Of Policies and Products

by Jonathan Guyton, CFP®

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I am continually impressed and gratified at the breadth and depth of exploration our financial planning profession has made into the subject of retirement these past two decades. This being my inaugural *Journal of Financial Planning* retirement column, allow me to share at least a glimpse of my foundation in this rich topic.

Consider for a moment what you—and we—did not yet know 20 years ago. In the left brain or science of our practice, we had not yet begun to broadly incorporate either stochastic modeling or mean-variance optimization; research into safe withdrawal rates may have still been just an idea spinning in Bill Bengen's head, and the complexities of income tax planning and wealth management (Roth IRAs were still 10 years away!) lived in the relative simplicity of defined benefit retirements. In the right brain or art of our practice, few practitioners saw their work as comprehensive planners touching their clients' relationship with money, Dick Wagner and George Kinder had yet to trip over Jacob Needleman's work that began their exploration of interior finance, and the discoveries of Daniel Kahneman and Amos Tversky—with whom the spark of behavioral finance ignited—were still just a glowing ember seeking the oxygen of visibility.

Now, consider three outgrowths of this reflection.

First, think back to your client and prospect meetings of the past week. Recall the contribution and value you brought via the insights, knowledge, and skills that emerged in just these last 20 years. Now imagine not having these at your disposal ... or not having made the investment to learn and incorporate them into your capabilities as a financial planner. What a difference that would make! We indeed have much to be thankful for.

Next, notice our profession's culture. It is no accident that the financial planning profession has been such a source for thought leadership into the emerging art and science of retirement these past few decades. Lived out, our values foster community, curiosity, collaboration, creativity, and collegiality. (And no doubt words starting with different letters.) We have been more colleagues than competitors. Former frontiers of knowledge have been re-shaped by enhancements, deeper understandings, the application of the "other" side of the brain, as well as by fresh insights. Like financial planning itself, our whole has somehow become greater than the sum of our parts. This matters: not because of sentimentality or as an end in itself, but because such a vibrant—and sometimes dysfunctional—environment is key to our profession's continued growth in knowledge and wisdom. Were this soil to lose such nutrients, we would stagnate. Our clients would no longer receive our highest and best. All

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we could offer would be the ways we've always done things before.

So, we must be open to contributions and inspirations not only from within our profession, but also from without. Imagine how radical it might have been to suggest 20 years ago that we may have much to learn from psychology, both its eastern and western teachings. (Imagine an economist's reaction to the prediction that one day "their" Nobel Prize would go to a professor of psychology!) I would not be surprised if, in 2030, we were looking back and noting our professional leaps that had been inspired by quantum physics, grief counseling, sociology, or poetry.

A third aspect of this history also strikes me. These insights and breakthroughs have shown up almost entirely as new processes, policies, and best practices rather than being revealed through or implemented with new financial products.

Yes, there are a few notable exceptions: long-term care insurance with its ability to provide for the transfer of a fairly random, potentially lifestyle-altering risk at a known cost; and exchange-traded funds with their combination of simplicity, diversification, and tax-deferral while preserving capital gain tax treatment come to mind. However, by-and-large, fiduciary planners have chosen to implement our profession's forward leaps using the financial service industry's existing product menu.

Products Versus Policies

I believe we may be at the start of a time when our professional judgment will be tested by the introduction of new or modified financial products, which, on their surface, may offer significant appeal. We need a framework—or a reframing—that can help us filter these offerings and make judgments that will be prudent and prescient. After all, many of our clients are better off than they otherwise could have been because the ongoing implementation of their financial plans now includes long-term care insurance and/or exchange-traded funds. And in the future, the integration of longevity insurance—competitively-priced—with the findings of safe withdrawal research offers compelling possibilities. This is because, while safe withdrawal rates increase only marginally when the time horizon is reduced from 40 years to 30, they appear to increase markedly when only having to sustain 20 years of distributions. Thus, carving out a chunk of a retiree's assets as a premium for enough longevity insurance to maintain his or her lifestyle from age 85 on is both intriguing and worthy of exploration.

So, when considering a new product for possible client implementation, I always begin by reminding myself of what I like to call Wagner's Third Law of Financial Planning: Don't do anything stupid. I then add my personal corollary gleaned from advisory mistakes I've made: Beware of trying to be a hero. Yet I can imagine adding positive footings to this foundation as well.

I imagine retirees articulating at least a few of the following financial ideals as part of their ideal retirement, a retirement income holy grail of sorts: (1) Maintain my lifestyle—and maximize my income from portfolio withdrawals—especially early in retirement; (2) Eliminate the chance that I could run out of money; (3) Offset inflation and maintain my purchasing power; (4) Avoid undesired changes to my spendable income; and (5) Preserve my nest egg for the people and causes I care about.

