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INDIVIDUAL RETIREMENT ACCOUNT COMPETITION

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1. What is being offered by banks, stockbrokerage firms, mutual fund organizations and insurance companies? Can insurance companies compete?

2. What has been 1982 experience and what future experience is anticipated on sales, premium persistency and movement among investment options?

3. What is the impact of Individual Retirement Accounts (IRA) on sales of other products?

4. What will be the impact of proposed changes in the tax laws, i.e., withholding tax and penalty tax, on the various IRA products being offered?

MR. GREGORY J. CARNEY: Our format for the presentation today will be to have each of our panelists present their prepared remarks in their particular specialty area. After the presentation, we will then have a question and answer session. We ask that you hold your questions or comments until that time.

Before turning this over to our panelists I would like to give you an idea of the overall IRA marketplace. The statistics I will quote are from a study prepared by the Life Insurance Marketing and Research Association (LIMRA) in April, 1982, entitled: <u>The Public's Response to IRA: A Consumer Study</u>. LIMRA determined that public awareness of IRAs is high; approximately 89% of those now eligible are aware of the changes in the 1981 tax law creating that eligibility.

LIMRA projected that banks will get about 60% of the IRA business. Stockbrokerage firms would do about 11%, insurance companies about 10% and mutual fund companies about 9%. Since estimates of the potential of the market range from $30-$50 billion, even a 10% market share will generate $3-$5 billion of new 1982 sales.

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The importance of an aggressive marketing effort to this large segment is also brought out in the LIMRA study. LIMRA noted that if an individual talked to an advisor who was affiliated with a financial institution, he would likely place the IRA business with that institution. If the individual talked to an unaffiliated advisor (his brother-in-law), or talked to no one, the IRA would most likely be placed with a bank. Certainly, it is of interest to note that 43% of those eligible have not talked to anyone.

For those desiring more information, the LIMRA study is very interesting. It can be ordered from LIMRA and is Research Report 1982-3.

The basic question we will try to address today is "Can Insurance Companies Compete?" In order to answer this question, we must understand the marketplace, our products, and the products of our competitors. We are fortunate today to have as our panelists, members of our competition who are truly experts in their respective fields. We have a unique opportunity today to learn about our competition.

At this point, I would like to turn the session over to our panel of experts for their prepared remarks.

MR. HOWARD H. KAYTON: I have been asked to present the insurance industry's position regarding products and experience available for IRA sales. Before getting into the products being sold by the insurance industry, I would like to set the stage regarding the history of our involvement with IRA sales.

IRAs were created in 1974 under the Employee Retirement Income Security Act (ERISA). Beginning in 1975, persons not covered by other retirement plans could contribute as much as 15% of their salary, but not to exceed $1,500 per year. Starting January 1, 1977, the individual was permitted to contribute an additional amount, which was generally referred to as a "Spousal IRA", if the employee had an unemployed spouse. The law was further changed in 1978 to permit the Simplified Employee Pension Program (SEP), which enabled an employer to set up a rather restrictive pension plan using IRAs.

The IRA account really got its jolt from the 1981 Revenue Act which created the so-called "Universal IRA". This was the point at which everyone started seeing IRAs as a tremendously increased market. You are all familiar with the tremendous amount of advertising and hype that occurred in the latter part of 1981 and the early part of 1982. That was the time when all the banks advertised you could become a millionaire simply by contributing to their IRA account.

The insurance industry's history of IRAs has pretty much followed this history. When IRAs were first available, the insurance industry saw this as a natural for it to move into. It had products which it could easily sell in this market, and in some cases it modified these to make them fit somewhat better. However, it was often a totally wrong product.

It was wrong because most of our products had high sales loads, low returns, and they included insurance protection. In fact, in a Wall Street Journal article in May of 1978, a report was given of how an individual had invested his IRA funds with Prudential into an IRA, but when he went to withdraw his IRA funds because of financial needs, he learned that the $870 that he had invested had been "consumed by administrative costs and commissions". That same article criticized fixed payment contracts that were being used by the insurance industry as: (1) inflexible, (2) front-loaded, and (3) poor performing. It indicated that many companies had stopped offering the fixed payment IRAs.

Later, to avoid an abuse in the insurance industry, the Internal Revenue Service (IRS) changed its rules on November 6, 1978, whereby an IRA account could no longer include life insurance protection.

The early results with IRA indicated that the insurance industry was not really excited about the potential in this market. Most companies at that time were more interested in the Keogh business than in the IRA business.

Since the product was called Individual Retirement Account, the product naturally fell into the individual life line, rather than the group line. Few companies offered a group product other than to their own staffs. The major problem was that those companies large enough to offer such products generally had their own pension plan, which made their employees ineligible. Because of this, the insurance industry's reaction was to use policies that were loaded to be sold by our agency forces in a market where others were offering the same benefits without sales charges.

As a result of the 1978 article and other similar attacks on the industry, there was a gradual shift toward no-load annuities. This required a change in pricing since the product had to be offered on a flexible premium basis, which reduced the likelihood of recovery of initial marketing expenses. Furthermore, with all of the competition from banks and mutual funds the contribution for each year effectively has to be resold.

The major change in the marketing of IRAs occurred in the latter part of 1981. The new tax act then made the universal IRA available to a huge potential market. Not only did the act increase the amount that could be put into IRAs by one-third, but it also made it available to anyone who is employed. Also, the 15% requirement was dropped in favor of a "first-$2000-basis". This made the IRA the hottest item in the latter part of 1981, if not in the marketing department, then certainly in the advertising department.

