach or a prevention approach.

- Ensure that service agreements and contracts do not contain provisions that conflict with objectives.

### Step 6: Monitoring

Monitoring includes the preparation of periodic reports that compare performance with objectives and include the following tasks:

- Monitor the client's core funding ratio using updated industry best practices for forecasting costs and inflation for health insurance, food, and shelter.
- Update estimates for future Social Security income and/or pensions, including pre-benefit start and post-benefit COLAs.
- In the near-retirement phase, discuss hedging the interest-rate risk to funding (savings) by matching the exposure with high-quality bonds of similar duration.
- In the decumulation phase, monitor longevity risk tolerances based on possible changes in health, mental capacity, death of a spouse, asset value, income, etc.

### Conclusion

Certified Investment Management Analyst® training empowers advisors to translate the complex ideas used by institutional pension plans to the private client arena. LDI has yet to be integrated into the mainstream prudent process for individuals—not as a better idea, but as an additional professional-grade solution for managing risk. Why not? First, it's important to acknowledge the following:

- LDI injects additional analytics (specific liability forecasting matched with funding vehicle betas) into the retirement-advice conversation, even though these are basic tenets of financial economics (e.g., loan interest rates matched to borrower default risk); and
- individual investors, who are not yet able to request immunization by name, already are overwhelmed by the advice industry's many competing options and conflicting points of view.

*Continued on page 60* ▶

SIX-STEP RETIREMENT-ADVICE PROCESS  
*Continued from page 51*

We conclude that this disconnect will be solved only by innovating a new retirement-advice process—one that is pragmatic for all clients regardless of net worth. Ideally, it includes a checklist that is easy to follow for the average advisor as well as the average client. Such a checklist follows the spirit of IMCA’s *Code of Professional Responsibility*, providing clients information that is “objective and unbiased, and relevant to the client’s decision-making process ... [in a way] that the client can reasonably be expected to understand.”

A consultative advisor, who has academic knowledge, an unbiased business model, and available tools, is in a position to honestly educate about the probability approach versus the prevention approach to longevity risk. Choosing a matched funding solution may lead to better retirement security through more-conservative income risk exposure and an increase in overall saving rate. Professional advisors who step up to lead this translation will spur the evolution of open architecture in the industry as they demonstrate the spirit of IMCA’s *Code* to “deliver, discuss, or make the information available to the client, as necessary, depending upon the circumstances, and

irrespective of whether the information is specifically requested by the client.” ●

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