As financial planners, we can employ a combination of policies and products to navigate the obvious conflicts, contradictions and trade-offs contained in these ideals. We may be inclined to substitute the word "processes" for "policies," but through my research and practice I have found the notion of policies conducive to crisper advisory judgments. In their 2006 article in this publication,[1] Yeske and Buie described planning policies as "the bridge between client goals and the steps to sustain progress toward achieving them." These steps are

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often processes. They go on to name two key characteristics of effective planning policies: They are "broad enough to encompass new or unexpected events" while also being "specific enough to (leave us) rarely in doubt about the action to take in response." In other words, planning policies are navigational tools for negotiating a client's financial journey.

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Combined with financial planning's research-based body of knowledge, such policies can be powerful and clear ways both for approaching the attainment of a client's financial ideals in retirement and for making advisory judgments in times of financial and psychological duress. Fifteen years ago, much of the empirical work around topics such as rebalancing, asset location, tax efficiency in the presence of retirement assets with blended tax treatments, sustainable withdrawal rates, and the impact of systematic withdrawal decision rules was yet to be done. However, in the stressful early days of 2009, a synthesis of the various works of Kitces, Guyton, and Klinger would have led us to conclude that, under the conditions then at hand, a current withdrawal rate of up to 6.5 percent remained sustainable at the 99 percent confidence level. Our advice to retired clients could have proceeded from that point. Even five years ago, we did not yet know that. Thankfully, this is now and not then!

Armed with such knowledge, we can formulate policies—complete with definable outcomes, trigger points, processes, and action steps—to encompass such areas as investment management, present and future tax liabilities, sustainable withdrawals, and cash flow planning. Examples of such policy statements could be, "We will fully employ the 15 percent federal income tax bracket annually" or "We will maintain sustainable withdrawals at the 99 percent confidence level with our core lifetime portfolio." The former statement would guide decisions about the mix of retirement income sources and Roth conversions, while the latter could lead to trigger points and mid-course adjustments for modifying overall withdrawal amounts when necessary.

Of course, in many cases, we cannot carry out such policies without the informed use of various financial products. Just as there are trade-offs to be considered between various planning policies, the same occurs when considering the products with which to implement them. I am reminded of something a friend once said that provides a great reminder for assessing such trade-offs: "For a lot more money, you can have just a little bit better." How often this is true! There is immense value in knowing how much of a client's planning ideals we can realize before needing to sacrifice a lot to have just a little bit better.

Marginal Analysis and the GMWB Rider

In economics terms, this has long been known as marginal analysis. In personal terms, it is a framework for navigating the triangle of my comprehensive knowledge and insight about my client as a person, myself as financial planner (with my experiences, orientations, fears, and imagination), and my profession's body of research and best practices. In formulating policies and evaluating products, marginal analysis can help in understanding the marginal gains an approach offers to certain desired outcomes and the compensation that is required from the other desired outcomes. This can be simple to understand and difficult to actually do, because clients and other humans (like financial planners) sometimes want to believe there are free lunches to be had! It is imperative to assess both the marginal benefit and the marginal cost, remembering that each is likely to have aspects that are non-quantifiable, emotional, and/or psychological in nature. It is also necessary to know whether the marginal benefit unique to a given policy or product has been validated empirically.

This can be particularly challenging when a financial product is designed to also be a policy-based approach. This occurs when the structure of the product itself requires trade-offs of such magnitude that they can make or break a client's retirement ideals because of inherent decision policies. This need not be a drawback as long as the consequences of its design are fully appreciated at the outset. What outcome-based trade-offs does the product pre-ordain? Some recent examples of products with such policy implications include structured investment products and the guaranteed minimum withdrawal benefit riders (GMWB) that can be added to variable annuity contracts.

As an example of such a marginal analysis, let's consider the variable annuity GMWB riders. A common version provides a guaranteed annual lifetime income of 5 percent of the benefit base. The rider guarantees that the annual income will never be less than 5 percent of the annuity value when payouts begin, the annuity need not be annuitized, and the benefit base resets periodically to potentially higher values that can increase the amount of the 5 percent

annual income. Thus, a $500,000 initial benefit base would always distribute at least $25,000 in annual income. The annuity may restrict the asset allocation under the rider's terms, the contract's normal expenses apply, and the GMWB rider adds additional annual expenses of 60 to 90 basis points for the guarantees it provides.