It is also important to examine the features of annuities that make them particularly suitable to the IRA market. Initially, the major motivation to life insurers to enter the field was to give their sales forces an additional product to compete with. In many cases, that motivation came from the field force rather than internally from the company. Clearly the life insurance agent who already had his foot in the client's door is a natural for selling this financial product. A second feature is that insurance companies are already set up to handle the premium flow. In many cases, they were only ready to accept regularly scheduled billable premiums. In other cases, such as tax sheltered annuities sold to school teachers, the companies were already in a position to handle flexible premium contracts. With the new emphasis on universal life, the facility for flexible premiums will clearly be there.

A further reason cited by many insurance companies is that they are the only ones who are able to offer life annuities. Clearly, this unique feature would make our product highly desirable. However, there are some flaws in this argument. Apparently a large percentage of those who "go on benefit" under IRAs are selecting interest-only options, which are also available from banks and savings and loan associations. Furthermore, those who have used other means of accumulating IRA funds can roll them over at maturity into a life annuity. The only negative here is that they may be paying sales charges at both ends. But it does give them the opportunity to take advantage of the highest forms of both accumulation and payout.

Another feature that the insurance companies can offer is their investing ability. In recent years, insurance companies have offered very competitive, non-qualified, high yielding, no-load annuities. It is this product that has generally been modified for use in the IRA and Keogh markets. The one drawback that insurance companies appear to have vis-a-vis banks and other institutions is that in the non-qualified market they are able to offer a feature that is unavailable to the competition, i.e., tax deferral. This same advantage does not exist in the IRA market, where all products benefit from the same section of the tax code.

A final advantage available through annuities is the ability of an insurer to offer both fixed and variable accumulations and payouts. Insurers are able to offer their clients the same advantages that they otherwise receive through mutual funds, with the added ability to switch back and forth among fixed and variable accumulations. This has recently been made available through some of the stockbrokerage IRA accounts (which I am sure Alan will discuss), but in the case of life insurance companies, it is probably available to a wider number of people.

One of the desirable byproducts of IRA accounts is that the client to whom you sell an IRA may also be a buyer of other products offered by the insurance company. However, I do not believe that most persons buying from an insurance company are buying for the first time from such insurance company. Instead, I believe that most insurance sales are because an insurance agent has sold the individual a prior life insurance policy, or even a health policy. For that kind of sale, it keeps the client from establishing another financial contact that could eventually result in attracting other funds that might have otherwise gone to the insurance company.

One of the items on the agenda related to premium persistency under IRAs. It is of course premature to develop or analyze the experience available from the universal IRA. I understand that LIMRA will be doing a study on this in the near future. With respect to pre-1982 IRAs, I was not able to find any companies that had actually segregated their experience between IRAs and other forms of annuities. There is also a question of definition. The definition of persistency becomes a little hazy for flexible premium contracts. A lapse could be defined as a policyholder who does not continue to have additional payments, or it could be defined as one that not only stops future payments, but also surrenders existing funds. And, in the case of companies offering annuities that credit interest on a new money basis, there is the added problem of termination and reinvestment within the same company.

As the size of the business grows, clearly there will be more attempts to measure the persistency of the business. My own impressions from our own sales of IRAs are that the business tends to persist better than non-qualified business, but that there are many accounts that are set up to receive a single payment, which never receive any additional contributions. Perhaps our clients have forgotten that they have set up their account one year ago, and instead fall prey to advertising of the "latest product in town".

The recently enacted Tax Equity and Fiscal Responsibility Act (TEFRA) will have an effect on policy design in the IRA market. The two changes that I am referring to are:

1. the deductibility of interest on short-term products, and

2. the reserve deductions for policies having guarantees beyond the end of the current year (i.e., excess interest).

In our company, we have had a product guaranteeing interest from month-to-month that was being used for both non-qualified funds and IRAs. We are now looking at the design of the non-qualified product, and will probably make the same changes for the IRA market, even though it is probably not necessary.

The reserving change that I referred to above was the elimination of reserves for interest guarantees beyond the end of the current tax year for interest deduction purposes. Companies that had issued long-term guarantees at high rates benefited somewhat from the reduction in taxes due to the larger statutory reserves that had to be maintained. TEFRA takes away such benefits, which will make long-term guarantees less desirable on the part of insurance companies.

A final impact of TEFRA will be the withholding required on payouts from IRA accounts. This will not give the insurance industry any disadvantage vis-a-vis other institutions, but will make the product less desirable to the insurance company.

Looking to the future, I believe that the insurance industry will be more and more interested in developing this market. We effectively dropped the ball when it appeared that the market was not going to be a very large one. As a result of this, the banks and savings and loans were able to capture a large share of this market. However, as other annuity products become less salable and as the amounts that can be contributed or transferred become larger and larger, I believe that the insurers are becoming much more interested. I would expect that in the future the government will further expand the present $2,000 limit. Furthermore, as accounts build up there will be tremendous competition for transfers. For example, if an individual made the maximum contribution starting in 1975, and earned interest at rates generally available through banks and savings and loans, that account would probably be worth somewhere close to $20,000 at the end of 1982. A single premium policy purchased with that kind of money clearly interests an insurance company.

There will also be greater emphasis on developing products that would attract a client to consolidate several small IRAs into one account. Although I do not have any statistics available, there must be large numbers of people having more than one account in which they are accumulating their IRA retirement funds. There will be less emphasis in the future on persons who have never before opened an IRA account, although the LIMRA study indicates that about one-third of those eligible are still undecided about opening accounts. Most of those cited lack of funds as their reason for not opening an account. Clearly, tax deferral is not a major need for those having insufficient income on which to live.

