

# THE JOURNAL OF RETIREMENT

VOLUME 1, NUMBER 2

FALL 2013

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The second issue of *The Journal of Retirement*, like the inaugural issue, has articles that should appeal to the whole range of professionals working on retirement security: plan sponsors and those that advise them, pension economists, retirement finance advisers, and regulators. It begins with four articles on the investment issues confronting people planning the financial aspects of their retirement. Leading off the batting order is “The Guidepath Illusion...and Potential Solutions” by Rob Arnott, Katrina Sherrerd, and Lillian Wu. Their article takes aim at Target Date Funds (TDFs), in some ways an intimidating target, given their increasing prominence as retirement saving vehicles. The hallmark of a TDF is its automatic shift in asset composition from risky to less risky assets as the investor ages, or from stocks to bonds in TDFs with only those two asset classes. Arnott and his coauthors run simulations of a basic TDF glidepath—where the allocation to stocks declines from 80% to 20% and that to bonds increases from 20% to 80% over a 41-year working lifetime using historical data on stock and bond returns. They compare the results with the results of simulating alternative asset allocation rules.

Their findings may be surprising to many of the Journal’s readers: to take one example, a fixed allocation of stocks and bonds (e.g., 50% stocks and 50% bonds) has a higher rate of return than the standard glidepath, without introducing extra risk. They find that even an “inverse glidepath” performs better than the standard glidepath. The authors fault TDFs for the narrowness of their asset classes—they argue in particular that they lack a good hedge against inflation—and take the controversial position that allocations to asset classes should not be cap-weighted. They also propose a novel approach to assessing the risk of a retiree’s income security, which they find is adequately captured not by the portfolio’s standard deviation or variability, but by the variability of the income it can sustain. A strategy that minimizes the former may not minimize the latter. The findings of Rob and his colleagues may seem paradoxical: Aren’t we supposed to be invested fully in safe or reasonably safe assets when we are old? If, however, the return on the alternative investment rules the authors test is so much higher than the return on a conventionally invested TDF, the investor will have a healthy margin to spare in her nest egg as she approaches retirement. The article also makes the point that the conventional approach has us

most fully invested in the stock market when we are young and our contributions are comparatively low.

A common approach to the investment side of retirement planning sets a goal of maximizing the expected rate of return on a portfolio subject to an acceptable degree of risk. In contrast to this approach, which can also be described as choosing the appropriate beta (risk–return combination) for a portfolio while at the same time looking for alpha (excess returns), in “Alpha, Beta, and Now... Gamma,” David Blanchett and Paul Kaplan propose five strategies for maximizing what they term gamma, which stands for the gains to be had from superior financial planning. These strategies are: more efficient tax arbitrage, defining assets to include the present value of social security benefits and pension income, investing part of a portfolio in annuities, treating an investor’s expenditure needs in retirement as a bond-like liability and focusing on net, not gross assets, and abandoning a fixed withdrawal rate (e.g., 4% of assets) in favor of a more flexible rule to achieve sustainable withdrawals from a retired investor’s nest egg.

By using a sophisticated technique that effectively quantifies an investor’s preferences, the authors estimate that these strategies can effectively increase wealth by over 20%, although they recognize that their results are sensitive to the assumptions made regarding an investor’s degree of risk aversion and her willingness to give up present for future consumption. In addition to illustrating a sophisticated technique for gauging the benefits of improved financial planning strategies, the article provides a valuable description of the strategies themselves, and explains why they should be part of the standard toolkit of investment advisors.

American investors have never really warmed to life annuities and their variants. Standard economic theory has always found this a paradox, because of the valuable longevity insurance these instruments provide. In “Applying a Stochastic Financial Planning System to an Individual: *Immediate or Deferred Life Annuities?*”, Agnieszka Konicz and John Mulvey apply the technique of stochastic financial planning using the standard assumptions in order to investigate how the optimal demand for deferred annuities (whose benefits are paid out sometimes many years after the premium is paid) would vary with the potential annuitant’s sex/gender, life expectancy, taste for risk, and the presence or absence of a bequest motive. Specifically, they assume that a potential annuitant, age 45 and planning to work to

age 65, wishes to enjoy a financially secure retirement (her retirement age is later increased to age 85). She is given initial savings at age 45 and may invest them in stocks, bonds, or deferred annuities that begin paying at retirement. Returns to stocks and life spans are both uncertain. At five-year intervals, she may make another choice among these instruments, although investments in annuities may not be liquidated. All liquid assets are converted to immediate annuities at retirement.

