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Changing the Retirement Advice Conversation[1]

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The retirement income crisis in America is compounded by a lack of objectivity in the financial advice industry. This may continue even with new fiduciary rules from government regulators. The problem stems from biases found not only in the business models of commission-based advisers but also those of many fee advisers. In short, ignoring ideas because they don't generate ongoing asset management revenues may result in failing the duty to place a client's interests first. Since this paradox is currently pervasive, achieving professional grade objectivity for individual retirement accounts may require more than regulators declaring a universal fiduciary standard; it may also take leadership from within the adviser industry itself.

One such effort is The Open Architecture 2020 Group, where the work is pro bono and new ideas for improving retirement advice for all Americans begins with the concept that best practices for managing the risk of outliving one's savings should not differ due to the business model of the person you happen to meet with. It's hard to dispute that a client is best served when all prudent ideas from academics and institutional thought leaders are inside their adviser's toolbox. But what's rarely acknowledged is that this kind of "open architecture" is not easily found. In fact, the closest thing we have to a personal pension plan—annuitization—is barely on the investment industry's radar screen. It's ironic, since many academics have pointed out for years that retirees without pensions may need at least 35% or more funds in 401(k) savings to achieve the kind of secure lifetime cash flows annuitization can provide (professors usually focus not on "index" and "variable-deferred" products with income riders, but instead on the more traditional vehicles used by pension plans that employ "mortality pooling" to enhance cash flow). The strategy may not be the best fit for everyone; as with pensions, lifetime income is prioritized over liquidity and leaving wealth to children is not the purpose. But the truth is most people are not wealthy at retirement, and many are not cut out to become successful investors in any of the risk-based capital markets. It's only rational to believe that a one-size-fits-all approach to satisfying a best interest standard is difficult to justify when, in the real world, people have different emotional reactions to bear markets.

Wanted: A New Value Proposition

We need a paradigm shift to redefine the level of "expert" advice for individuals in the post-retirement phase. The risk-return tradeoff could become less about modern portfolio theory and more about addressing different tolerances to longevity risk. Expected variability of income sources could be matched to expected variability of expenses. Retirement planning could look like the rigorous funding ratio work done by prudent institutional pension sponsors. Whatever the answer, new ideas should grow out of a historical perspective that understands the strengths and the weaknesses of the past. With so many baby boomers retiring in the coming decades, it's time to admit the best practices in place for the accumulation phase do not always translate well for average Americans at retirement. Behavioral finance studies show us this time and again and so does academic research, proving that many pension plan participants prefer the idea of annuitization instead of lump-sum distributions.

Here are five principles proposed as a new foundation for solving the problem.

- All major business channels in the investment industry have conflicts; clients won't fully understand them until advisers first agree on what the conflicts are and also admit to any ideas being excluded
- Disclosure alone is not enough; consumers deserve to fully understand the ramifications of what's being disclosed
- Academic thought leadership is well beyond asset allocation theory; best practices should stay

[1] The information and ideas presented here are not intended to be investment or insurance advice. The Open Architecture 2020 Group has no sales, sponsors or revenue of any kind.

current with practical solutions for behavioral finance issues and longevity risk
- The industry won't evolve to true open architecture until advisers can justify fees for advice that are separate from portfolio implementation; both advisers and clients need to embrace the value added
- Average Americans often name longevity risk as their No. 1 concern; managing this risk in the institutional arena has evolved to include liability-driven investing (LDI)

What is the current attitude toward how advisers to IRAs should be paid? There are many points of view, but Department of Labor rules for retirement accounts are now clear that compensation differentials create the potential for conflicts of interest. However, when registered investment advisers (RIAs) can't justify billing for annuitized products in client accounts because they're not managing them, advisory outcomes could be driven as much by exclusion as inclusion. It's a different kind of conflict and is less well defined, but it's there. To say this won't change is to deny history's lesson that evolution takes place over time via the resolution of inherent contradictions.

A Missing Link to Pension Finance 101

Professors commonly use annuitized income streams to model the amounts needed to fund retirements and often question why the sales of lifetime income annuity products are so anemic. One clue to be found is that many financial advisers are unfamiliar with how mortality pooling works. Many who advise individual investors see themselves as following fiduciary best practices in the institutional arena, but corporate defined benefit pension plan trustees and their consultants do more than just understand mortality pooling; they use it to think about their liabilities in terms of properly matched funding ratios and consider annuities as possible solutions for de-risking their exposure. One benefit of mortality pooling with annuitized income is predictable cash flows. Another feature is that, if you and I buy into the same pool and you live longer than I do, then you, in effect, get to spend my money. That's an oversimplification since there are more than two people invested in any one annuity, but you get the idea. It means we need less capital saved to generate income guaranteed for life than what we could earn from most other predictable investment options.