I have attempted to survey the IRA market, in general, as well as to indicate those features unique to insurance companies. For those of you wanting more in the way of statistics to either quote to your Product Development Committees or to use as the basis for speeches at groups such as this, I would highly recommend the LIMRA research report. It is now time to turn the program over to some of the other speakers who will discuss their own institution's reaction to the IRA market.

MR. CARNEY: Howard, you brought up a point at the beginning of your presentation about the banks' advertisements on how to become a millionaire. Do you think that there is any lack of competitiveness on the part of insurance companies because of annuity disclosure rules that we have to follow compared to some of our competitors?

MR. KAYTON: I think we have that problem both from our self-imposed discipline as well as the latest exposure draft from the Society Committee relating to Illustrations, which puts a severe restriction on our ability to make projections similar to those used by the banks and savings and loans. I guess a short answer to your question is yes.

MR. CARNEY: Our next speaker will be Jeff Baxter.

MR. S. JEFFREY BAXTER: The banking industry including thrifts and credit unions have probably been the most active and persistent force in the IRA market, since these plans were authorized by ERISA in 1974. Although eligibility was limited and usage rates hovered around 5%, depository institutions gathered approximately 66% of the $60 billion that was invested in IRA plans through the end of 1980.

Because of our success in the IRA market prior to the Economic Recovery Tax Act (ERTA), we look forward to gathering a substantial portion of new IRA investment funds after President Reagan signed the 1981 tax act. The expanded eligibility standards and increased contribution limits should ignite consumer demand and the removal of interest rate ceilings on IRA time deposits in the late fall of 1981 gave the banking industry an IRA investment vehicle we could price competitively.

The standard IRA product of the banking industry had been the traditional certificate of deposit (CD), complete with a government imposed fixed rate of interest, early withdrawal penalty and Federal Savings and Loan Insurance Corporation (FSLIC) or Federal Depository Insurance Corporation (FDIC) insurance. The instrument worked well enough for us, but it proved rather cumbersome and overly restrictive in today's interest rate environment.

The new IRA certificate of deposit retains the early withdrawal penalty and account insurance, but is totally deregulated in most other respects, as long as the term of the deposit is at least 18 months.

As we are free to set our own interest rates on these deposits, it is easy to see how a myriad of account types developed. In general, however, most institutions offer some combination of fixed and variable rates with the ability to make additional contributions directly to the same CD without extending the time of locked-in deposit.

Many observers expected cut-throat price competition between depository institutions, driving IRA interest rates to outrageous levels. While some competition was intense in some markets, this did not occur. The fixed rate product is generally priced at a true market rate, depending on the term of the deposit. The Treasury's All-Savers certificate rate is a common target. In addition, some institutions use front or back end interest rate bonuses to attract and retain IRA funds.

Floating or variable rate deposits, a CD on which the interest rate changed periodically according to an index or a predetermined schedule, were new animals altogether for both institutional and IRA depositors. The product is designed to react to changing market conditions in an attempt to compete with money market funds and variable rate annuities.

Most variable rate IRA deposits are indexed to current Treasury Bill rates, either three or six month, and are adjusted on a monthly or quarterly basis using either the most recent auction rates or previous averages. In many cases, between 25 and 200 basis points are added to the auction rates. Guaranteed minimum (or floor) rates are set between 8% and 10% to compete favorably with annuity products. The variable rate instruments were generally offered with lower minimums and higher yields than the fixed rate CD, hoping to draw more deposits into the account whose cost to the institution would fall as interest rates dropped.

Although the most recently developed figures are by no means complete, it seems fixed rate instruments have outsold variable rate deposits by almost 4 to 1. Figures from my institution bear this out.

Perhaps the most interesting product to be developed for new IRA sales is the so-called zero coupon certificate of deposit. "Zeros" resemble deeply discounted bonds where there are no interest payments during the term of the deposit. Typically sold for 20% to 50% of face value, with intermediate terms, anywhere from 5-15 years, these CDs offer a predetermined reinvestment rate for the earnings while retaining Federal Deposit Insurance. Bank of America, Virginia National Bank and First Federal Savings and Loan of Texas have recently issued zero coupon certificates to tax exempt depositors, including IRA investors. "Zeros" are generally marketed through brokerage houses which provide liquidity to the instrument by maintaining a secondary market for future trading.

This brings me to what I believe to be the most significant development in the competition for funds between financial service institutions, which is the offering of <u>combination products</u> as part of the consolidation of the industry. Some recent examples as they relate to IRA investments are the zero coupon CD between bank and brokerage houses, IRA disability and death completion plans offered through banks in partnership with several insurance companies, and a new product, the Depositors Investment Trust marketed by the Putnam Group which offers investments in several mutual funds to bank depositors. This process is obviously symptomatic of the coming consolidation of the financial services industry. Witness sweeps, discount brokerage and asset management accounts, and invest, the savings and loan brokerage subsidiary.

As with the whole array of financial/investment services, traditional delivery systems and products will not compete effectively in today's environment. Future IRA products will reflect this consolidation; joint products are and will be offered in partnership between bank and non-bank financial institutions. To compete, insurance companies should aim toward developing more ties with depository institutions in the joint offering of IRA products. Because one of your biggest competitive advantages is a guaranteed life payout, opportunities exist for you to draw large balance plans when the IRA investor retires. I would suggest offering reciprocal deposits, and sharing premiums and commissions to attract these funds.

Let's move on to the 1982 experience and future expectations. As you know, a huge media blitz occurred from December, 1981 through April, 1982, with every type of financial institution trying to draw a larger share of the huge new market. Bankers offered premiums, interest rate bonuses and free gifts to lure new customers through the doors.