The authors have kept their recourse to mathematics at a minimum, thereby making their findings available to a wider audience. Their article can serve as an accessible illustration of the technique of stochastic optimization, which can be applied to a whole range of financial planning issues, as well as a study of the economics of investing for retirement. Simply put, the choice between deferred annuities and stocks is one between security and higher rates of return. The authors find that, regardless of the degree of risk aversion, a woman without a bequest motive invests at least 18% of her initial capital in deferred annuities. She continues to place some of her savings in deferred annuities as she ages, because the gap between the expected rate of return on stocks and the rate of return on annuities declines. As might be expected, the greater the degree of risk aversion, the higher the holdings of annuities. A very risk-averse woman invests as much as 63% of her savings in deferred annuities.

The life annuity undoubtedly loses many customers because of their fear that they will die prematurely (the “get hit by a bus” phobia) thus depriving their heirs of a bequest, or a substantial part of one. Despite the insurance annuities provide against exhausting one’s assets late in life, it is generally believed that buying an annuity must reduce the size of a bequest. Matthew Kenigsberg and Prasenjit Mazumdar, in “Legacy Stabilization Using Income Annuities,” demonstrate convincingly that this need not be true, and that buying an annuity or a series of annuities can make a legacy more predictable. They demonstrate this stabilizing role of annuities by using both a simple model where asset returns are fixed and only the investor’s longevity is uncertain (the probability of death in any given year is based on a standard mortality table), and a more complicated model where asset returns and inflation behave as they actually did behave over various periods in the past. The authors find that, assuming an annuity is purchased to pay for a part of a specified expenditure stream, the probability of a legacy

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of any size is always increased. In some simulations, investment in an annuity actually increases the expected value of a legacy, and it always reduces its standard deviation (variability). Perhaps a reduction in the expected size of a legacy is not too large a price to pay for a more predictable legacy.

The next two articles deal with pension plans and mutual fund governance. “A Goal-Focused Approach to Full Funding,” by Andy Hunt and Stuart Jarvis, addresses the critical question of how traditional plans with a specific funding goal should design their investment policy and choose their asset allocation targets. Their article deals with the case of a plan that wishes to be fully funded, and the authors emphasize the asymmetry between a position of under funding and over funding: the positive weight attached to a surplus is not as large as the negative weight attached to a deficit of the same size. The authors demonstrate that a strategy that maintains full funding once achieved will be superior to a strategy that allows for fluctuations around the target. They argue that as 100% funding is approached, the portfolio should be “de-risked,” implying, in the case of a fund with only stocks and bonds, a reduction in the share of bonds. The article discusses the merits of rapid versus slow de-risking, and analyzes the impact on required plan contributions of different strategies. Finally, the authors address the question of how their analysis might be modified depending on the particular circumstances of a pension plan and its governance, including its advisers’ views as to the future behavior of asset prices and its relationship with the plan sponsor.

Tomas Dvorak and Jigme Norbu, in “Do Mutual Fund Companies Eat Their Own Cooking?,” address an intriguing issue: whether the 401(k) plans of mutual funds offer the same range of funds to the mutual fund’s employees—presumably a relatively financially sophisticated group—as they offer to the public. A divergence would suggest that the employees of mutual funds do not believe in what they are selling. The authors find that when a mutual fund shops outside for funds for the members of its 401(k) plan, the funds it picks tend to have lower expense ratios and better governance scores, even when the fund offers a broad range of classes of funds to the public. However, the authors also find that employees are usually offered the same funds their company offers the public, and that they tend to pick higher-cost funds. The authors conclude that the evidence for the view that employees of mutual funds

do not buy what they sell to the public—that they do not eat their own cooking—is mixed.