There is much initial appeal. An annual income is guaranteed, and the client's beneficiaries still receive the remaining contract value. A marginal analysis must consider what is uniquely gained and what the client must give up to get it. Clearly, the marginal benefit is the income guarantee—both in amount and its longevity—with all of the emotional and psychological ease this may provide the client. The marginal costs are the mortality and administrative charges, the GMWB rider cost, and the client's future inability to ever withdraw more than the formulated 5 percent amount without forfeiting the rider's guarantees. Other marginal cost issues include the less favorable ordinary income tax treatment if the annuity contains nonqualified funds or how IRA-required minimum distributions will be satisfied in later years if it contains qualified funds.

Of what marginal benefit is the income guarantee? Remember that all of the recent applicable research—Guyton/Klinger (March 2006), Bengen (August 2006) and Kitces (May 2008)—identifies 30- or 40-year withdrawal rates with less than a 1 percent chance of failure. Thus, the income guarantee is an example of trying to do "just a little bit better." To the extent that the client lives beyond the 30- and 40-year time horizons of existing withdrawal rate research, there may be a unique benefit; however, very few of the trials that sustained withdrawals for 30 or 40 years would have failed in the next year or two.

As for the amount of the guarantee, Kitces demonstrates that the 30-year safe withdrawal rate with annual increases for inflation based on the Consumer Price Index (CPI) is 4.5 percent when begun in a severely over-valued market, 5.0 percent when begun in a fairly valued market, and 5.5 percent when begun in a severely undervalued market. The GMWB rider's terms protect against withdrawal reductions but do not guarantee such annual CPI-based increases. Neither do the approaches of Guyton/Klinger's decision rules or Bengen's floor-and-ceiling method. However, both approaches provide for annual CPI-based increases except following individual years when their policy-based trigger points are reached. Under Bengen, this trigger could reduce (or increase) the withdrawal amount by as much as 5 percent in real terms in exchange for increasing the initial withdrawal rate by about 50 basis points above Kitces. Under the Guyton/Klinger trigger, the withdrawal amount could decrease (or increase) 10 percent in nominal terms in exchange for increasing the initial withdrawal rate by 90–100 basis points above Kitces. Thus, drawing on Kitces's work, the initial withdrawal rate would be 5.5 percent in an over-valued market and as much as 6.5 percent in an undervalued market.

How should we view the GMWB rider's payout provision? It has the potential to most closely resemble Kitces, as long as its payout method can keep pace with inflation. However, should this method give up ground to inflation in the long term, it would more closely resemble Bengen and Guyton/Klinger with their higher initial withdrawal rates and possibility of not fully maintaining purchasing power due to their various systematic withdrawal adjustments.

Point of Diminishing Returns

I built a spreadsheet to evaluate this question. It assumes the annuity generates an 8.5 percent gross return every year and has 2.5 percent annual expenses to cover mortality, administrative, fund management, and rider expenses. Indeed, under these assumptions and with a 5 percent annual withdrawal based on the prior year's ending value, the GMWB rider does increase the client's income every year; however, not at the rate of inflation. Assuming a 3.5 percent annual CPI increase, by Year 10, the GMWB rider generates just 77 percent of the amount needed to maintain the purchasing power of the initial 5 percent withdrawal amount. By Year 20 this declines to 58 percent of the amount needed, and by Year 30 it drops to 43 percent of the CPI-adjusted income. Even with an annual gross return of 10 percent, purchasing power maintenance by Year 30 is just 64 percent. Moreover, virtually any year with negative returns that is not followed at some point by a year with significant double-digit gains freezes the retiree's contractual withdrawals almost indefinitely.

Such a marginal analysis reveals that the marginal cost required to compensate for the GMWB rider's guarantees comes in terms of inflation protection and purchasing power maintenance as well as an initial withdrawal rate that could be 10 percent to 30 percent lower than other policy-based approaches that appear in financial planning literature. It also limits the retiree's flexibility and access to the benefit base beyond each year's formulated 5 percent withdrawal. The GMWB rider's attractiveness and suitability can now be evaluated with due care from this perspective. In so doing, we can also imagine design enhancements and cost reductions from competition that could be passed on to the client in the form of a higher income guarantee that could alter the conclusions of such an evaluation.

No doubt in the coming years, there will be many new policies and products that purport to increase retirees' ability to attain their financial ideals. Research-based marginal analysis, in the presence of a vibrant and curious professional community that supports planners' knowledge of their clients' situation and interior values, can lead to best practices and advice that serves each client well—always an ideal outcome.

Endnote

1. David Yeske and Elissa Buie, "Policy-Based Financial Planning Provides Touchstone in a Turbulent World," *Journal of Financial Planning* (July 2006).