Although we saw greatly increased activity in the early months of this year, the response was somewhat less than expected. I think that this is shown in the survey results, given at the start of this session. Most new IRA deposits came from existing customers of our institutions. However, the funds were often transferred from money market funds or traditional savings instruments.

Data is hard to come by with regard to this year's activity. From preliminary indications, it looks as if the banking industry lost market share during this period. This loss by the banks was a gain for the brokerage and mutual fund industry and should be attributed to their wide variety of investment alternatives and their selling and marketing skills.

As I previously stated, consumer response in early 1982 was disappointing and utilization rates remain low given the expanded eligibility for the IRA product. The anticipated wave of activity turned out to be low tide. However, there are reasons for this lower than anticipated activity.

1. 1982 contributions may be made through April 15, 1983.

2. Uncertain economic outlook has caused consumers to shy away from long term investments.

3. Confusing advertising and lack of consumer understanding of the immediate and long term benefits of an IRA investment.

Given this reasoning, we look for the real surge in interest and utilization rates to rise from this December through April, 1983. This should be the critical period for those interested in attracting IRA funds because most consumers will stick with the institution that served them first with the most expertise and the name of the game is recurring and transferred investment.

In this period the banking industry will probably once again rely on interest rates and premium give-aways to attract these funds, if only because we are, as a group, traditionally not as inventive marketers as some of our competition.

This is changing, however, in certain segments of our industry. From this more aggressive group, I believe you will be confronted with many of the combination products. It will be the decision of your industry to either compete directly with these products, or to work in tandem, utilizing your best resources to sell your products while sharing in revenues with your competitors through combined marketing, sales, and servicing efforts.

The future movement among investment options should follow the combined product line. Banking products, especially the certificate of deposit, should continue to hold a large share of IRA funds because of the guaranteed rate feature and deposit insurance. If we are moving into a period of economic recovery, equity and various mutual fund investments should do even better. Consequently, you will see more depository institutions moving into this area.

Given the current direction of the economy, most IRA investors will be moving toward longer term, fixed interest rate instruments, attempting to lock in rates in a declining rate market.

I do see some IRA funds, however, using variable rate instruments to anticipate a recovering economy next spring with a subsequent run-up in interest rates.

What has been the impact of our IRA sales on our sales of other products? To date, we have seen no impact. The question should probably be asked in reverse. Existing relationships have been more important to us than our IRA sales. Of IRA products sold to non-customers, we have seen very little evidence of further product sales. It could very well be that these relationships will develop over time as available funds are transferred to our banks for reinvestment.

Banks want IRA customers because of their demographic characteristics. Utilization rates are higher, up to 52.5%, by persons with adjusted gross incomes over $50,000 per year, according to a 1979 study by the Secretary of the Treasury. IRA customers are more likely to use Negotiable Order of Withdrawal (NOW) accounts and 50% have CD investments. A 1980 study by Accountline found that 53% of IRA customers were college graduates, 63% worked white collar jobs, 30% had incomes over $35,000 and 49% were between 45 and 64 years of age. Clearly these are desirable customers, which, for banks, have good cross-selling opportunities.

In closing, it is clear that IRA products have a great deal of growth and profitability potential for all financial services industries. Cross industry combinations are resulting in the beginnings of a new mixture of product types, a phenomenon that will continue to expand and trigger our imaginations. The more successful among us will either expand our product offerings across traditional industry lines or carve out a niche of specialized IRA products appealing directly to the customer we want, regardless of the mass market offerings.

IRA investments will represent a tremendous pool of capital as annual deposits accumulate and contribution limits are increased. This and expanded cross-selling opportunities to our existing IRA depositors should have a major impact on the growth and profitability of our institutions.

MR. CARNEY: Jeff, thank you for your comments. We really appreciate your insight. I think some of the products for the future will be discussed in the question and answer session.

I'd like to turn now to Alan Snyder.

MR. ALAN C. SNYDER: I think we have become a little jaded in our thinking about IRAs, because if I had come here a year ago and said "I've got a product that would help you save on taxes, help beat inflation, and set your fears about the Social Security System aside!", you would have said, "Alan, I think you're crazy!" But we've done it. The government has changed the regulations to allow us to have these products. The market is as big as my fellow panelists have talked about.

We live in a world of dynamically changing regulations. When I consider the impact of these changes, I think of the story I heard recently about the different ways different societies operate. In America and England, for example, everything is permitted that is not prohibited. In Germany, one could say that everything is prohibited except what is permitted. In Italy, everything is permitted, especially what is prohibited. And in Russia, everything is prohibited except what is compulsory.

The regulations have dramatically impacted the IRA market. And, I think in the future, the market will get bigger as adjustments are made to the size of the contribution and maybe as economic conditions improve and people can invest more money.

Earlier, I saw a show of hands of how many people have not contributed to their IRAs this year. Let me give you an interesting fact. Think about all that money you are paying out in taxes on that money you should be putting into your IRA. For a male age 24, by the time you retire, you would have lost over $60,000 of spendable money by delaying those payments. Think about it. I think it is a missed opportunity.

Who went after the market? The same players as before - banks, savings and loans, insurance companies, brokerage firms and mutual funds.

The consumer has been so bombarded with IRA advertising that a recent American Banking Association study showed that an amazing 87% of the public was aware of IRAs.

So the question of who's interested has already been answered by the advertising. In theory, everyone! So I don't want to dwell on that point.