The remaining three articles in this issue deal with some important policy issues and analyze a structural shift in the types of pensions that employers offer their workforce. The decline in the coverage of the traditional (final salary) pension plan has entailed a sea change in the U.S. pension landscape. It is not a solely American phenomenon; the role of the traditional pension has also declined in Canada, and, especially, in the United Kingdom. In the United States, corporations have often amended (effectively terminated) their traditional plans to create a cash balance plan, a form of hybrid, as a substitute for them. As a result, there has been a substantial growth in the number of such plans, and the share of the labor force covered by them has increased enormously. The article by Robert Clark, Alan Glickstein, and Tomeka Hill, “Converting Traditional Defined Benefit Plans to Hybrid Plans: *A Decade of Change*,” is a thorough analysis of the causes of the growth in conversions to cash balance plans in 2000–2009. Conversions were very sluggish in the middle of this period because of ambiguities in the law, but the passage of the 2006 Pension Protection Act, by clarifying their legal status, led to their revival. The authors also find that the generosity of the existing plan and the level of its funding ratio significantly increased the probability of conversion, possibly because conversion would save the sponsor money and because it would be easier to fund the accrued benefits of vested plan members. In addition, large companies, as measured by market capitalization, were significantly more likely to convert, while companies with union agreements were more likely to convert than to freeze their plans. In sum, both regulatory developments and economic/financial influences help explain the recent behavior of conversions of traditional to cash balance pension plans.

A lack of financial literacy may threaten to derail the financial plans or finances of both older working Americans and retired Americans. Bill Gale and Ben Harris, in “Developing and Disseminating Financial Guidelines for Retirement Planning,” propose the development of basic financial guidelines that can be embodied in a graphic, like the USDA’s food pyramid, to help older Americans make better financial decisions. Developing such a graphic will require a concerted effort by relevant government agencies. In addition to proposing that the graphic be easy to understand, the

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authors say that the graphic needs to convey the following basic recommendations and information: the critical role of Social Security as the bedrock of security in retirement and the importance of the timing of the claiming decision; the need to avoid high-cost debt; the potentially valuable role of insurance products such as annuities and long-term care insurance; sound asset allocation; and pitfalls to avoid. The authors acknowledge that experience with other graphics and similar instruments has been disappointing—for example, it does not appear that FDA-mandated “nutrition facts” labeling has had much impact on Americans’ eating habits. The authors argue that the graphic they propose could act as a portal—for example, by being linked to the SSA website—and might be a springboard for a broader campaign to boost financial literacy, and could even promote the development of new financial instruments. They are, however, under no illusions as to the difficulty of the objective they have advanced.

Finally, the article by John Turner, “Providing Longevity Insurance Annuities: *A Comparison of the Private Sector versus Social Security*,” returns to the topic of deferred annuities tackled by Agnieszka Konicz and John Mulvey, but from the policy angle. Turner begins by discussing the potential benefits of these unusual instruments, which appear to be substantial. He then surveys the markets for longevity

insurance in the United States and the United Kingdom, and finds them to be almost nonexistent. He suggests that adverse selection and other market failures may account for this, and proposes that a type of longevity insurance could be provided more efficiently by Social Security, which can deal more effectively with such market failures. For example, Social Security beneficiaries might agree to give up a part of the benefit they receive when they first claim the retirement benefit from Social Security in return for a higher pension starting at a later age, should they attain it. Some of *The Journal of Retirement’s* readers might take issue with an extension of an existing entitlement program in this way, but Turner’s article is definitely food for thought.

Allison Adams, her colleagues at Institutional Investor Journals, and I have been truly gratified by the response of readers to the inaugural issue of *JOR*, and by the interest shown by potential contributors. *JOR* welcomes articles on any aspect of financial security in retirement by economists, actuaries, pension lawyers, researchers in academia and think tanks, analysts in financial institutions, and even regulators. For further information, please email me at [sandy-mackenzie50@gmail.com](mailto:sandy-mackenzie50@gmail.com) or call me at (202) 740-4650.

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Editor

### ***Publisher’s Note***

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