Large pension plans employ truly objective professionals who aren't paid commissions by the products they sell or fees for assets under management (AUM). They add value by defining and managing risks in ways that are different from the asset management model of most RIAs, and charge in ways that maximize their objectivity. This gives them the professional luxury of considering all available solutions. Consultants are allowed compensation "offsets" from commissions, subject to safeguards against conflicts of interest from proprietary products, and this is a way the plan sponsor can direct revenue from their portfolio to offset the consultant's cost. What if individual retirees were similarly able to have a consultant capture and direct the fees and commissions generated by their accounts so that, over time, their advisers could be compensated in a transparent way? We would argue this could lead to more objectivity.

At a minimum, it seems appropriate that people should be able to at least consider all prudent ideas when they meet with their trusted advisers to discuss options. This is the spirit of open architecture in the investment business. However, many of today's financial advisers don't embrace the idea of annuitization for the wrong reasons; we have RIAs who want to manage the money in discretionary accounts, while commissioned brokers are incentivized to move assets to a different company in the future. Neither of these is possible with annuitization. Many still confuse the idea with variable deferred and index annuities, frequently criticized as overly complex and too expensive, and this provides an easy out for those who choose not to recommend it. But it's also true that most RIAs are paid more like money managers than like institutional retirement consultants, commissioned advisers are paid more like salespeople, and incentives have a way of driving outcomes.

In a perfect world, today's definition of "open architecture" would mean retirement advisers are compensated for a retirement process instead of an investment process. Advisers would tout their liability forecasting skills ahead of their asset management talent. RIAs would consider annuitization even though they're not actively managing that portion of the portfolio, and would bill for their total time spent advising a client minus any fees for AUM. Commission advisers would suggest it even with lower sales credits than other products, and their overall compensation might be calculated according to time spent advising minus any commissions generated. The academics would no longer have to preach to nearly deaf industry ears about the unique benefits derived from mortality pooling. Perhaps the best outcome would be lower stress and increased happiness for many retirees.

How Did We Get Here?

The sea change following the Employee Retirement Income Security Act of 1974 included retainer-based consultants who began operating as buffers between pension plans and their money managers. Billing was based on the scope of work performed. Then, in the retail segment, broker-dealers began to blur the lines between the way money managers are paid and the way advisers charge for providing the same consultative buffers the institutions have. The AUM fee "wrap accounts" were born, with compensation from retail clients removed from the products but tied to the platforms. Objectivity was defined as freedom from conflicts of interest. In truth, the idea of open architecture was compromised as managing the money became scalable via automation (and thus extremely profitable). Investments not on the platform due to custody or other constraints were excluded.

It's also important to note that many independent "wealth managers" left broker-dealers so they could become fee-only RIAs and own their firms. Platform technology at companies like Charles Schwab and Fidelity Investments was developed to serve this business segment, at first through mutual funds and individual stocks and bonds, and later through separate accounts and exchange traded funds (ETFs). Over time, the concept of AUM fee advice in every channel evolved down-market to accommodate smaller asset sizes. Almost always left behind was the evolution of the institutional retainer model. It's still used by the majority of today's large pension plans and their consultants, but only a small percentage of private client advisers have adopted it (even fewer retail clients understand the differences between the industry's many compensation models).

A casualty of the investment industry's history is the objective process itself, still constrained by implementation conflicts. Most private client advisers, both fee-only and commission, make their wealth management businesses run on revenue from asset management. With the exception of a relatively small number of hourly and retainer-based practitioners, ideas that can't be managed are not readily found in RIA client portfolios. Among commission advisers, sales of immediate annuities are not nearly as common as the more highly compensating deferred variable products with income riders. Today, immediately annuitized products average just 3–4% of total annuity sales in the United States (and coincidentally often pay a 3–4% commission as opposed to 5% or more for other types).

iShares: A Case Study in Disruption

A recent example of overcoming inertia in the investment industry is the iShares business, which launched well before ETFs reached their tipping point. Back in 2000, most consultant-advisers at the brokerage firms were against the idea of index funds, as they were taught their value came from identifying and monitoring active managers. They often articulated an ethical concern for justifying quarterly AUM fees while not even trying to beat a benchmark. Through a grass-roots effort, in conjunction with some visionary consultants at key firms like Smith Barney, a small group of pioneers inside the iShares business changed the mindset. By reinforcing a total portfolio process, and addressing the reality of active risk as a behavioral finance issue for individual investors, minds opened to the idea of index funds. Today, passive ETFs are fully embedded in the advisory and consulting platforms at every brokerage.

A similar grass-roots movement is now taking hold in the retirement income space. Our pro bono think tank, The Open Architecture 2020 Group, is comprised of seasoned financial advisers and industry veterans. It was founded to inspire positive change that can improve the golden years for all Americans, as opposed to focusing on just the wealthy, and to progress beyond fiduciary standards for IRAs. The focus is on creating a new definition of professional-grade objectivity for all silos of the investment industry, one that is pragmatic enough for every retiree, regardless of their net worth. Growth through word of mouth is slowly changing the conversation about best practices for retirement advice, with papers posted to *www.openarchitecture2020.com*.

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