But the next question then is, with whom should you set up an IRA? You get the same tax deduction regardless of where you open your IRA. Actually, the answer to this is provided by deciding how you wish to invest the money you put into the IRA. The investment spectrum within various IRAs includes savings accounts, CDs, mutual funds, deferred annuities, unit trusts, stocks, bonds, covered options, commercial paper, government bonds and limited partnerships. How you want to invest your money determines where you should go to open your IRA. Recent marketing studies show that most people will invest their IRA money in banks and savings and loans, followed by mutual funds and insurance companies. Most people have a checking or savings account with a bank or savings and loan, and will be inclined, through force of habit, to start their IRA in the same place. But at Dean, Witter, Reynolds (DWR), we strongly feel that as IRAs increase in size and popularity, more people will move their funds into an IRA which will provide the maximum investment flexibility - the self-directed IRA. And this is where DWR has concentrated its IRA marketing efforts.

Before we plunge into the Dean Witter specifics, let's pull back a bit to show what thinking went into our strategy selection. We've talked about the market at large but we need to isolate key product attributes so that we will know how to best build and market our product. Based on our market research for financial products and services in general and IRAs in the specific, five essential attributes or customer needs surface:

1. Tax reduction.
2. High return.
3. Need for more information to make an educated decision.
4. Safety.
5. Convenience.

The third one is maybe surprising, it was to us. We figured with that high awareness level, everybody knew what it was about. From subsequent surveys we did, we learned that people are not buying the story that's being advertised. They're afraid to make a decision because they feel they don't have the necessary information available to make the right decision. They do not truly understand how the tax reduction works.

Further research shows, interestingly, the market segments by income earned. In fact, each segment weighs the attributes differently, although the first three are uniformly high. Armed with this viewpoint, we explored which organization enjoyed which strengths and suffered which weaknesses. Our assessment:

Insurance Companies and Agency Sales Forces:

Advantages:

1. Transaction oriented.
2. Large built-in client base.
3. Offer unique contract guarantees (lifetime income, safety, etc.).

Disadvantages:

1. If the products are competitive, there is a low initial commission per sale. Therefore, single arrow prospecting is difficult to justify.

2. The selling process is one-to-one versus more efficient seminar selling.

3. The product choice is narrow and may be of limited appeal. However, conditions may be improving because of the shift from a negative to positive yield curve.

Brokerage Firms:

Advantages:

1. Client oriented sales force.
2. Built-in client base.
3. Large product selection.
4. Seminar selling.

Disadvantages:

1. Low commission per transaction may equal low broker interest except for rollovers.

2. Product guarantees may mean too low a yield (i.e., governments).

Banks:

Advantages:

1. Government guaranteed product (FSLIC and FDIC).
2. Large client base (inertia is a positive).
3. Best at demand pull advertising.
4. Good product selection.
5. Opportunity for cross-selling from All-Savers.

Disadvantages:

1. Less product breadth than brokerages.
2. Point of sale assistance questionable.

DWRs response has been our IRA-2000, a self-directed IRA. A self-directed IRA is an account where the individual chooses and controls how the IRA funds are invested. Such an IRA allows you to structure your retirement investment program to your needs and objectives, and to changing economic trends or conditions.

DWR has handled IRAs and IRA rollovers for the past half-dozen years, but through the use of outside custodians, mostly banks and trust companies. In the summer of 1981, we decided to become our own custodian for both IRAs, Keoghs and several other such functions. Due to the almost immediate impact of ERTA on the IRA market, our first concern became designing and creating our IRA. We decided to concentrate on ease of function, reasonable fees, and competitive investment features. One feature we decided on early that would help answer all these needs was a money market sweep. By putting this in our IRA, we eliminated noninvested funds for our clients. If, for example, a client purchases stock in his or her IRA, any quarterly dividends would be "swept" daily into a money market fund. In addition, our Account Executives would not need to write, buy or sell tickets for small amounts of money. Both the clients and our internal operations benefit from the "sweep".

The second major feature we decided on was to allow an extremely broad range of investments. DWR is a full line financial services firm, and we wanted our IRA to be able to handle many of the diverse investments we offer to our investors. IRAs are a long-term retirement oriented program, and our investors must have the ability to change investments over time due to the changes brought about by economic conditions. An inability to change investments to meet changing economic times can severely hurt an investor's portfolio.

Our third major concern was running an efficient operational system. Our computerized system of monitoring investments, contributions, earnings and distributions is so automated that our personnel-to-number of accounts ratio is among the lowest in the industry. Our fees are $20 per year, regardless of account size or number of transactions. There is also a one-time start-up fee of $20, which we waive for spousal accounts. We hoped our operations would "break-even" on these fees, regardless of commissions on any product sales. We have found after nine months of operations that we are making a reasonable profit on our fees, while still ignoring any commission stream.

A bonus of having these low fees has been our success within the IRA rollover market. We have found in past years that many IRA clients are very conscious of fees. Our low fees have attracted a larger number of IRA rollover accounts than we had projected. The average IRA rollover account we opened during 1980 was in excess of $60,000. When these accounts are added to our regular IRA accounts, our average account size is more than $5,000. For the first six months of 1982, we have averaged almost 400 new accounts per day. If historical trends hold true, these numbers will pick up from December of this year through April 15th of next year.

The thrust of our direct marketing efforts to date has been in the area of educating our client base as to the benefits of having a self-directed IRA instead of one limited to only one or two products. Conceptual awareness of IRAs was already there - we saw our job as one of helping potential clients choose from among the large number of various IRAs being advertised. Once they are aware of their investment possibilities, most clients appreciate the ability to invest in a wide range of products, including stocks, bonds, option writing, real estate limited partnerships, CDs and money market funds. If an individual can (and should) diversify his or her investment portfolio outside of a retirement plan, why not inside one? The range of investments that can be purchased within the DWR IRA covers a broad enough range to keep almost any type of investor happy. As more people become aware of this investment flexibility, we also feel the number of accounts transferring to us from other custodians will increase.

As 1982 is almost gone, we are already finalizing our 1983 plans and plans for future years. We plan to step up advertising somewhat during early 1983, since the bulk of IRA accounts are usually opened from January to April 15th. The next step is modifying and introducing a retirement plan that will meet the new Keogh and the top-heavy retirement plan market. We will, of course, amplify our marketing efforts within the existing Sears customer client base, as well as continue seeking a larger segment of the IRA rollover market. Any accurate market projections beyond that are hard to make. New legislation could add or subtract new markets as dramatically as the past two tax acts have. IRA dollar contributions could increase over the next few years, as has happened in the past. But one thing has been shown by recent legislative trends - the government is concerned with making retirement plan opportunities available to more people. If Social Security benefits are ever cut back, and there has, of course, been lots of legislative discussion in this area, increasing IRA contribution limits would be an excellent way of having individuals carry more of the burden of providing for their own eventual retirement needs.

A Prescription

1. The market is large, growing, and worth pursuit. Nevertheless, avoid disappointments by accepting that the market may not be as grand as some would have us believe. Tucking $4,000 away when economic conditions are bad may be more challenging than suspected.

2. Use competitive products. There is comparison shopping because of the intensive advertising.

3. Educate and deliver actionable client information. Consider demand pull advertising that has an editorial style.

4. Sell tax savings and yield with explicit information.

5. Target the prospect most desirous of your product's attributes, i.e., wage the battle where you can win; clearly, safety with guarantees is an advantage for insurance products.

6. Beware the impact of rollovers.

7. Have fun!

Thank you!

MR. CARNEY: Alan, thank you. The final speaker is Debbie Foord. Debbie is going to talk about the mutual fund industry. I think a lot of you will be very surprised, as I was, to learn about the growth in IRA mutual funds.

MS. DEBORAH C. FOORD: It is my pleasure to come to the meeting today of the Society of Actuaries to talk about mutual fund IRA products and in particular the product design, marketing and recent results for the Scudder Funds IRA.

Before getting down to specifics, I'd like to share with you some observations that I heard recently. At a meeting last week of the No-load Mutual Fund Association, a group whose fund assets total $240 billion, I heard the industry's IRA products and marketing characterized by friendly critics in the following manner:

- High cost
- Under advertised
- Under distributed
- Fragmented
- Lacking in cost analysis.

On the other hand, we were given credit for one of the best (though obviously underutilized) cash gathering and product distribution systems. Since I don't dispute the characterizations, it seems to me that if we, the mutual fund industry, can just start doing a few things right, we ought to be able to give the competition a run for their money and their market share.

My firm is Scudder, Stevens & Clark, advisor to the Scudder Funds. We're a no-load organization, which means that our funds are sold directly by our subsidiary, Scudder Fund Distributors, to the purchaser with no direct fees or charges to the purchaser. All shareholders absorb their pro rata share of fund expenses including brokerage, custody of securities, recordkeeping and investment counsel fees - the last being the way we earn our living on the enterprise. However, these expenses are charged against income of the fund holdings before credit to shareholder accounts, so that although the existence and level of expenses is fully disclosed, they are an invisible charge to many. Performance of our funds, by the way, is reported net after all expenses and fees.

We are one of a group of fund organizations offering what has come to be known as a "family of funds". As the name implies, the funds within the group cover a range of investment objectives, offering, as we like to say, "something for everyone". In addition, and perhaps more significant in the longer-term, the fund groups or families offer the building blocks for larger investors to implement a complete investment strategy. Thus, the fund groups come to the IRA marketplace with a considerable array of merchandise to offer. Typically, the mutual funds offered by the various firms fall into 3 or 4 categories:

1. Money Market - government
   - general purpose.
2. Income Funds - bonds, various quality and maturities
   - bonds and high yield stocks.
3. Common Stock Funds - running the gamut from general market or index-type to the more aggressive, non-diversified, i.e., special situations, high technology, small companies.
4. International - Non-U.S. stocks and bonds.

At Scudder, we look upon IRAs and the range of other tax-sheltered, retirement vehicles as excellent delivery systems for our funds. Our goals in designing and marketing our 2 IRA products - that is, payroll deduction and individual IRAs - were, and these are not necessarily in order of importance, to do the following:

- Increase our name recognition generally.
- Become known as one of <u>the</u> fund groups to be included in any business competition.
- To put new business on the books.
- Retain the reputation for quality that the Scudder name has in the investment counsel field - our first and still our largest business.

To those ends we designed a product which we characterize as offering the following primary features:

Wide choice.
Flexibility.
Low cost.

Other aspects include:

- Accessibility - call us on toll free telephone numbers.
- Regular reporting - via mutual fund fiduciary confirmation statements.
- Visibility of IRA investment - yields and prices in newspapers.
- Convenience - call, write or visit us.

In addition, we planned for and now have arrangements in place to offer our IRAs directly to the employees of over 200 companies via payroll deduction. We also offer purchase by pre-authorized checks, known familiarly as "PAC", for the individual who wants to invest on a regular basis via a charge to his or her checking account.

Let me return to our 3 primary characteristics:

1. Wide choice: We at Scudder offer 7 funds - 2 money market, 1 income, 3 growth equity and 1 international fund. We believe that this array offers at least 1 fund for IRA contributors in different financial and psychological circumstances. It also offers an investment for all seasons and markets.

2. Flexibility: The IRA participant can own as many funds in whatever combination he or she chooses subject only to the minimums of $1,000 in each fund for individual IRAs and $500 for payroll deduction. Transfers among funds may be made at any time in any amount. We will accept instructions for switches among funds over the telephone or in writing. You may also open a Scudder IRA with $240 and contribute thereafter at any time in any amount.

3. Low cost: Since our funds are no-load, the IRA investment is made without any fee or commission. Every dollar set aside by the consumer for the IRA is invested in the fund or funds chosen. With our product there are no annual maintenance fees, no fees for exchanges, new fund accounts, transfers to another IRA, withdrawals or distributions at retirement. There is some variation among mutual fund IRA products on the subject of charges - a number have an annual maintenance fee of about $5 which is taken as a charge against each fund held. Frequently, those fees are waived for large payroll deduction or affinity groups.

And speaking of retirement distributions as I did a minute ago, our plan provides for distributions in the form of a lump sum payment, periodic withdrawal or purchase of an annuity. The periodic withdrawal is accomplished by remitting a pre-authorized amount each month to the participant and selling off the required shares to do so.

Let me turn to our 1982 experience in IRA sales, which has been very rewarding. In rough terms, our IRA business has tripled since the beginning of the year. Not surprisingly, the greatest number of dollars have flowed into the money market funds, though our Income Fund and the Scudder Development Fund, which invests in small companies, have also seen substantial cash inflows from IRAs.

One of the topics on the agenda is our projection for the future, this brings to mind a comment made recently by one of our competitors who was asked to address the same topic at a large gathering. He replied, "I'll say a word about our projections for the future - pause - Thank you." I'll go a little farther than that, but with a note of caution. I found it partly because we are customarily silent on such subjects and partly because I don't think we are very good at near-term projections. As an example, I mentioned earlier that we have seen favorable trends in the IRA business so far this year. However, the composition of the business inflow was different than what we expected. To a certain extent we look to 1983 for some of what we thought would happen in 1982.

Shortly after passage of ERTA in August, 1981, we began a considerable product redesign and marketing campaign in view of the potential we saw in the IRA marketplace. We were one of the first of the mutual fund groups to have our payroll deduction processing system and investment program in place. We began to advertise and the response was good for both our payroll deduction and individual business. As 1982 progressed we saw excellent conversion ratios on the individual side and slower progress with payroll deduction. The reasons for this seem pretty apparent in retrospect - the continued economic recession and rising unemployment rate broadcast a clear message to the blue collar worker and many employees in cyclical sections - "don't tie up your income or your savings - you may need them". These employees form a significant part of our payroll deduction population and, we think, explain the slow start. However, we expect the economy to start to strengthen in early 1983 and, as the year progresses, confidence in their economic well-being should grow among workers in the cyclical sectors. We plan to give our program high visibility in the various companies and we look for good growth in the payroll deduction business.

We are also looking to the "rollover" business as the population ages and lump sum distributions from qualified plans increase.

As we consider the broader implications of ERTA and the advent of the "Universal IRA", we find a heightened interest in and awareness of the benefits of tax sheltered savings brought on by the media blitz earlier in the year. I doubt that any television viewer in the New York area will forget the sight this spring of Joe DiMaggio, spokesman for the Bowery Savings Bank, promising viewers that they can retire with $3 million, though the Bowery may wish to forget the interest rate assumptions they used in their calculations if inflation stays down and interest rates keep falling. One of our responses to this heightened awareness was to launch, about a month ago, the latest in our family of retirement plans, a Cash or Deferred Plan under Section 401(K) of the Internal Revenue Code. But that's a topic for another day. I will stop so that we can all entertain your questions.

MR. CARNEY: Debbie, thank you very much.

We've come to a point now where we've finished our prepared remarks. We'd like to take some questions from the audience for the next few minutes.

MR. GORDON H. LEAVITT: I work with the Bowery and I think they did pretty good with DiMaggio! How do the panelists see the market divided by income classes? It seems to me rather obvious that the higher paid people would go to the brokerage houses and middle class people would go to the banks, especially the savings bank.

MS. FOORD: I think you may be right. I haven't seen a great deal of documentation on that, although there was a study done in Massachusetts by a bankers association that confirmed that. Money market funds, for example, got some relatively small percentage of the market for the IRAs that were opened, but the feeling was that it was the upper income group, and while the other institutions got a much larger share, the feeling was it was from the lower income group.

MR. SNYDER: One thing that I think is interesting, in looking at how the market breaks down by income, is that different categories value different product attributes more, once you get through the top three. For example, the upscale people value high rate very highly and they feel they don't get the highest rates from banks. In fact, you probably know some of the studies that show they feel they get a higher rate from a security firm. We have tried to use this kind of tracking study as a way of positioning our products against a particular demographic segment. Also, we target direct mail for cross-selling to existing clients and make that direct mail available to stockbrokers, but make sure it is targeted to the market that they are going to go after.

MR. CARNEY: I think in the LIMRA study, they address some of these points. One of the significant market segments that they formed, as it relates to IRAs, is those people over age 55 earning $50,000 a year or more. About 80% of those people would be purchasing an IRA, for the maximum amount. Those people would most likely talk to the stockbrokerage firm.

MR. F. ALLEN SPOONER: I'll direct this question to Alan Snyder, although some of the panelists may also have some comments. One of the big challenges we all have facing us is getting all those people that gave us $2,000 this year, to do it again next year, and the year after and so forth. I wonder what plans you might have to try to make that happen?

MR. SNYDER: One of the areas where we plan on getting a lot of expertise is in using direct mail, by using statement enclosures. Where we intend to get some expertise in that is from Sears, which has done extensive research on direct mail activities using statements. As an example, it has always surprised me that annuity writers haven't used statement enclosures when sending out annual statements on annuities. That is one way of doing it, as long as you alert the agency sales force.

MR. CARNEY: I think what Alan is also saying is that Alan and Debbie would like to see the insurance industry and the banks get all of those deposits so that they can roll them out into their products.

MR. MICHAEL WINTERFIELD: In trying to come up with an answer as to what kind of product is best for the consumer, the thing that was hitting me is that it is largely a matter of sophistication of the client. And it seems to me along those lines, the bank and the insurance company products are probably better for the middle class market whereas the mutual funds and self-directed accounts will do a better job for the upper class market. I think the banks have a simple product which is very good for the middle class market and the insurance companies have an edge if you like to have an agent holding your hand. I think a reality we face with the insurance company products, when we are looking at some of the other options, is that we don't find that many people who are willing to read a prospectus.

MR. KAYTON: ITT Life recently had approved a combination policy which contained an IRA and a life insurance product. Apparently, the major advantage of it is that it doesn't permit you to use qualified money to buy life insurance but does allow the sale of a package to an individual. So, I think it is another example of packaging to meet a consumer need.

MR. CARNEY: It seems that all of this basically seems to relate to our distribution system. We've seen the introduction of the financial service supermarkets. Sears with Allstate and Dean Witter and Coldwell Banker is a good example. Citibank has been expanding, so has American Express. We have a true financial supermarket in the Kroger food stores which are offering insurance products, mutual funds and IRAs at the same time you buy groceries. What impact do we see that these newer types of distribution systems are going to have on the sales of IRAs and is this a viable way? Alan, you might want to respond. If there is anyone out there from Capital Holding, I'd like to hear from them also.

MR. SNYDER: We are testing the concept of putting a brokerage office, a Coldwell Banker residential real estate office, an Allstate savings and loan office and an Allstate insurance office altogether in what we're calling the Sears Financial Network, inside a Sears store. We have had 8 test centers open since the summer and they're working. The research indicates people are intimidated by a brokerage office, and for some reason, they find this a less threatening environment. They will, therefore, avail themselves of it, also it is convenient. We think for the IRA, it is a perfect market because of the enormous traffic that goes through a Sears store.

MR. BAXTER: The comment that I'd like to make goes back to the comment made earlier about banks having the middle class market as our customers. When IRA eligibility did expand, we were a little bit afraid because we had lost a lot of our core deposits to money market mutual funds, because of rate sensitivity. These were our old traditional middle class customers, and we felt that this might have been their introduction to the mutual fund business and also to the brokerage business. So we were a little worried about getting them back to the traditional middle class CD with their IRA deposit. I think the more aggressive of us are looking forward to being able to offer a combination of products, where we can sell that customer a mutual fund through various arrangements or some type of an annuity through an arrangement with an insurance company. I think that is where the future lies.

MR. MARTIN H. RUBY: Being from Capital Holding, I can say that yes, we are indeed marketing IRAs, mutual funds and insurance products of all types in supermarkets. Currently we have one test store in Columbus, Ohio open and we hope to have 15 stores open by the beginning of next year. So far, the one store has generated quite a bit of traffic. Kroger statistics are similar to Sears, they have 15 million people a week go through their stores, so the amount of traffic is tremendous. We think that the IRA is going to be one of the biggest sellers in that marketplace. A question I have for the panel is that we have not found through our traditional insurance companies that we sell through, that the life agent is the right kind of person to sell an IRA. It's not because of any lack of knowledge, but because of lack of motivation due to the low level of compensation. We have experienced in our life companies very poor results so far in having our agents sell an IRA. We are, however, doing much better through stockbrokers. I'd be interested to hear comments about the opinions of life insurance agents selling an IRA.

MR. KAYTON: As I mentioned in some of my earlier remarks, when we entered the market, we had these high commission products which were not competitive, so now we have the problem of trying to be competitive. So our agents don't care about them because of the low commissions. We do get interest periodically when some agent calls up and says he has a locked up 4,000 lives case and can we get a good price on it. That's about the only interest. I think it's a real problem for the industry. The agent is short-sighted because, clearly, someone who goes elsewhere to establish a relationship to set up an IRA could easily use that same basis for other funds he has to invest - non-qualified money or rollovers.

MR. CARNEY: I think the point there is that in IRA situations, the maximum scale is $2,000. If you're paying the agent a 4% commission, you don't generate a large reaction for $80. It should be treated as an ancillary sale. When the agent is selling a traditional life insurance product, that's the point in time to bring up the IRA. I think we have taken the opposite approach when it comes to marketing, and the agents just can't make a living. I think under current tax laws, the sales forces should be saying "buy term and IRA the difference".

MR. STEVE P. COOPERSTEIN: I have been selling insurance for the last four months, as a means of market research more than making money. I must say the incentive for selling has not been there due to the small commission. Even more importantly, people are not ready yet, they're not forced, not pressured to buy an IRA. I wonder if any of the panelists intend to plan market campaigns directed at those people who haven't made their IRA contribution this year.

MR. BAXTER: We obviously are attempting to go after the people we already have as our customers to convince them that an IRA is the investment that they should make. We don't have any specific marketing approach right now for the customer that does not plan to make the investment. We're directed to the belief that a majority of the customers will make the investment and we are trying to bring it to us. By looking at that survey, that might be an incorrect approach.

MR. KAYTON: I think clearly the best time to sell IRAs is the beginning of the year because you're picking up people who want to get the $60,000 extra income that Alan mentioned by putting in their current contribution. But you're also getting those people that have just calculated their taxes and suddenly realized that they need a big shelter for last year's money, and are looking for a place to get it.

MR. CARNEY: Unfortunately, we have used our allotted time. I'd like to thank all of you for your interest. Also, I'd like to thank our panelists, especially our guest panelists for a very interesting and informative presentation. Thank you.